CHAPTER 5

CAPITAL ISSUE
ACTIVITIES
1 Introduction

DURING The late 1980s portfolio investment to developing countries was perceived as a symbiosis that benefited everyone. LDCs were eager to welcome and kind of foreign capital inflow because after the debt crisis of the early 1980s they were facing a shortage of both foreign capital and invisible resources. From the supply side also there were some strong inducing factors which led the international investors towards developing country stock markets. The low correlation between movements in developed and developing country stock markets, the deceleration industrial country markets, and the growth prospects of the less developed markets made them an attractive option for portfolio diversification.

Asian emerging markets have a very low correlation with developed country stock markets. These markets therefore tend to act as natural hedge portfolio investors. Often bad news in developed markets in compensated with good news in these markets and vice versa. Other factors such as the sharp decline in US and global interest rates and continuing recession in major industrial countries played their part in pushing portfolio investment to developing counties.

Active encouragement from the World Bank and its sister concerns also contributed positively to this surge. As a result of all these, portfolio flows to developing countries grew from $5.5 billion in 1990 to $91.8 billion in 1996. Despite this growth, the remains whether developing countries themselves have benefited from the
boom. In the context of the current financial crisis in many developing countries, particularly in Asia, it is worth examining how much the developing countries have gained in this supposedly symbiotic relationship.
2 Management of Capital Issues

a) Pre-Issue Activities

The modus operandi for coming out with an Euro-issue is not a very complicated affair. The first step involved is passing of a board resolution to decide Euro-issue. It is followed by an application to the Ministry of Finance containing the terms of the issue and the price range. At this stage, the number of shares to be issue is not known. The next step is appointment of overseas underwriters, lead managers and custodian. The lead managers are responsible for marketing the issue by organising ‘road shows’.

Pre-issue Management The various steps which are taken in managing capital issues in general are listed below, the conforming to the guidelines issued by the Central Government, SEBI and the provisions of different enactment's as applicable thereto.

Steps to be Taken by the Issuing Company

1) Planning public issue of capital by the company concerned.

2) Choice of a merchant banker to act as lead manager to the issue and selection thereto.

3) Number of co-managers/advisors to the issue.

Steps to be Taken BY Lead Manager to the Public Issue
1) Obtaining stock exchange approvals to memorandum and articles of association.

2) Taking action as per SEBI guidelines.

3) Finalise appointment of following agencies:
   
i) Co-managers/advisors to the issues.
   
ii) Brokers to the issue.
   
iii) Underwriters to the issues.
   
iv) Bankers to the issue and refund banker.
   
v) Advertising agency.
   
vi) Printers.
   
vii) Registrar to the issue.

4) Advise the company to appoint:
   
i) Auditors.
   
ii) Solicitors/advocates/legal advisor.
   
iii) Broad-base board of directors.

5) Drafting of prospectus.

6) Obtaining approval to draft prospectus from company’s advocate/legal advisor, underwriting financial institutions/banks.

7) Obtaining consents from all concerned parties and agencies acting for the issue to be enclosed with the prospectus

8) Approval of prospectus by board of director in meeting and signing of the same by all the directors.
9) Filing of the prospectus with Registrar of the Companies

10) Making an application for enlistment with stock exchanges along with a copy of prospectus.

11) Publicity for the issue

    — Advertisements
    — Conferences — Press Conference
    — Brokers conferences
    — Investors conferences
    — Dealers/Traders conferences

12) Open subscription list
b) Post Issue Activities

To monitor the post issues process obligations have been placed to upon lead managers to strictly supervise and follow-up post-issues activities and periodically report to SEBI the progress in the matter of allotment and refunds as noted below:

a) 3-day post issue monitoring report
b) 78-day post issue monitoring report

The formats of the reports have been modified and the lead managers or advised to submit the reports in the new formats. These reports would be required to be submitted in duplicate within three working days from the due dates. The merchant bankers are expected to keep SEBI informed on important developments about the particular issues being lead managed by them during the intervening period of the reports.

