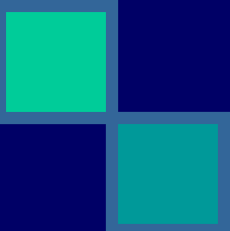
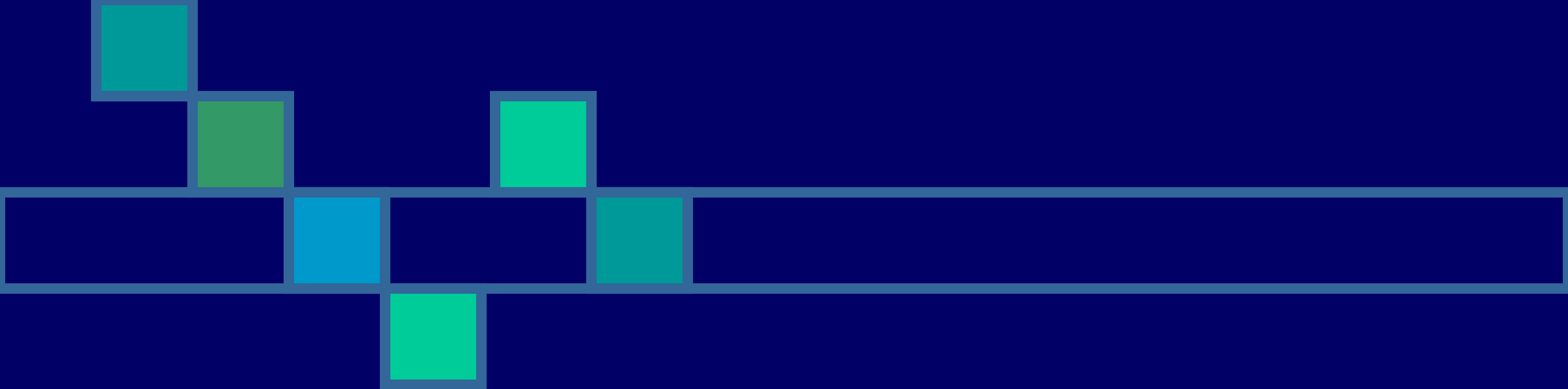




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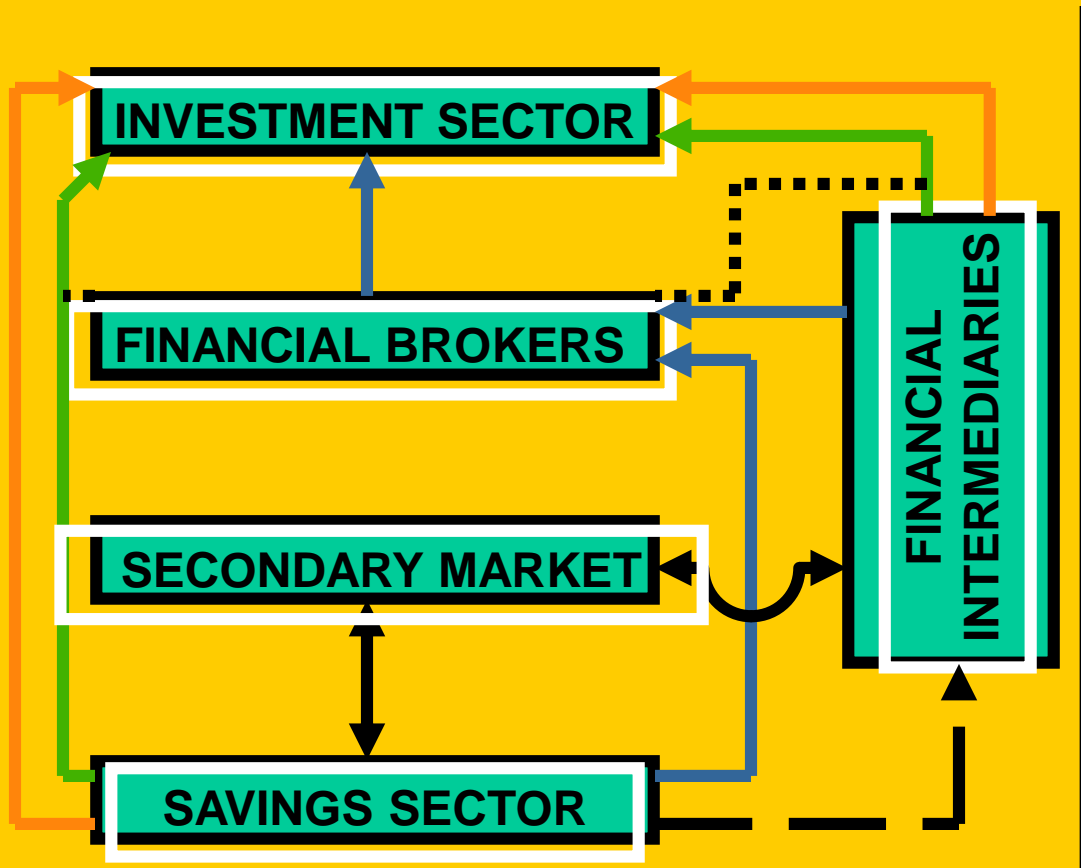
- 
- How does online trading take place?
 - Stock Broker & Client
 - Credit Rating
 - Mutual Fund
 - Stock Market Index
 - Asset Management Company
 - Investment Banker
- 



