Chapter 1

Introduction
1.1 About the Topic

A robust Small and Medium Enterprises (SMEs) sector is the pillar of broad-based economic growth in any country, and this is particularly true for India. Currently, there are 26.1 million SMEs in India. This includes 7.3 million manufacturing enterprises and 18.8 million service enterprises. Out of this, 2.1 million enterprises are managed by women, and rural enterprises account for 14.2 million. The total employment generation is 60 million and per unit employment are 6.24. The fixed investment per unit is Rs. 33.78 lakh, per unit original value of plant and machinery is Rs. 9.66 lakh.\[1\]

However, Indian SMEs are still a part of the unorganized sector. They face problems related to finance, infrastructure, consulting, marketing, research, export promotion, adequate water supply and power. Without this support Indian SMEs won’t be able to achieve the targeted growth of 10-12% in 2012-2013.\[2\]

It has been observed that SMEs of China, Malaysia, Thailand, Vietnam and Korea dump several products in Indian markets. Aided by their respective government and financial institutions, SMEs in these countries are able to market aggressively and promote exports. Many countries also provide incentives, which facilitate participation in exhibitions and business-to-business (B2B) meets. This enables SMEs to find buyers, importers, new technology, quality products, raw materials and business associates. The banks and financial institutions of these countries also extend adequate and timely credits to the SMEs and support them when they face problems.

In this situation for the development of Indian SMEs it is highly essential to provide the solid platform, which can help them to overcome existing challenges and provide ability to compete in the local and global markets with a strong growth rate. Investment Banks can contribute to build important pillars of such platform. Traditionally Investment Bank is a financial institution that assists individuals,
corporations and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank can also assist companies involved in mergers & acquisitions, and provides ancillary services such as market making, trading of derivatives, fixed income instruments, foreign exchange, commodities, and equity securities. It is perceived that there are some other areas where investment banks can also contribute, in this study an attempt is made to identify those significant areas where investment banks can accelerate the growth of Indian Small and Medium Enterprises.

The title of this research is “A Study on Role of Investment Banks for Development of Indian Small and Medium Enterprises”. In this research Indian SMEs sector (pertaining to Pharmaceutical and Plastic industries) is studied in detail and research is conducted on how current and undiscovered business portfolio (services) of Investment Banks can facilitate sustainable development of Indian SMEs in the local and global market, and place India Inc. the strongest on the Earth!

In this chapter overview on Indian SMEs, Indian Capital Market and Investment Banks are covered to demonstrate the theoretical and historical background. All these topics are discussed in detail during the subsequent chapters of this study.

1.2 About Small and Medium Enterprises

1.2.1 Small and Medium Enterprise are the Engines of a Smarter Planet!

We are living on a very different planet from the one we lived on even a few years ago. The world is becoming flatter, which means now, any size company, from any place on earth - including India - can now establish a global footprint. In fact, Small and Medium Enterprises (SMEs) are now responsible for nearly 65% of the global GDP. The world is definitely becoming smaller, as real-time communication and the Internet can link people, processes and innumerable things with unprecedented
speed and frequency. By 2013, there will be two billion people and as many as one trillion connected objects on the Web.\textsuperscript{[2]}

But something else is happening that holds even greater promise: the planet is becoming smarter. Today, almost anything in India and in the world can be instrumented, interconnected and also made intelligent – the systems, the processes and the devices that enable physical goods to be developed, manufactured, bought and sold; services to be delivered; and billions of people to both work and live.

This is possible, in large part, because the innovation driving a smarter planet is originating and proliferating from more varied sources than before. At a global level, small and medium sized represent more than 90% of the world’s workforce. They produce more patents and innovations per employee than large firms.\textsuperscript{[3]}

1.2.2 Indian Small and Medium Enterprise Industry Overview

In India, the potential of this sector to garner revenue, while playing a key role in country’s competitiveness in the global markets, is considerable. The second industrial policy of the government laid the foundation of a policy framework for SMEs industry. And, of late, this sector has seen considerable progress as evident from the data put together by the Ministry of Micro, Small and Medium Enterprise in their annual report for 2011-12 (Figure 1.1: Growth Performance).
SMEs contribute 45% of the manufactured output and 40% towards exports. The sector has consistently registered higher growth than the rest of the industrial sector. SME census data estimates that the sector employed about 60 million people in 26 million enterprises in 2006-07. A significant number of SMEs depend on agricultural, horticultural, and other forest and non-forest produce. Adding wealth to the local economy, they generate jobs, thus preventing migration from rural to urban areas in the long-run. However, the major challenge is to provide affordable technologies at the grassroots, and ensure at least primary processing at the village/cluster level. This will add value and reduce the costs of logistics. With the increasing number of educated youth at the village level, another key challenge is to train them to setup their own rural level enterprises and encourage them through policy as well as fiscal instruments. Luring unproductive labour from agriculture to productive enterprises would reduce disguised unemployment in the agricultural sector.\[1\]

Today, SMEs have to deal with a non-level playing field, reluctance of banks/financial institutions when it comes to providing credit, lack of access to technology, inadequate marketing capabilities etc. In spite of these problems, the service sector is growing at a faster pace than the manufacturing sector.
1.2.2.1 Selected Industry Snapshot

Since the study is confined to Pharmaceutical and Plastic industries, an overview about both is discussed as follows:

1.2.2.1.1 The Pharmaceutical Industry

The Indian pharmaceutical industry is one of the fastest-growing industries in the economy. It meets around 95% of the domestic demand for drugs besides offering Contract Research and Manufacturing Services (CRAMS). The industry caters to the developed and developing markets through exports. Demand on this front has been growing rapidly, as the Indian players have been producing cost-effective drugs by using world-class manufacturing facilities. The industry grew at a Compound Annual Growth Rate (CAGR) of around 15% during FY04-FY09, with exports accounting for around 40% of the total turnover. In FY09, the domestic pharmaceutical market was worth Rs. 555 billion. The industry is highly fragmented and consists of many small and medium scale bulk drug manufacturers and formulators. There are 10,563 pharmaceutical manufacturing units in India that can be broadly categorised into formulation drugs and bulk drugs. Around 77% of the total units are engaged in manufacturing formulation drugs and the remaining 23% are engaged in manufacturing bulk drugs. Manufacturing is concentrated in the coastal states of Maharashtra, Gujarat, West Bengal, and Andhra Pradesh due to the availability of raw materials and the facility of shipments in these regions. The coastal regions are also home to most of the pharmaceutical clusters that enjoy the various infrastructure facilities available to them. [1]

1.2.2.1.2 The Plastic Industry

The Indian plastic industry has been growing at the rate of 12-15% per year. The domestic demand for plastic is estimated at about 7 million metric tonnes with a compound annual growth rate (CAGR) of 13%, according to Frost & Sullivan. The
high growth potential is attractive significant investments. It is estimated that fresh investments of about US $ 80 billion will be made in this sector during next two to three years. India has more than 30,000 plastic processing units. The plastics industry is dominated by SMEs and employs more than 36 lakh people directly. While SMEs comprise more than 85% of the industry, small-scale industries (SSIs) constitute more than 75% of the total units. More than 60% of the plastic units which participated in an IndiaMART survey conducted in 2010 testified that their market picked up pace in 2010 compared to 2009. The consumer sentiment, which had suffered a beating due to the global recession, improved for 61.54% units at an average pace, while 17.95% reported a rise beyond expectations. However, 20.51% of the total respondents said that the consumer sentiment was negative. For the current calendar year, however, more than half of SME units hoped to achieve sales growth higher than 20%, while 37.18% expected it to be in the range of 0-20%. Only 11.54% were apprehensive of a decrease in sales during 2012. Similar too many other industries, input costs rose much faster than product prices during 2010. While only 15.38% respondents suggested that the prices of their products improved by more than 20% in 2010, 48.72% said that input costs grew by more than 20%. This indicates that a large number of plastic products manufacturers could not fully pass on the burden of increased input costs to their customers. Liquidity is also a major concern for plastic manufacturers as 74.36% of the units participating in the IndiaMART survey felt lending norms should be eased further. [3]

