

## **DISCLAIMER**

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Further, in the Elective Papers which are Case Study based, the solutions have been worked out on the basis of certain assumptions/views derived from the facts given in the question or language used in the question. It may be possible to work out the solution to the case studies in a different manner based on the assumptions made or views taken.

**PAPER 6B: FINANCIAL SERVICES AND CAPITAL MARKETS - ELECTIVE PAPER**

The Question Paper comprises three case study questions. The candidates are required to answer any **two** case study questions out of three.

While answering the multiple choice question, candidates are required to indicate the alphabet of their choice in capital letters.

In case, any candidate answers extra question(s)/ sub-question(s) over and above the required number, then only the requisite number of questions first answered in the answer book shall be valued and subsequent extra question (s) answered shall be ignored.

**I Case Study number One:**

The following data relates to a Mutual Fund as at 31-3-2018 :

	Quantity (Nos.)	Value (₹'000)
<b>Unit Capital :</b>		
Outstanding at the beginning of the year	264,31,998.59	2,64,319
Issued during the year	6,85,59,200.117	6,85,592
Redeemed during the year	66,77,620.32	66,776
Outstanding at the end of the year	<b>883,13,578.387</b>	<b>8,83,135</b>
<b>Reserves and Surplus</b>		
<i>Unit Premium Reserve</i>		
Balance at the beginning of the year		(3,396)
Net Premium/Discount on issue/ redemption of units		98,266
Balance at the end of the year		94,870
<i>Unrealized Appreciation Reserve</i>		
Balance at the beginning of the year		7,870
Change in unrealized appreciation in value of Investments		14,972
Balance at the end of the year		22,842
<b>RETAINED SURPLUS</b>		
Balance at the beginning of the year		6,23,319
Transferred to Revenue account		(1,366)
Surplus transferred from revenue account		19,65,669
Balance at the end of the year		<u>25,87,622</u>
Total Reserves		<b>27,05,334</b>

<b>Current Liabilities</b>		
Amount due to AMC for Management Fees		1615
<b>Others</b>		64
Sundry Creditors of units redeemed by investors		
Lateral Shift payable		420
Others		19
Contract for purchase of investments		2,60,840
Inter Scheme Payable		-
Dividend payable on units		-
Dividend Distribution Tax Payable		-
Unclaimed Dividend		-
Unclaimed redemption		
Unit Application pending allotment		70
Investor education expense provision		60
Interest on borrowing		
<b>Other Current Liabilities</b>		2878
<b>Investments</b>		
Listed Debentures and Bonds		14,20,321
Government Securities		<u>20,69,363</u>
Total		<u>34,89,684</u>
Deposit with scheduled banks		-
<b>Other Current Assets</b>		
Balances with Banks in Current Accounts		4851
Sundry debtors for units issued to investors		
-Lateral shift receivable		3
-Others		2
Inter-scheme receivables		689
Margin Deposit with Clearing Corporation of India		-
Outstanding and accrued income		86,336
Amount due from AMC		-
Collateralised Lending		<u>2,72,898</u>
<b>Total</b>		<u><b>3,64,779</b></u>
Interest		
Money market Instruments		188
Debentures and Bonds		57,425

Deposits		-
Government Securities (including Treasury Bills)		1,17,501
Collateralised Lending		6,950
Less : Interest on Borrowing		-
<b>Total</b>		<b>1,82,065</b>

The average expenses ratio (including management fees) amounted to 2.65% which also included GST.

(A) Answer the following questions and reason out your answers:

- (i) Under what type of a mutual fund product would you classify the above? Why? 2 Marks
- (ii) Is the scheme open or close ended? Why? 2 Marks
- (iii) Can it be assumed without any contradiction that the product is traded in the stock exchange? 2 Marks
- (iv) Is switching between plans permitted in this mutual fund product ? 2 Marks
- (v) Why is there a nil balance in deposit with scheduled banks ? 2 Marks
- (vi) Do you think that this scheme is a safe investment with negligible risk? Would you expect high returns from this product on an annualized basis ? 3 Marks
- (vii) What is your comment on the expense ratio given above ? 3 Marks
- (viii) Can you find out the NAV per unit of the scheme from the given data as on the closing date ? Substantiate with appropriate calculations and explain how you can or why you cannot find the NAV. 3 Marks
- (ix) What is the role of unrealized reserves? Is it not contrary to the fundamental accounting principles of prudence ? 3 Marks
- (x) From the given figures, do you conclude that the scheme has performed well during this year in question ? 2 Marks
- (xi) Can this fund borrow from the money market to meet the investors' income expectations or redemption obligations? 2 Marks
- (xii) What can you say about the entry and exit loads of this fund ? 3 Marks
- (xiii) The fund had invested in Treasury Bills of face value ₹1,00,000 each amounting to ₹90 crores. If the average annualized yield calculated based on 85 days as on 31<sup>st</sup> March, 2018 was 8.76%, what was the amount of average purchase price? 3 Marks
- (xiv) What will be the risk appetite of an investor in this type of product ? What would be the preferences of the investor in such a product ? 3 Marks

(xv) Why is there a fractional amount in the number of units column in mutual fund product ? 2 Marks

(B) Answer the following as directed along with **reasons**:

(i) The type of entity of a mutual fund is :

- (A) a private limited company
- (B) a public limited company
- (C) a partnership firm or LLP
- (D) none of the above

1 Mark

(ii) The investments by a mutual fund are controlled by

- (A) RBI
- (B) SEBI
- (C) Registrar of Companies
- (D) Both (A) and (B)

1 Mark

(iii) When the holder of units of a mutual fund can sell his units at any time during the year,

- (A) the fund is an equity fund
- (B) the fund is a bond fund
- (C) the fund is a balanced fund
- (D) nothing can be said about the classification of the fund from the saleability.

1 Mark

(iv) The following is not true in the context of a mutual fund's payment to its unit-holders :

- (A) a scheme that invests in equity pays dividends.
- (B) an exchange traded fund pays dividends.
- (C) a bond fund pays interest.
- (D) a G-sec. fund pays dividends.

1 Mark

(v) Under a Systematic Investment Plan, the following is NOT TRUE :

- (A) Unit holders can invest on a monthly basis whatever amount they can save.
- (B) Investors can invest only a pre-specified amount every period, say monthly, quarterly or half yearly.
- (C) If an investor has subscribed ₹ 3,000 in quarterly payments for a 3 year SIP, he can choose to step up this amount to ₹ 4000 from the second year.

- (D) Even where the SIP amount in a financial year does not exceed ₹ 50,000 an investor cannot invest in cash. 1 Mark
- (vi) An investor in a mutual fund who wants liquidity within a period shorter than the closure date should invest in \_\_\_\_\_. 4 x 1 = 4 Marks
- (vii) Gilt funds have risk.\_\_\_\_\_.
- (viii) An investor who does not want to incur a high expense ratio can opt for \_\_\_\_\_.
- (ix) \_\_\_\_\_is the standard measure of performance for investors in mutual funds for one year or more time periods.
- (x) Is there any difference between a mutual fund and a scheme ? 4 x 1 = 4 Marks
- (xi) How is a benchmark chosen for effective comparison of the performance of each type of mutual fund product ?
- (xii) Can a mutual fund invest in another mutual fund ? Explain the underlying concepts and laws.
- (xiii) Can a Real Estate Investment Mutual Fund invest in residential house property?