It may be noted that the provisions relating to penalty point advice for delay in the submission of the reports would be implemented strictly. If the reports are not submitted within the stipulated time limit to SEBI, it would be penalized. Once penalty point advice would be issues for delayed submission and action will be initiated under the regulations on awarding of four penalty points. It may please be noted that SEBI has started issuing one penalty point advice for delayed submission/non-receipt of final printed copy of the offer document if it does not reach head office of SEBI at least 15 days before the opening of the issue.
Over Subscription and Association of resource Personnels: in the following circumstances SEBI nominated public representative is request to be associated in the process of finalization of basis of allotment:

i) where over subscription level is more than five times for “PAR ISSUES”.

ii) Where over subscription level is more than two times for “PREMIUM ISSUES”.

Lead Manager should intimate the person concerned, the date, time, venue, etc. where the presence of the resource personnel will be required.

Lead Manager should also associate the SEBI regional Manager at New Delhi Madras and Calcutta with public representatives in procession of over subscriptions cases of public issues [SEBI (RMB) (GI Series) circular No. 5 (93-94), dated 02-04-93.

How GDR is Traded :- Once a GDR is issued, it can be traded freely among international investors. An investor who wants to cancel a GDR can send it back to India for exchanging against share certificates. The earlier requirement of a lock-in period of two years has now been removed. The objective of the lock-in period was to prevent investors from taking advantage of the arbitrage opportunity arising out of discount to market price at which the GDR is issued. It will be seen from the discussion above, that the
GDR comes into being when shares in local currency of an Indian company are allotted in the name of the depositary and physical possession is delivered to the local custodian bank of the depositary against which the depositary bank issues the depositary receipts denominated in US Dollars. These GDRs are freely tradeable in the overseas market like any other dollar denominated security either on a foreign stock exchange or in the over the counter market or among a restricted group such as Qualified Institutional Buyers (QIBs). The record of ownership in India does not change with every transfer of GDRs and as such the issuer is in no position to control the registration of transfers. The equity shares/bonds representing the GDRs are registered in the name of overseas depositary bank and the relative share certificates/bond certainties are delivered to another intermediary called the domestic custodian bank which acts as the agent of the overseas depositary bank in India.
3 Pricing of Capital Issues

One of the factors determining the success of the Indian papers is "Pricing". VSNL had to shelve the $1 bn GDR issue due to the incorrect pricing.

Pricing of in the international market is not done beforehand unlike the domestic market where the number of share to be offered by a company at a specified rate are disclosed in advance prior to the offering. In case of international Capital Market the price is fixed in the course of International offerings based on the demand for the securities offered and the account that the Indian Company wishes to raise.

It has been noticed that the FII pick-up the stocks they want through GDR issues since prices are more competitive. Some of them go for ARBITRAGING by buying GDRs, canceling them, and selling the equity in the Indian Market to book profits. Pricing of Debt in the International Markets is a little more complicated and is governed by the factors such as the credit rating of the country, the interest rate, the availability of an exit route etc. In case of convertible bond the investor has the option to convert the bond into equity at a specified price. If the Stock Markets perform well, he can convert the bond into equity to his advantage and on the other hand where the international markets are not doing well, he may continue to get the fixed rate of interest.

It has been noticed recently, that a number of GDR's are being issued at a discounted price to the BSE prices. In case of Dr. Reddy's GDR,
the price was settled finally at $11.16 per GDR (1 GDR = 1 Share) at a discount of around 30.1% to the previous five day average BSE price. Lead manager baring Brothers has to postpone the pricing from the earlier date of July 13, and increase the indicative discount from 0% - 10% to 5% - 12% and then to 30% during the period prior to pricing. Also the size was lowered from $50 mill to $40 mill. The 20% greenshoe option was exercised on July 20, increasing the issue size to $48 mill.

On July 19 Finolex Cables $45 mill issue, at $16.60 per GDR (1GDR = 1 share), was priced at a discount of 15% to the previous five day average BSE. The issue found demand in the US and Europe due to its inexpensive pricing and "good story" according to joint lead manager Merrill Lynch, BZW was the lead manager.

Jardine Fleming-led SIV Ltd’s $45 mill issue, priced at $19.1 per unit on July 27 (1 unit = to 3 GDRs and 1 warrant), was at a 20.12% discount to the BSE price on the day of pricing. Each GDR at $6.37 upto Jan 31, 1996.