1.2.3 Origins of MSMED Act

The study has taken deep drive into SMEs, in this scenario knowing definition of SMEs under MSMED Act is vital. In 1954, the MSME (Micro, Small and Medium Enterprises) Development Organisation was set up as an apex body for sustained and organised growth of SMEs in the country. The National Small Industries Corporation, the Khadi and Village Industries Commission (KVIC) and the Coir Board were also set up after a short span of two years. The promotional and developmental policies provided support in the areas of finance, technology, quality
up-gradation, marketing, infrastructural support, entrepreneurial development and fiscal incentives to the SMEs. \[4\]

In June 2006, the Government of India enacted the Micro, Small and Medium Enterprises Development act, 2006. This Act came into force on 2\textsuperscript{nd} October 2006 with the core purpose of strengthening the Indian SMEs and for making them globally competitive. The MSMED Act, 2006 is the first act exclusively for micro, small and medium enterprises in India; and defines enterprises in a much detail. The classification given below in Table 1.1 is done on the basis of investment in plant and machinery/equipment. \[4\]

<table>
<thead>
<tr>
<th>Segment</th>
<th>Manufacturing Enterprises</th>
<th>Service Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>Up to Rs. 2.5 million</td>
<td>Up to Rs. 1 million</td>
</tr>
<tr>
<td>Small</td>
<td>More than Rs. 2.5 million and up to Rs. 50 million</td>
<td>More than Rs. 1 million up to Rs. 20 million</td>
</tr>
<tr>
<td>Medium</td>
<td>More than Rs. 50 million and up to Rs. 100 million</td>
<td>More than Rs. 20 million and up to Rs. 50 million</td>
</tr>
</tbody>
</table>

Source: Ministry of Micro, Small and Medium Enterprises. www.msme.gov.in

The Act has been responsible for bringing about the much needed initiatives in the sector such as, the establishment of a statutory board for MSME called the National Board for Micro, Small and Medium enterprises, which replaced the non statutory Small Scale Industries Board. The classification of companies engaged in production of goods and those engaged in rendering services was simplified by introducing the concept of enterprises as against industries. The Act simplified the registration process.

The two other most crucial initiatives of this Act was the provision for facility of credit and promotion and development of MSMEs.

Brief background of Indian SMEs is discussed; let’s proceed to highlight basic challenges faced by them.
1.2.4 Basic Challenges Faced by Indian SMEs

SMEs manufacture more than 6,000 products that range from traditional to high-tech items. After agriculture, SMEs provide maximum opportunities for the employment. The sector has a rather heterogeneous character as its players operate across a wide spectrum of industries. The contribution of SMEs has been remarkable in the industrial development of the country. This sector holds a lot of potential. However, with increasing globalisation, SMEs have been facing many challenges. Since liberalisation in 1991, the sector has invariably been exposed to competition from across the globe. [1]

These are some of the basic challenges faced by Indian SMEs:

1.2.4.1 Unorganised Nature

The small and highly fragmented structure of SMEs makes them vulnerable to the external business environment. According to the interim results of the fourth All India Census, around 94% of the companies are unorganised sector. It creates below problems:

- Lack of formal channels of credit often creates problems for these firms. Often they are unable to garner enough financial resources to meet their working capital requirements.
- Policies and implementation of various government programmes become ineffective as the benefits from such initiatives do not reach the SMEs.
- The availability of skilled labour poses a challenge for firms in the unorganised sector. At times these firms are unable to afford the higher wages demanded by skilled personnel.
- Adaption of available technology may prove to be difficult for SMEs.

Moreover, about 95% of SMEs are proprietary firms and lack the professional outlook needed to drive growth. The problems of proprietary firms are further
compounded by their inability to bargain with the suppliers to source raw materials and other supplies on competitive terms. This also hampers their ability to procure credit on preferred terms, as the scale and size of operations of these firms is small. Banks and FIs are sceptical in extending finance to them. Even if banks do extend credit, the loan terms are rigid. [1]

1.2.4.2 Inadequate Funds

Despite their dominate numbers and importance in job creation, SMEs have traditionally faced difficulty in obtaining formal credit or equity capital. Adequate availability of cheap, timely and effective credit has always been a challenge for the small companies. The recent financial crisis lead to the slowdown in earnings of companies in general, and SMEs in particular, further reducing their chances of raising credit from financial institutions.

The SMEs use a wide spectrum of technology in operations and differ in the value of products manufactured and their individual size, among other parameters. The companies at the higher end of the spectrum that operate in sectors such as auto components, textiles, pharmaceutical, leather, IT hardware etc requires capital investments to meet their growing needs of quality and to attain their economics of scale.

However, despite high growth potential, these companies face obstacles in raising funds for their expansion and for meeting their working capital needs. Moreover, equity inflows in SMEs have remained low despite a very active primary market in recent years.

Hence, an SME focused exchange is needed. Also, alternative routes of funding such as venture capital and private equity remain elusive for these companies. The share of formal line of credit extended to SMEs has been declining. According to the RBI, the share of credit to small-scale industries as a percent of gross bank credit (GBC)
declined steadily from around 15% in 1998 to less than 7% in 2007. Their average share in GDP over 1998-2007 remained at around 13%. [1]

Commercial banks prefer advancing money to large corporate borrowers as such deals are less risky. Moreover, extending finance to SMEs in far-flung areas and maintaining their accounts involves additional cost for the banks. The RBI report, India’s Financial Sector – An assessment, says the average credit gap for SSIs during 2002-07 was 68.8%. [1]

Due to the nature of their ownership, the SMEs face problems in furnishing collaterals. Thus, they have to pay a higher rate of interest. There is, therefore, an immediate need for providing adequate, timely and affordable credit to SMEs in India on a regular basis.

1.2.4.3 Infrastructure

The quality of basic infrastructure namely roads, power, telecommunication, transport, among others, affect the growth prospects of SMEs. Industries in rural areas (about 52% of total SMEs), find it difficult to integrate efficiently with urban areas. This leads to inefficiencies both in procuring raw materials and in reaching out to target markets. [1]

1.2.4.4 Industrial Sickness

Industrial sickness is high in the SME segment. The alarmingly high sickness levels deter banks and financial institutions from extending credit to these units. They also cause inefficiencies in resource utilisation and production and are detrimental to economic growth.

Blame it on the difficult business environment or on administrative delays or even on the lack of management skills. But, the truth is that 79 small business units are turning financially unviable every day in the country. This translates to three units
falling sick every hour, according to data compiled by the Micro Small and Medium Enterprises - Development Institute (MSME-DI). It has also led to an outstanding bank credit of over Rs 7,000 crore.

The scheduled commercial banks lead to SMEs under directed lending to priority sector but show least interest in increasing advances to this category. The level of non-performing assets (NPAs) is very high in this segment. Hence, banks are reluctant to lend to SMEs.

There is an urgent need to increase the productivity of the units and to provide them assistance. Marketing efforts are required for increasing the demand for the products of SMEs. Also, steps are required for providing support to viable sick units. A suitable and speedy process for winding up unviable sick units is needed, so that more resources are not wasted.

1.2.4.5 Technology and Product Innovation

Technology and product innovation are very critical for the growth of SMEs and for maintaining their competitiveness. Indian SMEs suffer from the problems of sub-optimal scale of operations and technological obsolescence. They face tough competition from global companies due to liberalisation, advanced manufacturing strategies, and an uncertain market scenario.

Due to their small-scale of operations, SMEs cannot invest much in R&D for product innovation and in acquiring modern technologies. Indian SMEs need to come up with new products and processes to enhance profitability and competitiveness.