#### Answer to Case Study Number One

- (A) (i) The mutual fund discussed in the Case Study is a debt oriented scheme. The reason is that it's investments include Listed Debentures and Bonds and Government securities.
- (ii) Although not specifically mentioned in the Case Study, it seems that the scheme is open ended scheme because of following reasons:
- The number of units issued and redeemed during the year has been given in the Case Study.
  - The high amount of redemption (about 25% of units outstanding at the beginning of the year) indicates that the scheme is an open ended one.
  - No fixed maturity period has been given.
  - Lots of changes are happening in the current scheme.
- (iii) Only close ended schemes are required to be listed. Since, the present mutual fund scheme is an open ended scheme; it cannot be listed and traded in the stock exchange.

#### Alternative Answer

No, the scheme is not of the ETF (exchange traded fund) category since there is no margin with the Clearing Corporation of India Ltd. (CCIL).

- (iv) Yes, plans are permitted as lateral shift receivable and lateral shift payable is given in the Case Study itself, an indication that switching between plans is permitted in this mutual fund product.
- (v) Only liquid fund schemes need to hold substantial amounts as deposits with scheduled banks. This is not a liquid fund. It is a Bond Fund. It needs liquidity to the extent of repurchase of units, being open ended. This is available in the current account balances, probably on an estimated basis, depending on the usual redemption demands by investors. Value of units pending allotment should be deposited in a scheduled commercial bank.

**Alternative Answer**

One of the reasons that there is a nil balance in deposit with scheduled banks is that there are many payable items in the liability side of the balance sheet which is an indication that the fund has no cash in the scheduled banks.

- (vi) The scheme cannot be said to have negligible risk since although almost half the investments are in government securities, there is the other half in listed debentures and bonds. If the listed securities are risky, that risk will directly affect the riskiness and exposure of this scheme. Government bonds yields low interest and high safety. Similarly, the other investments are also listed debentures/bonds which give less than equity investment returns. Hence the overall risk of the scheme can be said to be moderate.

Collateralized lending and receivables are high. Since the fund is a bond fund scheme, it may be presumed that the lending is against similarly secured collaterals.

**Alternative Answer**

Yes, the scheme is a safe investment with negligible risk as it is a debt oriented scheme. Higher return on an annualized basis is not expected from the scheme because the investments are entirely debt oriented.

- (vii) The expense ratio as given above seems to be on the higher side because the current mutual fund scheme is a debt oriented one which involves lesser buying and selling in comparison to equity and therefore should amount to lesser expense ratio.

**Alternative Answer**

As a measure of investor protection, SEBI has set limits on the recurring expenses that can be levied on the scheme of the fund. The recurring expenses cannot be higher than 2.5% of the assets under management of equity schemes and 2.25% of the Debt schemes. Any service charge or GST will be in addition to the above limits.

In the above case, recurring expenses have to be limited to 2.25% since it is a debt fund. Prima facie, 2.65% in the question includes GST of 18%. If this element is excluded, as required by the risks, the expenses ratio work out to be slightly lower than 2.25% which is the permitted limit by SEBI. Hence, the fund has been incurring

expenses within the limit.

Schemes are also permitted to charge an additional 30% of the AUM depending on how much of the funds/scheme mobilizes resources from locations beyond the top 15 cities in the country.

- (viii) As the market values of various investments are not available, NAV of the scheme cannot be found out.
- (ix) Unrealised reserve is the value of increase or decrease in the value of the NAV of the units represented by unrealized gains net of losses due to increase/decrease in the value of the investments of the scheme. This is necessary to find the NAV of the units on a daily basis. Since it is unrealized and clearly demarcated, it is not considered as realized profit and hence not available for distribution as dividend or like retained profit.

**Alternative Answer**

Unrealized Reserve may be on account of valuation of securities to depict the actual position of the fund. The figures given in the question are not audited Balance Sheet as per the Indian Accounting Standards/Conventions which discourage the booking of unrealized gain. Therefore, it is contrary to the fundamental accounting principle of prudence which states that provides for all future losses and expenses but ignore all future profits.

- (x) Yes, fund has performed well during this year as surplus transferred from revenue account and increase in reserves is an indication that the mutual fund scheme has performed well during this year.
- (xi) This fund cannot borrow from the money market. However, they can invest in money market instruments for money market mutual fund schemes.

**Alternative Answer**

Mutual Funds are permitted to borrow upto 20% (of their net assets owned) for redemption or dividend payouts (Regulation 44 of Mutual Fund Regulations). This also explains why the fund has no balance in deposits in scheduled banks.

- (xii) From the data available in the Case Study, there is no hint regarding entry and exit load.

**Alternative Answer**

There is no entry load on any product because as per the SEBI (MF Regulations), mutual funds are not allowed to charge entry loads. However, it is upto the individual schemes to charge an exit load. Normally, no exit load is charged in a tax saving scheme or a liquid fund or an exchange traded fund, since the objective is to provide flexibility to the investor, given the volatility of the fund. However, in a product such as this scheme, investments are made in long term bonds or debts and Government



securities. Hence, there would be an exit load for a premature redemption of units within normally one year of the investment.

Such a load would be about 1% or lesser and this will enable the fund to liquidate its investments. In practice, it is 1% or less if a lock in period of one year is not adhered to. But as per regulation, upto 7% exit load is permitted. The exit load will be credited to the income of the scheme after netting off taxes, if any. However, no inference can be made with certainty about the exit load for lack of information from the given data.

(xiii) Average purchase price

$$= \frac{100000}{1 + 0.0876 \times \frac{85}{365}} = \frac{100000}{1.0204} = 98000$$

**Alternative Answer**

$$\text{Yield} = (\text{FV} - \text{Price}) / \text{Price} \times 365 / 85$$

$$8.76\% = \frac{(100000 - \text{Price})}{\text{Price}} \times \frac{365}{85}$$

$$\text{Price} = \frac{429412}{4.381712} = 98000.9640$$

Alternatively, if 360 days assumed in a year, then average purchase price

$$= \frac{100000}{1 + 0.0876 \times \frac{85}{360}} = \frac{100000}{1.0207} = 97972$$

(xiv) The risk appetite of the investor in this type of product is risk averse because the mutual fund invests mainly in debt oriented schemes. Therefore, the preference of the investor in such a product is to earn a steady income for a long period of time with minimum risk.

The investor in this product will require safety of the principal as well as want to earn higher than fixed income securities. Investors will have a low risk appetite and would want to benefit or rather ward off the danger of a falling interest rate scenario. In the case of falling interest rate, the investor will benefit from a debt fund by increase in capital gain, since the bond value increased if the interest rate falls.

(xv) During the NFO (New Fund Offer), the quantities are whole numbers. However, when investors ask for redemption of a fixed sum or invest a fixed sum, they will have to divide that fixed sum by the prevailing NAV at that date and hence the decimal is an inevitable occurrence. Moreover, when the dividend is reinvested, it is done at the prevailing NAV rates and hence there are allotments in decimals. It is optional for an investor to enter into a scheme for a fixed round sum rather than units. That sum,

when converted into units by dividing by a fractional NAV price results is a purchase of fractional number of holding.