Raising Long-Term Finance



Ram Kumar Kakani



■ Public issue

■ Privileged subscription

■ Private placement

..... Indicates the possible presence of a

“standby arrangement”

--- Indicates the financial intermediaries’ own securities flow to the savings sector

The Public Issue

The Basic Procedure

- Management gets the approval of the Board.
- The firm prepares and files a *registration statement* with the SEBI.
- The SEBI studies the registration statement during the *waiting period*.
- The firm prepares and files an *amended* registration statement with the SEBI.
- If everything is copasetic with the SEBI, a price is set and a full-fledged selling effort gets underway.

The Process of a Public Offering

Steps in Public Offering Time

1. Pre-underwriting conferences *Several months*
2. Registration statements *20-day waiting period*
3. Pricing the issue *Usually on the 20th day*
4. Public offering and sale *After the 20th day*

An Example of a Tombstone

7,540,872 Shares

ShopKo
ShopKo Stores, Inc.

Common Stock
(par value \$.01 per share)

Price \$25 Per Share

Upon request, a copy of the Prospectus describing these securities and the business of the Company may be obtained within any State from any Underwriter who may legally distribute it within such State. The securities are offered only by means of the Prospectus, and this announcement is neither an offer to sell nor a solicitation of an offer to buy.

6,032,698 Shares

This portion of the offering is being offered in the United States by the undersigned.

Goldman, Sachs & Co.

Merrill Lynch & Co.

Salomon Brothers Inc

Alex. Brown & Sons
Incorporated

Montgomery Securities

Robert W. Baird & Co.
Incorporated

C.L. King & Associates, Inc.

Nesbitt Burns Securities Inc.

1,508,174 Shares

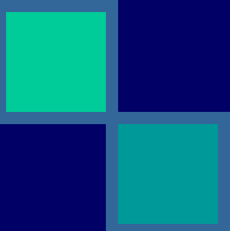

This portion of the offering is being offered outside the United States by the undersigned.

Alternative Issue Methods

- There are two kinds of public issues:
 - The general cash offer
 - The rights offer
- Almost all debt is sold in general cash offerings.



The Cash Offer

- 
- There are three methods for issuing securities for cash:
 - Firm Commitment
 - Best Efforts
 - Dutch Auction
 - There are two methods for selecting an underwriter
 - Competitive
 - Negotiated
- 

Firm Commitment

Underwriting

- The issuing firm sells the entire issue to the underwriting syndicate.
- The syndicate then resells the issue to the public.
- The underwriter makes money on the spread between the price paid to the issuer and the price received from investors when the stock is sold.
- The syndicate bears the risk of not being able to sell the entire issue for more than the cost.
- This is the most common type of underwriting in India.

Best Efforts Underwriting

- Underwriter must make their “best effort” to sell the securities at an agreed-upon offering price.
- The company bears the risk of the issue not being sold.
- The offer may be pulled if there is not enough interest at the offer price. The company does not get the capital, and they have still incurred substantial flotation costs.
- This type of underwriting is not as common as it used to be.

