



# MEASI INSTITUTE OF MANAGEMENT CHENNAI-14

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## UNIT I

### INTRODUCTION

#### DEFINITION

Wheeler defines Corporate Finance as “the business activity which is considered with the acquisition and conservation of capital in meeting the financial needs and overall objectives of business enterprise.”

#### MEANING

It is the process of raising, providing and administering of all money/funds to be used in a corporate firm.

#### EVOLUTION OF CORPORATE FINANCE:

1. Concept of raising funds (1920)
2. Concept of External Financing (1920 – 1930)
3. Liquidity concept – sound financial structure for maintaining liquidity (1930s)
4. Transitional phase – Only outsiders’ point of view (1940 to early 50s)
5. Transformation phase – New techniques of investment analysis were developed (1950s).
6. Modern Concept – Modern financial Information system like MM model were developed.

#### SCOPE OF CORPORATE FINANCE:

Functional Area:

1. Promotional and administration: Function of a new enterprise involving investment appraisal, raising and allocating funds
2. Control over financial matters and analysis of the effectiveness of the finance policy.



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3. Adjustment of the financial policy on the basis of the prevailing environment and situation.
4. Project management, thereby maximizing the firm's wealth.
5. Discharge of routine functions.

## Dynamic Nature:

As changes occur frequently it leads to change in financial policy, economic principles, accounts, fiscal policy, international finance, institutional finance etc.

## Diversified Nature:

Diversified business activities such as, Portfolio management, public issues, floatation of securities, etc.

## IMPORTANCE OF CORPORATE FINANCE:

1. Importance to the Investors
2. Importance to the management
3. Check against Corporate malpractices
4. Importance to the Government.

## VALUATION OF FIRM

### Valuation of Firms: Method # 1. Capitalised Earnings:

The capitalised earnings method is based on the philosophy that the price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations of future returns from such investments. The capitalised earnings will depend upon the (1) Estimate of earnings, and (2) Rate of capitalisation.



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The estimation of earnings will involve the study of past earnings. The past earnings over a long period will give an exact idea about the earning position of the business. The past earnings of one or two years may be influenced by abnormal causes such as price fluctuations, etc.; so, a true and fair opinion will not be made available and nothing should be concealed.

If the earnings are showing a stability then the earnings will be easily calculated; if, on the other hand, the earnings are showing a trend then some allowance should be made for the conditions prevailing at that time.

After estimating the average earnings, the earnings should be capitalised to arrive at an investment value. A decision about the rate of earnings at which the profits are to be capitalised is very difficult. It is a sort of arbitrary figure. One should be guided by economic factors only while calculating capitalisation rate. If the earnings per share are Rs. 5 and the capitalisation rate is 10%, then the value of the share will be Rs. 50.

### ***Valuation of Firms: Method # 2. Assets Approach:***

Assets approach is the commonly used method of valuation. The assets may be taken at book value, reproduction value and liquidation value. In book value method, the values of assets are taken from a current balance sheet. The excess of assets over debts will determine the assets values, divided by the number of equity shares will give the value of one share.

If preference stock is also outstanding then preference stock should be deducted before dividing the assets values by the number of equity shares. This approach is also known, as net worth value. There is a difference of opinion about the assets to be included and assets such as goodwill, patent rights, and deferred expenses should be excluded.

Another view is that goodwill and patents should be included while fictitious assets such as deferred expenses should only be excluded. The fixed assets are taken at book value less



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depreciation up to present balance sheet period. A company following a rigorous depreciation policy may be at a disadvantage than the company providing lower depreciations.

Public utilities may use the reproduction value of assets while valuing the property. Liquidation values of assets are used on the assumption that if the concern is liquidated at present then what values will be fetched by the assets. The concern is taken as a going concern and as such current book values of assets are used in most of the cases.

### ***Valuation of Firms: Method # 3. Market Value Approach:***

This approach is based on the actual market price of securities settled between the buyer and the seller. The market value will be the realistic value because buyers will be ready to pay in lieu of a purchase. The price of a security in the free market will be its most appropriate value.

Market price is affected by the factors like demand and supply and position of money market. The price of a security in the free market will be its most appropriate value. Market value is a device which can be readily applied at any time.

A number of practical problems are faced while applying market value approach. The market value will be available for securities of big companies only. The number of shares offered in the market is generally small and it will not be advisable to apply the same value to the whole lot of shares of the company.

Another objection against this method is that there are many upward and downward trends in values of securities in the stock exchanges and it becomes a problem to decide about the price to be taken for valuation. Despite practical limitations, market value approach may be used under many conditions.



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## *Valuation of Firms: Method # 4. Earnings per Share:*

Another method of determining the values of the firms under merger or consolidation is the earnings per share. According to this approach, the value of a prospective merger or acquisition is a function of the impact of merger/acquisition on the earnings per share.

Such impact could either be positive resulting into the increases in EPS or may be negative resulting into dilution of EPS. As the market price per share is a function (product) of EPS and Price-Earning Ratio, the future EPS will have an impact on the market value of the firm. The following illustrative examples explain the effect of merger/acquisition on EPS.

## TIME VALUE OF MONEY

### Single-Payment Problems

If we have the option of receiving Rs.100 today, or Rs.100 a year from now, we will choose to get the money now. There are several reasons for our choice to get the money immediately.

First, we can use the money and spend it on basic human needs such as food and shelter. If we already have enough money to survive, then we can use the Rs.100 to buy clothes, books, or transportation.

Second, we can invest the money that we receive today, and make it grow. The returns from investing in the stock market have been remarkable for the past several years. If we do not want to risk the money in stocks, we may buy riskless Treasury securities.

Third, there is a threat of inflation. For the last several years, the rate of inflation has averaged around 3% per year. Although the rate of inflation has been quite low, there is a good possibility that a car selling for Rs.15,000 today may cost Rs.16,000 next year. Thus, the Rs.100 we receive a year from now may not buy the same amount of goods and services that Rs.100 can buy today. We can avoid this erosion of the purchasing power of the dollar due to inflation if we can receive the money today and spend it.



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Fourth, human beings prefer to get pleasurable things as early as possible, and postpone unpleasant things as much as possible. We can use the Rs.100 that we receive today buy new clothes, or to go out for dinner. If you are going to get the money a year from now, you may also have to postpone all these nice things.

Then there is the uncertainty of not receiving the money at all after waiting for a year. People are risk-averse, meaning, they do not like to take unnecessary risk. To avoid the uncertainty, or the risk of non-payment, we would like to get the money as soon as possible.

Banks and thrift institutions know that to attract deposits from investors, they must offer some kind of incentive. This incentive, the interest, compensates the depositors for their inability to spend their money immediately. For instance, if the bank offers a 5% rate of interest to the depositors, the Rs.100 today will become Rs.105 after a year.

Let us look at the problem analytically. If we deposit a sum of money with the present value  $PV$  in a bank that pays interest at the rate  $r$ , then after one year it will become  $PV(1 + r)$ . Let us call this amount its future value  $FV$ . We may write it as

$$FV = PV(1 + r)$$

We may also think of  $(1 + r)$  as a growth factor. Continuing this process for another year, compounding the interest annually, the future value will become

$$FV = [PV(1 + r)](1 + r) = PV(1 + r)^2$$

This gives the future value after two years. If we can continue this compounding for  $n$  years, the future value then becomes

$$FV = PV(1 + r)^n \quad (2.1)$$

The above expression is valid for *annual* compounding. If we do the compounding quarterly, the amount of interest credited will be only at the rate  $r/4$ , but there will also be  $4n$  compounding periods in  $n$  years. Similarly, for monthly compounding, the interest rate is  $r/12$  per month and the compounding occurs  $12n$  times in  $n$  years. Thus, the above equation becomes



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$$FV = PV (1 + r/12)^{12n}$$

At times, it is necessary to find the present value of a sum of money available in the future. To do that we write equation (2.1) as follows:

$$PV = \frac{FV}{(1 + r)^n} \quad (2.2)$$

This gives the present value of a future payment. Discounting is the procedure to convert the future value of a sum of money to its present value. Discounting is a very important concept in finance because it allows us to compare the present value of different future payments.

Equations (2.1) and (2.2) relate the following four quantities:

$FV$  = the future value of a sum of money

$PV$  = the present value of the same amount

$r$  = the interest rate, or the growth rate per period

$n$  = number of periods of growth

If we know any three of the quantities, we can always find the fourth one.



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## Multiple-Payment Problems

In many financial situations, we have to deal with a stream of payments, such as rent receipts, or monthly paychecks. An annuity represents such a series of cash payments, even for monthly or weekly payments. Another example of an annuity is that of a loan that you take out and then pay back in monthly installments. Many insurance companies give the proceeds of a life insurance policy either as a lump sum, or in the form of an annuity. A perpetuity is a stream of payments that continues forever. In this section, we will learn how to find the present value and the future value of an annuity.

If there is a cash flow  $C$  at the end of first, second, third... period, then the sum of discounted cash flows is given by

$$S = \frac{C}{1+r} + \frac{C}{(1+r)^2} + \frac{C}{(1+r)^3} + \dots n \text{ terms} \quad (2.3)$$

Here  $S$  represents the present value of all future cash flows. We compare it to the standard form of geometric series

$$S = a + ax + ax^2 + ax^3 + \dots + ax^{n-1} \quad (1.1)$$

We notice that the first term  $a = \frac{C}{1+r}$ , and the ratio between the terms  $x = \frac{1}{1+r}$ . We

know its summation as

$$a(1-x^n)$$

$$S_n = \frac{a(1-x^n)}{1-x} \quad (1.2)$$

This gives

$$S = \frac{\frac{C}{1+r} \left(1 - \frac{1}{(1+r)^n}\right)}{1 - \frac{1}{1+r}}$$

Multiplying the numerator and the denominator in the above expression by  $(1+r)$ , we get, after some simplification,





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$$S = \frac{C [1 - (1 + r)^{-n}]}{r} \quad (2.4)$$

Using the sigma notation for summation, we may write (2.3) as

Thus, we get a very useful result, namely,

$$\frac{C [1 - (1 + r)^{-n}]}{r} \quad (2.5)$$

$$\sum_{i=1}^n \frac{C}{(1 + r)^i} =$$

**WR**

**Sum[C/(1+r)^i, {i,1,n}]**

For a perpetuity,  $(1 + r)^{-\infty} = 0$ , and from (2.5) we have

$$\sum_{i=1}^{\infty} \frac{C}{(1 + r)^i} = \frac{C}{r} \quad (2.6)$$



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WR

$\text{Sum}[C/(1+r)^i, \{i, 1, \text{infinity}\}]$

Note that (1.2) is a completely general formula for the summation of geometric series. We can use it to find the future value of an annuity. Equations (2.5) and (2.6) are special cases of (1.2) and they are useful only for finding the present value of an annuity or a perpetuity.

To review, the problems in this section can have either a single payment or multiple payments. The problems can be either future value or present value problems. The following examples illustrate the use of the above equations.

## Examples

*Single payment, future value?* You would like to buy a house that is currently on the market at Rs.85,000, but you cannot afford it right now. However, you think that you would be able to buy it after 4 years. If the expected inflation rate as applied to the price of this house is 6% per year, what is its expected price after four years?

Here we know the present value of the house, Rs.85,000. Its price is going to grow at the rate of 6% per year for four years. Using (2.1), we get

$$FV = PV(1 + r)^n = 85,000(1.06)^4 = \text{Rs.}107,311 \heartsuit$$

*Single payment, future value?* Jack has deposited Rs.6,000 in a money market account with a variable interest rate. The account compounds the interest monthly. Jack expects the interest rate to remain at 8% annually for the first 3 months, at 9% annually for the next 3 months, and then back to 8% annually for the next 3 months. Find the total amount in this account after 9 months.

The annual interest rates are 8% and 9%, or .08 and .09. They correspond to monthly rates at 0.08/12 and 0.09/12. We compound the growth for the nine months as

$$FV = 6,000(1 + 0.08/12)^3(1 + 0.09/12)^3(1 + 0.08/12)^3 = \text{Rs.}6,385.58 \heartsuit$$

*Single payment, future value?* You decide to put Rs.12,000 in a money market fund that pays interest at the annual rate of 8.4%, compounding it monthly. You plan to take the



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money out after one year and pay the income tax on the interest earned. You are in the 15% tax bracket. Find the total amount available to you after taxes.

The monthly interest rate is  $.084/12 = .007$ . Using it as the growth rate, the future value of money after twelve months is

$$FV = 12000(1.007)^{12} = \text{Rs.}13,047.73$$

The interest earned =  $13,047.73 - 12,000 = \text{Rs.}1047.73$ . You have to pay 15% tax on this amount. Thus after paying taxes, it becomes  $=1047.73(1 - .15) = \text{Rs.}890.57$

Total amount available after 12 months =  $12,000 + 890.57 = \text{Rs.}12,890.57$  ♥

*Present value, interest rate?* You expect to receive Rs.10,000 as a bonus after 5 years on the job. You have calculated the present value of this bonus and the answer is Rs.8000. What discount rate did you use in your calculation?

To find the present value of a future sum of money, we use

$$PV = \frac{FV}{(1+r)^n} \quad (2.2)$$

This gives  $8000 = \frac{10000}{(1+r)^5}$

Or,  $(1+r)^5 = 10,000/8000 = 1.25$

$$1+r = (1.25)^{1/5} = 1.0456, \text{ and thus } r = 4.56\% \text{ ♥}$$

To solve the problem on an Excel sheet, enter the following instructions.

	A	B	C
1	Future value, Rs.	10000	
2	Available after	5	years
3	Its present value, Rs.	8000	
4	The <i>required</i> discount rate	$=(B1/B3)^{(1/B2)}$	
		-1	

You may get the result by entering the following on WolframAlpha.



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$$\boxed{WR} \\ 8000 = 10000 / (1+r)^5$$

*Single payment, interest rate?* You have borrowed Rs.850 from your sister and you have promised to pay her Rs.1000 after 3 years. With annual compounding, find the implied rate of interest for this loan.

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The future value of the loaned money is  $FV = \text{Rs.}1000$ , while its present value is  $PV = \text{Rs.}850$ . The time for compounding is  $n = 3$  years. The interest rate  $r$  is unknown.

Using

$$FV = PV(1 + r)^n \quad (2.1)$$

We get

$$1000 = 850(1 + r)^3$$

or,

$$(1000/850)^{1/3} = 1 + r$$

or,

$$1 + r = 1.0556672$$

which gives

$$r = 0.0557 = 5.57\% \heartsuit$$

**WR**

$$1000=850(1+r)^3$$

To solve the problem with the help of Maple, write

$$\text{fsolve}(1000=850(1+r)^3)$$

with the result .05566719198, which is 5.57%, as before. Here we use the command **fsolve**, rather than **solve**, to get the answer in floating point.

*Single payment, interest rate?* You have borrowed Rs.10,000 from a bank with the understanding that you will pay it off with a lump sum of Rs.12,000 after 2 years. Find the annual rate of interest on this loan.

Here the future value is Rs.12,000, present value Rs.10,000, and  $n = 2$ . Use

$$FV = PV(1 + r)^n \quad (2.1)$$

This gives

$$12,000 = 10,000(1 + r)^2$$

Or,

$$r = \sqrt{\frac{12,000}{10,000}} - 1 = .09545 = 9.545\% \heartsuit$$



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*Single payment, interest rate?* Ampere Banking Corporation offers two types of certificates of deposit, each requiring a deposit of Rs.10,000. The first one pays Rs.11,271.60 after 24 months, and the second one pays Rs.12,139.47 after 36 months. Find their monthly-compounded rate of return.

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Using

We get for the first CD, Solving for  $R_1$ , we get

$$FV = PV(1 + r)^n \quad (2.1)$$

$$11,271.60 = 10,000(1 + R_1)^{24}$$

$$R_1 = \frac{(11,271.60)^{1/24} - 1}{10,000} = 0.005$$

Similarly working on the second CD, we get

$$R_2 = \frac{(12,139.47)^{1/36} - 1}{10,000} = 0.0054$$



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The first certificate gives a return of .5%, and the second one .54% per month. The second one is higher because the investor has to tie up the money for a longer period. ♥

*Single payment, time?* A bank account pays 5.5% annual interest, compounded monthly. How long will it take the money to double in this account?

If the present value is Rs.1, its future value is Rs.2. The bank is compounding monthly, thus the interest rate is 5.5/12 percent per month. Using (2.1),

$$FV = PV (1 + r)^n \tag{2.1}$$

we get  $2 = 1(1 + .055/12)^n$

Taking logarithms of both sides,  $\ln 2 = n \ln(1.0045833)$ ,

or,  $n = \frac{\ln(2)}{\ln(1.0045833)} = 151.58 \text{ months} = \text{approximately, } 12 \text{ years and } 8 \text{ months. ♥}$

One can do the above example by using Excel, as follows. Adjust the number in the blue cell, B3, until the quantity in cell B4 becomes very close to 2.

	A	B	C
1	Present value, Rs.	1	
2	Interest rate, r	.055	per year, compounded monthly
3	Time required	151.58	months
4	Future value, Rs.	$B1*(1+B2/12)^{B3}$	2

To do the problem with Maple, we enter

**solve(2=(1+.055/12)^n)**

The result is 151.5784326, or 152 months.

WR  
**2=(1+.055/12)^n**

*Multiple payments, future value?* Suppose you deposit Rs.350 at the beginning of each month in an account that pays 6% annual interest, compounded monthly. Find the total





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amount in this account at the end of 25 months.