To make SMEs more competitive, the government has initiated several programmes to upgrade technology and encourage product innovation. However, there is an immediate need to sensitise and disseminate knowledge about new and modern
technologies to these SMEs, and to support them in acquiring, adapting to, and implementing these technologies.

The outline of challenges faced by SMEs clearly indicates that they need solid support to compete and grow. At the same time if one analyse, it open-ups tons of opportunities for individual / entity who can assist SMEs to overcome existing challenges. Both of these aspects are discussed and studied in detail during subsequent chapters.

1.2.5 Key Note for Entrepreneur of Indian Small and Medium Enterprises

The success, of and indeed the survival, of a small and medium business is a David vs. Goliath story. SMEs have it tough. SMEs have limited resources and access to capital. They are unable to leverage economies of scale, tap into efficient sales channels, or invest in Research and Development (R&D). Attractive talent is difficult, and building a brand even more so. With weak pricing power, high costs, and sales inefficiencies, the fact that SMEs survive is amazing; the fact that they often thrive is testament to the power of entrepreneurial ingenuity.

The greatest asset of any business is the mind, the passion and the hunger of an entrepreneur. The ingenuity of an entrepreneur will create new products, open new markets and sometimes even break down industry structures. The transformation of the Indian economy in the last two decades has been fuelled largely by entrepreneurs who started out as small businesses. They were SMEs for a long time before their success led them to outgrow the tab.

The opportunity for SMEs in India is bigger than ever. Technology and Internet have already broken down information barriers. The Internet allows SMEs to collaborate across organisations and helps reduce the disadvantages of scale, while technology helps them to amplify their flexibility. Their market reach has extended from local
customers to domestic and international markets. Technology is helping businesses achieve their lifecycle, from conceptualisation to execution to scaling.

The real story ahead lies in the tire - 11 cities and rural market. The Indian consumer has rising awareness and purchasing power, needs specific solutions and has the scale to create successful businesses overnight. The challenge is market reach. But there is remarkable business models creating products and market networks in urban and rural markets. The sheer size of these markets can potentially create companies larger than Google. Lower price points are leading to the evolvement of innovative processes, creating very capital and cost-efficient products and market networks. These innovations will transform many sectors.

The creation of fund is one of the key factor for sustainability of any business. The growth of any economy is based on facilities prevailing in the financial market. The next point is discussed in this context.

1.3 Overview of Indian Capital Market

Before debating on difference between commercial and investment banking, understanding various services offered by investment banking and their relevance in context to this research, it is almost become pre-requisite to know about the capital market, as it set up base for functioning of the investment banks.

The economy of a country functions on the fundamental mechanism of savings and investment of financial capital into economic activities that help in the creation of economic wealth. Economic wealth in turn creates a conducive atmosphere for consumption that creates economic demand for goods and services thereby stimulating production and further investment. Therefore, this continuous economic cycle leads to growth in the economy which is usually measured by the gross domestic product or the GDP. Economic growth when channelized optimally leads
to economic development which is measured by the standard of living of the people and other parameters such as their availability of developed capital and money markets, the exchange value of the country's domestic currency and the level of infrastructural development to sustain economic activity.

1.3.1 Generation of Capital

With the above backdrop of broad economic considerations in mind, it is necessary to understand the role of economic capital and its movement in the economy. Economic capital is created through savings out of incomes earned by all types of economic activity. If the savings rate in an economy is not commensurate with its investment requirement, it becomes a high consumption economy and would therefore require depending upon external resources for its investment requirements. This kind of external dependence beyond a point could lead to inflation, depreciation in the exchange rate of the domestic currency, burgeoning foreign debt and other long-term economic maladies.

In India, it has traditionally been the household sector that has been a net saver (income exceeding expenditure), which has contributed to capital formation. The business sector (corporate and non-corporate) and the government sector have been negative contributors to savings with their expenditure exceeding their income. The gap in the requirement of savings and investment vis-a-vis the actual domestic savings is met by external resources. External resources are raised both through governmental and commercial borrowings from overseas either as loans or as mobilization of savings from non-residents. However, the more important long-term source of external resources for developing economies has been foreign investment in their domestic business. India had a precarious position as regards its external payments in 1991 due to which the government initiated the process of economic liberalization which has eased the foreign exchange position of India since then. Presently, the country is grappling with a situation of managing its burgeoning foreign exchange reserves, which are in excess of $ 290.37 billion. [9]
The role of household savings in the country's savings and investment pattern is captured in Table 1.2:

Table 1.2: Role of Household Savings in Country's Savings and Investment Pattern (In %)

<table>
<thead>
<tr>
<th>Household Saving Types</th>
<th>2005-06</th>
<th>2006-07</th>
<th>2007-08</th>
<th>2008-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Savings</td>
<td>33.08</td>
<td>34.43</td>
<td>36.41</td>
<td>32.50</td>
</tr>
<tr>
<td>Household Savings</td>
<td>23.17</td>
<td>22.88</td>
<td>22.64</td>
<td>22.63</td>
</tr>
<tr>
<td>In Financial Assets</td>
<td>11.36</td>
<td>10.95</td>
<td>11.17</td>
<td>10.43</td>
</tr>
<tr>
<td>In Physical Assets</td>
<td>11.80</td>
<td>11.93</td>
<td>11.47</td>
<td>12.20</td>
</tr>
<tr>
<td>Private Corporate Saving</td>
<td>7.49</td>
<td>7.99</td>
<td>8.72</td>
<td>8.44</td>
</tr>
<tr>
<td>Gross Domestic Investment</td>
<td>34.30</td>
<td>35.50</td>
<td>37.70</td>
<td>34.90</td>
</tr>
</tbody>
</table>


1.3.2 Institutional Intermediation in Capital Flows

Having appreciated the need to move capital from savings pool in the economy to the investment pool, it would be necessary to understand how such movement actually takes place. The need for institutional intermediation in movement of capital cannot be over-emphasized. Savings by themselves do not create economic wealth unless they are channelized into productive uses that create it. Therefore, two things are paramount for sustained economic activity - (a) adequate domestic savings in the economy and more importantly (b) the movement of such capital saved to productive investments in the economy. The second aspect is extremely critical since real growth in an economy is achieved only if real investments are made leading to increased supply of goods and services. Institutional intervention in the economy not only channelizes savings into investments, but helps in moving investments from financial assets into real assets as well. If capital moves only within the orbit of one mode of saving to another, i.e. within the domain of financial assets without reaching the real investment channels the economy would register financial growth but the real economy would suffer. This situation over a sustained period could once again lead to inflation and other economic maladies.

Further, perhaps the biggest contribution of institutional intervention in the economy is in the allocation of available capital. This function is also of vital
importance since the available capital may not be sufficient to meet all the envisaged investment requirements. By rationing capital to the most efficient productive uses, these intermediaries help in optimizing scarce and valuable economic capital. However, the extent to which institutional intervention can mobilize and allocate capital would depend upon the depth of the financial markets in the economy and the presence of a congenial legal and regulatory backbone to support such sophistication.

The movement of capital in the economy from the savings pool to the investment pool is performed by two main platforms of institutional intervention – (a) the financial institution and banking framework and (b) the capital market framework. Banks mobilize funds by raising deposits from domestic investors and other sources of savings and help in re-deployment of these resources productively in the economy by advancing loans and other financial assistance to borrowers. Therefore, it can be said that banks perform the role of intermediation primarily through mobilization and deployment of debt capital in the economy. However, banks confine themselves largely to the sourcing and deployment of short and medium term debt capital. Financial institutions perform the bigger role of mobilizing and deploying long term capital through long term resource mobilization and term lending. Financial institutions can be further differentiated into term lending institutions, insurance institutions and investment institutions.