Performance of Indian GDRs
The domestic market price of shares of companies who have floated GDR issues are moving in tandem with GDR price listed at the Luxumberge Stock Exchange. Today FII is the hottest word. For FIIs Indian is an Asian tiger in the making and offers of potentials. They are aggressive players in Indian stock markets and we are seeing a
virtual boom. This fact becomes more evident when we see Indian Euro Issues receiving tremendous response in global markets. Till date dozens of companies have grossed. In over US $ 3.3 Billton through GDRs and Euro Bond Issues: European market markers and investors appear to have a sharp appetite for GDRs. Convertible Bonds and Warrants issued by Indian companies. The market for these in fact is becoming increasingly buoyant. The collapse of Indian issues, in the beginning of 1994, on the international financial markets was primarily due to the issue once of capital by many companies at unjustified prices firming up interest rates in the US and increase in the German money supply.

To a large extent the foreign merchant bankers, who sold some of the high-priced issues of Indian companies, were also responsible for this debacle.

The other reasons listed by PHDC for the failure of Indian GDRs in the first quarter of this year, includes the depression stage in the domestic market, which greatly influence the movement of their counterparts overseas.

On the global front, firming of interest rates in the United States has led to the withdrawal by US investors, who have moved their funds back.

Similarly increase in the German money supply led to an increase in the interest rates, which in turn influenced the decisions of European
funds managers and institutional investors. It can be seen that the GDRs issued before December '93 have not declined as compared to the GDRs issued after December '93.

In the today's competitive word the price of a commodity is determined by the interacting forces of demand and supply and an equilibrium price is arrived at by the interacting forces. The economics demand and supply rule states that if the demand of a commodity is more than its supply the price goes up and vice versa. Indian papers trading abroad is in no way an exception to this universally accepted law. In the recent times there has been unabated flow of Euro Issues from Indian companies representing excess supply, which has caused a sharp rise in discounts. The supply of Indian paper is in excess of demand among the foreign investors. Thus it is believed at this juncture that only the companies doing very well will be able to tap the international capital market.

It can be seen that the GDRs issued before December 93, have not declined as compared with the GDRs issued after December 1993. This is because upto Dec 93, the demand for the Indian paper was in excess of its supply. However after Dec. 1993, a number of Indian companies entered the Euro market resulting in excess supply and therefore today we find that a number of Indian papers are trading at heavy discounts.
Criteria for Pricing of GDR

The various criteria to be considered for pricing of GDR issue are given below:-

Prospective Earnings

The prospective earnings for the next three years are one of the most important criteria for pricing of GDR. Since the investment in GDR is made with prospects of long-term appreciation, future earnings potential is more important than the past-earnings.

Market price

The current market price of the share is taken as a benchmark for pricing of the issue. The average price of the company’s securities on the Bombay Stock Exchange for the 10 days period to the GDRR is relevant for this purpose. The GDR is usually issued at a discount of 10 – 20% to the market price of the share. A discount in excess of 20% could result in arbitrage trading in the securities.

Price Earnings Ratio

A price earnings ratio of between 15 to 20 per cent is considered optional for emerging markets. PE ratios of some of the developing markets are – Malaysia 20, Thailand 17, Korea 17 and Mexico 15. The price of the GDR is worked out by applying a PE ratio of 18 to the expected earnings for the current year, subject to a discount of 10-15 per cent of the average market price for the ten days prior to the opening of the issue.
A ratio of the PE to the normalised earnings over a period of three to five years of less than or equal to 0.7 is considered healthy. Alternatively, a company with PE ratio of 20 should be able to project earnings growth of 40% per annum. This ratio ranges between 0.7 to 1.2 per cent worldwide.
Turnover and market capitalisation

Though there is no hard and fast rule for turnover and market capitalisation, a minimum turnover of Rs. 500 crores and market capitalisation of Rs. 1200-1500 crores are the basic eligibility criteria for smaller companies.

Fundamental analysis

The fundamental analysis of the company and the industry is a prerequisite for launching a GDR issue. The short-term and long-term prospect of the industry/industries in which the company is operating, the track record of the company, quality of technology, marketing strategy and price competitiveness of the company are key factors in assessment of a company’s fundamental. Other important factors are market image, labour costs and market share.