The monthly rate of interest is  $\frac{1}{2}\%$ , or 0.005. Consider the first deposit of Rs.350. Its future value after 25 months is  $350(1.005)^{25}$ . The second deposit is a month late; it has only 24 months to grow, and its final value is  $350(1.005)^{24}$ . In a similar way, we find that the last deposit has just one month to earn interest. Putting it all together, the following expression gives the total at the end of 25 months:

$$S = 350(1.005)^{25} + 350(1.005)^{24} + \dots + 350(1.005)$$

This is a geometric series with  $a = 350(1.005)^{25}$ , and  $n = 25$ . The exponent of the factor (1.005) is decreasing. This implies that the multiplicative factor  $x = 1/1.005$ . Using (1.2),

$$S_n = \frac{a(1-x^n)}{1-x} \quad (1.2)$$

we find

$$FV = \frac{350(1.005)^{25}(1 - 1/1.005^{25})}{1 - 1/1.005} = \text{Rs.}9,342.17 \heartsuit$$

To find the answer on WolframAlpha, enter the following and click on approximate form.

[WR](#)

`Sum[350*1.005^i,{i,1,25}]`

*Future amount, installment payment?* In order to buy a house you want to accumulate a down payment of Rs.15,000 over the next four years. You can do that by putting a certain sum of money in a savings account on the first of every month for the next 48 months. The account credits interest every month at the annual rate of 6%. What is your required monthly deposit?

Suppose you put  $C$  dollars on the first of every month for the next forty-eight months. The annual interest rate is 6%; the monthly interest rate is thus  $\frac{1}{2}\%$ , or .005. After 48 months, the first deposit has grown to  $C(1.005)^{48}$ . The next deposit has only 47 months to grow, and its final value is  $C(1.005)^{47}$ . Continuing in this fashion, the final total value in the account is the sum of future values of all deposits. We may write this as

$$15,000 = C(1.005)^{48} + C(1.005)^{47} + \dots + C(1.005)$$



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This is again a geometric series with  $a = C(1.005)^{48}$ ,  $n = 48$ , and  $x = 1/1.005$ . Using (1.2) again, we have

$$S_n = \frac{a(1-x^n)}{1-x} \quad (1.2)$$

Or,

$$15,000 = \frac{C(1.005)^{48}(1-1/1.005^{48})}{1-1/1.005}$$

which gives

$$C = \text{Rs.}275.89 \heartsuit$$



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$$15000 = \text{Sum}[C * 1.005^i, \{i, 1, 48\}]$$

To do the problem on Excel, enter the following. Adjust the number in the blue cell, B3, until the number in cell B4 comes very close to Rs.15,000.

	A	B
1	No. of months	48
2	Annual interest rate, $r$	.06
3	Monthly deposit needed, Rs.	275.89
4	Future amount, Rs.15,000	$=B3 * ((1+B2/12)^{B1}-1)/(1-1/(1+B2/12))$

*Future amount, time required?* You have just opened an IRA in which you plan to deposit Rs.100 a month, at the beginning of every month. The IRA will pay 9% annually, with monthly compounding. Approximately, how long will it take you to accumulate Rs.20,000 in this account?

This is a multiple-payment, future value problem. Here  $FV = \text{Rs.}20,000$ ,  $P = \text{Rs.}100$ ,  $r = 0.0075$ , and  $n$  is the unknown quantity. We may write the future value of this account as the sum of future value of each of the monthly deposits. The first deposit will accumulate interest for  $n$  months, the second deposit for  $n - 1$  months, and so on. The last monthly deposit, made at the beginning of the month, will earn interest only for that month. This expressed as

$$20,000 = 100(1.0075)^n + 100(1.0075)^{n-1} + \dots + 100(1.0075)$$

Using (1.2), and with  $a = 100(1.0075)^n$ ,  $n = n$ ,  $x = 1/1.0075$ , we can sum the above series as

$$20,000 = \frac{100(1.0075)^n(1 - 1/1.0075^n)}{1 - 1/1.0075}$$

Rearranging terms,



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$$20,000(1 - 1/1.0075) = 100(1.0075)^n - 100$$

$$148.88337 = 100(1.0075)^n - 100$$

$$248.88337 = 100(1.0075)^n$$

Or,  $1.0075^n = 2.4888337$

Taking logarithms of both sides, we get

$$n \ln(1.0075) = \ln(2.4888337)$$

Or,  $n = \ln(2.4888337)/\ln(1.0075) = 122.0305670$  122 months ♥

To solve the problem on [WolframAlpha](#), enter the following

**WR**

$$20000 = \text{Sum}[100 * 1.0075^i, \{i, 1, n\}]$$

To do problem using Excel, follow these instructions. Adjust the number in the blue cell, B3, until the number in B4 becomes very close to Rs.20,000.

	A	B	C
1	Mo. deposit, Rs.	100	at the beginning
2	Interest rate, r	.09	comp. monthly
3	Time required	122.03	months
4	Final value, Rs.20,000	$= B1 * ((1 + B2/12)^{B3} - 1) / (1 - 1/(1 + B2/12))$	

To do the problem with Maple, key in

$$20000 = \text{sum}(100 * 1.0075^i, i=1..n);$$

**solve(%);**

It gives the answer 122.0305695, which is approximately 122 months.

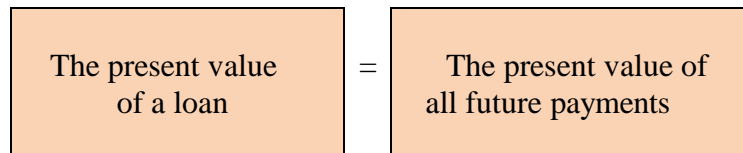
*Loan amortization, payment?* Suppose you borrow Rs.10,000 at the annual interest rate of 9%, and you are required to pay it back in 60 equal monthly installments, the first one is due at the end of the first month. How much is the monthly installment?



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The basic financial principle in a loan amortization, or loan repayment, problem is:



The present value of the loan is Rs.10,000. Equation (2.5),

$$\sum_{i=1}^n \frac{C}{(1+r)^i} = \frac{C [1 - (1+r)^{-n}]}{r} \quad (2.5)$$

gives the present value of the installment payments. With  $C$  = monthly payment,  $n = 60$ ,  $r = .09/12 = .0075$ , we get

$$10,000 = \frac{C (1 - 1.0075^{-60})}{0.0075}$$

or, 
$$C = \frac{0.0075(10,000)}{1 - 1.0075^{-60}} = \text{Rs.}207.58 \heartsuit$$

**WR**

$$10000 = \text{Sum}[C/(1+.09/12)^i, \{i, 1, 60\}]$$

*Loan amortization, payment?* You plan to buy a Jaguar XJ for Rs.28,000, but you have only Rs.6,000 in cash. The bank will loan you the rest at the annual interest rate of 12%, with the payments spread over 60 months. Find your monthly payment.



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Since you already have Rs.6,000, you need to borrow Rs.22,000. Equating the present value of the loan to the present value of the payments,  $P$ , we get

$$22,000 = \frac{P}{1.01} + \frac{P}{1.01^2} + \dots + \frac{P}{1.01^{60}}$$

We can do the summation by using (2.5), with  $r = .01$ , and  $n = 60$ . This gives us

$$22,000 = \frac{P [1 - 1.01^{-60}]}{0.01}$$

which gives,

$$P = \text{Rs.}489.38 \text{ per month } \heartsuit$$

**WR**

$$22000 = \text{Sum}[x/1.01^i, \{i, 1, 60\}]$$

*Loan amortization, payment?* Suppose the price of a house that you are interested in buying is Rs.100,000 and you have your Rs.15,000 down payment handy. The bank will loan you the remaining Rs.85,000 at 8% annual interest for a 25-year term. Find your monthly payment.

Equate the present value of the loan to the present value of the payments. Using (2.5), write it as

$$L = \sum_{i=1}^n \frac{C}{(1+r)^i} = \frac{C [1 - (1+r)^{-n}]}{r} \quad (2.5)$$

In this case,  $L = 85,000$ ,  $n = 300$ ,  $r = .08/12$ , and the monthly payment is  $C$ . Thus

$$85,000 = \frac{C [1 - (1 + 0.08/12)^{-300}]}{0.08/12}$$

Or,

$$C = \frac{85,000(.08/12)}{1 - (1 + .08/12)^{-300}} = \$656.04 \heartsuit$$

**WR**



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$$85000 = \text{Sum}[C/(1+.08/12)^i, \{i, 1, 300\}]$$

*Future payments, present value?* Ronald Wilson has won a million dollars in the state lottery that will pay him Rs.50,000 annually in 20 annual installments. He will get the first installment right now. Using a discount rate of 10% per year, find the present value of all these payments.

The present value of the immediate payment is Rs.50,000. Thus the present value of the all 20 payments is given as

$$PV = 50,000 + \sum_{i=1}^{19} \frac{50,000}{1.1^i}$$

Use (2.5),

$$\sum_{i=1}^{19} \frac{1}{1.1^i}$$



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$$PV = 50,000 + \frac{50,000 [1 - 1.1^{-19}]}{0.1} = \text{Rs.}468,246 \heartsuit$$

Thus, the million-dollar lottery is worth only Rs.468,246 in current dollars.

WR

$$x = 50000 + \text{Sum}[50000/1.1^i, \{i, 1, 19\}]$$

*Loan amortization, interest rate?* You have a loan of Rs.5000 that you have to pay in 7 annual installments of Rs.1100 each, the first one at the end of the first year. What is the annual interest rate on the loan?

In this problem we have to equate the present value of the loan, Rs.5,000, to the present value of 7 payments, each one being Rs.1,100. Use (2.5)





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$$L = \sum_{i=1}^n \frac{C}{(1+r)^i}$$

$$\frac{C [1 - (1+r)^{-n}]}{R} \tag{2.5}$$

and substitute  $L = 5000$ ,  $C = 1100$ , and  $n = 7$ . This gives

$$5000 = \frac{1100[1 - (1+r)^{-7}]}{r}$$

We may solve the above equation by any one of the following methods:

1. Use Excel. Adjust the value of the quantity in the blue cell B4 until the quantity in cell B5 becomes equal to the amount of loan.

	A	B
1	Amount of loan, Rs.	5000
2	Number of payments,	7
3	Each payment, Rs.	1100
4	Required interest rate, $r$	0.121268
5	Loan paid off, Rs.5000	=B3*(1-1/(1+B4)^B2)/B4

You can calculate the value of  $r$  if you copy and paste the following instruction in any blank Excel cell.

=RATE(7,-1100,5000,0)

2. Use Maple. To solve the above equation using Maple, we key in

**fsolve(5000=1100\*(1-1/(1+r)^7)/r)**



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This gives the result as .1212687404, that is, 12.13%.

3.  $5000 = \text{Sum}[1100/(1+r)^i, \{i, 1, 7\}]$

which gives the answer as  $r \approx .121269$

4. Use a financial calculator programmed to solve such problems.

5. Use PVIFA tables on page 150, Chapter 12, to solve the problem.

This is a somewhat archaic method to solve these problems, but you can still use it to get an approximate value of the implied interest rate. First, find the Present Value Interest Factor of an Annuity, or PVIFA, which is defined as

$$\text{PVIFA} = \frac{\text{Total value of the loan}}{\text{Amount of each installment}} = \frac{5000}{1100} = 4.5455$$

The number of installments,  $n = 7$ . If you move across the line for  $n = 7$ , searching for this number, you will find it between  $r = 12\%$  and  $r = 13\%$ . Now, interpolate the value of  $r$  as follows:

$n$	$r$	PVIFA
7	12%	4.5638
	13%	4.4226
	Difference for 1%	0.1412

The difference between 4.5455 and 4.5638 is  $4.5638 - 4.5455 = 0.0183$ . Thus a more precise value of  $r$  is  $12\% + (.0183/.1412)$  of 1%. This give  $r = 12.1296034 \approx 12.13\%$

*Loan amortization, interest rate?* You are planning to buy a high definition TV set from your friend for Rs.1200 cash. Alternatively, he would allow you to pay for it in six monthly installments of Rs.210 each, the first one after one month. What is the implied monthly rate of interest in this transaction?

Equating the value of the loan to the present value of installment payments, we have

$$1200 = L = \sum_{i=1}^n \frac{C}{(1+r)^i}$$



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$$6 \quad \underline{210}$$

$$(1 + r)^i$$

$$i=1$$

$$\Sigma$$

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WR

$$1200 = \text{Sum}[210/(1+r)^i, \{i, 1, 6\}]$$

and the result comes out as  $r \approx 0.0141207$ . This about 1.412% per month. ♥

*Loan amortization, interest rate?* You would like to buy an iPad from your friend who is asking Rs.400 for it. However, you offer to pay for it in 3 monthly installments of Rs.140 each, and you will pay the first Rs.140 after one month. Find the implied *annual* interest rate in your offer.

Suppose the annual interest rate is  $r$ . The monthly rate is  $r/12$ . Equating the loan to the present value of installments, write

$$400 = 3 \frac{140}{\sum_{i=1}^3 (1 + r/12)^i}$$

WR

$$400 = \text{Sum}[140/(1+r/12)^i, \{i, 1, 3\}]$$

This gives the answer  $r \approx 0.297571$ . The annual rate is 29.76% per year. ♥

*Loan amortization, time?* Suppose you have borrowed 72,000 as a mortgage loan on your house. The interest rate is 6%. The bank has calculated the monthly payment to be Rs.515.83. How long will it take you to pay the loan?

The monthly interest rate is  $\frac{1}{2}\%$ , or .005. In this problem, the number of payments,  $n$ , is unknown. Since the amount of loan is equal to the present value of the payments, we can write

$$72,000 = n \frac{515.83}{\sum_{i=1}^n 1.005^i}$$

Or,

$$72,000 = \frac{515.83(1 - 1.005^{-n})}{.005}$$



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$$\text{Or,} \quad \frac{.005(72,000)}{515.83} = 1 - 1.005^{-n}$$

$$\text{Or,} \quad \frac{.005(72,000)}{515.83} - 1 = -1.005^{-n}$$

$$\text{Or,} \quad -.3020956517 = -1.005^{-n}$$

$$\text{Canceling the negative signs,} \quad .3020956517 = 1.005^{-n}$$

$$\text{Taking logarithms,} \quad \ln(.3020956517) = -n \ln(1.005)$$

$$\text{Or,} \quad -1.197011584 = -n(.004987541511)$$

$$\text{Or,} \quad n = \frac{1.197011584}{.004987541511} = 240 \text{ months} = 20 \text{ years.} \heartsuit$$

**WR**

$$72000 = \text{Sum}[515.83/1.005^i, \{i, 1, n\}]$$

*Comparing present values:* You want to buy a piece of land for Rs.12,000 cash. The owner would allow you to pay for it in six annual installments of Rs.2300 each, the first one right now. Which method is cheaper for you if the time value of money is 12%?

We must compare the present value of the two methods of payment. Choose the smaller one as the better one.

$$\text{PV of installment payments} = 2300 + \sum_{i=1}^5 \frac{2300}{1.12^i} = 2300 + \frac{2300[1 - 1.12^{-5}]}{.12} = \text{Rs.}10,590.98$$

PV of cash payment = Rs.12,000, and thus it is cheaper to pay by installments.  $\heartsuit$

**WR**

$$2300 + \text{sum}[2300/1.12^i, \{i, 1, 5\}]$$



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## UNIT II

### INDIAN CAPITAL MARKET

#### 1. Backward Financial System:

One of the important drawback of industrial finance in India is that it is not yet developed fully, the extent of capital market which is a source of long term finance including equity and debt is quite small. It also fails to provide risk capital in adequate quantity. The development of non-bank financial intermediaries is also very poor.

Very little arrangement is made about venture capital which usually makes risky investment for high returns. The system is very much inadequate in respect of financial deepening which can be measured as a ratio of liquid liabilities to GNP. All these indicators reflect about the undeveloped financial system prevailing in our country.

#### 2. Paucity of Funds:

Another shortcoming of industrial finance is that it is grossly inadequate for the continuously growing and large requirements, especially to meet the needs of large industries. Moreover, the small industries are also facing shortage of finance in a acute manner. Besides, the securing and servicing of foreign funds are becoming difficult and expensive. Thus as a result of paucity of fund the expansion of industries is becoming very difficult.

#### 3. Unsatisfactory Interest Structure:

The interest rate structure for different types loans like short term, medium term and long term are more or less unsatisfactory. These rates are not appropriate and are not properly aligned with one another and these rates are largely distorted and does not attain demand – supply equality for



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capital. Indigenous money lenders also charges high rate of interest from small and village industries distorting the market interest rate structure.

#### **4. Lack of Adequate Capital Formation:**

Industrial finance usually suffers from lack of adequate capital formation. There are inherent difficulties of mobilizing the quantum of incremental rural incomes which could have been utilized for financing rural industries.

#### **5. Difficulties of Small Industries:**

Small industries located both in urban and rural areas are facing serious problem in realizing adequate finance. The problems faced by SSIs are varied. Firstly, there is lack of institutional finance available to SSI units. Even till to day financial corporations exclusively meant for SSI units have not yet been set up in all the states of the country. Secondly, in meeting the short term needs of SSI Units, banks and other financial institution demand adequate security acceptable to them showing least regard to potentials and other qualities of SSI units reducing the credit worthiness of these units.

Thirdly, in respect long term capital also, i.e., in raising share capital, SSI units are getting less favour as compared to that of large industries. Finally, whatever financial support are available informal and indigenous sources of industrial finance to SSI units are considered to be small and costly considering the high rate of interest charged by these lenders.

Thus the industrial finance as a system in India has been suffering from several drawbacks. Accordingly, it is found to be inadequate, undeveloped following unsatisfactory interest structure and less friendly to small reach and tiny industrial units.



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## REMEDIAL MEASURES

**The following are some of remedial measures suggested for the purpose:**

### **1. Strengthening the Domestic Source of Finance:**

In order to improve the system of industrial finance, the domestic sources of finance need to be strengthened and expended. Therefore, reliance on foreign aid needs to be reduced gradually because of its unreliable character.