The capital market comes into their picture to perform the other role-i.e. the primary role of a facilitator and an intermediary in raising and deployment of equity capital in the economy. Capital market brings the issuers of equity and the investors in equity together and helps the issuers of equity to raise capital for productive deployment in creating economic wealth. At the same time, the capital market offers investment avenues to investors with appetite for higher risks and returns as compared to the safe investment options with banks. From an issuer’s perspective, the capital market provides an alternative source of raising business capital and balancing the debt-equity mix in its capital structure.
The respective places of each institution in the capital flows of an economy are depicted in Figure 1.2

*Figure 1.2: Capital Flows in an Economy*


1.3.3 Financial Markets

Having discussed the role of capital flows in an economy and the need for institutional intervention, it would be necessary to appreciate the structure of the financial markets. Both the banking institutions and the capital market are sub-segments of the financial markets in which there are other segments that perform vital functions as well. Together, the segments in the financial markets, apart from
capital flow intermediation, keep the economy vibrant and resourceful. The overview of the various segments in the financial market is depicted in Figure 1.3.

Figure 1.3: Overview of Financial Markets (The Financial Economy)

1.3.3.1 Capital Market

Capital markets deal with raising finance through issue of publicly traded financial instruments in equity and debt which can be bought and sold at any time through dedicated market places called stock exchanges. Notwithstanding the clear roles played by banks and the capital market in the economy, the capital market also offers wide scope for raising long-term debt capital through issue of debt securities as distinguished from loans provided by banks and financial institutions. This kind of debt capital being in the nature of tradable securities is more flexible both from an investor and an issuer's perspective. There, the capital market becomes an agency of bank disintermediation in that it not only brings investors and issuers to gather on an alternative platform; it also helps in the movement of debt capital, a function that is primarily the domain of banks and financial institutions. However, banks and financial institutions on one hand and the capital market on the other continue to co-exist and perform their respective functions as it is not possible for each of them to completely substitute the other in taking care of the needs of the economy. However, considering the fact that the capital market has a wider role to play beyond merely being a catalyst for capital creation, a developed and vibrant capital market is the backbone of a healthy economy. It can thus be inferred that the capital market is the most important instrument for wealth creation in an economy. However, capital markets have had their times of turbulence as well. Historically speaking, capital markets have seen great crashes as in 1927, 1987, 1991 and 2001 wiping out each time, billions of dollars of wealth of investors.\(^5\)

1.3.3.2 Money Market

An offshoot of the capital market is the money market, which is the marketplace for short-term debt capital. However, the money market is significantly different from the capital market. In this market, the government, banks and other issuers raise short-term capital either through issue of short-term securities or through short-term borrowings. Typically, short-term instruments in the Indian context have a life not exceeding twelve months. The money market is also supported by several
investment institutions that mobilize funds from investors to be deployed in this market. However, the money market is confined only to the short-term debt products such as treasury bills of the government, inter-bank short-term issuance such as overnight call money, repurchase options or 'repos' issued by the RBI and corporate instruments such as commercial paper.

The money market is characterized purely by institutional players such as banks, financial institutions, investment institutions, insurance companies, mutual funds and the Discount and Finance House of India (DFHI). It is also supported by the network of primary dealers, a category of intermediaries set up by the RBI in 1995. The DFHI is a specialized institution set up by the RBI in 1988 with the support of financial institutions and banks to provide depth in the primary and secondary segments of the money market. Unlike the capital market, the money market does not have an organized trading market place such as the stock exchange for its primary issues and secondary market trades. The primary issues are subscribed by the market players through private placement and as far as the government treasury bills are concerned, these are auctioned by the RBI periodically. The secondary market functions mostly through the telephonic deals backed by suitable documentation. It is therefore an impersonal but un-organized market. The RBI is the regulatory authority for the money market. The RBI set up several committees such as the Sukhamoy Chakarborty Committee in 1985 and the Vaghul Committee in 1987 to revamp the money market. As a fall out of their recommendations, the money market has been spared of controls on interest rates and several instruments such as 182 day treasury bills (1986), certificates of deposit, commercial paper and inter-bank participation certificates (1989), and 364 day treasury bills were introduced. In 1992, the RBI permitted mutual funds into this market by allowing them to float dedicated money market funds. [5]
1.3.3.3 Foreign Exchange Market

Foreign exchange markets comprise of banks and foreign exchange dealers who buy and sell for profit, foreign exchange and their derivates in various currencies including the home currency. Foreign exchange markets are also closely linked to economic variables and can be much more volatile than capital markets. An adverse movement in the economy can affect the foreign exchange markets and vice versa. The South-East Asian crash in 1997 in the currencies of countries such as Thailand, Malaysia, Indonesia, Hong Kong, Taiwan and Korea bled their economies to near bankruptcy. [5]

1.3.3.4 Loan Market

Loan markets refer to the activities of banks and financial institutions that make available loans to business houses for various types of business activities which can be industrial, trading, manufacturing, infrastructure, service or financial. Loans can be long term or short-term depending upon business needs and these can be used for acquiring business assets such as buildings and equipment or in meeting day-to-day operational expenses or to meet the cost of stocks of raw material and finished products. Banks and financial institutions raise their resources from the public by way of deposits and other instruments. They perform the important function of channelizing resources from investors into productive uses for business.

1.3.3.5 Insurance Market

Insurance performs a very vital function in the financial markets in raising long term resources that can be deployed for long term uses in the economy. From a different viewpoint, insurance also provides the much needed risk coverage in the life and non-life segments. This risk coverage makes available funds for exigencies involving individuals, properties and business thereby ensuring their protection.
1.3.3.6 Retirement Savings Market

Retirement savings are long term funds pooled from investors by provident funds, pension funds and superannuation funds. They perform the important function of providing resources to maintain the ageing population in the economy. These funds are accumulated over long periods of time and are therefore meant for being used to create financial security for investors upon their retirement. These funds being long term in nature are ideal to be invested in long term economic wealth creation in the economy. In the developed countries, pension funds played a big role in the creation of infrastructure such as roads, ports, power and urban infrastructure. In India, this sector has been traditionally under government control through compulsory savings schemes. Though the government has been reluctant to liberalize this sector, move are onto let pension reforms set in into the county.

1.3.3.7 Savings and Investment Market

This consists of several retail financial savings products available to the household sector to deploy in financial assets. Several types of investment institutions proliferate this market such as the government sector consisting of government savings schemes, the institutional segment consisting of mutual funds and banks, the corporate sector consisting of financial and investment companies and the unorganized sector consisting of chit funds, nidhis and mutual benefit societies.

The data pertaining to household savings in the financial economy for the past four years is shown in Table 1.3.
Table 1.3: Financial Savings of the Household Sector

<table>
<thead>
<tr>
<th>Item</th>
<th>Rs. In Crore</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008-09</td>
</tr>
<tr>
<td>Financial Saving (Gross)</td>
<td>100.0</td>
</tr>
<tr>
<td>a) Currency</td>
<td>12.7</td>
</tr>
<tr>
<td>b) Deposits</td>
<td>60.7</td>
</tr>
<tr>
<td>i) With Commercial Banks</td>
<td>52.8</td>
</tr>
<tr>
<td>ii) With Non-banking Companies</td>
<td>2.0</td>
</tr>
<tr>
<td>iii) With Cooperative Banks and Societies</td>
<td>4.7</td>
</tr>
<tr>
<td>iv) Trade Debt (Net)</td>
<td>1.2</td>
</tr>
<tr>
<td>c) Share and Debentures</td>
<td>-0.7</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
</tr>
<tr>
<td>i) Private Corporate Business</td>
<td>1.0</td>
</tr>
<tr>
<td>ii) Banking</td>
<td>0.0</td>
</tr>
<tr>
<td>iii) Bonds of public Sector undertakings</td>
<td>0.1</td>
</tr>
<tr>
<td>iv) Mutual Funds (including UTI)</td>
<td>-1.4</td>
</tr>
<tr>
<td>d) Claims on Government</td>
<td>-3.8</td>
</tr>
<tr>
<td>i) Investment in Government securities</td>
<td>0.0</td>
</tr>
<tr>
<td>ii) Investment in Small Savings, etc.</td>
<td>-3.8</td>
</tr>
<tr>
<td>e) Life Insurance Funds</td>
<td>21.0</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
</tr>
<tr>
<td>i) Life Funds of LIC and private insurance companies</td>
<td>20.3</td>
</tr>
<tr>
<td>f) Provident and Pension Funds</td>
<td>10.1</td>
</tr>
</tbody>
</table>