Venture Capital

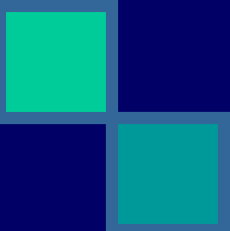

- Venture Capital is money invested to finance a new firm (start-ups). These are high-risk, unproven businesses that need financing.

Example: Aurobindo Pharma, Indiabulls.com, classteacher.com, egurucool.com, etc.

- Since success of a new firm is highly dependent on the effort of the managers, restrictions are placed on management by the venture capital company and funds are usually dispersed in stages, after a certain level of success is achieved.



Venture Capital

- So, venture capital is provided in stages after ensuring the progress of the firm.
 - Typically, firms require large amounts of capital to grow rapidly.
 - Usually, the instruments include large amounts of convertibles, warrants, etc.
- 
- 

Public Issue

- Public Issue is sale of bonds or stocks to the general public (example – ASPET's IPO/FCD issue totalling Rs. 75 crore issue)
- Securities are sold to hundreds, and often thousands, of investors under a formal contract overseen by regulatory authorities especially SEBI (prospectus filling, etc.)
- Prospectus is a formal summary that provides information on an issue of securities

Public Issue

- When a company issues securities to the general public, it usually uses the services of an investment banker (ASPET had IDBI, SBI Caps, JM Morgan, and UTI Bank).
- Investment Banker/Underwriter is a firm that buys an issue of securities from a company and resells it to the public
- Investment banker receives an underwriting spread when acting as a middleman in bringing together providers and consumers of investment capital.

Investment Banker

- Underwriting spread -- the difference between the price the investment bankers pay for the security and the price at which the security is resold to the public.
- Underpricing – Issuing securities at an offering price set below the true value of the security
- Total costs of IPOs are high for smaller issues (approx Rs. 1 to 30 crores).
- Large issues are generally handled by several underwriters to spread the risk among them.

Investment Banker

- Investment bankers have expertise, contacts, and the sales organization to efficiently market securities to investors.
- Thus, the services can be provided at a lower cost to the firm than the firm can perform the same services internally.
- Three primary means companies use to offer securities to the general public:
 - Traditional (firm commitment) underwriting
 - Best efforts offering
 - Shelf registration

Traditional Underwriting

Underwriting -- Bearing the risk of not being able to sell a security at the established price by virtue of purchasing the security for resale to the public; also known as *firm commitment underwriting*.

- If the security issue does not sell well, either because of an adverse turn in the market or because it is overpriced, the underwriter, not the company, takes the loss.

Traditional Underwriting

Underwriting Syndicate -- A temporary combination of investment banking firms formed to sell a new security issue.

A. Competitive-bid

- The issuing company specifies the date that sealed bids will be received.
- Competing syndicates submit bids.
- The syndicate with the highest bid wins the security issue.

Traditional Underwriting

B. Negotiated Offering

- The issuing company selects an investment banking firm and works directly with the firm to determine the essential features of the issue.
Together they discuss and negotiate a price for the security and the timing of the issue.
- Depending on the size of the issue, the investment banker may invite other firms to join in sharing the risk and selling the issue.
- Generally used in most corporate bond issues.


Underwriting ... Other Ways

Best Efforts Offering -- A offering in which the bankers agree to use only their best efforts to sell the issuer's securities. The bankers do not commit to purchase any unsold securities.

Shelf Registration -- A procedure whereby a company is permitted to register securities it plans to sell over the next two years. These can then be sold whenever the company chooses.