### **2. Diversity Sources:**

In order to tone up industrial finance, sources of this finance should be diversified by setting up new institutions and expanding the existing ones. Thus the banking institution including regional rural banks, cooperative banks, and non-banking financial institutions need to be expanded for the purpose. Moreover, to expand the scope of long term finance, securities market needs to be developed and strengthened.

### **3. Expanding Market-finance:**

Strengthening of industrial finance in India requires expansion of market finance which includes setting up of market related institutions, and extension of market- based institutions. These requires development of capital market, development of financial instrument, to promote financial deepening of the system, promoting market finance as a good signaling device and finally to attract household savings, especially from the rural untapped areas.

### **4. Improvement of Banking Institutions:**

In order to improve the quantity and quality of industrial finance, banking institutions need to be improved and strengthened. This requires reforming the banking structure and its activities





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improving the management of banks and upgrade the quality of banking personnel and the internal system followed by banks also needs to be improved.

## **5. Strengthening NBFIs:**

In order to tone up industrial finance, the non-banking financial institutions needs to be strengthened by setting up new units NBFIs, and also toning up the existing ones by developing appropriate legal framework. Development of long term finance institutions. Mutual fund industry etc. and establishing proper monitoring framework can strengthen this sector of industrial finance.

## **6. Encouraging Foreign Capital:**

Considering the paucity of domestic finance, arrangement be made for smooth flow of foreign capital. In this respect, inflow of foreign direct investment in more important than the entry of portfolio of investment. Foreign capital should also facilitate entry of advanced technology and improved business practices.

## **7. Benefitting Small Industries:**

Industrial finance set up should benefit the small scale industrial units adequately, without discriminating their stature.

## **FISCAL POLICY**

The means by which the government adjust its spending levels along with tax rates to influence and monitor the nation's economy it is known as fiscal policy. Let us learn the Fiscal Policy of India here.

Fiscal Policy of India



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There are several component policies or a mix of policies that contribute to the fiscal policy. These include subsidy, taxation, welfare expenditure, etc. Also, there are a certain investment and disinvestment policies and debt and surplus management that contributes to fiscal policies.

## Objectives of a Fiscal Policy

- In order to stabilize the pricing level in the economy.
- The main objective is to achieve and maintain the level of full employment in the country.
- Also, to stabilize the growth rate in the economy.
- Also, promote the economic development in a country.
- In order to maintain the level of balance of payment in the economy.

## Various Types of Fiscal Policies

### Contractionary Fiscal Policy

This involves cutting government spending or raising taxes. Thus, the tax revenue generated is more than government spending. Also, it cuts on the aggregate demand in the economy. So, the economic growth leading to the reduction in inflationary pressures of the economy.

### Expansionary Fiscal Policy

This is generally used to give a boost to the economy. Thus, it speeds up the growth rate of the economy. Also, during the recession period when the growth in national income is not enough to maintain the current living of the population.

So, a tax cut and an increase in government spending would boost economic growth and decrease the unemployment rates. Although this is not a sustainable solution. Because this can lead to a budget deficit. Thus, the government should use this with caution.

### Neutral Fiscal Policy



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This policy implies a balance between government spending and Furthermore, it means that tax revenue is fully used for government spending. Also, the overall budget outcome will have a neutral effect on the level of economic activities.

## **Types of Fiscal Policy**

There are major components to the fiscal policies and they are

### **Expenditure Policy**

Government expenditure includes capital expenditure and revenue expenditure. Also, the government budget is the most important instrument that embodies government expenditure policy. Furthermore, the budget is also for financing the deficit. Thus, it fills the gap between income and government spending.

### **Taxation Policy**

The government generates its revenue by imposing both indirect taxes and direct taxes. Thus, it is important for the government to follow a judicial system for taxation and impose correct tax rates. This is because of two reasons. The higher the tax, the reduction in the purchasing power of the people.

This will lead to a decrease in investment and production. Furthermore, the lower tax will leave more money with people that lead to high spending and thus higher inflation.

### **Surplus and Debt Management**

When the government receives more amount than it spends than it is known as surplus. Also, when the spending is more than the income than it is known as a deficit. In order to fund the deficits, the government needs to borrow from domestic or foreign sources.

**SEBI**



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## **SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI):**

The Securities and Exchange Board of India was established as an interim administrative body on 12 April 1988 by the Government of India.

Its main objective was to promote orderly and healthy growth of securities and to provide protection to the investors.

The Ministry of Finance of the Government of India has overall administrative control over its functions. On 30th January 1992, it was given a statutory status through an ordinance, which later on was replaced by Act of Parliament known as Securities and Exchange Board of India Act, 1992. SEBI is considered as watchdog of the securities market.

## **REASONS FOR THE ESTABLISHMENT OF SEBI:**

During 1980s, there was tremendous growth in the capital market due to increasing participation of public. This led to many malpractices like Rigging of prices, unofficial premium on new issues, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. by the brokers, merchant bankers, companies, investment consultants and others involved in the securities market.

This resulted in many investor grievances. Because of lack of proper penal provision and legislation, the government and the stock exchanges were not able to redress these grievances of the investors. This necessitated a need for a separate regulatory body, and hence Securities and Exchange Board of India was established.

## **PURPOSE AND ROLE OF SEBI:**

The main objective is to create such an environment which facilitates efficient mobilization and allocation of resources through the securities market. This environment consists of rules and regulations, policy framework, practices and infrastructures to meet the needs of three groups which mainly constitute the market i.e. issuers of securities (companies), the investors and the market intermediaries.

### **(i) To the Issuers:**



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SEBI aims to provide a market place to the issuers where they can confidently look forward to raise the required amount of funds in an easy and efficient manner.

## **(ii) To the Investors:**

SEBI aims to protect the right and interest of the investors by providing adequate, accurate and authentic information on a regular basis.

## **(iii) To the Intermediaries:**

In order to enable the intermediaries to provide better service to the investors and the issuers, SEBI provides a competitive, professionalized and expanding market to them having adequate and efficient infrastructure.

## **OBJECTIVES OF SEBI:**

**Following are the main objectives of SEBI:**

### **1. Protection:**

To guide, educate, and to protect the rights and interests of the investors.

### **2. Competitive and Professional:**

To make the intermediaries like merchant bankers, brokers etc. competitive and professional by regulating their activities and developing a code of conduct.

### **3. Prevention of Malpractices:**

To prevent trading malpractices.

### **4. Balancing:**

To establish a balance between statutory regulation and self regulation by the securities industry.

### **5. Orderly Functioning:**

To promote orderly functioning of stock exchange and securities industry by regulating them.



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## FUNCTIONS OF SEBI

The functions of SEBI can be divided into three parts viz:

- (1) Regulatory function
- (2) Development Function &
- (3) Protective function.

### *1. Regulatory Functions:*

**Regulatory functions of SEBI are as follows:**

#### **(a) Registration of Brokers and Agents:**

It registers brokers, sub-brokers, transfer agents, merchant banks etc.

#### **(b) Notifications of Rules and Regulations:**

It notifies rules and regulations for the smooth functioning of all intermediaries in the securities' market.

#### **(c) Levying of Fees:**

It levies fees, penalties and other charges for contravening its directions and orders.

#### **(d) Regulator of Investment Schemes:**

It registers and regulates collective investment schemes and mutual funds.

#### **(e) Prohibits Unfair Trade Practices:**

SEBI prohibits fraudulent and unfair trade practices.

#### **(f) Inspection and Enquiries:**

It undertakes inspection and conducts enquiries & audit of stock exchange

#### **(g) Performing and Exercising Powers:**

It performs & exercises such powers under Securities Contracts (Regulation) Act 1956, as have been delegated to it by the Government of India.



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## ***2. Development Functions:***

**Development functions of SEBI are as under:**

### **(a) Training to intermediaries:**

It promotes training of intermediaries of the securities.

### **(b) Promotion of fair trade:**

It promotes fair trade practices by making underwriting optional.

### **(c) Research:**

It publishes information useful to all market participants for conducting research.

## ***3. Protective Functions:***

**Protective Functions of SEBI are as under:**

### **(a) Prevents Insider Trading:**

It does so by prohibiting insiders such as directors, promoters etc. to make profit through trading of securities using confidential price sensitive information.

### **(b) Prohibits Fraudulent and Unfair Trade Practices:**

It prohibits fraudulent and unfair trade practices in the security market, such as price rigging and sale or purchase of securities through misleading statements.

### **(c) Promotes Fair Practices:**

It promotes fair practices and code of conduct in the securities market e.g. it looks after the interests of the debenture holders in terms of any mid-term revision of interest rates etc.

### **(d) Educates Investors:**

It educates the investors through campaigns.

## **POWERS OF SEBI**

Securities and Exchange Board of India has the following three powers:



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**Quasi-Judicial:** With this authority, SEBI can conduct hearings and pass ruling judgements in cases of unethical and fraudulent trade practices. This ensures transparency, fairness, accountability and reliability in the capital market. SEBI PACL case is an example of this power.

**Quasi-Legislative:** Powers under this segment allow SEBI to draft rules and regulations for the protection of the interests of the investor. One such regulation is SEBI LODR (Listing Obligation and Disclosure Requirements). It aims at consolidating and streamlining the provisions of existing listing agreements for several segments of the financial market like equity shares. This type of regulation formulated by SEBI aims to keep any malpractice and fraudulent trading activities at bay.

**Quasi-Executive:** SEBI is authorised to file a case against anyone who violates its rules and regulation. It is empowered to inspect account books and other documents as well if it finds traces of any suspicious activity.

## STOCK MARKET

**Definition:** It is a place where shares of public listed companies are traded. The primary market is where companies float shares to the general public in an initial public offering (IPO) to raise capital.

**Description:** Once new securities have been sold in the primary market, they are traded in the secondary market—where one investor buys shares from another investor at the prevailing market price or at whatever price both the buyer and seller agree upon. The secondary market or the stock exchanges are regulated by the regulatory authority. In India, the secondary and primary markets are governed by the Security and Exchange Board of India (SEBI).

A stock exchange facilitates stock brokers to trade company stocks and other securities. A stock may be bought or sold only if it is listed on an exchange. Thus, it is the meeting place of the stock buyers and sellers. India's premier stock exchanges are the Bombay Stock Exchange and the National Stock Exchange.

## FUNCTIONS OF STOCK MARKET





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## ***1. Economic Barometer:***

A stock exchange is a reliable barometer to measure the economic condition of a country.

Every major change in country and economy is reflected in the prices of shares. The rise or fall in the share prices indicates the boom or recession cycle of the economy. Stock exchange is also known as a pulse of economy or economic mirror which reflects the economic conditions of a country.

## ***2. Pricing of Securities:***

The stock market helps to value the securities on the basis of demand and supply factors. The securities of profitable and growth oriented companies are valued higher as there is more demand for such securities. The valuation of securities is useful for investors, government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.

## ***3. Safety of Transactions:***

In stock market only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of company. The companies which are listed they also have to operate within the strict rules and regulations. This ensures safety of dealing through stock exchange.

## ***4. Contributes to Economic Growth:***

In stock exchange securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.

## ***5. Spreading of Equity Cult:***

Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and by educating public about investment.

## ***6. Providing Scope for Speculation:***

To ensure liquidity and demand of supply of securities the stock exchange permits healthy speculation of securities.



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## **7. Liquidity:**

The main function of stock market is to provide ready market for sale and purchase of securities. The presence of stock exchange market gives assurance to investors that their investment can be converted into cash whenever they want. The investors can invest in long term investment projects without any hesitation, as because of stock exchange they can convert long term investment into short term and medium term.

## **8. Better Allocation of Capital:**

The shares of profit making companies are quoted at higher prices and are actively traded so such companies can easily raise fresh capital from stock market. The general public hesitates to invest in securities of loss making companies. So stock exchange facilitates allocation of investor's fund to profitable channels.

## **9. Promotes the Habits of Savings and Investment:**

The stock market offers attractive opportunities of investment in various securities. These attractive opportunities encourage people to save more and invest in securities of corporate sector rather than investing in unproductive assets such as gold, silver, etc.

## **LIST OF STOCK EXCHANGES IN INDIA**

<b>Name of the Stock Exchange</b>	<b>Headquarters</b>	<b>Vision/ Mission</b>	<b>Year of Establishment</b>
Bombay Stock Exchange (BSE)	Mumbai	Emerges as the premier Indian stock exchange by establishing global benchmarks.	1875
	Mumbai	It is mutually-owned	1992



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National Stock Exchange of India (NSE)		by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India but its ownership and management operate as separate entities.	
Calcutta Stock Exchange (CSE)	Kolkata	It is the second largest bourse in India.	1908
Madras Stock Exchange	Chennai	The MSE is the fourth stock exchange to be established in the country and the first in South India.	1937
Inter-connected Stock Exchange Ltd.	Mumbai	It is a national-level stock exchange, providing trading, clearing, settlement, risk management and surveillance support to its trading members.	1998
United Stock Exchange of India	Mumbai	It is the fourth pan India exchange to be launched for trading financial instruments in India over the last 140 years.	2010
OTC Exchange Of India	Mumbai	It is the first exchange for small companies.	1990



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MCX Stock Exchange	Mumbai	It is an India-wide electronic platform for trading in currency futures under the regulatory control of Securities and Exchange Board of India (SEBI) and Reserve Bank of India (RBI).	2008
Multi Commodity Exchange of India Ltd (MCX)	Mumbai	It is an independent commodity exchange based in India.	2003
Bangalore Stock Exchange (BgSE)	Bangalore	The stock exchange is managed by a Council of Management, consisting of members appointed by the Securities and Exchange Board of India.	1963

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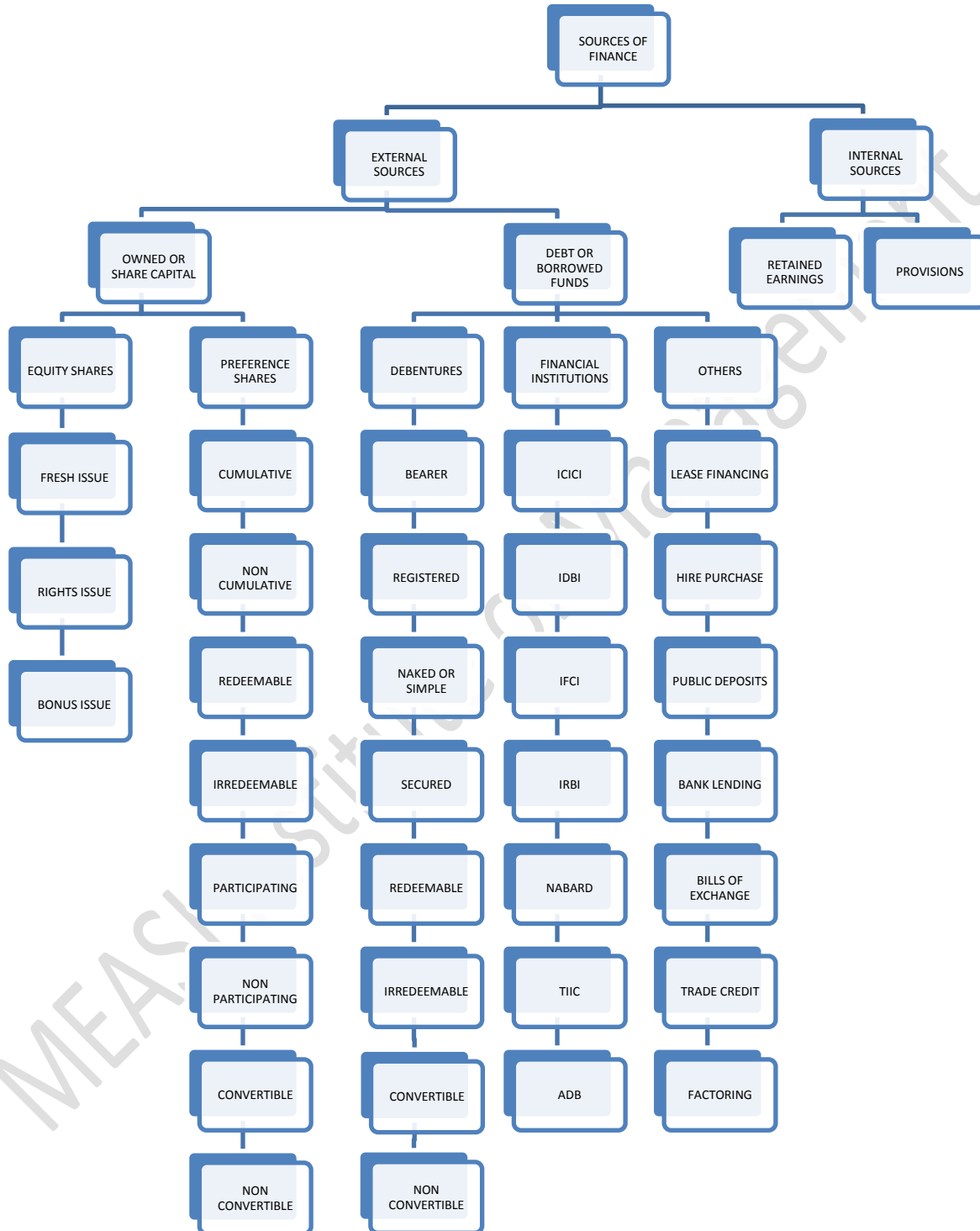
## **SOURCES OF FINANCE**

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## SHORT TERM FINANCING

1. BANK LOAN OR CREDIT
2. BANK O/D OR CASH CREDIT
3. BILLS OF EXCHANGE
4. FACTORING
5. TRADE CREDIT

## TYPES OF CREDIT

1. OPEN ACCOUNT
2. NOTES PAYABLE (PROMISSORY NOTE)
3. ACCEPTANCES

## FORMS OF TRADE CREDIT

1. CASH DISCOUNT
2. PAYMENT PERIOD
  - a. CBD
  - b. COD
  - c. Net Terms, No Cash Discount
  - d. Net Terms with Cash Discount
  - e. Seasonal – discount before peak sales.