Profitability is measured as a ratio of capital employed and is compared with that of similar company’s worldwide. Low geared companies with a debt-equity ratio of less than 1:1 are preferred to high-geared companies.

Size of the issue

The size of the issue is linked to the demand for the securities. Once the road shows are complete, a company is in position to access the issue size that market can absorb. The issue may be made to the full extent of the demand. Alternatively, the issue may be made to the extent of 60-70 per cent of the demand only to ensure great stability in GDR prices after the issue.
4 Recent Developments in International Capital Activities

Foreign Investments: Emerging Trends

FDI inflows to developing countries are estimated to have gone up to US $ 149 billion in 1997 from US $ 130 billion in 1996. India’s share of global FDI flows rose from 1.8 percent in 1996 to 2.2 percent in 1997 (Table).

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On the other hand, India’s share in net portfolio investments flows to the developing counties declined to 5.1 per cent in 1997 after increasing to 8.7 per cent in 1996.

Foreign investment inflows, which recorded a healthy rising, trends since 1991-92 except per a temporary decline during 1995-96, exhibited a reversal during 1996-97. However, the foreign investment in 1997-98 was lower at US $ 5,025 million compared to US $ 6.008 million in 1996-97 because of a decline in portfolio investment.
Although foreign direct investment (FDI) increased by 18.6 percent from US $ 2,696 million in 1996-97 to US $ 3,197 million in 1997-98, portfolio investment declined from US $ 3,312 million in 1996-97 to US $ 1,828 million in 1997-98. This decline in portfolio investment is mainly attributable to the contagion from the east Asian Crisis, which adversely affected capital flows to all emerging markets.

Mauritius, as in the previous two years, was the dominant source of FDI inflows in 1997-98. USA and S Korea were, respectively, the second and third largest sources of FDI. The striking feature was that S Korea increased its flow of investment in India from a meager US $ 6.3 million in 1996-97 (0.2 per cent of total FDI) to US $ 333.1 million in 1997-98 (10.4 per cent).

On the sectoral side, although the engineering industry witnessed a decline in inflows in 1997-98, it remained an attractive area for FDI, being the second largest recipient after electronics and electrical equipment.

The decline in portfolio investment, from 1997-98 onwards, has been contributed by a decline in inflows of both foreign Institutional investment and GDRs (Table-2).

Portfolio investment flows in India come in various forms such as issuance of Global Depository Receipts (GDRs) by India Corporates, investment by Foreign Institutional Investors (FIIs) and non-resident Indians (NRIs) in equity and debt instruments (both corporate and Government securities) and through floating of off-shore funds.
Portfolio flows boost the sentiment in the capital market and help in bringing down the cost of capital of new issues. In the development of the capital market and foreign exchange market, portfolio flows play a synergic role. Reflecting adverse external and internal developments, portfolio investment flows, however, declined substantially to US$ 1,828 million during 1997-98 from US$ 3,12 million during 1996-97. The amount raised under GDRs fell from US$ 1,366 million in 1997-97 to US$ 645 billion in 1997-98 due to pessimistic sentiments prevailing in domestic stock exchanges. GDR offerings were recorded predominantly in the month of April, May and December in 1997-98.

The slackening of investments by FIIs was mainly on account of currency turmoil in East Asia. Portfolio investments by FIIs decreased from US$ 1,926 million in 1996-97 to US$ 979 to February 1998. Inflows under various offshore funds and other schemes increased form US$ 20 billion in 1996-97 to US$ 204 million in 1997-98. Offshore funds and others schemes flows occurred mainly in the months of may and November 1997 and March 1998.

Following the global trend of the 1980s, the Indian stock market shed its inertia and started gaining prominence within the Indian financial system. The market capitalisation to GDP ratio shot up from about 5 per cent in 1980-81 to more than 60 per cent in 1992-93. New capital raised by the private sector grew from about Rs. 600 crore in 1980-81 to Rs. 20,000 crore in 1992-93. Active support from the government in the form of many sops and tax incentives helped the stock market to achieve such phenomenal growth rates.
There are at present 23 stock exchanges in India. As on March 31, 1997, 9,890 companies were listed on stock exchange in India, compared to 9,100 companies list at the end of 1995-96. This is the highest listing in the world. With over 20 million shareholders, India also has one of the largest investor bases in the world. Of the 23 stock exchanges in the country, Mumbai’s Bombay Stock Exchange (BSE) is the largest. Before the entry of the National Stock Exchange (NSE), the BSE accounted for over two-thirds of the total trading volume in the country. Established in 1875, this exchange is also the oldest in Asia, Approximately 70,000 deals are executed on a daily basis, giving it one of the highest per hour rates of trading in the world. There are around 3,500 companies in the country which have a serious trading volume. The market capitalisation of the BSE is Rs. 5 trillion.