Other Offers

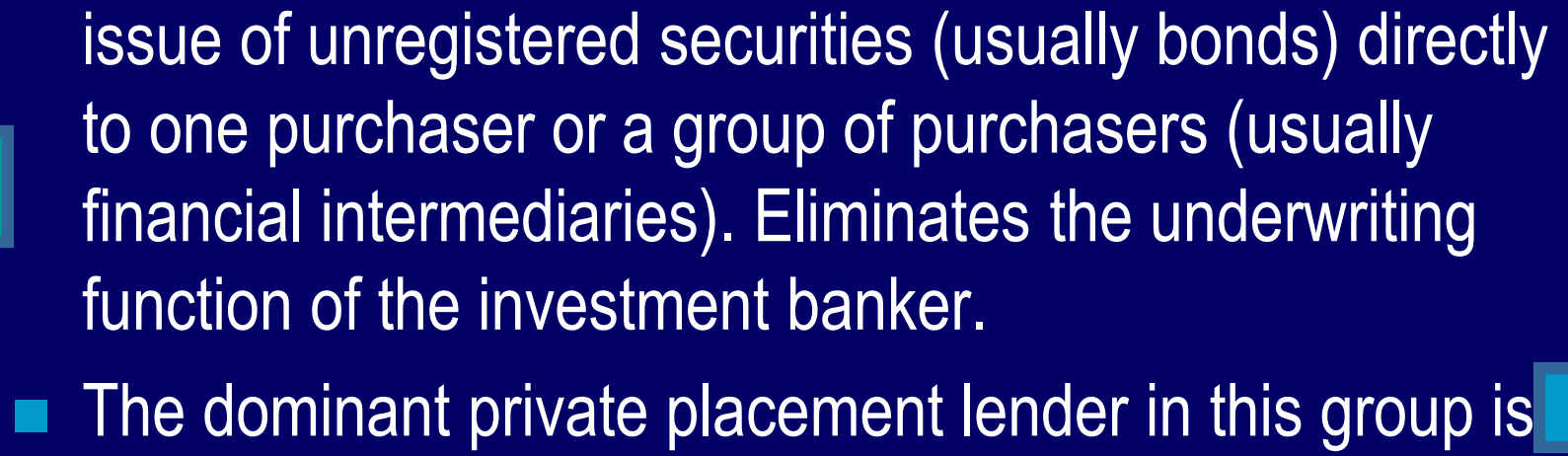
- Seasoned Offering – Sale of securities by a firm that is already publicly traded
 - General Cash Offer – Sale of securities open to all investors by an already public company
 - Rights Issue – Issue of securities offered only to a current stockholders
 - Private Placement – Sale of securities to a limited number of investors without a public offering (start-ups and venture caps generally opt for this route)
- 

Rights Offerings

- SPL currently has 11 crore shares outstanding. The market price is Rs. 24 per share. SPL decides to raise additional funds via a 1 for 11 rights offer at Rs. 22 per share. If we assume 100% subscription, what is the value of each right?
- Current market value = 264 crores, total shares (after rights) = 12 crores; amount of new funds = Rs. 22 crores; new share price = Rs. 23.83 per share; value of right = market price – ex-rights price




Private Placement

- Private (or Direct) Placement -- The sale of an entire issue of unregistered securities (usually bonds) directly to one purchaser or a group of purchasers (usually financial intermediaries). Eliminates the underwriting function of the investment banker.
 - The dominant private placement lender in this group is the mutual funds (even insurance companies and FIs are very active as well).
- 