## SEBI Guidelines for issue of fresh share capital

1. All applications should be submitted to SEBI in the prescribed form.
2. Applications should be accompanied by true copies of industrial license.
3. Cost of the project should be furnished with scheme of finance.
4. Company should have the shares issued to the public and listed in one or more recognized stock exchanges.
5. Where the issue of equity share capital involves offer for subscription by the public for the first time, the value of equity capital, subscribed capital privately held by promoters, and their friends shall be not less than 15% of the total issued equity capital.



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6. An equity-preference ratio of 3:1 is allowed.
7. Capital cost of the projects should be as per the standard set with a reasonable debt-equity ratio.
8. New company cannot issue shares at a premium. The dividend on preference shares should be within the prescribed list.
9. All the details of the underwriting agreement.
10. Allotment of shares to NRIs is not allowed without the approval of RBI.
11. Details of any firm allotment in favor of any financial institutions.
12. Declaration by secretary or director of the company.

### **SEBI Guidelines for first issue by new companies in Primary Market:**

1. A new company which has not completed 12 months of commercial operations will not be allowed to issue shares at a premium.
2. If an existing company with a 5-year track record of consistent profitability, is promoting a new company, then it is allowed to price its issue.
3. A draft of the prospectus has to be given to the SEBI before public issue.
4. The shares of the new companies have to be listed either with OTCEI or any other stock exchange.

### **SEBI guidelines for Secondary market**

1. All the companies entering the capital market should give a statement regarding fund utilization of previous issue.
2. Brokers are to satisfy capital adequacy norms so that the member firms maintain adequate capital in relation to outstanding positions.
3. The stock exchange authorities have to alter their bye-laws with regard to capital adequacy norms.
4. All the brokers should submit with SEBI their audited accounts.





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5. The brokers must also disclose clearly the transaction price of securities and the commission earned by them. This will bring transparency and accountability for the brokers.
6. The brokers should issue within 24 hours of the transaction contract notes to the clients.
7. The brokers must clearly mention their accounts details of funds belonging to clients and that of their own.
8. Margin money on certain securities has to be paid by claims so that speculative investments are prevented.
9. Market makers are introduced for certain scrips by which brokers become responsible for the supply and demand of the securities and the price of the securities is maintained.
10. A broker cannot underwrite more than 5% of the public issue.
11. All transactions in the market must be reported within 24 hours to SEBI.
12. The brokers of Bombay and Calcutta must have a capital adequacy of Rs. 5 lakhs and for Delhi and Ahmadabad it is Rs. 2 lakhs.
13. Members who are brokers have to pay security deposit and this is fixed by SEBI.

## COST OF CAPITAL

The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by a firm. The capital used by a firm may be in the form of debt, preference capital, retained earnings and equity shares. The concept of cost of capital is very important in the financial management. A decision to invest in a particular project depends upon the cost of capital of the firm or the cut off rate which is the minimum rate of return expected by the investors.



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## DEFINITIONS

James Cavan Horne defines cost of capital as, "a cut-off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock.

According to Solomon Ezra, "Cost of capital is the minimum required rate of earning or the cut-off rate of capital expenditures".

'The cost of capital is the minimum required rate of earnings or the cut off rate of capital expenditures'.

'The cost of capital represents a cut off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock'. From the above definition we can say that cost of capital is the minimum rate of return which a company is expected to earn from a proposed project so as to make no reduction in the earning per share to equity shareholders and its market price.

## COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL

Weighted average cost of capital is the average cost of the costs of various sources of Financing. Weighted average cost of capital is also known as composite cost of capital, overall cost of capital or average cost of capital. Once the specific cost of individual sources of finance is determined, we can compute the weighted average cost of capital by putting weights to the specific costs of capital in proportion of the various sources of funds to the total. The weights may be given either by using the book value of the source or market value of the source. The



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market value weights suffer from the following limitations: It is very difficult to determine the market values because of frequent fluctuations. With the use of market value weights, equity capital gets greater importance. For the above limitations, it is better to use book value which is readily available. Weighted average cost of capital can be computed as follows:

$$WACC = \Sigma X / \Sigma W$$

X = Cost of specific source of finance

W = Weight, proportion of specific source of finance

## MARGINAL COST OF CAPITAL

Sometimes, we may be required to calculate the cost of additional funds to be raised, called the marginal cost of capital. The marginal cost of capital is the weighted average cost of new capital calculated by using the marginal weights. The marginal weights represent the proportion of various sources of funds to be employed in raising additional funds. In case, a firm employs the existing proportion of capital structure and the component costs remain the same the marginal cost of capital shall be equal to the weighted average cost of capital.

## MEASUREMENT OF COST OF CAPITAL

The term cost of capital is an overall cost. This is the combination cost of the specific cost associated with specific source of financing. The computation of cost capital therefore, involves two steps: The computation of the different elements of the cost in term of the cost of the different source of finance.

The calculation of the overall cost by combining the specific cost into a composite cost. From the view point of capital budgeting decisions the long-term sources of fund are relevant as the constitute the major source of financing of fixed cost. In calculating the cost of capital, therefore, the focus is to be on the long-term funds.



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In other words the specific cost has to be calculated for: 1) Long term debt 2) Preference Shares 3) Equity Shares 4) Retained earnings

## COST OF DEBT

The cost of debt is the rate of interest payable on debt. For example, a company issues Rs.1, 00,000 10% debentures at par; the before-tax cost of this debt issue will also be 10%.

In case the debt is raised at premium or discount, we should consider P as the amount of net proceeds received from the issue and not the face value of securities.

Further, when debt is used as a source of finance, the firm saves a considerable amount in payment of tax as interest is allowed as a deductible expense in computation of tax. Hence, the effective cost of debt is reduced.

## COST OF PREFERENCE CAPITAL

A fixed rate of dividend is payable on preference shares. Though dividend is payable at the discretion of the Board of directors and there is no legal binding to pay dividend, yet it does not mean that preference capital is cost free. The cost of preference capital is a function of dividend expected by its investors, i.e., its stated dividend. In case dividend share not paid to preference shareholders, it will affect the fund raising capacity of the firm. Hence, dividends are usually paid regularly of preference shares expect when there are no profits to pay dividends.

Where, = Cost of preference Capital  $D = \text{Annual Preference Dividend}$   $P = \text{Preference Share Capital (Proceeds.)}$  Further, if preference shares are issued at Premium or Discount or



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when costs of floatation are incurred to issue preference shares, the nominal or par value or preference share capital has to be adjusted to find out the net proceeds from the issue of preference shares.

## COST OF EQUITY SHARE CAPITAL

The cost of equity is the „maximum rate of return that the company must earn of equity financed portion of its investments in order to leave unchanged the market price of its stock“. The cost of equity capital is a function of the expected return by its investors. The cost of equity is not the out-of-pocket cost of using equity capital as the equity shareholders are not paid dividend at a fixed rate every year. Moreover, payment of dividend is not a legal binding. It may or may not be paid. But it does not mean that equity share capital is a cost free capital. Shareholders invest money in equity shares on the expectation of getting dividend and the company must earn this minimum rate so that the market price of the shares remains unchanged. Whenever a company wants to raise additional funds by the issue of new equity shares, the expectations of the shareholders have to evaluate. The cost of equity share capital can be computed in the following ways:

### **(a.) Dividend Yield Method or Dividend/Price Ratio method:**

According to this method, the cost of equity capital is the „discount rate that equates the present value of expected future dividends per share with the new proceeds (or current market price) of a share“.

**(b) Dividend Yield plus Growth in Dividend Method:** When the dividends of the firm are expected to grow at a constant rate and the dividend-pay-out ratio is constant this



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method may be used to compute the cost of equity capital. According to this method the cost of equity capital is based on the dividends and the growth rate.

Further, in case cost of existing equity share capital is to be calculated, the NP should be changed with MP (market price per share)

## **MANAGEMENT OF LONG TERM CAPITAL**

The cost of capital is an important factor in formulating a firm's capital structure. In deciding the capital structure of a firm, it is very necessary to consider the cost of each source of capital and compare them so as to decide which source of capital is better is on the interest of owners and creditors etc. Now a days cost of capital is used as the very basis of capital budgeting decision and to evaluate the alternative sources of capital.

### **CONCEPT OF COST OF CAPITAL:**

There are two school of thought have emerged having basic differences on the relevance of the concepts but both concepts are based on optimal policy. One school of a thought is of the opinion that the cost of capital of a firm is constant and it is quite independent of the method and the level of financing. The other view is that cost of capital varies with the method of and level of financing.

### **USES OF COST OF CAPITAL IN FINANCIAL DECISION MAKING:**

#### **1. CAPITAL BUDGETING DECISION:**

Cost of capital may be used as the measuring tool for adopting an investment proposal. In various methods of capital budgeting, cost of capital is the key factor in deciding the project out of various proposals pending before the management. NPV or profitability index uses the cost of



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capital to discount the future cash inflows. Under IRR method, IRR is compared with the cost of capital. Thus in capital budgetary the cost of capital provides the criterion of accepts or reject of the proposals.

## **2. DESIGNING OF CAPITAL MIX:**

The cost of capital is significant factor in designing the firm's capital structure. The mix of debt and equity increased the rate of return on equity capital, other things remaining the same. But use of debt increases, the financial risks also. When the financial risk increases, the firm finds it difficult to raise additional funds at existing cost of capital. It has to offer higher, interest rate or to sell new shares on discount. The situation results in a higher cost of capital for the firm. Thus cost of capital affects the capital structure.

## **3. DECIDING ABOUT THE METHOD OF FINANCING:**

A capable finance manager must have knowledge of the fluctuation in the capital market and should analyse interest rate and dividend rates in the market from time to time. Whenever additional finance requires, he may have a better choice of the source of finance, which bears he minimum cost of capital.

## **4. PERFORMANCE OF TOP MANAGEMENT:**

The performance of top management should be evaluated by comparing actual profitability of projects, with (a) the projected overall cost of capital and (b) the actual costs of funds raised to finance the projects.

## **5. OTHER AREAS:**

The concept of cost of capital is also important in many other areas of decision making, such as dividend decision and working capital policy.



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## WEIGHTED AVERAGE COST OF CAPITAL

The total cost of capital or weighted average cost of capital is the aggregate of cost of specific capitals. In financial decision making, the concept of weighted average cost is relevant. This approach enables the maximization of corporate profits and the wealth of the equity shareholders by investing the funds in a projects earning in excess of the cost of its capital mix.

Weighted average is an average of the costs of specific sources of capital employed in a business, properly weighted by the proportion, they hold in the firm's capital structure. The following steps are used to calculate the weighted average cost of capital.

Ascertain the cost of individual components of the capital structure. Multiply the cost of each source by its proportion in the capital

Structure.

Add the weighted costs of all sources of funds to get the weighted cost of capital.

In financial decision making, the cost of capital should be calculated on after tax basis. Therefore, the component costs to be used to measure the weighted cost of capital should be after tax. If we assume that a firm has only debt and equity capital in its capital structure, then its weighted averages cost of capital will be

$$K_0 = k_d (1-t) P/V + k_e s/v$$

Where  $k_0$  is the weighted average cost of capital,  $V$  is the total value of the firm,  $D$  is the debt and  $S$  is the amount of equity.

## **BOOK VALUE WEIGHTS AND MARKET VALUE WEIGHTS:**





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The weighted cost of capital can be computed by using the book value or the market value weights. Book value weight will be understated if the market value of the share is higher than the book value and vice-versa. The book value weight is simple to calculate and it has the following advantages.

- Firms in practice set their capital structure targets in terms of book values.
- The book value information can be easily derived from the published sources.
- The book value debt equity ratios are analysed by investors to evaluate the riskiness of the firms in practice.

## ADVANTAGES OF WEIGHTED AVERAGE COST OF CAPITAL:

- It is straight forward and logical.
- It reflects each element of capital structure will be reflected as small changes in overall cost of capital and vice-versa.
- It is fairly accurate cut-off point in periods of normal profits. The reason is that  $K_o$  considers relatively low cost of debts and the need to achieve the higher returns on equity shares.
- It handles, the lower cost debt properly, if proportion debt is not excessive.

## MEASUREMENT OF SPECIFIC COST OF DIFFERENT SOURCES:

### 1. COST OF DEBT: ( $K_d$ )

The cost of debt is defined in terms of the required rate of return that the debt investment must yield to protect the shareholders' interest. For calculating the costs of debt both explicit as well as imputed cost should be taken into account. The explicit costs are measured by interest rate duly adjusted by tax rate. The yearly-imputed interest can be calculated by the difference between the actual receipts of debentures and the amount to be paid at the end of maturity divided by the years of maturity.



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$$\text{Cost of irredeemable debentures} = \frac{I}{NP} (1 - T)$$

I = Interest                      T = Tax rate

NP = Net Proceeds

**Cost of redeemable debentures (before tax)**

$$\frac{I + (P - NP) / n}{(P + NP) / 2}$$

**Cost of redeemable debentures (after tax) = Kd(before tax) x (I - T)**

I = Interest

NP = Net Proceeds

N = Number of years for maturity

P = Principal

## 2. COST OF PREFERENCE SHARES (Kp):

Cost of preference shares are the fixed cost bearing securities. The dividend rate is fixed well in advance at the time of their name. The cost of a preference share can be determined in the same way as the cost of debentures except the adjustment of tax because dividends on preference capital are paid after taxes as it is not tax deductible. Thus the cost of preference share is high than the cost of debt.

**Cost of Irredeemable Preference shares = Kp = Dp / NP**

Dp = Dividend for preference share holder

NP = Net proceeds



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$$\text{Cost of Redeemable Preference shares} = \frac{D + (P - NP) / n}{(P + NP) / 2}$$

### 3. COST OF EQUITY SHARES (Ke):

The cost of equity capital is the minimum rate of return that the firm must earn on the equity financed portion of an investment project in order to leave unchanged the market price of the stock. Normally cost of equity must be somewhat greater than shareholder's opportunity rate of return. The cost of equity can be ascertained by different approaches. They are explained below:

#### (a) Dividend / Price Approach:

According to this approach the value of an equity share is equivalent to the present value of future dividends plus the present value of the price expected to be

$$\text{Realized. } K_e = D / NP \text{ or } D / MP$$

#### (b) Dividend / Price + growth rate Approach:

This approach takes into account dividend as well as rate of growth in the dividend, which is assumed to be equal to the growth rate in earnings per share and market price per share.

$$K_e = \frac{D}{NP \text{ OR } MP} + G$$

This approach is considered to be the best measure of the cost of new capital that ensure the optimum capital budgeting decisions. The main difficulty in this approach is to determine rate of growth of price appreciation expected by a shareholder when he is willing to pay a certain price for current dividend.



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## (c.) E earnings Price ratio Approach:

This ratio establishes the relationship between earnings and market price of the shares. Shareholders capitalize a stream of unchanged earnings by the capitalization ratio of E / P in order to evaluate their holdings. Its limitations are 1. All earnings are not distributed as dividend. 2. Earnings and share price per share are not constant over the years.

Hence this approach can be used only when the earnings of the firm are stable and consequently future earnings will be equal to the present earnings.

$$K_e = E / NP \text{ or } MP$$

## (d) Realised Yield Approach:

This approach is based on the rate of return actually realized for a period of time by investors in a company. Under this approach, the realized yield is discounted at the present value factor and then compared with the value of investment.

$$K_e = \frac{E}{NP \text{ OR } MP} + G$$

## 4. Cost of Retained Earnings:

Retained earnings also have opportunity cost. Opportunity cost of retained earnings is other rate of return which they can get by investing the after tax dividends in other alternative opportunities. It can be expressed as:

$$K_r = K_e (1-T) (1-B)$$



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## UNIT III

### INVESTMENT ANALYSIS

#### INTRODUCTION

The word Capital refers to be the total investment of a company of firm in money, tangible and intangible assets. Whereas budgeting defined by the “**Rowland and William**” it may be said to be the art of building budgets. Budgets are a blue print of a plan and action expressed in quantities and manners. Investment decision is the process of making investment decisions in capital expenditure. A capital expenditure may be defined as an expenditure the benefits of which are expected to be received over period of time exceeding one year. The main characteristic of a capital expenditure is that the expenditure is incurred at one point of time whereas benefits of the expenditure are realized at different points of time in future. The examples of capital expenditure:

1. Purchase of fixed assets such as land and building, plant and machinery, good will, etc.
2. The expenditure relating to addition, expansion, improvement and alteration to the fixed assets.
3. The replacement of fixed assets.
4. Research and development project.

#### MEANING

The process through which different projects are evaluated is known as capital budgeting. Capital budgeting is defined “as the firm’s formal process for the acquisition and investment of capital. It involves firm’s decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets”.