1.3.3.8 Market Intermediaries

In all the segments of the financial markets as detailed above, there exist several intermediaries whose main function is to act as facilitators to the functioning of the financial markets. In the capital markets, there are intermediaries such as broking houses, investment firms, mutual funds, underwriters, investment banks and merchant banks. In the foreign exchange markets, there are intermediaries such as foreign currency brokers, dealers, arbitrage operators and speculators and money changers. In the loan markets, there are debt syndicators and financial advisors. Insurance markets have intermediaries such as insurance advisors, financial consultants and distribution companies.

To conclude the above discussion, it is clear that there are two parallel segments in the economy, i.e. the real economy consisting of demand and supply of goods and
services and the financial economy consisting of demand for financial assets and supply thereof. Institutional intervention performs the dual function of (a) mobilizing savings to be converted into financial assets in the financial economy and (b) allowing capital flows from the financial economy into the real economy so as to provide economic growth. The capital market is the more important means of institutional intervention that has grown phenomenally over the centuries and has helped the cause of economic growth and development of several countries. At the same time, with the evolution of sophistication and depth in the financial economy and the development of regulatory framework to protect investors, capital markets across the world have become mature marketplaces wherein several sophisticated instruments including risk-hedged derivatives are traded day after day with the volumes of trades amounting to billions of dollars. Speculations on movement of stock prices are stock indices have come to stay as the main fuel that drives the capital market and keeps it buoyant. The capital market has also grown in stature to become one of the important barometers in assessment of the economic development of a country.

1.3.4 Evolution of the Indian Capital Market

The Indian capital market is one of the oldest markets in Asia having found its initiation nearly 200 year ago. While the early days were characterized mostly by dealings of the East India Company, the first deals in shares and securities were witnessed in Bombay in the 1830s. Stock broking was initiated at this time and by the 1860s the number of stock brokers was around 60. By 1874, native brokers started assembling in the famous Dalal Street in South Bombay to conduct transactions in shares and securities. The Bombay Stock Exchange, now known as the BSE was established in 1875 as “The Native Share and Stock Brokers Association'. It is older than Tokyo Stock Exchange, which was established in 1878. It was constituted as a voluntary non-profit association of brokers primarily to protest their interests in security trading business. The BSE is currently engaged in the process of converting itself into a demutualised corporate entity. It was the first stock exchange in India to
have been granted permanent recognition in 1956 by the Government of India under the Securities Contracts (Regulation) Act, 1956. The SCRA was the culmination of a process initiated by the government to regulate the several stock exchanges that had proliferated during the Second World War. After independence, regulation of securities business and stock exchanges became a central subject under the Constitution. The SCRA was passed in 1956 to substitute all state level legislations on the subject. [5]

1.3.4.1 Capital Market Constituents

The discussion on the Indian capital market is best understood if the basic constituents are listed first. The basic constituents of a capital market are the five 'I's which are the followings:

*Figure 1.4: Constituents of the Capital Market*

![Diagram of Capital Market Constituents]


1. **Issuers** of securities are basically companies incorporated under the Companies Act, 1956. These companies can again be privately owned or owned by the government (either central or state). Apart from companies, other entities that can issue securities in the capital market are bodies' incorporated under special Acts of the Parliament or the State Legislature. The Government can also raise finance from the capital market using the
long-term debt route. This is the reason why a major portion of the debt being issued and traded in the debt market consists of dated government securities.

2. **Investors** in securities can be either wholesale investors or retail investors. The wholesale segment primarily comprises of institutional investors such as mutual funds, investment institutions and others. The retail segment consists of households and other small investors.

3. **Intermediaries** and service providers help in the mobilization of resources from the investors and provide other support services. Capital market intermediaries consist of brokers, merchant bankers and market makers. Support service providers include underwriters, custodians, depository participants, registers and share transfer agents.

4. **Instruments** are floated in the capital market for the purpose of raising capital both in debt and equity. These include equity instruments such as equity shares, preference shares, convertibles such as fully or partly convertible debentures, warrants and pure debt instruments such as non-convertible debentures and bonds. Debt instruments carry interest, which is usually fixed beforehand so that the investor knows the return that can be made in the investment. Equity instruments (called shares) are more like ownership in the underlying business of the company that issues such shares. Therefore shares do not carry any assured return and can either provide high returns in the form of share in profits of the business (known as dividends) or can wipe out the entire investment itself if the underlying business makes a loss. Thus equity instruments are perceived as risky and require thorough knowledge of the relevant businesses before one chooses to invest in them.

5. **Infrastructure** is required for the efficient functioning of the capital market, which consists of the stock exchanges, the depositories, the regulators and the necessary statutory framework. Moving further, since the capital market cannot function without the development of adequate infrastructure, the stock exchanges play a pivotal role in providing trading and settlement platforms backed by technology backbones that create efficiency in transactions. The stock exchanges also provide stock indices, which are the
barometers for judging which way the market will move and in taking up positions in stocks accordingly.

In order to maintain the orderly functioning, growth and efficiency of the capital market, most economies have capital market regulators and a framework of law to instil confidence and legal protection among the players in the market. The distinction between the capital markets of the medieval era and that of the modern era is the presence of sophisticated default protection mechanisms and legal framework to prevent moral hazards and promote corporate governance.

1.3.4.2 Capital Markets Segments

The capital market is a resource for raising equity and long term debt capital while the money market deals with raising of short-term debt capital. Together, they constitute the securities market. Figure 1.5 depicts the securities market in general and the capital market in particular.
1.3.4.2.1 Primary and Secondary Markets

The main segments of the capital market in terms of the type of capital raised are (a) the equity market and (b) the long-term debt securities market. However, since the capital market broadly deals with raising of capital on one hand and providing liquidity and trading between investors on the other, a more important way of classifying it would be as primary market and secondary market segments. While the primary market consists of resource mobilization by issuers from investors by the issue of new equity and debt securities, the secondary market consists of providing trading mechanisms and institutional support to create liquidity in stocks.
and securities. The instruments that have been issued in the primary market are sold and purchased constantly in the secondary market providing the investors with a ready market, transparent pricing mechanism and liquidity for the securities. As can be appreciated, the primary and secondary markets complement each other in their functionality and one cannot exist without the other. While the primary market creates marketable securities, the secondary market provides the infrastructure for putting such marketability to work. Therefore this classification of the capital market into primary and secondary markets is very fundamental understanding its structure. Since investment banking is associated with the primary market issuances, the discussion on primary market has been provided in the 5th chapter of this thesis.

1.3.4.2.2 Derivatives Markets

A third sub-segment of the secondary markets which has been of recent origin is the derivative segment that deals exclusively with over the counter products such as futures and options. These are specialized instruments meant for trading exclusively on a futuristic basis and help in speculation on the price movements of the underlying equity share. They are known as derivatives since they are not shares by themselves but are instruments that are derived from shares. With the advent of the derivatives market in India, the equity trading in their normal segment has been strictly converted into cash trading based on delivery. All speculative and forward trading has been shifted to the derivative segment.