**Alternative Answer**

There is a fractional amount in the number of units column in mutual fund product because when the value of the securities changes, NAV of the units are not in whole number. Accordingly, when we divide the amount received by the NAV, sometimes we get the amount in fraction.

- (B) (i) (D) Mutual Fund is a trust and is therefore regulated by the Indian Trusts Act. Therefore, option (D) is the correct answer.
- (ii) (D) - RBI regulates MF's investments in the money market, investments outside the country, investments from people other than residents in India and remittances inward and outward of foreign currency; other transactions are regulated by SEBI (Mutual Funds Regulations) and other provisions common to the common listing and issue regulations of SEBI.
- (iii) (D) – Nothing can be said about the classification of the fund from the saleability. Options (A), (B) and (C) are about the investments made by the mutual fund. Saleability is based on whether it is open ended or exchange traded funds.
- (iv) (C) – All mutual funds pay dividends to their unit holders, whatever be their investments, whether shares or bonds. The Mutual Fund is a Trust and its payments to members (unit holders) are called dividends, irrespective of its mode of investments.
- (v) (A) - the amount is not variable from month to month.
- (vi) Open ended schemes or exchange traded funds.
- (vii) Interest Rate OR Lower/least/nil
- (viii) Direct Plan OR Debt Fund
- (ix) Compounded Annual Growth Rate (CAGR)
- (x) The term 'fund' and 'scheme' are used interchangeably in common parlance. However, they are very different. A mutual fund is a trust and this is the entity that has many schemes – equity fund, debt fund, balanced fund, growth fund, etc. There are many schemes operated by mutual fund. For example, LIC mutual fund is the business entity registered as a Trust, whereas LIC MF Debt fund, LIC MF, G Sec Fund, etc are schemes within the same entity. Each scheme could have a different manager, who is called a fund manager. NAV is computed for each scheme individually based on the investments out of the scheme funds, scheme related expenses, income, etc. Each scheme is a product that mutual fund has to offer. Since the scheme has names like debt fund, equity fund, exchange traded fund, etc, we

actually mean scheme performance when we talk of the fund performance in common usage.

**Alternative Answer**

‘Scheme’ is a broader term while ‘Fund’ is a narrower term. For example, under debt schemes, overnight funds, liquid funds, money market funds come.

- (xi) Benchmark is chosen for comparison on the basis of nature or type of securities (a major portion) invested by the fund house. For example, in case of equity linked products, equity index is the best benchmark. For debt funds, yield curve is the benchmark.

**Alternative Answer**

When a scheme is issued, it is decided in advance where the scheme would invest its funds – whether across companies within a sector, or in debt instruments or fully diversified. Accordingly, a benchmark is chosen to represent the appropriate mix of investments. Diversified equity investments use Nifty 50 or S & P BSE Sensex, Mid cap funds use a mid-cap index, banking sector use a bank index like S & P BSE Bankex, etc.

- (xii) Yes, a mutual fund can invest in another mutual fund which is called Fund of Funds.

**Alternative Answer**

Mutual fund can invest upto 5% of its net asset value in another mutual fund, keeping in line with its objectives. For example, a debt fund cannot invest in any other equity fund, even within the 5% level. It has to only align its investment in a fund that has a similar objective. However, in the case of FoF (Fund of Funds), this 5% does not apply, since this FoF does not have a portfolio of debt securities, but its portfolio consists of units of other mutual funds which invest in debt securities.

- (xiii) No, a Real Estate Investment Mutual Fund cannot invest in residential house property. It has been clearly mentioned in Sebi (Real Estate Investment Trust) Regulations, 2014 that a Real Estate Investment Trust (REIT) shall invest in commercial real estate assets only.

**II. Case Study Question Number Two :**

*You are practicing in the area of advisory services giving opinions on technical issues relating to the capital markets and financial instruments. The following questions have been raised by different clients for whom you need to explain your answers or give your opinion. Your clients range from well informed CFOs of companies to ordinary individuals.*

(A) Answer the following :

- (i) What is meant by a recognized stock exchange? Is there any stock exchange which is functional that is not recognized? 3 Marks
- (ii) Does SEBI (ICDR) Regulations 2009 (amended in 2017) apply to preference

shares ? If so, under which regulation ? Explain in detail. 4 Marks

- (iii) Point out the flaws or the irregularities of the following proposal and state how rectification may be done, quoting relevant rules or sections or procedures and the authority:

IJK Ltd. wants to publicly issue for the first time, 10,00,000 equity shares of a face value of ₹ 10 by book building process. It wants to keep the bid open from the 14<sup>th</sup> of May 2018 up to 5<sup>th</sup> June 2018. The price band offered is to be fixed between ₹ 30 to ₹ 40 per share. The promoter intends to contribute to 15% of the shares proposed to be offered at ₹ 30 per share and hold the investment up to two years. To what extent can anchor investors provide the support necessary? 8 Marks

- (iv) In case the promoter is an individual, can his holding be counted for the limit applicable for a retail individual investor? State the regulation in support of your answer. 3 Marks

- (v) A soap manufacturing company has requested SEBI's prior approval to use a popular actor to advertise for the proposed equity issue to public. The same actor has been employed by the company to promote the sales of its soaps. Is it alright to grant approval ? 2 Marks

- (vi) X is an individual having a surplus of ₹ 5 lacs. He is interested in investing the amount in shares of a company in an initial public offer. He has a preference for A Ltd. which is to open for subscription on 30<sup>th</sup> May 2018. The market predictions indicate an oversubscription of that issue. If he does not get any allotment or if he is allotted shares for any lesser value, he would like to invest in Company B Ltd. whose offer is to open on July 1<sup>st</sup>. He fears that his money will be blocked in the first issue and may not be refunded to him in time for him to apply for B Co. Ltd.'s issue. If he does not want to borrow any money for that purpose, how will he overcome the problem ? Discuss. 3 Marks

- (vii) What do you mean by large cap, mid cap and small cap stocks ? 4 Marks

- (viii) S & P BSE Sensex was 32840.5 on a certain day. On the same day, Nifty 50 was 10,287.70. Explain the vast difference between the numbers and the underlying concept. 3 Mark

- (ix) Will the equity share prices of a company be the same in both BSE and NSE at the same point in time ? If so, explain the concept. If not, explain why they could differ? If they differ, will an investor not be able to profit by buying at a lower price and simultaneously selling it at a higher price? 3 Marks

- (x) Identify suitable investments (indicate broad category rather than specific instruments) that may ideally fit into the investment objectives of the following individuals :

<i>Investment Objective</i>	<i>Instrument</i>	<i>Instrument</i>
<i>Growth and Appreciation in value</i>		
<i>Regular Income</i>		
<i>Liquidity</i>		
<i>Capital Preservation</i>		

4 Marks

(B) Choose the most appropriate answer from the following and give your reason:

2 Marks x 5 = 10 Marks

(You are required to only state the Roman numeral and the alphabet of choice in capital letters rather than copy the entire question into the answer books) :