#### DEFINITION

Capital budgeting (investment decision) as, “Capital budgeting is long term Planning for making and financing proposed capital outlays.” ----- Charles T.Horngreen

“Capital budgeting consists in planning development of available capital for the purpose Of maximizing the long term profitability of the concern” – Lynch

“Capital budgeting is concerned with the allocation of the firm source financial resources among the available opportunities. The consideration of investment opportunities involves the



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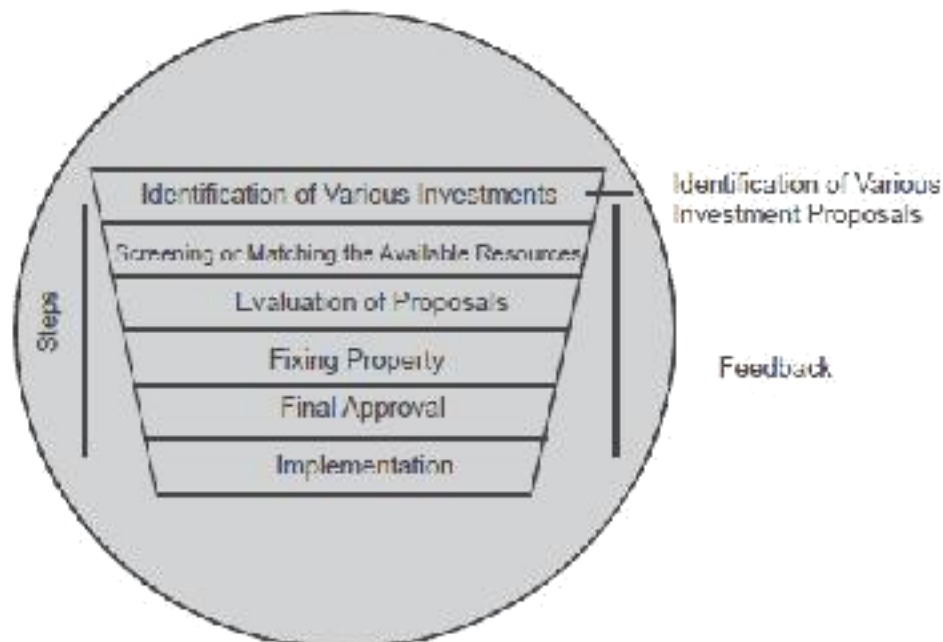
comparison of the expected future streams of earnings from a project with the immediate and subsequent streams of earning from a project, with the immediate and subsequent streams of expenditure”. ---- **G.C. Philippatos**

## NEED AND IMPORTANCE OF CAPITAL BUDGETING

- 1. Huge investments:** Capital budgeting requires huge investments of funds, but the available funds are limited, therefore the firm before investing projects, plan and control its capital expenditure.
- 2. Long-term:** Capital expenditure is long-term in nature or permanent in nature. Therefore financial risks involved in the investment decision are more. If higher risks are involved, it needs careful planning of capital budgeting.
- 3. Irreversible:** The capital investment decisions are irreversible, are not changed back. Once the decision is taken for purchasing a permanent asset, it is very difficult to dispose of those assets without involving huge losses.
- 4. Long-term effect:** Capital budgeting not only reduces the cost but also increases the revenue in long-term and will bring significant changes in the profit of the company by avoiding over or more investment or under investment. Over investments leads to be unable to utilize assets or over utilization of fixed assets. Therefore before making the investment, it is required carefully planning and analysis of the project thoroughly.

## CAPITAL BUDGETING PROCESS

Capital budgeting is a complex process as it involves decisions relating to the investment of current funds for the benefit to be achieved in future and the future is always uncertain. However the following procedure may be adopted in the process of capital budgeting:





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Step 1 and Step 2	= Project generation
Step 3	= Project evaluation
Step 4 and 5	= Project selection
Step 6	= Project execution

## PROJECT GENERATION

### 1. Identification of Investment Proposals:

The capital budgeting process begins with the identification of investment proposals. The proposal or the idea about potential investment opportunities may originate from the top management or may come from the rank and file worker of any department or from any officer of the organization. The departmental head analyses the various proposals in the light of the corporate strategies and submits the suitable proposals to the capital expenditure planning committee in case of large organizations or to the officers concerned with the process of long-term decisions.

### 2. Screening the Proposals:

The expenditure planning committee screens the various proposals received from different departments. The committee views these proposals from various angles to ensure that these are in accordance with the corporate strategies or a selection criterion's of the firm and also do not lead to departmental imbalances.

## PROJECT EVALUATION

### 3. Evaluation of Various Proposals:

The next step in the capital budgeting process is to evaluate the profitability of various proposals. There are many methods which may be used for this purpose such as payback period method, rate of return method, net present value method, internal rate of return method etc. All these methods of evaluating profitability of capital investment proposals have been discussed in detail separately in the following pages of this chapter.

It should, however, be noted that the various proposals to be evaluated may be classified as:

- (I) Independent proposals
- (ii) Contingent or dependent proposals and
- (iii) Mutually exclusive proposals.





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Independent proposals are those which do not compete with one another and the same may be either accepted or rejected on the basis of a minimum return on investment required. The contingent proposals are those whose acceptance depends upon the acceptance of one or more other proposals, eg., further investment in building or machineries may have to be undertaken as a result of expansion programmed. Mutually exclusive proposals are those which compete with each other and one of those may have to be selected at the cost of the other.

## PROJECT SELECTION

### 4. Fixing Priorities:

After evaluating various proposals, the unprofitable or uneconomic proposals may be rejected straight ways. But it may not be possible for the firm to invest immediately in all the acceptable proposals due to limitation of funds. Hence, it is very essential to rank the various proposals and to establish priorities after considering urgency, risk and profitability involved therein.

### 5. Final Approval and Preparation of Capital Expenditure Budget:

Proposals meeting the evaluation and other criteria are finally approved to be included in the Capital expenditure budget. However, proposals involving smaller investment may be decided at the lower levels for expeditious action. The capital expenditure budget lays down the amount of estimated expenditure to be incurred on fixed assets during the budget period.

## PROJECT EXECUTION

### 6. Implementing Proposal:

Preparation of a capital expenditure budgeting and incorporation of a particular proposal in the budget does not itself authorize to go ahead with the implementation of the project. A request for authority to spend the amount should further be made to the Capital Expenditure Committee which may like to review the profitability of the project in the changed circumstances.

Further, while implementing the project, it is better to assign responsibilities for completing the project within the given time frame and cost limit so as to avoid unnecessary delays and cost over runs. Network techniques used in the project management such as PERT and CPM can also be applied to control and monitor the implementation of the projects.

### 7. Performance Review:

The last stage in the process of capital budgeting is the evaluation of the performance of the project. The evaluation is made through post completion audit by way of comparison of actual expenditure of the project with the budgeted one, and also by comparing the actual return from the investment with the anticipated return. Some deviations may be taken into and the causes of the same are identified so that





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## DEVELOPING CAH FLOW DATA (cash inflow and cash outflow)

Before we can compute a project's value, we must estimate the cash flows both current and future associated with it. We therefore begin by discussing cash flow estimation, which is the most important and perhaps the most difficult, step in the analysis of a capital project. The process of cash flow estimation is problematic because it is difficult to accurately forecast the costs and revenues associated with large, complex projects that are expected to affect operations for long periods of time.

### Calculation of cash inflow

Sales	XXXX	
Less: Cash expenses	<u>XXXX</u>	
PBDT	XXXX	
Less: Depreciation	<u>XXXX</u>	
PBT	XXXX	
less: Tax	<u>XXXX</u>	
PAT	XXXX	
Add: Depreciation	<u>XXXX</u>	
<b>Cash inflow p.a</b>		<b><u>XXXX</u></b>

### Calculation of cash outflow

Cost of project/asset	XXXX	
Transportation/installation charges	XXXX	
Working capital	<u>XXXX</u>	
<b><u>Cash outflow</u></b>		<b><u>XXXX</u></b>



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## PROJECT EVALUATION TECHNIQUES (OR) CAPITAL BUDGETING TECHNIQUES

At each point of time a business firm has a number of proposals regarding various projects in which it can invest funds. But the funds available with the firm are always limited and it is not possible to invest funds in all the proposals at a time. Hence, it is very essential to select from amongst the various competing proposals, those which give the highest benefits. The crux of the capital budgeting is the allocation of available resources to various proposals.

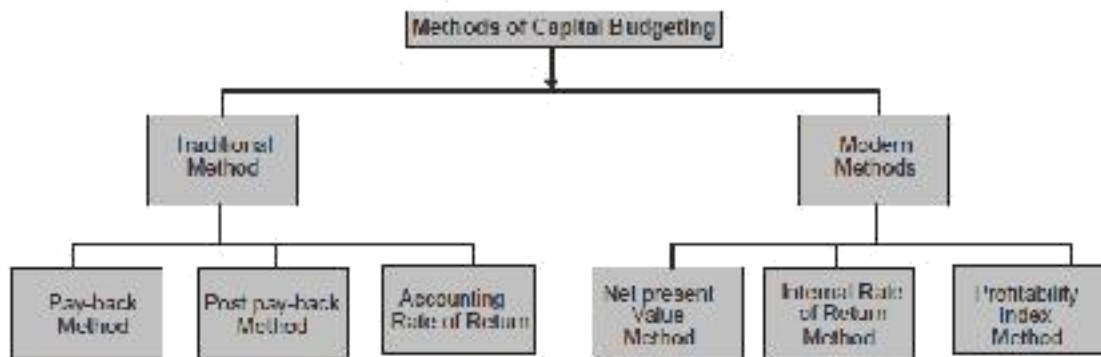
There are many methods of evaluating profitability of capital investment proposals. The various commonly used methods are as follows:

### (A) Traditional methods:

- (1) Pay-back Period Method or Pay out or Pay off Method.
- (2) Improvement of Traditional Approach to pay back Period Method.(post payback method)
- (3) Accounting or Average Rate of Return Method.

### (B) Time-adjusted method or discounted methods:

- (4) Net Present Value Method.
- (5) Internal Rate of Return Method.
- (6) Profitability Index Method.



### (A) TRADITIONAL METHODS: 1. PAY-BACK PERIOD METHOD

The ‘pay back’ sometimes called as pay out or pay off period method represents the period in which the total investment in permanent assets pays back itself. This method is based on the principle that every capital expenditure pays itself back within a certain period out of the additional earnings generated from the capital assets.



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Under this method, various investments are ranked according to the length of their payback period in such a manner that the investment within a shorter payback period is preferred to the one which has longer pay back period. (It is one of the non-discounted cash flow methods of capital budgeting).

$$\text{Pay-back period} = \frac{\text{Initial investment}}{\text{Annual cash inflows}}$$

## MERITS

The following are the important merits of the pay-back method:

1. It is easy to calculate and simple to understand.
2. Pay-back method provides further improvement over the accounting rate return.
3. Pay-back method reduces the possibility of loss on account of obsolescence.

## DEMERITS

1. It ignores the time value of money.
2. It ignores all cash inflows after the pay-back period.
3. It is one of the misleading evaluations of capital budgeting.

## ACCEPT /REJECT CRITERIA

If the actual pay-back period is less than the predetermined pay-back period, the project would be accepted. If not, it would be rejected.

## 2. POST PAY-BACK PROFITABILITY METHOD:

One of the serious limitations of Pay-back period method is that it does not take into account the cash inflows earned after pay-back period and hence the true profitability of the project cannot be assessed. Hence, an improvement over this method can be made by taking into account the return receivable beyond the pay-back period.

Post pay-back profitability = Cash inflow (Estimated life – Pay-back period)  
Post pay-back profitability index = Post pay-back profitability/original investment

## 3. AVERAGE RATE OF RETURN:

This method takes into account the earnings expected from the investment over their whole life. It is known as accounting rate of return method for the reason that under this method, the



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Accounting concept of profit (net profit after tax and depreciation) is used rather than cash inflows. According to this method, various projects are ranked in order of the rate of earnings or rate of return. The project with the higher rate of return is selected as compared to the one with lower rate of return. This method can also be used

to make decision as to accepting or rejecting a proposal. Average rate of return means the average rate of return or profit taken for considering

## (a) Average Rate of Return Method (ARR):

Under this method average profit after tax and depreciation is calculated and then it is divided by the total capital outlay or total investment in the project. The project evaluation. This method is one of the traditional methods for evaluating

The project proposals

$$\text{ARR} = \frac{\text{Total profits (after dep \& taxes)}}{\text{Net Investment in the project} \times \text{No. of years of profits}} \times 100$$

OR

$$\text{ARR} = \frac{\text{Average Annual profits}}{\text{Net investment in the project}} \times 100$$

## (b) Average Return on Average Investment Method:

This is the most appropriate method of rate of return on investment Under this method, average profit after depreciation and taxes is divided by the average amount of investment; thus:

$$\text{Average Return on Average Investment} = \frac{\text{Average Annual Profit after depreciation and taxes}}{\text{Average Investment}} \times 100$$

### Merits

1. It is easy to calculate and simple to understand.
2. It is based on the accounting information rather than cash inflow.
3. It is not based on the time value of money.
4. It considers the total benefits associated with the project.

### Demerits

1. It ignores the time value of money.
2. It ignores the reinvestment potential of a project.



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3. Different methods are used for accounting profit. So, it leads to some difficulties in the calculation of the project.

### Accept/Reject criteria

If the actual accounting rate of return is more than the predetermined required rate of return, the project would be accepted. If not it would be rejected.

### (B) TIME – ADJUSTED OR DISCOUNTED CASH FLOW METHODS: or MODERN METHOD

The traditional methods of capital budgeting i.e. pay-back method as well as accounting rate of return method, suffer from the serious limitations that give equal weight to present and future flow of incomes. These methods do not take into consideration the time value of money, the fact that a rupee earned today has more value than a rupee earned after five years.

#### 1. NET PRESENT VALUE

Net present value method is one of the modern methods for evaluating the project proposals. In this method cash inflows are considered with the time value of the money. Net present value describes as the summation of the present value of cash inflow and present value of cash outflow. Net present value is the difference between the total present values of future cash inflows and the total present value of future cash outflows.

#### NPV = Total Present value of cash inflows – Net Investment

If offered an investment that costs \$5,000 today and promises to pay you \$7,000 two years from today and if your opportunity cost for projects of similar risk is 10%, would you make this investment? You

Need to compare your \$5,000 investment with the \$7,000 cash flow you expect in two years. Because you feel that a discount rate of 10% reflects the degree of uncertainty associated with the \$7,000 expected in two years, today it is worth:

$$\begin{aligned} & \text{Present value of \$7,000 to be received in two years} \\ & - \frac{\$7,000}{(1 + 0.10)^2} = \$5,785.12 \end{aligned}$$

By investing \$5,000 today, you are getting in return a promise of a cash flow in the future that is worth \$5,785.12 today. You increase your wealth by \$785.12 when you make this investment.

#### Merits

1. It recognizes the time value of money.



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2. It considers the total benefits arising out of the proposal.
3. It is the best method for the selection of mutually exclusive projects.
4. It helps to achieve the maximization of shareholders' wealth.

## **Demerits**

1. It is difficult to understand and calculate.
2. It needs the discount factors for calculation of present values.

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3. It is not suitable for the projects having different effective lives.

## Accept/Reject criteria

If the present value of cash inflows is more than the present value of cash outflows, it would be accepted. If not, it would be rejected.

## 2. PROFITABILITY INDEX METHOD

The *profitability index* (PI) is the ratio of the present value of change in operating cash inflows to the present value of investment cash outflows:

$$PI = \frac{\text{Present value of the change in operating cash inflows}}{\text{Present value of the investment cash outflows}}$$

Instead of the *difference* between the two present values, as in equation NPV is the *ratio* of the two present values. Hence, PI is a variation of NPV. By construction, if the NPV is zero, PI is one.

## 3. INTERNAL RATE OF RETURN METHOD

This method is popularly known as time adjusted rate of return method/discounted rate of return method also. The internal rate of return is defined as the interest rate that equates the present value of expected future receipts to the cost of the investment outlay. This internal rate of return is found by trial and error. First we compute the present value of the cash-flows from an investment, using an arbitrarily elected interest rate. Then we compare the present value so obtained with the investment cost. If the present value is higher than the cost figure, we try a higher rate of interest and go through the procedure again. Conversely, if the present value is lower than the cost, lower the interest rate and repeat the process. The interest rate that brings about this equality is defined as the internal rate of return. This rate of return is compared to the cost of capital and the project having higher difference, if they are mutually exclusive, is adopted and other one is rejected. As the determination of internal rate of return involves a number of attempts to make the present value of earnings equal to the investment, this approach is also called the Trial and Error Method. Internal rate of return is time adjusted technique and covers the disadvantages of the Traditional techniques. In other words it is a rate at which discount cash flows to zero. It is expected by the following ratio





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**Steps to be followed:**

**Step 1.** Find out factor Factor is calculated as follows:

$$F = \frac{\text{Cash outlay (or) initial investment}}{\text{Cash inflow}} \times \frac{\text{Cash inflow}}{\text{Investment initial}}$$

**Step 2.** Find out positive net present value

**Step 3.** Find out negative net present value

**Step 4.** Find out formula net present value

**Formula**

$$\text{IRR} = \text{Base factor} + \frac{\text{Positive net present value}}{\text{Difference in positive and Negative net present value}} \times \text{DP}$$

Base factor = Positive discount rate

DP = Difference in percentage

**Merits**

1. It considers the time value of money.
2. It takes into account the total cash inflow and outflow.
3. It does not use the concept of the required rate of return.
4. It gives the approximate/nearest rate of return.

**Demerits**

1. It involves complicated computational method.
2. It produces multiple rates which may be confusing for taking decisions.
3. It is assume that all intermediate cash flows are reinvested at the internal rate of return.

**Accept/Reject criteria**





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If the present value of the sum total of the compounded reinvested cash flows is greater than the present value of the outflows, the proposed project is accepted. If not it would be rejected.

## NPV vs. IRR Methods

**Key differences** between the most popular methods, the NPV (Net Present Value) Method and IRR (Internal Rate of Return) Method, include:

- **NPV** is calculated in terms of currency while **IRR** is expressed in terms of the percentage return a firm expects the capital project to return;
- Academic evidence suggests that the **NPV Method is preferred** over other methods since it calculates additional wealth and the IRR Method does not;
- The IRR Method cannot be used to evaluate projects where there are **changing cashflows** (e.g., an initial outflow followed by in-flows and a later out-flow, such as may be required in the case of land reclamation by a mining firm);
- However, the **IRR Method does have one significant advantage** -- managers tend to better understand the concept of returns stated in percentages and find it easy to compare to the required cost of capital; and, finally,
- While both the NPV Method and the IRR Method are both DCF models and can even reach similar conclusions about a single project, the use of the IRR Method can lead to the belief that a smaller project with a shorter life and earlier cash inflows, is preferable to a larger project that will generate more cash.
- Applying NPV using **different discount rates** will result in different recommendations. The IRR method always gives the same recommendation.