Apart from the BSE, the NSE is also playing a major part in the Indian stock market. Though relatively new, the NSE has overtaken the BSE in many important respects. Introduced in 1994, with a view to promote scruples trading, NSE has a nationwide network with connectivity to over 180 cities. The turnover of the capital market segment of the NSE, at the end of financial year 1996-97, stands at Rs. 2,94,504 crore, a four-fold increase over FY 1995-96. In fact, NSE’s turnover is currently more than BSE’s. This increased turnover is due to the introduction of scruples trading through a nationwide network of brokers who are connected, through Very Small Aperture Terminal (VSATs). There has been significant increase in the number of companies listed. From 135 companies in 1994-95, NSE has now
more than 550 listed companies. Market capitalisation has also increased to Rs. 2,52,894 crore. However, due to the slump in share prices, the increase in market capitalisation is not as dramatic as the increase in turnover.

The BSE ‘Sensex’ is a widely used market index. The BSE sensex is a value-weighted index composed of 30 companies with the base April 1979 = 100. There set of companies in the index is essentially fixed. These companies account for around one-fifth of the market capitalisation of the BSE. The BSE index rose sharply during the late 1980s and early 1990s. From a base of 100 in the year 1979-80, it reached the 4,500 mark in 1992-93.

The market capitalisation to GDP ratio has not shown any upward trend either. In spite of the huge amount of money that has been umpped in by the FIIs, there has not been much change in the market capitalisation ratio of the India stock markets. But the entry of the foreign portfolio investors has increased the turnover and the volatility of the stock market. The introduction of screen based trading is also said to be responsible for this increase in turnover. There has been a decline in new capital raised by the private sector also. New capital raised rose to Rs 18,000 crore in 1992-93 and further to Rs 27,000 crore in 1994-95. But since then there has been a decline. Only Rs 14,300 crore has been raised from the market in 1996-97. This raised doubts over whether the influx of FPI has actually done anything positive for the primary market in India.
5 Critical Study

Characteristics of Euro-issues
There are different types of Euro-bonds:

**Straight Bonds:** These are most current and represent about three forth of the total value. Nominal value of bonds is minimum $ 5,000 DM 10,000 FFr 10,000 JPY 1,000,000 etc.

**Floating Rate Bonds:** The interest rate of these bonds is revised every six months. It is based on LIBOR to which a margin is added; the margin varies and it is a function of the risk of the borrower.

**Converting Bonds:** These bonds may be converted into shares of the issuing company. The advantage of this formula for the issuer is a lower interest rate that that on straight bonds. For the buyers of this bond the advantage is the possibility of a gain in ease of a significant increase in share prices.

**Floating Rate Bonds with Collar:** The rates of these bonds can fluctuate between a certain minimum and a fixed maximum. The buyer of this type of bonds receives a yield rate higher than the market rate but does not benefit from the increase if the market rate exceeds the maximum fixed by the issuer.

**Reverse Floating Rate Bonds:** These bonds pay a higher interest rate when the rate of reference decreases. The coupon is fixed at a rate
minus-LIBOR. So, when LIBOR decrease, the interest rate increases. For clarity, suppose a Euro-bank offers a rate of 16-LIBOR per cent; therefore, at LIBOR of 7.5 per cent, the effective rate is 8.5 per cent. Subsequently, if LIBOR increases to 8.2 per cent, the effective rate will be $16 - 8.2$ per cent, i.e. 7.8 per cent. It may be noted that increase in LIBOR rate has in effect, decreased the effective rate for the borrowers.

**Bonds with Warrant:** These bonds resemble convertible bonds with the difference that warrants are detached from bonds and negotiated separately. They allow their holders to buy shares or other securities at a later date on advantageous terms.