- (i) The following is true:
- (A) An investment Bank needs no licence from RBI
  - (B) SEBI has to approve the draft prospectus within thirty days of submission to it. If no reply is received within 30 days of submission, it is deemed to have no objection and the company may proceed with public issue,
  - (C) A Merchant Banker shall not apply for the shares of its client company,
  - (D) An Asset Management Company is a Banking Company governed by the RBI to deal with a mutual fund's investments in different sections of the financial market.
- (ii) The following commodity is not traded in the Indian Commodity Exchange:
- (A) Diamonds
  - (B) Tomatoes
  - (C) Crude Oil
  - (D) Pepper
- (iii) A company has receivables of ₹150 crores from four borrowers. It converts these into smaller portions of ₹ 500 each and sells these to smaller investors in the secondary market. This fragmentation of the loan is called
- (A) Debt unit scheme
  - (B) Mutual fund scheme
  - (C) Debt securitization
  - (D) Asset Reconstruction

- (iv) *Margin Trading is the following:*
- (A) *Stock brokers trade on the client's behalf up to the variation margin maintenance.*
  - (B) *Stock brokers trade on the clients' behalf even consuming the initial margin.*
  - (C) *Investors buy more number of shares than they have money for by paying a lower proportion of the cost and getting the balance funded by their bankers.*
  - (D) *A stock broker keeps a margin in his account with the stock exchange for the netting position shortfall among his clients.*
- (v) *AM Inc., an American company wants to set up its marketing company in India. The following process does not violate Indian Regulations :*
- (A) *AM has identified 205 entities / individuals in India who are willing to subscribe to the shares of the new company. AM would like to raise money from these persons and not invoke the provisions relating to public issue.*
  - (B) *AM will restrict the issue to about 150 persons and raise the capital without having to comply with SEBI regulations.*
  - (C) *AM will set up a Mutual Fund and offer its units to either the 150 or the 205 persons and use the proceeds to set up its new company and will comply with the SEBI (Mutual Fund) Regulations.*
  - (D) *AM will get a banking licence in India and set up the new company as the subsidiary of the banking company.*
- (C) *Fill in the blanks : (The blank is not restricted to one word. There could be one to four words to fill the blanks. The question Roman numeral and the content filling the blank will be sufficient for presentation in the answer books)*
- (i) \_\_\_\_\_ *is an arrangement between parties A and B, where A has given a loan to C and is afraid that C may not pay it back and in that case, B will make good A's loss. In return for this, B will charge a periodic premium from A.*  
1 Mark
  - (ii) *When shares are traded in the \_\_\_\_\_, the company's share capital account is not affected.*  
1 Mark
  - (iii) *A group of engineers has designed an air conditioning machine which is a revolutionary product that efficiently admits fresh air circulation. This will replace the wide air conditioning market within the country. The new product has been successfully tested and is being patented. The group has had a start-up venture as a private limited company. A big company that enjoys over 50% of the air*

*conditioning market, which is threatened by this product should attempt a \_\_\_\_\_ to retain its market leadership.* 1 Mark

**Answer to Case Study Number Two**

- (A) (i) Recognized stock exchange is a stock exchange which operate under the rules, regulations and guidelines approved by the government. As per section 2(j) of the Securities Contract Regulation Act, 1956, “stock exchange” means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

Further, no stock exchange is permitted to function as such to trade in the securities of a publicly held company without being recognized.

**Alternative Answer**

A stock exchange is a trading platform for securities of different kinds. It has member brokers who facilitate the trade between buyers and sellers. The legal entity of a stock exchange could, prior to the SEBI Act, be a Body of Individuals or a Company. After the SEBI Act came into force, this entity should have been corporatized or demutualized. In order to protect investors from fraudulent activities, the Central Government has appointed SEBI, The Securities and Exchange Board of India as the regulatory authority. SEBI, by virtue of the SEBI Act has the power to recognize stock exchanges upon their fulfilling certain requirements imposed by it. The main requirements are that the legal entity should be a company in which the public are interested to at least the extent of 51% and following certain disciplines regarding membership of brokers, trade and procedures to be complied with, in addition to having members appointed by SEBI on the company’s Board. Subject to these formalities stated under section 4 of the Securities Contract Regulations Act (SCRA), the Central Government, through SEBI grants recognition to a stock exchange. If subsequent to the registration, any requirement is not complied with, the Central Government can derecognize the stock exchange under section 5 of the SCRA.

The recognition can be permanent as in the case of BSE, NSE or valid upto a certain period.

However, there are OTC exchange platforms (Over the Counter) platforms for trade of unlisted securities informally. Since, there is no governance of this; there is counterparty risk in abundance. The OTCEI was de-recognized by SEBI due to irregularities.

- (ii) In Regulation 4 of SEBI (ICDR) Regulations 2009, the indication is given with regard to specified securities. Specified securities is defined under 2(zj) as equity shares and convertible securities. Also, 2(k) defines a convertible security as a security which is convertible into or exchangeable with equity shares of the issuer at a later date, with or without the option of the holder of the security and includes convertible debt instruments and convertible preference shares.

Hence, the regulations apply to convertible preference shares.

However, this inclusion is superseded by a separate SEBI (ICDR) Regulation for redeemable, non-convertible preference shares and for perpetual non-cumulative preference shares.

Thus, the SEBI (ICDR) Regulations 2009 amended by the Finance Act, 2017 does not apply to preference shares that are non-convertible.

(iii) The various flaws of the proposal, their rectification along with relevant regulations is explained as below:

**(a) The company wants to keep the bid open from the 14<sup>th</sup> of May, 2018 upto 5<sup>th</sup> June, 2018.**

The proposal is wrong because **Regulation 46** of SEBI (ICDR), Regulations, 2009, clearly provides that an issue through book building system remains open for three to seven working days. In case of revision of price band, the issue period disclosed in the red herring prospectus shall be extended for a minimum period of three working days. However, the total bidding period shall not exceed ten working days.

**(b) The price band is to be fixed between ₹ 30 to ₹ 40 per share.**

As per regulation 30 (2) of SEBI (ICDR), Regulations, 2009, the issuer shall announce the floor price or price band at least five working days before the opening of the bid (in case of an initial public offer) in all the newspapers in which the pre issue advertisement was released. As no detail has been given about the price band or the floor price in the question, it seems that the efficacy of the rule that the spread of price between floor price and cap in the price band should not be more than 120% [(regulation 30(4))] is not satisfied by the company. Moreover, the difference between ₹30 to ₹40 per share seems to exceed the spread between 100% to 120%.

**(c) The promoter intends to contribute to 15% of the shares proposed to be offered at ₹30 per share and hold the investment upto two years.**

The proposal is wrong. As per Regulation 32 (1) (a) of the said regulations, in a public issue by an unlisted issuer, the promoters shall contribute not less than 20% of the post issue capital. Further, as per Regulation 36, minimum promoters' contribution shall be locked-in for a period of three years from the date of commencement of commercial production or date of allotment in the public issue, whichever is later. And, promoters' holding in excess of minimum promoters' contribution shall be locked-in for a period of one year.