Recent variations of these methods include:

- The Adjusted Present Value (APV) Method is a flexible DCF method that takes into account interest related tax shields; it is designed for firms with active debt and a consistent market value leverage ratio;



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- The Profitability Index (PI) Method, which is modelled after the NPV Method, is measured as the total present value of future net cash inflows divided by the initial investment; this method tends to favour smaller projects and is best used by firms with limited resources and high costs of capital;
- The Bailout Payback Method, which is a variation of the Payback Method, includes the salvage value of any equipment purchased in its calculations;

The Real Options Approach allows for flexibility, encourages constant reassessment based on the riskiness of the project's cash flows and is based on the concept of creating a list of value-maximizing options to choose projects from; management can, and is encouraged, to react to changes that might affect the assumptions that were made about each project being considered prior to its commencement, including postponing the project if necessary; it is noteworthy that there is not a lot of support for this method among financial managers at this time.

## PAYBACK PERIOD

### *Advantages*

1. Simple to compute.
2. Provides some information on the risk of the investment.
3. Provides a crude measure of liquidity.

### *Disadvantages*

1. No concrete decision criteria to tell us whether an investment increases the firm's value.
2. Ignores cash flows beyond the payback period.
3. Ignores the time value of money.
4. Ignores the riskiness of future cash flows.

## DISCOUNTED PAYBACK PERIOD

### *Advantages*

1. Considers the time value of money.
2. Considers the riskiness of the cash flows involved in the payback.

### *Disadvantages*

1. No concrete decision criteria that tells us whether the investment increases the firm's value.
2. Calls for a cost of capital.
3. Ignores cash flows beyond the payback period.



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## REASONS FOR BUSINESS FAILURE

### I. INTERNAL REASONS

#### 1. FINANCE:

- a. Inappropriate finance structure
- b. Under utilization of Assets
- c. Insufficient working capital
- d. Absence of financial planning
- e. Improper diversion of funds

#### 2. PRODUCTION:

- a. Site Selection
- b. Inappropriate Plant & Machinery
- c. Inadequate material control
- d. Lack of quality control

#### 3. MARKETING

- a. Poor demand forecasting.
- b. Inappropriate product mix
- c. Lack of product planning
- d. Lack of market research

#### 4. PERSONNEL

- a. Poor wages & salary
- b. Strained labour relations.

#### 5. CORPORATE MANAGEMENT

- a. Poor corporate Planning.
- b. Poor co-ordination and control
- c. Resistance to change

### II. EXTERNAL REASONS

#### 1. FINANCIAL PROBLEM

- a. Credit Restraints
- b. Delay in loan disbursements
- c. Unfavourable investment climate.
- d. Fear of Nationalization

#### 2. PRODUCTION CONSTRAINTS

- a. Shortage of inputs
- b. Import restrictions on essential inputs

#### 3. MARKETING CONSTRAINTS

- a. Liberal licensing of project in a particular industry
- b. Restrain on purchases by bulk purchasers
- c. Change in international marketing scene
- d. Excessive taxation policy of government

#### 4. PERSONNEL CONSTRAINTS

- a. Non-availability of skilled manpower
- b. General Labour unrest in the areas.
- c. Inter union rivalry.



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## MERGER CONSOLIDATION AND LIQUIDATION

### **Merger:**

A merger is an agreement that unites two existing companies into one new company. There are several types of mergers and also several reasons why companies complete mergers

**Acquisition:** A company acquired by another company on the approval of the selling company

**Takeover:** When a company is acquired by another company against its wishes then it is referred as takeover.

**Consolidation:** When two or more companies join together to form one single entity then it is called as consolidation.

**Joint Venture:** When two existing companies join together to start a new company and carry on only that business and the two companies will not carry this business individually.

**Holding and subsidiary companies:** If 51% of the shares of one company are held by another company or if a company has powers to change the board of directors of another company then the company holding the shares is called as holding company and the other company is called as subsidiary company.

### **Types of Merger:**

#### **Congeneric**

A congeneric merger is also known as a Product Extension merger. In this type, it is a combining of two or more companies that operate in the same market or sector with overlapping factors, such as technology, marketing, production processes, and research and development (R&D). A product extension merger is achieved when a new product line from one company is added to an existing product line of the other company. When two companies become one under a product extension, they are able to gain access to a larger group of consumers and, thus, a larger market share. An example of a congeneric merger is Citigroup's 1998 union with Travelers Insurance, two companies with complementing products.

#### **Market Extension**

This type of merger occurs between companies that sell the same products but compete in different markets. Companies that engage in a market extension merger seek to gain access to a



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bigger market and, thus, a bigger client base. To extend their markets, Eagle Bancshares and RBC Centura merged in 2002.

## **Horizontal**

A horizontal merger occurs between companies operating in the same industry. The merger is typically part of consolidation between two or more competitors offering the same products or services. Such mergers are common in industries with fewer firms, and the goal is to create a larger business with greater market share and economies of scale since competition among fewer companies tends to be higher. The 1998 merger of Daimler-Benz and Chrysler is considered a horizontal merger.

## **Vertical**

When two companies that produce parts or services for a product merger the union is referred to as a vertical merger. A vertical merger occurs when two companies operating at different levels within the same industry's supply chain combine their operations. Such mergers are done to increase synergies achieved through the cost reduction which results from merging with one or more supply companies. One of the most well-known examples of a vertical merger took place in 2000 when internet provider America Online (AOL) combined with media conglomerate Time Warner.

## **Conglomerate**

This is a merger between two or more companies engaged in unrelated business activities. The firms may operate in different industries or in different geographical regions. A pure conglomerate involves two firms that have nothing in common. A mixed conglomerate, on the other hand, takes place between organizations that, while operating in unrelated business activities, are actually trying to gain product or market extensions through the merger.

Companies with no overlapping factors will only merge if it makes sense from a shareholder wealth perspective, that is, if the companies can create synergy. A conglomerate merger was formed when The Walt Disney Company merged with the American Broadcasting Company (ABC) in 1995.

## **Advantages of Merger and consolidation**

### 1. Economies of scale

When the production is large the cost of production is less. Due to merger company becomes large and increases the production level thereby the cost increases. There are four types of economies of scale viz., technical economies, bulk buying economies, financial economies and organizational economies



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## 2. Tax benefits

When a merged company takes over a company making loss, the loss can be set off from the profit making units, thereby benefiting in reduced tax payment.

## 3. Financial resources

After merger the company will have additional financial resources, the combined assets of the company will help to increase the credit worthiness of the merged company, increase the bargaining power to obtain loans at a subsidized rate of interest.

## 4. Entry into global markets

The global market does not have any restrictions for entrances. Merger helps the merged company to get into the global market which encompasses various regions.

## 5. Growth and expansion

Mergers help the merged company to grow and expand. This growth and expansion are achieved by making a strong presence in the domestic markets and entering into various foreign markets.

## 6. Helps to face competition

Merger helps the merged company to face competition at both levels, national as well as international markets. Generally the merged company face the market competition by merging the competitors in their company and providing the goods and services at competitive prices.

## 7. Increase in market share

Merger helps in increasing the market share of the company in two ways the first one by providing the adequate supply of goods and services as needed by clients and entering into an agreement with clients for continuous supply of goods and services.

## 8. Increases goodwill

Merger helps the merged company to boost its goodwill in the market. It creates goodwill by increasing the confidence of the shareholders of the merged company and creating good image of the merged company among the customers.





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## 9. Research and development

Merger helps the R&D program of the merged company this enhancement is achieved by allowing uninterrupted investment in research and development programs and by appointing skilled professionals to carry out research and development programs.

## 10. Synergy

Merger and consolidation helps in synergizing the activities of the organization. Logically  $3 + 3 = 6$  but it is not 6 rather it will be 9. This is synergy.

## 11. Miscellaneous advantages

It may help the merged companies to deal with the threats of multinational companies. It also helps to reduce redundancies observed in business activities and/or operations. Merger generates value of the merged company by assessing funds and assets and supports its business growth and development.

### Disadvantages of merger and consolidation

- Increased market share will lead to monopoly power and higher prices for consumers.
- Firm may at time become inefficient
- A larger firm may experience diseconomies of scale
- Two very different firms may struggle to merge
- Less choice for consumers
- Job losses

Share Exchange Ratio/ Swap Ratio Swap Ratio may be defined as No. of equity shares issued by Acquiring Company to Target Company for every one share held by Target Company.

### Methods of Calculating the Swap Ratio:

- On the basis of MPS Swap Ratio = 
$$\frac{\text{MPS of Target Company}}{\text{MPS of Acquiring Company}}$$





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2. On the basis of EPS Swap Ratio = 
$$\frac{\text{EPS of Target Company}}{\text{EPS of Acquiring Company}}$$
  
3. On the basis of NAV per Share Swap Ratio = 
$$\frac{\text{NAV of Target Company}}{\text{NAV of Acquiring Company}}$$
  
4. On the basis of Book Value per share Swap Ratio = 
$$\frac{\text{BVPS of Target Company}}{\text{BVPS of Acquiring Company}}$$
  
5. On the basis of P/E Ratio Swap Ratio = 
$$\frac{\text{P/E Ratio of Target Company}}{\text{P/E Ratio of Acquiring Company}}$$

Note: EPS = Earning available to Equity Shareholder / Total number of equity shares  
 NAV = (Total Assets – Total External Liability) / Total number of equity shares  
 P / E Ratio = Market Price per Share / Earning Price per Share

### Some Basic concepts

1. Total Number of Equity Shares after Merger Number of Shares<sub>A+B</sub> = N<sub>A</sub> + N<sub>B</sub> × ER
2. EPS after Merger or EPS A + B or EPS of a Merged Firm/ Combined Firm = 
$$\text{EPS}_{A+B} = [ \text{E}_A + \text{E}_B + \text{Synergy Gain} / \text{N}_A + \text{N}_B \times \text{ER} ]$$
3. MPS after Merger or MPS A + B or MPS of a Merged Firm
  - Alternative 1: If P/E Ratio is given  

$$\text{MPS}_{A+B} = \text{EPS}_{A+B} \times \text{P/E}_{A+B}$$
  - Alternative 2: If P/E Ratio is not given  

$$\text{MPS}_{A+B} = [ \text{Total MV after Merger} / \text{Total No. of Equity Shares after Merger} ] \text{ Or}$$

$$\text{MPS}_{A+B} = [ \text{MV}_A + \text{MV}_B + \text{Synergy Gain} / \text{N}_A + \text{N}_B \times \text{ER} ]$$



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Note:

- ❖ Answer by both alternative will be different.
- ❖ Alternative 1 should be preferred whenever any hint regarding P/E after merger is given in question.

4. Market Value of Merged Firm or  $MV_{A+B}$

$$\text{Alternative 1: } MV_{A+B} = MPS_{A+B} \times [N_A + N_B \times ER]$$

$$\text{Alternative 2: } MV_{A+B} = MV_A + MV_B + \text{Synergy Note:}$$

- ❖ Answer by both alternative will be different.
- ❖ Alternative 1 should be preferred

5. Equivalent EPS of Target Co. in Merged Firm

$$\text{Equivalent EPS of Target Co. in Merged Firm} = EPS_{A+B} \times ER$$

6. Equivalent MPS of Target Co. in Merged Firm

$$\text{Equivalent MPS of Target Co. in Merged Firm} = MPS_{A+B} \times ER$$

Gain or Loss

Merger may result in gain or loss for acquiring company and target company.

On the basis of EPS/MPS/Market value (MV)

Particulars	Company X	Company Y
EPS/ MPS / Market Value after merger	XXX	XXX
EPS/ MPS / Market Value before merger	XXX	XXX
	-----	-----
Gain / Loss	XXX	XXX
	-----	-----



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## UNIT IV FINANCE FROM INTERNATIONAL SOURCES

### Different Types of Export finance

There are basically five types of export finance.

1. Pre-shipment export finance
2. Post shipment export finance
3. Export finance against collection of bills.
4. Deferred export finance
5. Export finance against allowances and subsidies.

#### **Pre-shipment export finance:**

The exporter is provided finance even for the purchase of raw materials and processing them into finished products but this finance can be provided only when the exporter has firm order from the importer and the importer has also given an anticipatory Letter of Credit from his bank. So, against the export order received from the importer, the exporter is given finance by his bank which is called pre-shipment export finance.

#### **Post shipment export finance:**

After dispatching the goods to the importer, the exporter draws a bill, against which the importer will make payment. But this may take a minimum period of 3 to 6 months and this time gap will affect the exporter in his continuation of production. For this purpose after exporting, the export bill will be presented by the exporter to his bank. The bank will prefer to purchase the bill or collect the bill or even discount the bill, which depend on the economic status of the importing country.

#### ***Examples for Post shipment export finance***

For example 1, if the export is made to USA against the Letter of Credit of the importer, the exporter's bank will purchase the bill and pay the full value to the exporter. Here, the bank gains as the value of currency is bound to go up since it belongs to a developed country. The entire risk of the bill is borne by the bank.

For example 2, if the export is made to Egypt or Philippines, the bill will be discounted for 60 or 70% of the value as they both belong to developing countries. If the export is made to countries in Africa, such as Namibia, Rwanda, Somalia, etc., the bill will be collected and paid to the exporter after 3 or 6 months, since the importing country happens to be a poor country.



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## **Export finance against collection of bills:**

When export is made to different countries, loan can be obtained from the bank against the bills sent for collection. As there are institutions such as Export Credit Guarantee Corporation, banks will come forward to provide finance to exporters. In case of a default, the guaranteeing company will indemnify at least 80% of defaulted amount. While financing against the export bills, the banker will take into account the FOB invoice and not CIF invoice (FOB — Free on Board invoice — Price includes all expenses incurred until the goods are kept on board the ship. CIF invoice includes costs, insurance and freight and so this type of an invoice will not be taken by the banker for financing).

## **Deferred export finance:**

To enable the importer to purchase valuable goods, hire purchase financing or lease finance may be arranged. There are two types of **deferred export finance**.

1. Supplier's finance; and
2. Buyer's finance.

### ***Supplier's finance in exporting:***

In the supplier's finance, exporter's bank will finance the exporter so that he will sell the goods on installment basis to the importer. The exporter will receive the full value and the payment made in installments by the importer will be received by the exporter's bank.

### ***Buyer's Finance in exporting:***

In buyer's finance, the buyer is given credit under line of credit by the exporter's bank and the exporter will be made to export.

## **Export finance against allowances and subsidies:**

Exporters are given subsidies by the government so that they can sell the goods on reduced price to importer. For example, cash compensatory support is a subsidy given to the exporter by the government whenever there is an increase in expenditure, due to reasons beyond the control of the exporter, such as increase in transport cost or wage of the laborers.

There are also allowances given for increasing exports. Example for this is duty drawback. Here, when a product is imported duty is paid. After processing, it is exported at a higher value. The duty paid at the time of import is refunded which is called duty drawback. Gold is imported and duty is paid. It is converted into jewel and exported at a higher value and the import duty is refunded. It may take some time to receive the refund but the bank will finance against the refund of duty.

When the exporter is faced with a sudden increase in expenditure due to reasons beyond his control, the government comes forward to provide cash compensatory support which is a percentage of costs of his finished product. Example: Deviation in the shipping route due to war.



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There is also export finance given to deemed exports i.e., in free trade zones at Mumbai, Chennai, Calcutta, Delhi, Cochin and Vizag, the suppliers of goods to foreign exporters are given finance. In these free trade zones, the value of the goods exported should be not less than 50% from the domestic market. Hence, the suppliers are provided finance under deemed export finance.

In the year 2000, the government has come forward to start economic zones in Gujarat and Tamilnadu for the purpose of increasing exports. There is also a pass book facility available to the exporter for continuous finance from the banks.

### **Institutions involved in export finance:**

Number of institutions have not only emerged in providing export finance but even the existing institutions have opened up various avenues in granting export finance. The institutions are:

1. Export Import bank
2. Commercial banks, both nationalized and non-nationalized
3. Development banks such as IDBI, ICICI, etc.
4. Small Industries Development Bank of India
5. State Finance Corporations
6. National Small Industries Corporation
7. Export Credit Guarantee Corporation.

All the above institutions are providing finance for exporters directly as well as indirectly. They are also guaranteeing for the loans given by foreign banks. The foreign banks are giving offshore lending which our Indian banks are yet to take up. In offshore lending, loans are given in foreign exchange enabling the foreign buyers to purchase goods from the domestic producer. There is also export finance given to deemed exports which consists of finance made available to those who are supplying raw materials or semi finished goods to foreign companies operating in India, especially in export processing zones or in free trade zones.

## EXIM BANK

The Export-Import Bank (Exim bank) was set up on January 1, 1982 to take over the operations of international finance wing of the IDBI and to provide financial assistance to exporters and importers and to function as a head financial institution for coordinating the working of other institutions engaged in financing of exports and imports of goods and services.



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The authorised capital of Exim bank is Rs. 200 crore and paid-up-capital is Rs. 100 crore wholly subscribed by the Central Government.

## **Organisation and Management:**

The Exim Bank is managed by a Board (16 directors) consisting of a Managing Director who is the Chairman and 15 Directors representing different areas. They are Secretary to the Department of Industrial Board, Commerce Secretary, Finance Secretary, Secretary to Banking, Secretary IDBI, Secretary ECGC Secretary RBI, 3 directors representing other scheduled commercial banks, 4 Directors chosen from export community and 3 others representing ministries and departments.