Private Placement Features

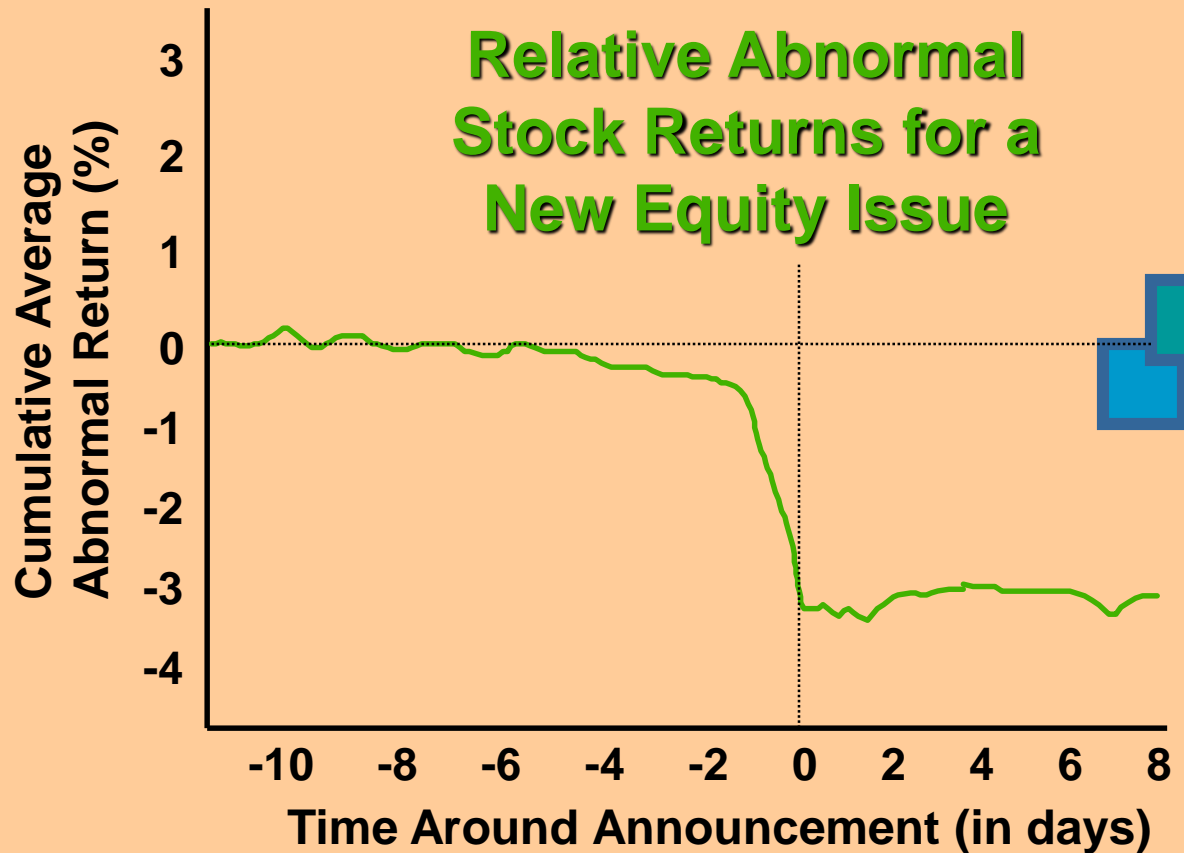
- Allows the firm to raise funds more quickly.
 - Eliminates risks with respect to timing.
 - Eliminates SEBI regulation of the security.
 - Terms can be tailored to meet the needs of the borrower.
 - Flexibility in borrowing smaller amounts more frequently rather than a single large amount.
- 

Private Placement and Other Developments

- ◆ Event Risk -- The risk that existing debt will suffer a decline in creditworthiness because of the issuance of additional debt securities.
- ◆ Private Placement with Registration Rights – It combines a standard private placement with a contract requiring the issuer to register the securities with the SEBI for possible resale in the public market.

Signaling Effects

- Negative stock price reaction to common stock or convertible issues.
- Straight debt and preferred stock do not tend to show statistically significant effects.



Possible Explanations for Price Reactions

Asymmetric (Unequal) Information


- Potential investors have less information than management (particularly for common stock).
- Exchanges of different types of securities show that increases (decreases) in financial leverage are associated with positive (negative) abnormal returns. (questionable in India)



Terms of Offering

Right – A short-term option to buy a certain number (or fraction) of securities from the issuing corporation; also called a **subscription right**.

Terms specify:

- the number of rights required to subscribe for an additional share of stock
 - the subscription price per share
 - the expiration date of the offering
- 

Subscription Rights

Options available to the holder of rights:

- ◆ Exercise the rights and subscribe for additional shares
- ◆ Sell the rights (they are transferable)
- ◆ Do nothing and let the rights expire

Generally, the subscription period is four weeks or less.

Subscription Rights

A shareholder who owns 77 shares and just received 77 rights would like to purchase 8 new shares. It takes 10 rights for each new share. **What action should the shareholder take?**

The shareholder can then purchase 7 shares (use 70 rights) and still retain the 7 remaining rights.

Thus, the shareholder needs to purchase an additional 3 rights.

Value of Rights

What gives a right its value?

A right allows you to buy new stock at a discount that typically ranges between 10 to 20 percent from the current market price.