**Zero Coupon Bonds:** These bonds do not pay interest. They are issued at a price lower than their reimbursement value to take care of yield for investors. Purchasers of these bonds pay no income tax as they do not receive interest payment. They pay taxes at a lower rate on long-term capital gain when the bonds are refunded at face value. They are more often issued by blue chip companies as the default risk is concentrated on the reimbursement on maturity.

As far as the currencies involved in Euro-bonds are concerned, eleven of them cover almost all the amount of issues. They are US dollar Deutschmark, Japanese yen, pound sterling, French, ECU, Canadian dollar, Italian Lira, Dutch guide, Australian dollar and Swedish kroner. Out of these also, the first five currencies account for about 85 per cent of the total.
As regards the size of each operation, it has been increasing year after year, for example, $190 million in 1993; $171 million in 1992. The biggest issues of $5.5 billion was launched by Italy in 1993. Big issues are known as “Jumbo” issues.

**Difference between Euro-Bonds and Euro Credits (Euro-Currency Loan)**

Both Euro-bonds and Euro-credit (Euro-currency) financing have their advantages and disadvantages. For a given company, under specific circumstances, one method of financing may be preferred to the other. The major differences are given below:

**Cost of Borrowing:** Euro-bonds are issued in both fixed rate and floating forms. Fixed rate bonds are an attractive exposure management tool since the known long-term currency inflows can be offset by the known long-term outflows in the same currency. In contrast, Euro-currency loans carry variable rates.

**Maturity:** Euro-bonds have longer maturities while the period of borrowing in the Euro-currency market has tended to lengthen over time.

**Size of the Issue:** Earlier, the amount of bendable funds at any time has been much more in the interbank market than in the bond market. But of late, this situation no longer holds true. Moreover, although in
the past the flotation costs of a Euro-currency loan have been much lower than a Euro-bond (about 0.5 per cent of the total loan amount versus about 2.25 per cent of the face value of a Euro-bond issue), compensation has worked to lower Euro-bond flotation costs.

**Flexibility:** In the Euro-bond issue, the fund must be drawn in one sum on a fixed date and repaid according to a fixed schedule unless the borrower pays loan can be staggered to suit the borrower’s needs and can be repaid in whole with a multi currency clause enables the borrower to switch currencies on any A to currency B would require a costly, combined refunding and reissuing operation.

**Speed:** Funds can be raised by a known borrower very quickly in the Euro-currency market. Often, a period of two to three weeks. A Euro-bond financing generally takes more time, though the difference is becoming less significant.

**Euro –Notes:** These financial products are hybrid between Euro-bonds and Foreign bonds. They consist of three categories, namely Renewable Euro-notes, Euro-commercial paper and Euro-medium term notes.

Renewable Euro-notes are of several types: RUF (Revolving Underwriting Facilities), NIF (Note Issuance Facilities), (Short Term Note Issuance Facilities), MOF (Multiple Option Facilities). The note are issued for a maturity of three months to one year in the Euro-bond market, at regular intervals according to need. If possible,
banks prefer to enter into an agreement for placing these Euro-notes with investors. Otherwise, they place the notes with underwriters at a determined rate. Banks receive commission both for management and agreement.

The interest rate is calculated from a reference rate: LIBOR, for example, Costs of Euro-notes are less than those of Euro-credit or Euro debt,

Euro-commercial papers be the notes in Euro-currency with a maturity of three to six months. The OECD calls them “non-subscribed issuance facilities”, placed by dealers with investors.

Thirdly, Euro medium-term notes are the instruments between the bonds of more than five years and short-term Euro-notes. They are issued just like Euro-commercial paper. These notes are very frequently used by companies like EDF in France. These sums involved vary between $2 and $5 million.

The major advantages of Euro-notes comprise their (i) flexibility and (ii) choice of maturity date.

**Flexibility:** A borrower who is already committed to a rate (fixed or variable) suffers loss if the rate decreases subsequently. But the enterprise that has resorted to Euro-notes can wait before borrowing if it thinks that the rate is likely to go down.

**Choice of maturity date:** Issues who have Euro-note the possibility of issuing them for different maturity periods.