## **Functions or Roles of EXIM Bank:**

### **1. Financing Programmes (Various Currencies) Loans for Exporting Units**

- Export Credit
- Import Credit
- Loans for Exporting Units Medium / Long Term
- Lines of Credit
- Buyer's Credit
- Supplier's Credit
- Pre/Post Shipment Credit
- Import Loan for capital goods
- Bulk Import Loan for Raw Materials
- Term Loans for expansion/ diversification/ new projects/ export product development/ export marketing/ research & development
- Term Loans for overseas equity investment
- Direct equity stake in Indian/ Overseas ventures of exporting companies

### **2. Export Marketing Finance**

- Administer Export Marketing Fund from World Bank
- SMEs are extended export marketing finance to implement strategic export marketing plans aimed at entry into developed country markets
- Term loans for supply side upgradation



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- Exim Bank in India, has shared its experience with other developing countries, with World Bank funding.

### 3. Enterprise Management Development Services

- Competency as Collateral
- Term Loans
- Pioneering initiative for supporting SMEs

### 4. Global Trade Finance under IFC

- MOU with IFC
- Envisages confirmation of Letter of Credits
- Covers the risk of non-payment by Issuing Bank to Negotiating / Paying banks

### 5. Export Marketing Services

- Exim Bank has launched an 'Export Marketing Services' programme. It seeks to help Indian SME sector to establish their products overseas and enter new markets through Exim's overseas offices and institutional partner network.
- Helps Indian SMEs in their export efforts by proactively assisting in locating overseas buyers/partners for their products/services without any upfront fees, but operates on success-fee basis.

### 6. Seminars and Workshops

- Set up to organize seminars and workshops
- Has center of Learning for knowledge building and capacity creation for SMEs

### 7. Research Publication

- Exim Bank has brought out Research Papers pertaining to SMEs on policies, institutional support and infrastructure.

### 8. Institutional Linkages

- Multilateral agencies
- Export Credit agencies
- Trade & Investment Promotion Agencies





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- EXIM Bank of other Nations
- IFC
- UNCTAD
- Linkages with other Regional Banks like ADB, African Development Bank etc.

## COMMERCIAL BANKS

A commercial bank is a financial institution that grants loans, accepts deposits, and offers basic financial products like savings accounts and certificates of deposit to individuals and businesses. It makes money primarily by providing different types of loans to customers and charging interest.

### The functions/Roles of Commercial Banks:

- **Advancing Credit Facilities**

Advancing Loans is an essential function and basic function of a bank. Few Types of Loans offered by commercial banks are:

- Bank Loan
- Cash Credit
- Bank Overdraft
- Discounting Bills of Exchange

- **Credit Creation**

While granting loans to customers, banks do not provide the loan in cash to the borrower. Instead, the bank creates a deposit account from which the borrower can draw funds. This allows the borrower to withdraw money by cheque according to his needs. By creating a demand deposit in the borrower's account without printing additional money, the bank increases the amount of money in circulation.

- **Agency Functions**

Commercial banks serve as agents of their customers by helping them in collecting and paying cheques, dividends, interest warrants, and bills of exchange. Also, they pay insurance premiums, utility bills, rent, and other charges on behalf of their clients. Banks also trade shares, securities, and debentures, and they provide advisory services for





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customers that want to buy or sell these investments. In property administration, commercial banks act as trustees and executors of the estate on behalf of their customers.

- **Other Functions**

Apart from the above primary functions, banks also perform several other functions. They provide foreign exchange to clients who are in the import and export business, by buying and selling foreign currency. However, banks must get permission from the regulatory body, mainly the central bank, before dealing with foreign exchange. A commercial bank also acts as a custodian of precious stones and other valuables. They provide customers with lockers where they can put their jewelry, precious metals, and crucial documents. Such items are more secure when stored at the bank than keeping them at home where they may be stolen or damaged.

## REVIVAL AND REHABILITATION OF SICK UNITS UNDER COMPANIES ACT, 1956

### Section 253-DETERMINATION OF SICKNESS

**Section 253** of the Companies Act, 2013 talks about the determination of the sickness of a company. According to it any secured creditor of a company representing 50 % or more of outstanding amount of debt, the company has failed to pay the debt within a period of thirty days of the service of the notice of demand or to secure or compound it to the reasonable satisfaction of the creditors, then any secured creditor shall file an application to the tribunal in a prescribed manner along with references of all such evidence for such default, non-payment, etc.

On the receipt of the application from the secured creditor, then the tribunal shall decide within sixty days on to the merit of the application that whether a company has become sick or not.

Once the tribunal is satisfied that a company has become a sick company, and it is in a position to repay its debts, within a reasonable time, it shall order the company to repay its debts.

On satisfaction, the tribunal shall give a reasonable time to the company to make payment of its debts.

### Section 254-APPLICATION FOR REVIVAL AND REHABILITATION

**Section 254** of the Companies Act, 2013 talks about the application for revival and rehabilitation and according to which any company that has been determined as sick company under section 253 of the Act can make an application to the tribunal to order for necessary steps to be taken for its revival and rehabilitation and the application shall be accompanied by-

- Audited financial statements of the company relating to the immediately preceding financial year;



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- Such particulars and documents, duly authenticated in such manner, along with such fees as may be prescribed.
- A draft scheme for revival and rehabilitation of the company in such manner as may be prescribed. The application shall be made to the tribunal within sixty days from the date of determination of the company as a sick company by the tribunal under section 253 of the Companies Act, 2013.

## **Section-256 APPOINTMENT OF INTERIM ADMINISTRATOR**

As per **section-256**, on the receipt of an application under section 254, the Tribunal shall, not later than 7 days from such receipt:

- fixes a date for hearing not later than 90 days from date of its receipt
- appoint an interim administrator (PCS can be appointed) to convene a meeting of creditors to be held not later than 45 days from receipt of the order of the Tribunal
- issue such other directions to the interim administrator as the Tribunal may consider necessary to protect and preserve the assets of the sick company. Interim administrator has to consider whether on the basis of the documents furnished and draft scheme filed, it is possible to revive and rehabilitate the sick company.

Interim administrator is to ascertain and submit a report to Tribunal, within 60 days from date of the order whether it is possible to adopt measures for the revival and rehabilitation of the sick company.

Where no draft scheme is filed by the company and a declaration has been made to that effect by the Board of Directors, the Tribunal may direct the interim administrator to take over the management of the company.

## **Section 257 - COMMITTEE OF CREDITORS**

According to **section 257**, an interim administrator shall appoint a committee of creditors such number of creditors as he may determine but shall not exceed seven and these members shall meet in all the meetings and the interim administrator may direct all the promoters, directors, key managerial personnel of the company to come in any meeting and furnish such information as is required and necessary.

## **Section 258- ORDER OF TRIBUNAL**

As per **Section 258**, on the date of hearing fixed by the Tribunal and on consideration of the report of the interim administrator filed under sub-section (1) of section 256, if the tribunal is satisfied that the secured creditor's representing 3/4th in value of the amount outstanding against the sick company present and voting have resolved that:



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- “It is not possible to revive and rehabilitate such company”- Tribunal shall record such opinion and order that the proceedings for the winding up of the company be initiated.
- “It is possible to revive and rehabilitate such company by adopting certain measures”- Tribunal shall appoint a company administrator for the company & cause such administrator to prepare a scheme of revival and rehabilitation.

### **Section 261-SCHEME OF REVIVAL AND REHABILITATION**

A scheme for revival and rehabilitation shall be prepared by the company administrator as per the provision of **section 261** and it shall include measures like

- financial reconstruction of the sick company
- proper management of the sick company
- amalgamation of the sick company with other company or other company with the sick company
- takeover of the sick company by solvent company
- sale or lease of a part of any assets
- rationalization of managerial personnel
- Such other preventive measure as may be necessary.

The scheme shall be sanctioned as per **section 262** of the Act and shall be binding on the party and shall be implemented by the tribunal by taking all necessary steps.

### **Section 263-Winding up of Company on the report of company administrator**

As per the provisions of the **section 263** of the Act, the company shall be wound up if the scheme is not approved by the creditors and the administrator shall submit the report within fifteen days and the tribunal shall order for the winding up of the company.

### **OTHER LAWS WHICH ARE AS FOLLOWS:**

SECTIONS	PROVISIONS
Section-259	Appointment of Administrator
Section-260	Duties of Company Administrator
Section-262	Sanction of the Scheme
Section-263	Binding of the Scheme



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Section-264	Implementation of the Scheme
Section-265	Winding up of the Company
Section-266	Power of Tribunal to assess damages against delinquent (law-breaking) directors
Section-267	Punishment for certain offences
Section-268	Bar of Jurisdiction
Section-269	Rehabilitation and insolvency fund

### **CONCLUSION**

Thus, the Companies Act provides exhaustive measures for the revival and rehabilitation of the sick companies and the tribunal is vested with powers to take all necessary measures for the revival and rehabilitation of the sick companies. One has to see the grounds, facts and to collect certain documents before filing any such application or appeal for revival of Company. The time limit prescribed under the provisions for making an application is 20 years, applicant can choose to file the said application after arranging all such documents.

### **SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985 (SICA) REPEALED**

It is a special law relating to revival of sick companies. There were some loopholes in SICA like non-applicability of SICA to non-industrial companies and small companies, misuse of immunity provided under section 22 of SICA etc. that's why parliament has passed Companies (second Amendment) Act 2002 which has inserted **PART VI A**, consisting relating to revival of sick companies.

The effect of the Amendment act is that the SICA shall be repealed and **PART VI A** of the companies Act shall take its place.

### **PURPOSE BEHIND (SICA) SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985**

The basic rationale (grounds) of enacting SICA was to determine sickness in the industrial units. It also aimed at expediting (facilitate) the revival of potentially viable units so as to make the



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investments in such units profitable. It also close unusable units to release investment which is locked up for productive use somewhere.

## **SOME FEATURES OF SICA, 1985**

- Sick industrial Companies (Special provisions) Act, 1985 (SICA) is a special law relating to revival of sick companies.
- SICA intends to timely detect the sickness and take the appropriate corrective measures for revival of sick companies.
- SICA has the overriding effect overall the existing laws. So whenever an industrial company becomes a sick industrial company, it need not comply with number of laws.
- The sick industrial company can ignore the provisions of other laws and comply with the provisions of SICA only.

## **OBJECTS OF THE ACT**

- To evaluate the economic viability of the sick companies and either rehabilitate them if possible, or close them, if not possible
- To stop continued drain of public and private resources in the interest of the economics of our country
- To protect employment.

## **FOLLOWING ARE NUMBER OF REASONS FOR THE REPEALMENT (CANCELLATION) OF SICA**

- The authorities i.e. **BIFR** (Board for Industrial and Financial Reconstruction) and **AAIFR** (Appellate Authority for Industrial and Financial Reconstruction) have not been very effective in pursuing the objectives of SICA,
- The approach of industrialists I respect of sick companies is not very constructive
- Section 22 of SICA gives the overriding effect to BIFR over other authorities. This section has been misused to a large extent.



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## INFLATION & FINANCIAL DECISION

Just saving money from your salary now may not be enough to meet your financial goals after taking inflation into account. Investors need to make timely and informed decisions to ensure that inflation doesn't gobble up their savings.

### **a. Bonds**

There are many bonds you can choose to make inflation-beating returns. One example for this is Treasury Inflation Protected Securities, also called as TIPS. It is a government bond designed to make up for possible inflation. But if inflation is low, this can backfire and result in lesser returns.

### **b. Commodities**

It depends on the type of product. For instance, gold and silver have always managed long been able to cut down losses by inflation. But food commodities could never hedge against price rises.

### **c. Mutual funds**

Long-term mutual funds like ELSS, gilt funds and dynamic bonds have delivered good returns in recent years. Also, debt funds if held for at least 3 years can generate long-term gains.

### **d. Laddering**

This is a concept in which you continue to reinvest your money gained from earlier investments once they mature. Say, you receive a corpus of Rs. 2 lakhs from an older FD after maturity. You can invest a lakh each in a one-year and two-year schemes. This way, you keep earning from your investments.

### **e. Smart conversion through debentures**

We are talking about convertible debentures (complete or partial) that can be changed into shares after certain term. If the interest rates come down, you can convert it to equities to hedge losses.

### **f. Calculated risks are not as risky as impulsive risks**

This is not merely investing in more bonds or mutual funds. Investing in company deposits can be risky but also rewarding if you opt for rated companies.



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## **g. Get dividends**

Many fund houses now choose to share their profits with investors. If you choose plan that gives the benefits of both debt and equity, you can get dividend annually.

## **Conclusion**

In a nutshell, investors must take inflation into account when making investment decisions. If you invest with caution, rest assured that your money goes into top performing avenues.

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## UNIT V FOREIGN COLLABORATION

### FOREIGN DIRECT INVESTMENT AND FOREIGN INSTITUTIONAL INVESTMENT

**Foreign Direct Investment (FDI)** is defined as the type of investment into production or business in a country, by an enterprise based in another country. It is often contrasted with **Foreign Institutional Investment (FII)**, which is an investment fund, based in the country, other than the country, in which investment is made.

Both are the forms of investment made in a foreign country. FDI is made to acquire controlling ownership in an enterprise but FII tends to invest in the foreign financial market. In most cases, the former is given preference over the latter because it benefits the whole economy.

#### **Definition of FDI**

Foreign Direct Investment shortly known as FDI refers to the investment in which foreign funds are brought into a company based in a different country from the investor company's country. In general, the investment is made to gain a long lasting interest in the investee enterprise. It is termed as a direct investment because the investor company looks for a substantial amount of management control or influence over the foreign company.

FDI is the considered as one of the primary means of acquiring external assistance. The countries where the availability of finance is quite low can get finance from developed countries having the good financial condition. There are a number of ways through which a foreign investor can get controlling ownership like by way of merger or acquisition, by purchasing shares, by participating in a joint venture or by incorporating a wholly owned subsidiary.

#### **Definition of FII**

FII is an abbreviation used for Foreign Institutional Investor, are the investors that pool their money to invest in the assets of the country situated abroad. It is a tool for making quick money for the investors. Institutional investors are companies that invest money in the financial markets in the country based outside the investor country. It needs to get itself registered with the securities exchange board of the respective country for making the investment. It includes banks, mutual funds, insurance companies, hedge funds, etc.





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FII plays a very crucial role in any country's economy. Market trend moves upward when any foreign company invests or buys securities, and similarly, it goes down if it withdraws the investment made by it.

## **Key Differences between FDI and FII**

1. Foreign Direct Investment or FDI is defined as the investment made by a company in the company situated outside the country. Foreign Institutional Investor or FII is when investors, most commonly in the form of institutions that invest in the country's financial market.
2. FII is a way to to make quick money, the entry and exit to the stock market are very easy. On the other hand, the entry and exit are not easy in FDI.
3. FDI brings long-term capital in the investee company whereas FII may bring long or short term capital in the country.
4. In the case of FDI, there is the transfer of funds, resources, technology, strategies, know-how. Conversely, FII involves the transfer of funds only.
5. FDI increases job opportunities, infrastructural development in the investee country and thus leads to economic growth, which is not in the case of FII.
6. FDI results in the increase in the country's productivity. As opposed to FII that results in the increase in the country's capital.
7. FDI targets a particular company, but FII does not target a particular company.
8. FDI obtains management control in the company. However, FII does not enable such control.

## **Comparison Chart:**

<b>BASIS FOR COMPARISON</b>	<b>FDI</b>	<b>FII</b>
Meaning	When a company situated in one country makes an investment in a company situated abroad, it is known as FDI.	FII is when foreign companies make investments in the stock market of a country.
Entry and Exit	Difficult	Easy
What it brings?	Long term capital	Long/Short term capital



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BASIS FOR COMPARISON	FDI	FII
Transfer of	Funds, resources, technology, strategies, know-how etc.	Funds only.
Economic Growth	Yes	No
Consequences	Increase in country's Gross Domestic Product (GDP).	Increase in capital of the country.
Target	Specific Company	No such target, investment flows into the financial market.
Control over a company	Yes	No

## Advantages of FII

- FII's will enhance the flow of capital into the country
- These investors generally prefer equity over debt. So this will also help maintain and even improve the capital structures of the companies they are investing in.
- They have a positive effect on the competition in the financial markets
- FII help with the financial innovation of capital markets
- These institutions are professionally managed by asset managers and analysts. They generally improve the capital markets of the country.

## Disadvantages of FII's

- The demand for the local currency (rupee) increases. This can cause severe inflation in the economy.



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- These FII's drive the fortune of big companies in which they invest. But their buying and selling of securities have a huge impact on the stock market. The smaller companies are taken along for the ride.
- Sometimes these FII's seek only short-term returns. When they pull their investments banks can face a shortage of funds.

## Advantages of Foreign Direct Investment

### 1. Economic Development Stimulation.

Foreign direct investment can stimulate the target country's economic development, creating a more conducive environment for you as the investor and benefits for the local industry.

### 2. Easy International Trade.

Commonly, a country has its own import tariff, and this is one of the reasons why trading with it is quite difficult. Also, there are industries that usually require their presence in the international markets to ensure their sales and goals will be completely met. With FDI, all these will be made easier.

### 3. Employment and Economic Boost.

Foreign direct investment creates new jobs, as investors build new companies in the target country, create new opportunities. This leads to an increase in income and more buying power to the people, which in turn leads to an economic boost.

### 4. Development of Human Capital Resources.

One big advantage brought about by FDI is the development of human capital resources, which is also often understated as it is not immediately apparent. Human capital is the competence and knowledge of those able to perform labor, more known to us as the workforce. The attributes gained by training and sharing experience would increase the education and overall human capital of a country. Its resource is not a tangible asset that is owned by companies, but instead something that is on loan. With this in mind, a country with FDI can benefit greatly by developing its human resources while maintaining ownership.