The main categories of derivatives traded are futures and options. Due to this reason, the derivative market is also known as the F&O segment. Futures contracts are basically standardized exchange traded forward contracts for buying or selling a particular underlying asset (usually a share or other financial interest, commodity or currency) at an agreed price on a particular date. In Indian stock market, the system of future was not prevalent but forward contracts in shares were being practiced under the name of ‘badla’. Under this system dealer in stocks could carry forward their positions from one settlement date to the next settlement date by paying a badla
charge, which was basically meant to represent interest cost to the person carrying forward. This system drew rampant support from specialized badla system contributed to the growth of the stock markets; it was also responsible for several unhealthy practices such as excessive speculation and unfair market practices that proved to the detriment of the common investors. Therefore, in order to bring about healthy practices into the market, the badla system was abolished in the late nineties.

Options however, have a different history in India. Simply put, an option is a right to buy or sell an underlying asset on or before a specified date at an agreed price. Therefore the option owner has the choice to buy or sell depending on the type of option purchased without being obliged to do so. Option contracts in securities were prohibited in India under section 20 of the SCRA and therefore, such contracts in securities could not be entered into. However, by an amendment to the SCRA in 1995, this section was omitted and the concept of derivatives was allowed in the stock market. Under the new section 18A of the SCRA, derivatives are permitted in Indian stock market if these are exchange-traded derivatives. This was born of the F&O segment, which is currently being offered on the NSE and the BSE. With the advent of the derivative segment on the stock exchanges, the markets have now been clearly made into water tight compartments. The equity segment in the market deals with shares strictly on cash basis for delivery at the end of each settlement and no carry forwards are allowed. The F&O segment deals only with derivative contracts in shares and stock indices and thereby allows only speculative trades in derivatives. The debt segment deals with all kinds of debt securities issued by the government and corporate issuers.

These details has provided good understanding about the capital market and created a platform to study the Investment Banking.
1.4 About Investment Banks

At a very macro level, 'Investment Banking' as the term suggests, is concerned with the primary function of assisting the capital market in its function of capital intermediation, i.e. the movement of financial resources from those who have them (the Investors), to those who need to make use of them for generating GDP (the Issuers). As already discussed in overview of capital market section, banking and financial institutions on the one hand and the capital market on the other are the two broad platforms of institutional intermediation for capital flows in the economy. Therefore, it could be inferred that investment banks are those institutions that are the counterparts of banks in the capital market in the function of intermediation in resource allocation. Nevertheless, it would be unfair to concluded so, as that would confine investment banking to a very narrow sphere of its activities in their modern world of high finance. Over the decades, backed by evolution and also fuelled by recent technological developments, investment banking has transformed repeatedly to suit the needs to the finance community and thus become one of the most vibrant and exciting segment of financial services. Investment bankers have always enjoyed celebrity status, but at times, they have paid the price for excessive flamboyance as well.

To continue from the above, in the words of John F. Marshall and M.E. Ellis, 'investment banking is what investment banks do'. This definition can be explained in the context of how investment banks have evolved in their functionality and how history and regulatory intervention have shaped to such an evolutions. Much of investment banking in its present form thus owes its origins to the financial markets in USA, due to which, American investment banks have been leaders in the American and Euro markets as well. Therefore, the term 'investment banking' can arguably be said to be of American origin. Their counterparts in UK were termed as 'merchant banks' since they had confined themselves to capital market intermediation until the US investment banks entered the UK and European markets and extended the scope of such businesses. [5]
1.4.1 Global Industry Structure

The investment banking industry on a global scale is oligopolistic in nature ranging from the global leaders (known as the 'Global Bulge Group') to 'Pure' investment banks and 'Boutique' investment banks. The bulge group consisting of eight investment banks has a global presence and these firms dominate the league tables in key business segments.

Below Investment Banks have won "Global Awards" for the Best Investment Banks of 2012:

1.4.1.1 Goldman Sachs – Best Investment Bank [6]

In a year when success in investment banking was defined by survival, Goldman Sachs gained market share by devising extraordinarily creative solutions for its clients in raising capital across asset classes and industries, according to Fred Cannon, director of research and head of equity strategy at KBW in New York. Many of its larger rivals, particularly Morgan Stanley, actually lost market share to Goldman last year.

In public equity markets, Goldman raised $54.36 billion for its clients, climbing up a notch from second place last year, according to Dealogic, a capital markets research firm. Goldman also scored the biggest market share—8.6%, up from 7.6% in 2010. Goldman executed more equity deals that raised more than $1 billion each than any other bank in the world. Among its landmark deals last year were for those for AIG, Kinder Morgan, MetLife, Commerzbank, Continental, Samsonite, Prada and other clients. The bank served as the sole bookrunner in more equity deals than any other bank, raising a total of $14 billion for clients, the bank reported. In M&A, Goldman also hit the jackpot, landing in first place by all three measures—fees ($1.73 billion), number of deals (381), and deal value ($685 million) — according to Dealogic. [6]
1.4.1.2 J.P. Morgan – Best Equity Bank [6]

J.P. Morgan may not have devised the most creative of solutions to dodge bullets and steer around potholes in last year’s turbulent global equity markets, but it certainly did make judicious use of one of the strongest balance sheets on Wall Street to keep IPOs and follow-on equity deals on track for its clients, according to KBW’s Cannon.

As a result, the New York investment bank closed more public equity deals than any other bank in the world last year—a total of 271 IPOs and follow-ons, according to Dealogic. Among the largest was a $1.91 billion follow-on equity issue by Mosaic on September 23. To get complicated deals done in emerging markets during the darkest hours of the second half of last year, when few other banks were willing to take substantial risks, J.P. Morgan decided to partner with well-connected local banks as joint bookrunner. [6]

1.4.1.3 Bank of America Merrill Lynch – Best Debt Bank [6]

The synergies created by the merger of Bank of America and Merrill Lynch in late 2008 became apparent last year when the combined Wall Street behemoth underwrote more investment-grade corporate bonds in North America than any of the competitors. It was the lead bookrunner of six of the 10 largest dollar-denominated investment-grade bond issues—by Sanofi-Aventis, Verizon, GECC, Wal-Mart, Intel and Amgen. Of these, the most ambitious was the $6 billion issue by Amgen, which closed on November 7. [6]

The bank did not shy away from the challenge of underwriting high-yield bonds, either. It played the important role of “lead left” bookrunner in at least one of every five of high-yield offerings in the US last year, including Chrysler Group’s $3.2 billion May bond issue. [6]
It was lead bookrunner on the unique Ford Upgrade Exchange Linked Notes. Backed by auto loans, the $1.5 billion in high-yield debt is required to be exchanged for newly-issued senior unsecured notes if Ford receives an investment-grade rating from any two of three specified rating agencies—S&P, Moody’s and Fitch. [6]

1.4.1.4 Goldman Sachs – Best M&A Bank [6]

No other investment bank in the world came close to beating Goldman Sachs in mergers and acquisitions last year. The bank advised clients on no less than 381 deals that actually closed during calendar year 2011, more than any other bank. By deal value, Goldman’s share of the global and M&A market more than tripled last year from the year before, growing from 7.6% to an astounding 24.3%, according to Dealogic. [6]

Goldman positioned itself at the top of the high-tech deal world last October—even as global markets had crumbled a couple of months earlier—when it joined hands with the deep-pocketed J.P. Morgan in advising Skype on its $8.5 billion sale to Microsoft. The bank also proved itself agile in many of the largest hostile and unsolicited M&A deals last year. In Australia, it advised Foster’s on an unsolicited bid from, and subsequent sale to, SABMiller for $11 billion in a controversial deal that was approved by the Australian government when global equity markets were near their nadir last November. [6]

"The firm's longstanding M&A leadership position demonstrates that clients have consistently hired us based on the quality of advice and execution expertise, particularly on some of the most complex transactions around the world," says Gene Sykes, co-head of global M&A at Goldman Sachs.
1.4.1.5 Evercore Partners – Best Up and Comer [6]