The market value of a right is a function of:

- the market price of the stock
- the subscription price
- the number of rights required to purchase an additional share of stock

How is the Value of a Right Determined?

$$P_0 - R_0 = [(R_0)(N) + S], \text{ therefore}$$

$$R_0 = P_0 - [(R_0)(N) + S]$$

R_0 = the market price of one right when the stock is selling "rights-on"

P_0 = the market price of a share of stock selling "rights-on"

S = the subscription price per share

N = the number of rights required to purchase one share of stock

How is the Value of a Right Determined?

Solving for R_0 .

$$R_0 = \frac{P_0 - S}{N + 1}$$

$$P_x = P_0 - R_0 = [(R_0)(N) + S]$$

By substitution for R_0 , we can solve the “ex-rights” value of one share of stock, P_x .

$$P_x = \frac{(P_0)(N) + S}{N + 1}$$

Theoretical versus Actual Value of Rights

Why might the actual value of a right differ from its theoretical value?

- Transaction costs
- Speculation
- Irregular exercise and sale of rights over the subscription period

Arbitrage acts to limit the deviation of the actual right value from the theoretical value.

Standby Arrangement

Standby Arrangement -- A measure taken to ensure the complete success of a rights offering in which an investment banker or group of investment bankers agrees to “stand by” to underwrite any unsubscribed (unsold) portion of the issue.



Oversubscription Privilege



Oversubscription Privilege -- The right to purchase, on a pro rata basis, any unsubscribed shares in a rights offering.

Privileged Subscription versus Underwritten Issue

- Investors are familiar with the firm's operations when using a rights offering. The principal sales tool is a discounted price (rights offering) and the investment banking organization (underwriting).
- There is a wider distribution of shares with a public offering.

Regulation of Security Offerings

Registration Statement -- The disclosure document filed with the SEBI in order to register a new securities issue.

Part 1: **Prospectus** -- Discloses information about the issuing company and its new offering and is distributed to investors.

Part 2: Additional information required by the SEBI that is not part of the printed prospectus.

Red Herring

Red Herring -- The preliminary prospectus. It includes a legend in red ink on the cover stating that the registration statement has not yet become effective.

- SEBI reviews the registration statement to see that all the required information is presented and that it is not misleading.
- Deficiencies are communicated in a *comment letter*.
- Once satisfied, SEBI approves the registration. If not, it issues a *stop order*.

Regulation of Security Offerings

Tombstone Advertisement -- An announcement placed in newspapers and magazines giving just the most basic details of a security offering.

- The term reflects the stark, black-bordered look of the ad
- Includes the company's name, a brief description of the security, the offering price, and the names of the investment bankers in the underwriting syndicate.

Book Building Process

- Bharti Tele and Idea Tele undertook a process by which demand for its proposed IPO shares was elicited (and built up).
The IPO price was assessed for determination of the quantum of shares to be issued by means of an advertisement/offer document.
- SEBI defines Book Building as a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document.

Book Building Process

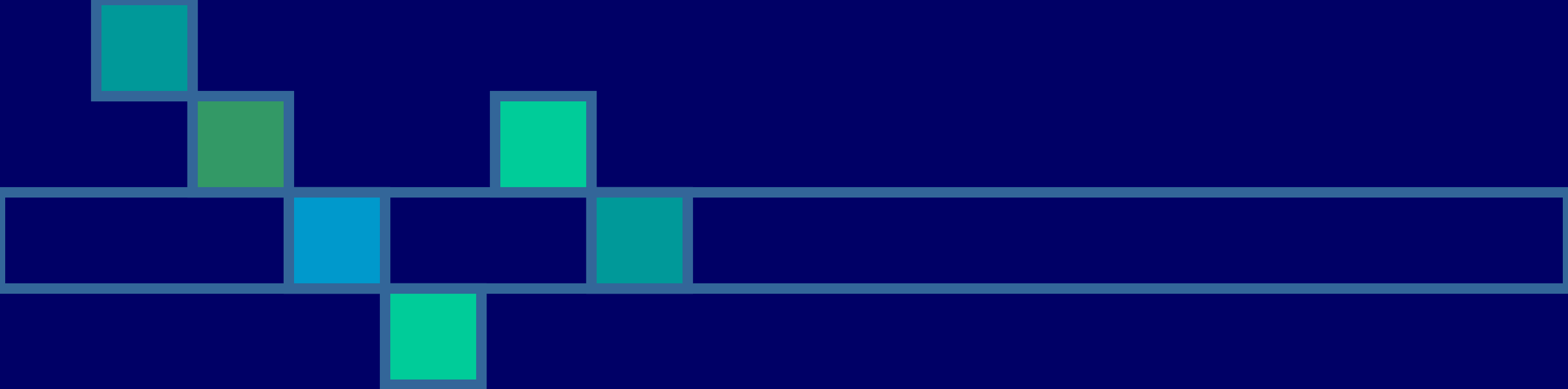
- Trading Member – These are entities who can participate in the book building process. They can bid on their own account or on behalf of their clients.
- Floor Price - The minimum offer price below which bids can't be entered.
- Merchant Banker - An entity registered under SEBI Regulations.
- Syndicate Members - Intermediaries registered with the Board and permitted to carry on activity as an underwriter. They are appointed by the Book Runner(s) to the issue.