**(d) Support of anchor investors.**

Anchor investors cannot be used here. The anchor has to apply for at least ₹ 10 crore value in a public issue. Here, the total value itself is less than that of the



minimum required for anchor investors. [Schedule XI of SEBI (ICDR), Regulations, 2009]

- (iv) In case the promoter is an individual, his holding cannot be counted for the limit applicable for a retail individual investor. The reason is that in Regulation 32 of the said regulations, it has been clearly mentioned that minimum promoters' contribution shall be 20% of the post issue capital. And, in regulation 43 (2), it has been categorically mentioned that in the net offer to public category, not less than thirty five per cent shall be allocated to retail individual investors. Further, in regulation 43(4), in the net offer to public category, in an issue made other than through the book building process, minimum fifty per cent shall be allocated to retail individual investors.

From the above discussion, it seems to be clear that promoter's holding cannot be counted towards the limit applicable for a retail individual investor.

#### **Alternative Answer**

Even if the promoter is an individual, his holding cannot be counted under "retail individual investor" since the definition of a retail individual investor or shareholder under Regulation 2(ze) and (zf) define him as one who applies for or bids for a value not more than ₹ 2 lacs. Hence, the promoter's holding cannot be reckoned under the retail individual investor or shareholder.

- (v) According to Regulation [60(7)(h)] of the said regulations, no issue advertisement shall display models, celebrities, fictional characters, landmarks or caricatures or the likes. In view of the above, the soap manufacturing company will not be successful in getting SEBI's approval to use a popular actor to advertise for the proposed equity issue to public.

However, product advertisement is not covered under this regulation and hence that is alright.

- (vi) The ASBA (Application Supported by Blocked Amount) has been made mandatory by SEBI not only for book built issue but to also any public issue of equity shares. Under this arrangement, the investor has to submit an application to the Self-certified Syndicate Bank (SCSB) with whom the bank account to be used for the application money is maintained. By virtue of this ASBA facility, the amount payable on application is merely blocked by the SCSB and released to the company only on allotment, thereby obviating the necessity for a refund on non-allotment and also enabling the investor to have his liquidity for immediate other use of his funds.

#### **Alternative Answer**

It has specifically given in regulation 18 (1) of the said regulations that the issuer and merchant bankers shall ensure that specified securities are allotted and/or application moneys are refunded within fifteen days from the date of closure of the issue.

From the above, it can be said that X will be able to get the allotment or refund, as the case may be before the Company B Ltd.'s open offer.

However, if he still have any doubts or fears in his mind, he can proportionately invest his surplus money of ₹ 5,00,000. For example, in company A Ltd., he can invest 50% or 75% of ₹ 5,00,000. And, in case, anything unfavourable happens, he can invest rest of the amount in company B. This way he can overcome the problem to a certain extent.

- (vii) As per the SEBI circular dated October 6, 2017, large cap, mid cap and small cap has been defined as follows:
- (a) Large Cap: 1<sup>st</sup> – 100<sup>th</sup> company in terms of full market capitalization.
  - (b) Mid Cap: 101<sup>st</sup> – 250<sup>th</sup> company in terms of full market capitalization.
  - (c) Small Cap: 251<sup>st</sup> company onwards in terms of full market capitalization.

#### **Alternative Answer**

Market Capitalization of a company means number of shares outstanding multiplied by market price per share. The market cap measures the market value of a company's share capital. Stocks traded on the stock exchange are categorized by market cap. Though there is no regulation to determine a cut off the classification, conventionally, top 50 stocks ranked according to market capitalization in a stock exchange are called large cap or blue chip stocks, the next 200 are mid cap and the next 500 are small cap. The large cap stocks represent liquidity and stability. Mid cap stocks provide momentum and opportunity, while small cap stocks do not enjoy much liquidity.

- (viii) The numbers are leading market indices. A market index normally is computed by computing market capitalization of select number of shares chosen to represent market movement. The S & P BSE Sensex was set at 100 on April 1<sup>st</sup>, 1979 and consists of the market cap weighted index of 30 chosen stocks, whereas the Nifty 50 consists of 50 companies' stocks listed on the National Stock exchange. The base period is November 3<sup>rd</sup> 1995 and the base value has been set at 1000. Since the base values are very different, we have a big gap in the updated values on every trade day. However, daily % increases/decreases of the indices are almost the same, indicating the general market movement. Apart from these, there are sectoral indices to track specific sectors.
- (ix) The prices will be almost the same. There could be minor differences. The prices displayed on the screen are the last traded prices. Hence, even if we want to buy at a lower price and sell it higher, by the time we order, that price will not be applicable. Moreover, this guaranteed profit arising out of arbitrage cannot be attempted by an ordinary person, since there are software programs and specific algorithms that are continuously working on the trading platform set up by the bigger traders and the

arbitrage mechanism is soon put out by equalization of prices. Then prices differ by a slim margin, that even if they are available at that margin, the cost of the transaction brokerage, STT, etc. will not justify it and will wipe out the potential profits.

(x)

Investment Objective	Instrument	Instrument
Growth and appreciation in value	Equity Shares	Equity based Mutual Fund
Regular Income	Debentures	Bonds
Liquidity	Liquid Funds	Money Market Mutual Funds
Capital Preservation	Government Securities	Debentures

**Alternative Answer**

Investment Objective	Instrument	Instrument
Growth and appreciation in value	Equity Shares, mutual funds in equity	Real Estate, gold
Regular Income	Deposits, debt instruments	Debt funds, Real estate
Liquidity	Bank Deposits	Mutual Funds – Short term, liquid funds
Capital Preservation	Bank Deposits	Ultra-short term funds

- (B) (i) (A) Investment banking is entirely different from commercial banking which needs license from RBI. Further, permission is not automatic. Objections are raised, set right and then approved.
- (ii) (B) Goods have to be durable to be traded on the exchange. Diamonds have been recently introduced for trading.
- (iii) (C) The breaking up of an entire portfolio of loans into smaller marketable portions of negotiable instruments is called debt securitization.
- (iv) (C) Margin trading is a facility given to the investors in which they can invest in shares by part financing from the bank. The shares purchased are themselves the collateral for the bank and variation in prices will easily be covered by the margin contributed by the borrower.
- (v) (B) The number of persons beyond 200 will invoke public offering and therefore SEBI will come into picture. Hence, restricting the issue to 150 persons will be private placement and in order. Setting up a Mutual Fund will not be possible since the money cannot be invested in one company or even mainly in one company. Moreover, Mutual Fund should be an Indian entity. Also, banking and

marketing cannot go together. In such cases, license will not be granted.