Evercore showed the strongest performance of any midsize investment bank last year, expanding its European interests and its oil and gas business and forming a strategic partnership with Kotak Mahindra Capital of India, for cross-border M&A advisory services. Evercore was particularly successful in M&A, which is its core business, last year. It ranked in 16th place globally, advising clients on 73 deals worth $110.5 billion, according to Dealogic. [6]

Tim LaLonde, global COO for investment banking at Evercore, the bank’s most successfully completed M&A transaction last year was Sanofi-Aventis’s $20.1 billion purchase of Genzyme. Evercore advised Sanofi-Aventis on the transaction, “and [it] looks to be a very successful outcome for our client,” he says. In equity capital markets, Evercore made history in Mexico last year by structuring the IPO of the country’s first-ever REIT for Fibra Uno. [6]

1.4.1.6 Stifel Nicolaus Weisel – Most Creative [6]

Stifel Nicolaus Weisel has grown deftly through the acquisitions of several small investment banks in the past couple of years, each of which was known for underwriting and advising in different industries. Based in St. Louis, Missouri, Stifel has rapidly built itself into an agile player in a range of industries from finance to technology, says Joel Jeffrey, an analyst at KBW in New York who covers midsize banks.

The landmark deal in Stifel’s growth-through-acquisition strategy was its $318 million acquisition of Thomas Weisel Partners Group, an investment bank in San Francisco that specialized in high-tech M&A in Silicon Valley. Not by coincidence, last year marked Stifel’s 16th year of record net revenues. [6]
Braving political turmoil and civil wars in North Africa and the Middle East, Stifel served as the sole adviser to California electronics manufacturer Newport in its $230 million acquisition of Ophir Optronics, a laser manufacturer in Israel, on July 7. [6]

Moving from the above awards, the ten largest global investment banks as of December 31, 2010 (by total fees) and the five leading universal banks in the world and their important group affiliates are listed in below respectively in Table 1.4 and Table 1.5. [6]

**Table 1.4: Ten Largest Global Investment Banks as of Dec. 31, 2010 (by total fees)**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Fees ($m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>J.P. Morgan</td>
<td>5,533.85</td>
</tr>
<tr>
<td>2</td>
<td>Bank of America Merrill Lynch</td>
<td>4,581.59</td>
</tr>
<tr>
<td>3</td>
<td>Goldman Sachs</td>
<td>4,386.52</td>
</tr>
<tr>
<td>4</td>
<td>Morgan Stanley</td>
<td>4,055.48</td>
</tr>
<tr>
<td>5</td>
<td>Credit Suisse</td>
<td>3,379.12</td>
</tr>
<tr>
<td>6</td>
<td>Deutsche Bank</td>
<td>3,286.80</td>
</tr>
<tr>
<td>7</td>
<td>Citi</td>
<td>3,238.67</td>
</tr>
<tr>
<td>8</td>
<td>Barclays Capital</td>
<td>2,864.44</td>
</tr>
<tr>
<td>9</td>
<td>UBS</td>
<td>2,614.44</td>
</tr>
<tr>
<td>10</td>
<td>BNP Paribas</td>
<td>1,433.89</td>
</tr>
</tbody>
</table>


**Table 1.5: Universal Banks and their Investment Banking Affiliates**

<table>
<thead>
<tr>
<th>Citigroup (US)</th>
<th>CSFB (Swiss)</th>
<th>Deutsche (German)</th>
<th>J.P. Morgan (US)</th>
<th>UBSWarburg (Swiss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citibank</td>
<td>CSFB</td>
<td>Deutsche Bank</td>
<td>J.P. Morgan Chase</td>
<td>UBS Warburg</td>
</tr>
<tr>
<td>Salomon Smith Barney</td>
<td>Donaldson, Lufkin &amp; Jenrette</td>
<td>Morgan Grenfell Chemical Bank (merged)</td>
<td>Dillon Read</td>
<td></td>
</tr>
<tr>
<td>Schroders</td>
<td>Pershing</td>
<td>Alex Brown</td>
<td>Beacon Group</td>
<td>Paine Webber</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bankers Trust</td>
<td>Robert Fleming</td>
<td>Phillips &amp; Drew</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Hambrecht &amp; Quist</td>
<td>Swiss Bank (merged)</td>
</tr>
</tbody>
</table>

Therefore, the global investment banking industry ranges from the acknowledged global leaders listed above to a larger number of mid-sized competitors at a national or regional level and the rear end is supported by boutique firms or advisory and sectoral specialists.

1.4.2 Business Portfolio of Investment Banks

Globally, investment banks handle significant fund-based business of their own in the capital market along with their non-fund service portfolio which is offered to clients. However, these distinct segments are handled either on the same balance sheet or through subsidiaries and affiliates depending upon the regulatory requirements in the operating environment of each country. All these activities are segmented across three broad platforms—equity market activity, debt market activity and merger and acquisitions (M&A) activity. In addition, given the structure of the market, there is also a segmentation based on whether a particular investment bank belongs to a banking parent or is a stand-alone pure investment banks. Figure 1.6, represents the broad spectrum of global investment activity.

From this diagram, it may be appreciated that investment banking encompasses a wide area of capital market based businesses and services and has significant financial exposure to the capital market. Though investment banks also earn a significant component of their income from non-fund based activity, it is their capacity to support clients with fund-based services, which distinguishes them from pure merchant banks. In the US capital market, investment banks underwrite issues or buy them outright and sell them later to retail investors thereby taking upon themselves significant financial exposure to client companies. Besides, being such large financial power houses themselves, the global investment banks play a major role as institutional investors in trading and having large holdings of capital market securities. As dealers, they take positions and make a market for many securities both in the equity and derivative segments. They hold large inventories and therefore influence the direction of the market. Goldman Sachs, Salomon Brothers,
Merrill Lynch, Schroeders, Rothschild and others are significant Market Investors both on their own account and on behalf of the billions of dollars of funds under their management.

The global mergers & acquisitions business is very large and measures up to trillions of dollars annually. Investment banks play a lead advisory role in this booming segment of financial advisory business. Besides, they come in as investors in management buy-outs and management buy-in transactions. On other occasions, wherein investment banks manage private equity funds, they also represent their investors in such buy-out deals.
Figure 1.6: Investment Banking Spectrum

INVESTMENT BANKING

CORE BUSINESS PORTFOLIO

Non -fund based

Equity portfolio - Market Banking (Issue Management), Private placement

Debt portfolio - Issue Management, Private placement, structured finance Issuances such as securitisation

M & A – M & A advisory, Corporate advisory, project advisory

Fund based

Equity portfolio - Underwriting, Market making

Debt portfolio - Underwriting, Market making

M & A portfolio - Investing in private equity, LBOs and MBOs

SUPPORT ACTIVITY PORTFOLIO

Non -fund based

Equity portfolio - Equity broking, Distribution, asset management Custodial services, wealth management (private banking), research and analysis

Debt portfolio - Issue Management, Private placement, structured finance Issuances such as securitisation

Derivative portfolio - Derivative broking, risk management, custodial services.

Fund based

Equity portfolio - Proprietary trading and portfolio investing, managing private equity funds and asset management funds

Debt portfolio - Trading, underwriting, market making and investing on own account in debt products and securitised instruments

Derivative portfolio - Proprietary trading, managing hedge funds

In the case of universal banks such as the Citigroup or UBS Warburg, loan products form a significant part of the debt market business portfolio. Pure investment banks such as Goldman Sachs, Merrill Lynch and Morgan Stanley Dean Witter do not have commercial banking in their portfolio and therefore, do not offer loan products. Besides the larger firms, there are a host of other domestic players present in each country and mid-sized investment banks, which either specialize in local markets or in certain product segments.