Example - when an IPO fails

3/1/2002, Delhi, ICICIDirect.com: The IPO worth Rs 70 crore issued by ASPET got a lukewarm response from investors. Sources say that the issue could garner only 15-20 per cent of the target (it closed on 29/12/2001). The lead managers to the issue J M Morgan Stanley declined to comment. The other members to the issue were IDBI, SBI Caps and UTI Bank.

The company issued 50 lakh equity shares at a par rate of Rs 10 per share and had also issued 69.5 lakh 14 per cent FCDs of Rs 100 each aggregating Rs 69.50 crore. CRISIL and CARE had assigned a AAAr and AAA (SO) rating to FCDs.

The issue was totally underwritten and the remaining issue will be subscribed by underwriters, unless the promoters of the company Khaithan group has other plans. Sources said that the number of applications were very less.



Terms Used in Capital Markets



Equity Markets

- Spot Market - Orders that have spot settlement are entered into the Spot market.
- Screen Based Trading vis-à-vis Outcry System
- Settlement is the payment or receipt of an outstanding due at the end of the period.
- Price Rigging - When a person or persons acting in concert with each other collude to artificially increase or decrease the prices of a security, that process is called price rigging.

Equity Markets

- Buyer, Seller, Opening Price, Closing Price, Average Price
- Counterparty: When a member enters an order, any other member with an order on the opposite side is referred to as the counterparty.
- Brokerage - It is the commission charged by the broker.
- Auction: It is a mechanism utilized by Exchanges to fulfill its obligation to the trading members.
- Arbitration: Quasi-judicial process to resolve disputes.
- Order Driven Trading: No intervention of a market maker or jobber → avoids manipulation, high spread, monopoly
- Bid and Offer: Bid is the price at which the market maker buys from the investor and offer is the price at which he offers to sell the stock to the investor. The offer is higher than the bid.

Equity Markets

- Dematerialization - It is the process by which shares in the electronic form are cancelled and credit in the form of electronic balances are maintained at the depository.
- Disclosed Quantity (DQ) - A dealer can enter such an order in the system wherein only a fraction of the order quantity is disclosed to the market.
- Clearing - Clearing refers to the process by which the mutual indebtedness between members is settled (using multilateral netting).
- Circuit Breakers - Pre-established mechanisms used to alter the procedures/pace of trading when the market gets 'overheated'.

Equity Markets

- Matching - When a buy and a sell order satisfy the price - time priority, they can result in a trade (can be full or partial depending on order conditions)
- No-delivery Period - Whenever a Record Date is announced by a company, the Exchange sets a no-delivery period for that share. During this period, trading is permitted in that security. However, these trades are settled only after the no-delivery period is over.
- Insider Trading - Trading carried out by people who have access to non-public price sensitive information.

Equity Markets

Carry Forward Trading - Trading where the settlement of trades is postponed on the stock exchange until a future settlement period involving payment of interest on the account.

- Carry forward trading has evolved in response to local needs and in India, it refers to 'badla'.
- Trading in which the settlement is postponed to the next account period on payment of contango charges (known as 'vyaj badla') in which the buyer pays interest on borrowed funds or the backwardation charges (a.k.a 'unda badla') in which the short seller pays a charge for borrowing securities.