- (C) (i) Credit Default Swap (CDS)  
 (ii) Secondary Market/Stock Exchange  
 (iii) Takeover/Strategic Acquisition

**III. Case Study Number 3:**

*Krishi Vikas Equipment Ltd. (KVE) is an existing unlisted and successful company engaged in manufacturing and marketing agricultural equipment in India. The Company is family-owned and is now headed by a qualified engineer and a member of the family who is the Managing Director (MD). Though family-owned, the Company employs qualified professionals and is soundly managed. Being a player catering to the agri-sector, the Company's products are in good demand and its profitability is sound. The family owners are keen on new products and expansion. In the past, they have been reluctant to borrow except for genuine working capital requirements on short term basis.*

*The MD has had various discussions with the in-house professionals who have zeroed in on a set of new agricultural implements and have all related marketing and technical information ready. The key figures in relation to the expansion they have planned are summarized as below :*

	(₹ In lakhs)
Total project cost	2000
Annual sales (upon full implementation)	3000
Earnings before interest, depreciation & tax	900
Annual depreciation	120

*The Chief Financial Officer (CFO) went to discuss with the MD (Project Meeting 1) with the following additional information :*

- (i) Latest audited Balance Sheet and profitability summary) - Annexure 1  
 (ii) Estimated Cash Flow Statement for the next 3 financial years - Annexure 2  
 (iii) Earnings Per Share (EPS) data - KVE vs. Market - Annexure 3

*At Project Meeting 1, MD explained to the CFO that the family does not wish to invest 'own money' further; but it is keen about expansion; therefore, company should think of external equity without diluting control. He studied the information brought by the CFO and then said that a senior executive of a Private Equity (PE) enterprise will be coming to meet him in three days' time. Before meeting with the PE, the MD wanted to know from the CFO, among other things, the following:*

- (a) *If the KVE's shares were to be quoted in the secondary capital market, what would be price/share?*

- (b) How the price per share will be fixed if KVE comes up with a capital issue?
- (c) What are the advantages and disadvantages of going with the PE ?
- (d) Any other suggestions / points relevant to the issue at hand

It was decided then that the MD and the CFO will again meet (Project Meeting 2) the day before the meeting with the PE.

In the above background, kindly deal with the following situations. Your detailed answers may be given to each of the requirements in the question.

- (i) Bearing in mind the views of the present ownership / management on the question of ownership and equity dilution, what would be your recommendations for putting through the project?

Would you prefer equity dilution in the primary or the secondary market or through private placement of shares ?

What are the requirements of SEBI for entities making a public issue of shares? Discuss. 8 Marks

- (ii) Would you like to examine the debt-equity position of the company and suggest a quantum of debt to be raised by the company additionally ? It is gathered that the normal debt equity ratio applicable to the business in which the company is engaged is 2:1. 7 Marks

- (iii) You are required to indicate the possible additional equity issue by the company based on the understanding that the present ownership will relax its stand on dilution. Indicate the alternatives when equity dilution of 40%, 50% or 60% takes place. 10 Marks

- (iv) Kindly indicate the issue price of the additional equity. You may be aware that though this company's shares are not listed in the exchange, shares of similar sized companies are quoted - details of which all given in the schedule - and this company's valuation may not be vastly different from that of the average company in the quoted / listed group.

- (v) What is private equity and what are its attributes? Discuss.

One P.E. firms is prepared to invest in this company and take a 45% interest in the equity. It has made its working and is prepared to project the company's future workings and offer now a rate based on EPS of ₹ 10. The multiplier is expected to be the same as established by the details in the schedule of listed companies functioning. 15 Marks

- (vi) What will be the recommendations of the CFO to the Managing Director?

3 Marks

- (vii) Kindly prepare an executive summary of the recommendations to be put up to the Board of Directors of the company. 7 Marks

**ANNEXURE 1****KRISHI VIKAS EQUIPMENT LTD.****BALANCE SHEET AS AT 31<sup>st</sup> MARCH (Amounts in ₹lakhs)**

	2018	2017	2016
<b>ASSETS</b>			
Non-current Assets			
Property, plant and equipment	1080	1025	1000
Financial assets	330	250	
Other Non-current assets	35	40	40
Sub-total	1445	1315	1040
Current Assets	<u>1985</u>	<u>1881</u>	<u>1750</u>
<b>TOTAL ASSETS</b>	<b><u>3430</u></b>	<b><u>3196</u></b>	<b><u>2790</u></b>
<b>EQUITY &amp; LIABILITIES</b>			
Equity			
Equity Share Capital *	500	500	500
Other Equity	1510	1360	980
Sub-total	2010	1860	1480
Non-current Liabilities	583	581	580
Current Liabilities			
Trade payables	680	600	575
Provisions	15	15	15
Other Current Liabilities	142	140	140
Sub-total	837	755	730
<b>TOTAL EQUITY &amp; LIABILITIES</b>	<b>3430</b>	<b>3196</b>	<b>2790</b>

\*Shares of ₹10 each.

**PROFIT / LOSS SUMMARY**

	(Amount in ₹Lakhs)		
	2018	2017	2016
Profit Before Tax	640	970	450
Taxes	190	290	135
Net profit	450	680	315
Dividend	300	300	250
Retained Profit	150	380	65

**ANNEXURE 2**  
**KRISHI VIKAS EQUIPMENT LTD.**  
**ESTIMATED CASH FLOW STATEMENT**  
**Year ended 31<sup>st</sup> March – Amounts in ₹ lakhs**

	2019	2020	2021
<i>Cash flow from Operating activities :</i>			
<i>Profit before tax</i>	1750	2012	2515
<i>Adjustments for Depreciation</i>	180	200	220
<i>Dividend &amp; Interest Income</i>	(100)	(120)	(150)
<i>Change in operating assets &amp; liabilities</i>			
<i>Increase/decrease in current assets</i>	(250)	(300)	(400)
<i>Increase/decrease in current liabilities</i>	120	140	160
<i>Cash generated from operations</i>	1700	1932	2345
<i>Income tax paid</i>	(525)	(605)	(755)
<i>Net cash inflow from operating activities</i>	1175	1327	1590
<i>Cash flow from investing activities:</i>			
<i>Dividends &amp; Interest received</i>	100	120	150
<i>Net cash flow from investing activities</i>	100	120	150
<i>Cash flow from financing activities</i>			
<i>Dividends</i>	(300)	(300)	(300)
<i>Dividend taxes</i>	(32)	(32)	(32)
<i>Net cash outflow from financing activities</i>	(332)	(332)	(332)
<i>Net increase/(decrease) in cash &amp; cash equivalents</i>	943	1115	1408
<i>Cash &amp; cash equivalents at the beginning of the year</i>	525	1468	2583
<i>Cash &amp; cash equivalents at the end of the year</i>	1468	2583	3991

**ANNEXURE 3**  
**EARNINGS PER SHARE INFORMATION**

S. No.	Name of company	EPS (₹) YE 31/03/2018	Market Price (₹)	
			High	Low
1	Agri- Imp Ltd.	4.50	45	41
2	Implements (I) Ltd.	3.20	51	42
3	Beta Products Ltd.	6.00	110	80

**Answer to Case Study Number Three**

- (i) An option of looking at external equity without diluting control do not seem feasible because such practices are followed by listed companies after their initial public offerings in which the shares are offered for sale by private shareholders, such as directors or other insiders (like venture capitalists) looking to diversify their holdings. So, in such situations, a company may not benefit at all. And, KVE is an unlisted company.

However, it can be argued that the company can increase its external equity without diluting control by issuing Differential Voting Rights i.e. issuing shares which are having more dividend rights but very less voting rights. Or, it can issue convertible warrants for the time being to avoid diluting its voting rights.

There are various options before the company for equity dilution.

- (i) **Primary Market.** If the company wants equity dilution in the primary market, it shall new equity shares to the public.
- (ii) **Secondary Market.** Equity dilution cannot happen in the secondary market because KVE is an unlisted company.
- (iii) **Private Placement.** Further, when an issuer makes an issue of shares or convertible securities to a select group of persons not more than 50 but can extend upto 200, and which is neither a rights issue nor a public issue, it is called a private placement.