Some investment banks in the overseas market also specialize in niche segments such as management of hedge funds, bullion trade, commodity hedges, real estate and other exotic markets.

1.4.3 Scale and Smallness: Investment Banking in the 21st Century

Although investment and commercial banking were separated by the 1933 Glass-Steagall Act, commercial banks started in the 1980s to encroach upon some investment banking activities. The establishment in the late 1980s of so-called Section 20 subsidiaries allowed several major commercial banks to underwrite corporate debt issues provided this activity accounted for no more than 20% of the banks' gross revenue. [3]

Commercial banks had clear advantages in the debt markets: the securities were similar to corporate loans, which they had already started to trade actively in a burgeoning secondary market; and the commercial banks had the capital and the computer systems necessary to make an impact. Commercial banks also brought their capital to bear in the new derivatives markets by taking controlling stakes in the small trading partnerships that had previously dominated these markets: O’Connor & Associates was acquired by Swiss Bank, CRT by Nations Bank, and Cooper Neff by BNP.
So the commercial banks had a significant toehold in the investment banking market before the 1999 repeal of the Glass-Steagall Act. By 1999 the financial engineering techniques that grew out of early applications of the Black-Scholes model to derivatives trading had achieved a high degree of sophistication. Today's traders rely upon computers to analyze and report the risks of derivatives, as well as to place a value upon them. And it is possible in today's financial markets to parcel up and sell virtually any risk. Commercial banks may have lacked some of the tacit skills of the older investment banking houses, but in place of such skills they were able to substitute financial capital and an investment in financial engineers. [5]

The entry of commercial banks into the investment banking industry in the wake of the Gramm-Leach-Bliley Act provided concrete evidence of the codification of practice. A further development was to provide additional impetus to this codification. The series of serious corporate frauds that was uncovered at the turn of the century in Enron, Global Crossing, WorldCom, and others resulted in popular outrage, and ultimately in legislation intended to curb the perceived excesses of the corporate world. The Sarbanes-Oxley Act imposes rules for company audits, restricts company policies, and requires companies to set up formal and verifiable systems for tracking and checking internal controls. This legislation has therefore worked to undermine the informal and tacit contracting in which investment banks had historically specialized.

In short, the technological shift that started in the 1960s to codify some investment banking activities continued to gather pace through the 1990s and beyond. A combination of formal economic analysis and computerization has reduced the importance of tacit skill in many activities that were once the sole preserve of the skilled human capitalist. Players in the affected businesses are no longer protected by reputational barriers to entry, and they have been forced to expand the scale, and often the scope, of their businesses to compete. Houses like Morgan Stanley, which just 20 years ago were small privately owned firms that catered to America's elite
fund-raisers, are today publicly quoted, full-service financial firms offering a wide range of services from retail brokerage to specialized corporate advice. [6]

Is a full-service financial services firm really an investment bank in the sense that J. P. Morgan & Co. was a century ago? At one level this is a trivial question: investment banking is whatever the investment banks do. But it is reasonable to wonder what the costs of expansion have been for the biggest firms. Traditional investment banking is relationship and reputation intensive, and the tacit skill that it requires is best incubated in a small firm where informal peer-group monitoring is possible, and where there is relatively little staff turnover. Large full-service businesses have much obvious strength, but they are forced by both their scale and the exigencies of regulation to use formal and codified reporting lines. It is very difficult in public companies to tie the skilled agent’s fortunes to those of the firm in the way that older partnerships did. In short, it is harder for the largest firms to create an environment within which the traditional human capitalist can prosper.

Many tacit human capitalists have little need for the financial resources of a large firm. Indeed, many of them find the culture of such a firm unappealing. Moreover; tacit skill is most effectively fostered in small, closely-held companies. It is perhaps unsurprising that the emergence of the full-service investment bank coincided with a rapid expansion in the market for small boutique-style firms that sell tacit knowledge. Many of these firms are constituted as partnerships; those that are not are small and closely-held. Hence they can offer the collegiality and the peer-group monitoring that characterized the older investment banking partnerships. Scott Bok, the U.S. co-president of the advisory boutique Greenhill & Co., stated in a recent interview that “We’re trying to re-create what existed at the bigger Wall Street firms 20 years ago.”

The work of the boutique investment banking firms is discussed in detail in the 5th chapter. Three areas were identified in which such firms are likely to be particularly competitive. The first is advisory work, both in M&A and in corporate restructuring,
One of the earliest M&A advisory firms was Wasserstein Perella, whose eponymous founders arguably created the modern M&A market. The 1990s saw a steady rise in the number of boutique M&A advisors, partly because M&A specialists frequently found the boutique firms more appealing places to work than the larger investment banks, and partly because boutique firms are free of the conflicts that could potentially arise in full-service firms. [5]

M&A advice is a relatively recent business line for investment banks, which identified it as a separate business line only in the 1960s. Corporate restructuring advice, on the other hand, has been an important business line for investment banks since the middle of the 19th century. Like M&A advisory work, it relies upon long-term relationships and trust, and therefore sits comfortably in specialist boutique firms like DKW and Houlihan Lokey. These firms experienced an upswing when the dot.com bubble burst at the start of this century. [5]

Investment bank boutiques act as principals in two businesses: private equity investment and hedge fund trading. Private equity houses make control investments in unlisted equity. The tacit relationship and analytic skills that are important for advisory businesses are also essential for the activist investment management that the private equity business requires. Indeed, we described earlier the use that J.P. Morgan's 19th-century partners made of their relationships and contacts as board members and active investors. If similar skills are required in the private equity business, it is no surprise that so much private equity investment occurs within boutiques that can support informal reporting, flat reporting lines, and the teamwork upon which they rest.

Finally, we argue that hedge funds can be viewed as investment bank boutiques. The immense scale of the trading operation in the typical full-service investment bank reduces costs and ensures that clients receive the most comprehensive service possible, but it relies upon codified risk-management systems and systematized monitoring of trader activities. These features are hard to reconcile with the most
complex and hard-to-codify proprietary trading businesses. Traders working in these businesses are increasingly choosing to work outside the organizational and regulatory constraints of the traditional investment bank. The unregulated and privately owned institutions to which they have moved are known as hedge funds.

In summary, boutique firms emerged because it became increasingly difficult for investment banks to combine their codified large-scale activities with the tacit human capital businesses they had traditionally performed. The compensation structures, career structure, and governance arrangements that work for more codifiable activities are inappropriate for businesses that rely upon the tacit skill that has traditionally been the investment banker’s chief selling point. Hence, to the extent that clients still demanded tacit skills, investment banks had to spin off into boutiques.

The growth of boutique businesses could therefore be attributed, at least in part, to the desire of the larger investment banks to outsource businesses for which their size and governance arrangements made them ill-suited. In support of this interpretation of industry dynamics, we can point to the frequency with which the two types of firms work together. Full-service banks often recommend an advisory firm to a client that requires an unbiased “fairness opinion” on their pricing recommendations. And, in another increasingly common arrangement, full-service institutions help clients to resolve governance problems by referring them to private equity firms that can take them private and provide close monitoring. Investment banks are also paying high prices for stakes in hedge funds. We argue that this is happening precisely because hedge fund trading skills cannot be incubated within investment banks. Hence the banks stand at arm’s length from the funds, take capital stakes in them, and provide them with the codifiable settlement skills they require.

In short, investment banks are outsourcing their most complex and hard-to-codify trading to organizations that are better able to provide the right incentives and governance structures to the traders.
To bring to a close, Chapter 1 has covered selection of the problem, introduction to Indian capital market, small and medium enterprises and investment banks. The subsequent Chapter 2 is pertaining to the research methodology. It has covered objectives of study, hypothesis, scope of study and research methodology.

1.5 Bibliography

[8] Ishan Srivastava. "79 SME units fall sick a day." The Times of India. 20th July 2012.