Equity Markets

Order Types –

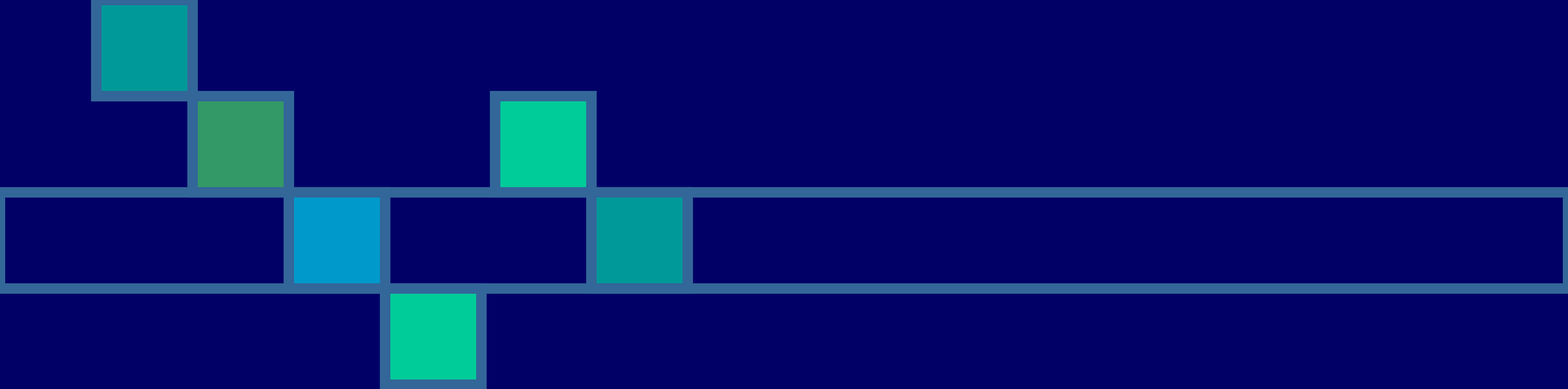
- 'Limit' or 'Market'
- Good Till Cancelled
- Good Till Date
- Minimum Fill
- Negotiated Trade
- All or None condition
- At the Opening
- Immediate or Cancel

Bond Markets

- Certificate of Deposit (CD) is issued by scheduled commercial banks. These are unsecured negotiable promissory notes. (maturity period: 91-365 days)
- Commercial Paper (CP) is a short term, unsecured instrument issued by corporate bodies to meet working capital requirements. (91-365 days)
- Wholesale Debt Market (WDM) provides for trading in a minimum lot size of Rs. 5 lakhs.
- Treasury Bills are short-term obligations issued by RBI on behalf of the Government of India at a discount. (14-364 days, issued by tender)

Bond Markets

- Time Conditions – Day, Good Till Cancelled, Good Till Day, Immediate or Cancel.
- Volume Conditions – Disclosed Value, Minimum Fill, All or None.
- Negotiated Market refers to deals that have been negotiated outside the exchange and are reported on the trading system for approval by the exchange.
- Repo Trades are Repurchase agreements. In these a trader sells securities to a customer while simultaneously agreeing to repurchase them at a future date.



Badla [Carry Forward Trading]



Ram Kumar Kakani

What is Badla?

- It is a carry forward mechanism at the BSE
 - i.e., one can carry forward his purchases or sales of shares in his account without paying complete money for them on the stock exchange
 - you just pay a small margin of the amount involved.

In case of a Long Position

- On the settlement day, you will take a loan (vyaj badla) from a badla financier
 - for the margin money to be paid
 - and deliver the margin money needed to carry forward the settlement by another week.
 - If you are big broker or a reputed trader - then there will be no dearth of the money you can take from the market.
 - But, when the risks you take are beyond your payment capacity OR when the markets act very volatile (say, against your expectation of a rise) – then?

In case of a Short Position

- On the settlement day, you need to deliver the securities (shares)
- So, you will take the required securities to be delivered as loan (undha badla) from a badla financier for the securities to be delivered
- *In other words, the badla session, is designed to bring together longs (tejiwallahs or bulls), shorts (mandiwallahs or bears) and lenders of cash (vyaj badla financiers) and stock (share badla financiers) to match demand for delivery stock cash obligations.*