**Issue requirements and Pricing**

SEBI has laid down entry norms for entities making a public offer of shares which are briefly discussed as follows:

**Some Basic Requirements**

An unlisted issuer making a Public Issue is required to satisfy some conditions among others viz.,

- a) Net Tangible Assets of at least ₹ 3 crores in each of the preceding three full years of which more than 50% is held in monetary assets;
- b) Minimum of ₹ 15 crores as average pre-tax operating profit during the three most profitable years out of immediately preceding five years.
- c) Net Worth of at least one crore rupees in each of the preceding three full years.

SEBI has also provided an alternative route to the companies which are not able to satisfy any of the above conditions – that is, such companies should mandatorily offer at least 75% of the net offer to the public to be mandatorily allotted to Qualified Institutional Buyers (QIBs).

It can be seen that KVE does not satisfy the requirement for a minimum pre-tax operating profit of ₹ 15 crores and hence it will be required to find QIBs to take at least 75% of the



proposed issue. As per norms applicable in this regard, the number of QIBs should be two which would not be difficult to arrange for.

Further, in a public issue by an unlisted issuer, the promoters' contribution should be not less than 20% of the post issue capital and should be locked in for a minimum period of 3 years; also, the remaining pre-issue capital of the promoters should also be locked for a period of 1 year. These requirements can be easily satisfied in the case of KVE.

### Pricing

SEBI does not play any role in fixation of price for shares. The issuer in consultation with merchant banker decides the price.

However, it may be noted that there are two routes to the price fixation exercise as indicated below:

- FIXED PRICE ISSUE where the issuer in consultation with the Merchant Banker decides the price at the outset; and
- BOOK BUILT ISSUE where the price is discovered on the basis on demand received from the prospective investors at various price levels.

KVE can tackle this aspect at a later stage after a decision has been taken to go for a public issue and after appointment of the Merchant Banker.

- (ii) As regards raising of money through debt, two broad courses are available to the company. Money can be raised through issue of debentures or by way of bank finances. Bonds or debentures are long term debt securities and carry an interest rate dependent on market forces. Movements in the interest rates in a volatile market, viz., and interest rate risks are possibilities in this area, because debentures are long term investments, commitments made are unchangeable once the period of instrument namely 7 to 9 years are through. Interest on bonds is tax-deductible and the feature presents a possibility of adoption in cases of companies having current liquidity, the long term effects are to be considered. Bank financing is an option on medium term plan and often tried when the company is anticipating to make profits in the future to service the loan obligations and to pay of the liability, the prospects are bright for the adoption of bank financing as a distinct possibility.

It has been stated that the ownership/management is reluctant to resort to borrowings except for occasional working capital requirements now not resorting to any loans. This is a bad financial management solution since businesses are expected to maximize their profits by adequate resources – equity and debt. Debt financing done at reasonable level is a good financing option and reasonable from the equity holder's point of view since debt servicing is tax deductible and enhances EPS. A good EPS also encourages good market price for the shares and leads to maximization of an equity holder's shares. It leads to overall financial and economic development.

In the present case, the equity base of the company is ₹ 2010 lakhs against which apparently no debt obligations exist. Even if the non-current liabilities sum at ₹ 583 lakhs

were taken as bank loans or outside debts, the debt equity ratio is only around 0.25: 1. The permissible ratio in the financial circles being 2 :1, the unit upto which long and short term debt finances could of the order of ₹ 4020 lakhs. There is a gap of around ₹ 3500 lakhs which the company can comfortably leverage and the present proposal of additional revenue requirements of ₹ 2000 lakhs could be fully met by such borrowings. Even at ₹ 2000 lakhs of fresh bank advances, the debt equity ratio of the company could be just around 1 :1 which is a very healthy sign, with a 30% tax shield available for interest expense, the effective rate gets reduced to 7% wealth. This could be brought to the notice of the ownership/ management to change their perceptions.

In the circumstances, we could advice the company to go in for debt capital from banks and financial institutions.

There are distinct advantages in using debt as a source of project finance. These are summarized below:

Merits of using Long Term (LT) debt as source of finance:

- Debt is cheaper than equity because of the tax shield that payment of interest provides. If the applicable interest rate is 10%, with a 30% tax shield available for interest expense, the effective rate gets reduced to 7%. The effective cost of debt could thus just be 7% while the equity holders are sure to expect return well above this rate. Debt is cheaper than equity because of the tax shield that payment of interest provides.
- A reasonable capital gearing ratio will provide opportunity to maximize the rate of earnings per share (EPS). Thus, the market of the share will be maximized.
- KVE, given its tract record, can get a very good credit rating and easy access to Term Debt.
- Resorting to LT Debt is one good way of keeping the size of new equity down within desirable limits and ensures promoters majority controls.

The amount of LT Debt suggested as above is only recommendatory; it can be increased or decreased depending upon the final numbers as to issue price/ share, cost of issue and any other relevant parameter.

#### **Alternative Answer**

It has been given in the Case Study itself that debt equity ratio applicable to the business in which the company is engaged is 2:1. Therefore, the company has to reconsider its debt equity ratio. KVA's equity is almost 4 times that of its debt. Increasing the debt does bring some advantages which are explained as follows:

- (a) The earning per share (EPS) of the company will get increased.
- (b) The company will be able to save more tax.

However, some disadvantages are also there by increasing the debt:

- (a) Default risk i.e. if the company fails to make interest payment in time.

(b) Too much interest payment may eat into the profits of the company.

Therefore, from the above discussion, it can be suggested to the company that debt should be increased slowly and gradually so that interest burden can be manageable by the company and sound profitability position can also be maintained by the company. This way, KVA can substantially reduce its default risk also.

(iii) Additional Equity to be Issued

	40% Dilution	50% Dilution	60% Dilution
Existing No. of Shares (A)	50 lakhs	50 lakhs	50 lakhs
Existing Ownership (B)	100%	100%	100%
Diluted Ownership (C)	60%	50%	40%
Revised Total No. of Shares (D)	$\frac{50 \text{ lakh}}{0.60}$	$\frac{50 \text{ lakh}}{0.50}$	$\frac{50 \text{ lakh}}{0.40}$
	= 83.33 lakh	= 100 lakh	= 125 lakh
Additional Equity Shares (A) – (D)	33.33 lakh	50 lakh	75 lakh

(iv) Estimated Price Per KVE Share

P/E Multiples of Industry

Name of Company	Market Price per share		Earnings per share	P/E Multiple		
	High	Low		High	Low	Average
Agri-Imp Ltd.	45	41	4.5	10	9	9.5
Implements (I) Ltd.	51	42	3.2	16	13	14.5
Beta Products Ltd.	110	80	$\frac{6.00}{4.57^*}$	18	13	$\frac{15.5}{13.17^*}$

Calculation of Market Price per Share

= Average P/E Multiple x Average Earnings per share

= 13.17 x 4.57 = 60.19

\* Average P/E Multiple =  $\frac{9.5 + 14.5 + 15.5}{3} = 13.17$

\* Average Earnings per share =  $\frac{4.5 + 3.2 + 6}{3} = 4.57$

(v) **Meaning and attributes of private equity**

Private equity is the capital brought in by the Private Equity firms (simply called as 'PE firms') into the enterprise as part of equity capital. PE firms are the investment fund companies who take strategic stake in the enterprise once the enterprise is established as

a successful cash generating unit. This is the basic difference – the PE would come in post the Venture Capitalist (VC) - a typical example will be of a PE firm replacing a VC interested to exit out by repaying off its investment debt, and taking a position in the equity capital of the firm. PE firms are in a broader sense, the long term investors into the enterprise and act like 'mentors' to the management.

### **Industry Overview**

Private Equity (PE) is the alternate form of investment, as compared to publicly traded equity markets, where the PE investor (or the PE firm) invests majorly into startups and emerging sectors through strategies like early funding, venture capital, growth capital, etc. The main characteristic is that these investments function on a higher risk to reward model, and in order to amplify the returns, the PE firms use a leveraged approach of using debt as the funding instrument. PE firms target a return based on IRR or the 'multiple based' approach.

The PE industry has grown significantly in the past three decades, and over a period of time PE firms like Bain Capital, Blackstone have grown tremendously entering successfully into Asian markets too. There was a temporary setback in the PE industry during the dotcom bubble seen in 2000-2003, but has staged a comeback, stronger and more resilient. The growth in PE has also seen marked increase in regulations in both US and Europe. In US, the SEC regulates PE industry, and in addition has added FATCA (Foreign Account Tax Compliance Act) and the Alternative Investment Fund Managers Directive to have greater transparency in the workings of PE.

The concept of alternate investments has slowly gained a steady trajectory in India. An excerpt from *The Economic Times* dated Mar 11, 2017 on the PE industry in India - 'The year 2016 turned out to be a mixed bag for India in term of private equity and venture capital investments. The volume and value of these investments in 2016 decreased by 25% and 39% respectively compared to the year before (2015). This decline was expected as the flurry of investments in 2015 was shouldered by a high volume of startup deals during the year. In 2016, the political and economic turmoil in Europe, including Brexit, rising oil prices and increased risk premium for technology/internet sector investments affected the sentiments of foreign investors.

### **Alternative Answer**

#### **Private Equity – Some Details**

##### **What is Private Equity?**

There are funding groups operating in the capital market who specialize in identifying startups and emerging players, investing in them as if they are a partner group for a limited period of time and exit at the end of term making a significant profit. Their main characteristics is that they operate on a higher risk to reward model – meaning they are willing to take risks that normal investing/lending institutions will be reluctant to assume for a higher than normal reward.

**How they go about?**

The PE firms do a due-diligence of the investee firm/company covering all aspects of the business prospects i.e. capabilities, management, profitability, growth etc.

After satisfying themselves about the suitability of the investee company, they negotiate the terms.

They enter into an agreement with the management group – called Private Equity Shareholders agreement. Some of the important clauses incorporated in the agreement will include among other things the following:

- Mode of introduction of the private equity and the time period for which they intend to be an investor.
- Appointment of nominee(s) of the PE investor in the investee company
- Appointment of auditors
- Prohibition of further issue of capital without the permission of the PE investor.
- Prohibition on the sale of the promoter's stake.
- Exit routes for the PE firm which may contain provisions for minimum guaranteed buy back price.
- Such other points that the PE firm would like to include to protect themselves.

Normally, it is at the time of exit from the investment that the PE firms make a significant gain. The buyback amount is often defined in the shareholders' agreement or the mode of computing the same is mentioned or clarified. If the venture has been successful, the marketable value of the shares will be high and the PE firm will move to cash in on the same.

**To whom PE is a Good Fit**

PE is an alternate source of capital to emerging unlisted companies or partnership firms planning to go public in the medium term.

Typically, PE investors would be replacing a Venture Capitalist as a stage in the growth of a business. The venture Capitalist specializes in identifying talented startups and innovative enterprises in need of capital and works with them; the PE investor would come in post the Venture Capitalist, i.e. when the firm has found its feet and is ready to grow further. PE firms in a broader and general sense are medium/long term investors who can act like mentors to the promoter group.

PE is a good source to consider when the investee company is not sure of good response to its proposal for capital issue or when it would think that the cost of raising capital of the planned size is likely to be high.

**(vi) Recommendations of the CFO to the Managing Director**

- (a) If the management is keen on equity dilution without losing control, it shall consider its option of equity share with differential voting rights. Alternatively, an easy and less feasible approach is to issue convertible warrants.
- (b) A better approach for the company is to go with the Initial Public Offer. However, if the company wants to save issue expenses and future compliance costs, it can consider a private placement of shares.
- (c) A company may also consider increasing its debt-equity ratio slowly and gradually as it will help the company to save tax and increase its earning per share.

**Alternative Answer**

The present ownership can think of dilution of its 100% equity holdings in the company. Even if it divests 60% of its present holdings, the value of 40% alongwith other retail holders, who can be from the promoter's fold, will enable the ownership to retain control.

On the balance, the management will recommend at 45% divestment in favour of the PE at an enhanced value of ₹ 100 per share which will achieve twin objectives of the present administration – control and progress.

**(vii) Executive summary of the recommendations to be put up to the Board of Directors of the company**

- (a) The company can increase its external equity without diluting control by issuing Differential Voting Rights i.e. issuing shares which are having more dividend rights but very less voting rights. Or, it can issue convertible warrants for the time being to avoid diluting its voting rights. However, control may get diluted when warrants will be converted into equity shares at a later stage.
- (b) A better option before a company if it wants to issue capital for expansion purpose is to raise capital either through the primary market or a private placement.
  - (i) **Primary Market.** If the company wants equity dilution in the primary market, it shall issue new equity shares to the public. A company can raise large amount of capital through this route. However, it also leads to comparatively higher issue expenses and compliance costs.
  - (iii) **Private Placement.** Further, if the company wants to save issue expenses and future compliance costs, it can consider a private placement of shares. When an issuer makes an issue of shares or convertible securities to a select group of persons not more than 50 but can extend upto 200, and which is neither a rights issue nor a public issue, it is called a private placement. So, Private Placement makes sense if the company wants limited capital for its expansion purpose. Otherwise raising capital through primary market seems to be a better idea.

- (c) A company may also consider increasing its debt-equity ratio slowly and gradually as it will help the company to save tax and increase its earning per share.
- (d) If the company issues additional equity shares, it can quote issue price of the additional equity at ₹ 60.19.

**Alternative Answer**

- Krishi Vikas is in a growing curve.
- The project calling for an investment of ₹ 2000 lakhs is plainly stable.
- The additional revenues expected to be earned will strengthen the company.
- The requirements of funds for the next project are for ₹ 2000 crores.
- Can be raised through additional equity or borrowings.
- Borrowings can be either through bonds or bank finances.
- Interest rate can be competitive and is tax deductible.
- Leveraging on debt equity ratio will still present the company in sound health resulting in higher EPS and maximization of share value.
- The proposal will add considerably to capital base by way of substantial share premium.
- The prospects for the future are good and PE can be offered an exit 4/5 years down the line by way of a buy-out or as IPO.
- The management recommends the PE proposal.