### 5. Tax Incentives.

Parent enterprises would also provide foreign direct investment to get additional expertise, technology and products. As the foreign investor, you can receive tax incentives that will be highly useful in your selected field of business.



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## **6. Resource Transfer.**

Foreign direct investment will allow resource transfer and other exchanges of knowledge, where various countries are given access to new technologies and skills.

## **7. Reduced Disparity Between Revenues and Costs.**

Foreign direct investment can reduce the disparity between revenues and costs. With such, countries will be able to make sure that production costs will be the same and can be sold easily.

## **8. Increased Productivity.**

The facilities and equipment provided by foreign investors can increase a workforce's productivity in the target country.

## **9. Increment in Income.**

Another big advantage of foreign direct investment is the increase of the target country's income. With more jobs and higher wages, the national income normally increases. As a result, economic growth is spurred. Take note that larger corporations would usually offer higher salary levels than what you would normally find in the target country, which can lead to increment in income.

## **Disadvantages of Foreign Direct Investment**

### **1. Hindrance to Domestic Investment.**

As it focuses its resources elsewhere other than the investor's home country, foreign direct investment can sometimes hinder domestic investment.

### **2. Risk from Political Changes.**

Because political issues in other countries can instantly change, foreign direct investment is very risky. Plus, most of the risk factors that you are going to experience are extremely high.

### **3. Negative Influence on Exchange Rates.**

Foreign direct investments can occasionally affect exchange rates to the advantage of one country and the detriment of another.

### **4. Higher Costs.**

If you invest in some foreign countries, you might notice that it is more expensive than when you export goods. So, it is very imperative to prepare sufficient money to set up your operations.

### **5. Economic Non-Viability.**

Considering that foreign direct investments may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable.



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## 6. Expropriation.

Remember that political changes can also lead to expropriation, which is a scenario where the government will have control over your property and assets.

## 7. Negative Impact on the Country's Investment.

The rules that govern foreign exchange rates and direct investments might negatively have an impact on the investing country. Investment may be banned in some foreign markets, which means that it is impossible to pursue an inviting opportunity.

## 8. Modern-Day Economic Colonialism.

Many third-world countries, or at least those with history of colonialism, worry that foreign direct investment would result in some kind of modern day economic colonialism, which exposes host countries and leave them vulnerable to foreign companies' exploitations.

## BUSINESS VENTURES ABROAD

**International ventures abroad**, refers to the trade of goods, services, technology, capital and/or knowledge across national borders and at a global or transnational level. It involves cross-border transactions of goods and services between two or more countries. Transactions of economic resources include capital, skills, and people for the purpose of the international production of physical goods and services such as finance, banking, insurance, and construction. International business is also known as globalization.

**Various methods of Business Ventures Abroad are:**

### 1. Direct Exporting

**Direct exporting** involves you directly exporting your goods and products to another overseas market. For some businesses, it is the fastest mode of entry into the international business.

Direct exporting, in this case, could also be understood as **Direct Sales**. This means you as a product owner in India go out, to say, the middle east with your own sales force to reach out to the customers.

In case you foresee a potential demand for your goods and products in an overseas market, **you can opt to supply your goods to an importer** instead of establishing your own retail presence in the overseas market.

Then you can market your brand and products directly or indirectly through your sales representatives or importing distributors.



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And if you are in an online product based company, there is no importer in your value chain.

## **Advantages of Direct Exporting**

- You can select your foreign representatives in the overseas market.
- You can utilize the direct exporting strategy to test your products in international markets before making a bigger investment in the overseas market.
- This strategy helps you to protect your patents, goodwill, trademarks and other intangible assets.

## **Disadvantages of Direct Exporting**

- For offline products, this strategy will turn out to be a really high cost strategy. Everything has to be setup by your company from scratch.
- While for online products this is probably the fastest expansion strategy, in the case of offline products, there is a good amount of lead time that goes into the market research, scoping and hiring of the representatives in that country.

## **2. Licensing and Franchising**

Companies which want to establish a retail presence in an overseas market with minimal risk, the **licensing and franchising strategy allows another person or business assume the risk on behalf of the company.**

In Licensing agreement and franchise, an overseas-based business will pay you a royalty or commission to use your brand name, manufacturing process, products, trademarks and other intellectual properties.

While the licensee or the franchisee assumes the risks and bears all losses, **it shares a proportion of their revenues and profits you.**

When does this work the best?

I explored this strategy in the case where **one of the established companies of the other country already had a loyal audience with them.**

At the same time, their product line had gaps which I was able to fill up. Therefore, just like two pieces of jigsaw, it made complete sense for them to carry my product.

How is this different from a Joint Venture, you would think? It is.

And in this case, I shall explain the little difference in the subsequent part of the article.

## **Advantages of Licensing and Franchising**

- Low cost of entry into an international market
- Licensing or Franchising partner has knowledge about the local market
- Offers you a passive source of income



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- Reduces political risk as in most cases, the licensing or franchising partner is a local business entity
- Allows expansion in multiple regions with minimal investment

### **Disadvantages of Licensing and Franchising**

- In some cases, you might not be able to exercise complete control on its licensing and franchising partners in the overseas market
- Licensees and franchisees can leverage the acquired knowledge and pose as future competition for your business
- Your business risks tarnishing its brand image and reputation in the overseas and other markets due to the incompetence of their licensing and franchising partners

### **3. Joint Ventures**

A **joint venture** is one of the preferred modes of entry into international business for businesses who do not mind sharing their brand, knowledge, and expertise.

Companies wishing to expand into overseas markets can form joint ventures with local businesses in the overseas location, wherein both joint venture partners share the rewards and risks associated with the business.

Both business entities share the investment, costs, profits and losses at the predetermined proportion.

This mode of entry into international business is suitable in countries wherein the governments do not allow one hundred per cent foreign ownership in certain industries.

For instance, foreign companies cannot have a 100 hundred per cent stake in broadcast content services, print media, multi-brand retailing, insurance, power exchange sectors and require to opt for a joint-venture route to enter the Indian market.

That's the difference between a Licensing/Franchisee kind of a setup and a Joint Venture.

The subtle nuance that comes across while recently creating a strategy was that a franchise setup would work well when you as a franchiser are a bigger brand in that particular product.

You could be big in your own country and not necessarily in the franchisee's country.

In case of a Joint Venture, both the brands have a similar level of brand strength for that particular product. And therefore, they wish to explore that product in that international market together.

### **Advantages of Joint Venture**

- Both partners can leverage their respective expertise to grow and expand within a chosen market





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- The political risks involved in joint-venture is lower due to the presence of the local partner, having knowledge of the local market and its business environment
- Enables transfer of technology, intellectual properties and assets, knowledge of the overseas market etc. between the partnering firms

### **Disadvantages of Joint Venture**

- Joint ventures can face the possibility of cultural clashes within the organisation due to the difference in organisation culture in both partnering firms
- In the event of a dispute, dissolution of a joint venture is subject to lengthy and complicated legal process.

## **4. Strategic Acquisitions**

Strategic acquisition implies that **your company acquires a controlling interest in an existing company in the overseas market.**

This acquired company can be directly or indirectly involved in offering similar products or services in the overseas market.

**You can retain the existing management of the newly acquired company** to benefit from their expertise, knowledge and experience while having your team members positioned in the board of the company as well.

### **Advantages of Strategic Acquisitions**

- Your business does not need to start from scratch as you can use the existing infrastructure, manufacturing facilities, distribution channels and an existing market share and a consumer base
- Your business can benefit from the expertise, knowledge and experience of the existing management and key personnel by retaining them
- It is one of the fastest modes of entry into an international business on a large scale

### **Disadvantages of Strategic Acquisitions**

- Just like Joint Ventures, in Acquisitions as well, there is a possibility of cultural clashes within the organisation due to the difference in organisation culture
- Apart from that there mostly are problems with seamless integration of systems and process.
- Technological process differences is one of the most common issues in strategic acquisitions.

## **5. Foreign Direct Investment**





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**Foreign Direct Investment** involves a company entering an overseas market by making a substantial investment in the country. Some of the modes of entry into international business using the foreign direct investment strategy includes mergers and acquisitions, joint ventures and greenfield investments.

This strategy is viable when the demand or the size of the market, or the growth potential of the market is substantially large to justify the investment.

**Some of the reasons because of which companies opt for foreign direct investment** strategy as the mode of entry into international business can include:

- Restriction or import limits on certain goods and products.
- Manufacturing locally can avoid import duties.
- Companies can take advantage of low-cost labour, cheaper material.

### **Advantages of Foreign Direct Investment**

- You can retain your control over the operations and other aspects of your business
- Leverage low-cost labour, cheaper material etc. to reduce manufacturing cost towards obtaining a competitive advantage over competitors
- Many foreign companies can avail for subsidies, tax breaks and other concessions from the local governments for making an investment in their country

### **Disadvantages of Foreign Direct Investment**

- The business is exposed to high levels of political risk, especially in case the government decides to adopt protectionist policies to protect and support local business against foreign companies
- This strategy involves substantial investment to be made for entering an international market.

### **Factors to be considered while going for a business venture abroad:**

While expanding an organization internationally comes with a host of risks and challenges. From factoring time zones into meeting calendars to navigating differences in culture, there's a lot more than the upfront cost to think about when you're expanding abroad.

1. Address Language Barrier:
2. Get Good Local Advice
3. Understand Local Customs
4. Make Local Connections
5. Make Sure There is Product-Fit Market



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6. Have a Physical Office
7. Start Partnership Programs
8. Account for Time Differences
9. Start Marketing Early
10. Account for Travel Expenses
11. Learn the Hiring Process and Culture
12. Understand International Tax Laws
13. Ask for Help

### INTERNATIONAL FINANCIAL INSTITUTION (IFI)

An **International Financial Institution (IFI)** is a financial institution that has been established (or chartered) by more than one country, and hence are subjects of international law. Its owners or shareholders are generally national governments, although other international institutions and other organizations occasionally figure as shareholders. The most prominent IFIs are creations of multiple nations, although some bilateral financial institutions (created by two countries) exist and are technically IFIs. The best known IFIs were established after World War II to assist in the reconstruction of Europe and provide mechanisms for international cooperation in managing the global financial system.

Today, the world's largest IFI is the European Investment Bank, with a balance sheet size of €573 billion in 2016. This compares to the two components of the World Bank, the IBRD (assets of \$358 billion in 2014) and the IDA (assets of \$183 billion in 2014). For comparison, the largest commercial banks each have assets of \$2,000-3,000 billion.

### Multilateral Development Bank (MDB)

A **multilateral development bank (MDB)** is an institution, created by a group of countries, that provides financing and professional advising for the purpose of development. MDBs have large memberships including both developed donor countries and developing borrower countries. MDBs finance projects in the form of long-term loans at market rates, very-long-term loans (also known as credits) below market rates, and through grants.

The following are usually classified as the main MDBs:

- World Bank
- European Investment Bank (EIB)



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- Islamic Development Bank (IsDB)
- Asian Development Bank (ADB)
- European Bank for Reconstruction and Development (EBRD)
- CAF - Development Bank of Latin America (CAF)
- Inter-American Development Bank Group (IDB, IADB)
- African Development Bank (AfDB)
- New Development Bank (NDB)
- Asian Infrastructure Investment Bank (AIIB)
- Arab Petroleum Investments Corporation (APICORP)

There are also several "sub-regional" multilateral development banks. Their membership typically includes only borrowing nations. The banks lend to their members, borrowing from the international capital markets. Because there is effectively shared responsibility for repayment, the banks can often borrow more cheaply than could any one member nation. These banks include:

- Caribbean Development Bank (CDB)
- Central American Bank for Economic Integration (CABEL)
- East African Development Bank (EADB)
- West African Development Bank (BOAD)
- Black Sea Trade and Development Bank (BSTDB)
- Economic Cooperation Organization Trade and Development Bank (ETDB)
- Eurasian Development Bank (EDB)

There are also several multilateral financial institutions (MFIs). MFIs are similar to MDBs but they are sometimes separated since they have more limited memberships and often focus on financing certain types of projects.

- European Commission (EC)
- International Finance Facility for Immunisation (IFFIm)
- International Fund for Agricultural Development (IFAD)
- Nordic Investment Bank (NIB)
- OPEC Fund for International Development (OFID)
- Nederlandse Financieringsmaatschappij voor Ontwikkelingslanden NV (FMO)
- International Investment Bank (IIB)
- Arab Bank for Economic Development in Africa (BADEA)

## BRETTON WOODS INSTITUTIONS



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The best-known IFIs were established after World War II to assist in the reconstruction of Europe and provide mechanisms for international cooperation in managing the global financial system. They include the World Bank, the IMF, and the International Finance Corporation. Today the largest IFI in the world is the European Investment Bank which lent 61 billion euros to global projects in 2011.

<b>Founded</b>	<b>Name</b>	<b>Notes</b>	<b>HQ</b>
1944	IMF International Monetary Fund	Specialised agency of the UN	Washington, DC
1944	IBRD International Bank for Reconstruction and Development	World Bank Group, Specialised agency of the UN	Washington, DC
1956	IFC International Finance Corporation	World Bank Group	Washington, DC
1960	IDA International Development Association	World Bank Group	Washington, DC
1966	ICSID, International Centre for Settlement of Investment Disputes	World Bank Group	Washington, DC
1988	MIGA Multilateral Investment Guarantee Agency	World Bank Group	Washington, DC

## INTERNATIONAL MONETARY FUND (IMF)

### **Introduction**

The International Monetary Fund is an organization of many countries that seeks to promote international monetary co-operation and to facilitate the expansion of trade and thus to contribute to increase employed and improved economic condition in all member countries. In early 1966 179 countries were members of IMF. The member countries of the Fund today account for over 80% of the total world production and 90% of the world trade.

Membership in the IMF is open to every country that controls its foreign relations and is able and prepared to fulfill the obligations of membership. Membership in the fund is prerequisite to membership



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in the World Bank (IBRD) and close working relationships exist between the two organizations, as well as between the Fund and the GATT and the Bank for International Settlements (BIS). The Fund is a specialized agency within the United Nations system, cooperating with the UN on matters of mutual interest.

## Purposes and Functions of the IMF

The purpose of the Fund, as set forth, in the Articles of Agreement of the IMF are the following:

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
3. To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
4. To assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
5. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
6. In accordance with the above to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

## Structure and Management

- ❖ The work of the fund is carried out through a Board of Governors, an Executive Board, a Managing Director, and Staff.
- ❖ Each member country is represented by a Governor and an Alternate Governor on the Board of Governors, which is the fund's highest authority and which meets annually and may cast ballots by mail or cable between meetings.
- ❖ A member country's voting power primarily reflects its contribution to the Fund's financial resources, which in turn, is related to its relative size in the world economy.



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- ❖ The highest authority of the Fund is the Board of Governors, in which each of the member countries is represented by a Governor and an alternate Governor.
- ❖ In most cases the Fund's Governors are finance ministers or the central bank governors in their countries or held comparable rank.
- ❖ The Board of Governors meet once a year but may vote by mail at other times.
- ❖ The Board of Governors had delegated most of its powers to the Executive Board, which is responsible for conducting the business of the Fund.
- ❖ The permanent session at the fund is held at the headquarters in Washington.
- ❖ The Executive Board is chaired by the Managing Director.
- ❖ The Executive Board acts on requests by members for financial assistance, conducts consultations with members, takes decisions on general fund policies and makes recommendations to the Board of Governors on matters requiring a vote of the Governors, such as the admission of new members and increases in the Fund's resources.
- ❖ The Executive Board appoints the Fund's Managing Director, who serves both as the Chairman and as Chief of the operating staff of the Fund, with a five year term of office.
- ❖ The professional and administrative staff of the Fund is comprised of international civil servants, appointed by and owing their duty exclusively to the Fund.
- ❖ The Fund's professional staff consists primarily of economists, but there are among others accountants and legal experts.
- ❖ Nearly 1,500 staffs are located mainly at the Washington headquarters.
- ❖ The staff is organized in five area departments (for Africa, Asia, Europe, the Middle East, and the Western Hemisphere) and a number of other departments (Administration, Central Banking Service, Exchange and Trade Relations, Fiscal Affairs, IMF institute, Legal Research, Secretary's and Treasurer's). In addition, there is a Bureau of Language Services and a Bureau of Statistics.
- ❖ The Fund also maintains small permanent offices in Paris and Geneva and at the United Nations in New York.

## Resources

### Quotas and Subscription:

- ❖ Every member of the Fund is required to subscribe to the Fund an amount equal to its quota. The Fund's system of quotas is one of its central features.
- ❖ Each member is assigned a quota expressed in Special Drawing Rights (SDRs). Quotas are used to determine the voting power of members, their contribution to the Fund's resources, their access to these resources, and their share in allocations of SDRs.
- ❖ A member's quota reflects its economic size in relation to the total membership of the Fund.



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- ❖ Each member pays a subscription to the fund equivalent to its quota, and the Board of Governors decides on the proportion to be paid in SDRs or in the member's currency.
- ❖ Quotas of all members are reviewed at intervals of not more than five years.

## **Borrowings:**

- ❖ IMF is authorized its Articles of Agreement to supplement its ordinary resources by borrowing.
- ❖ The Fund may seek the amount it needs in any currency and from any source, i.e. from official entities as well as from private sources. Under the General Agreement to Borrow (GAB), eleven industrial countries have undertaken to lend to the IMF if this should be needed to forestall or cope with an impairment of the International Monetary system.
- ❖ Under the revised GAB, the Fund can enter into **associated borrowing agreements**. The IMF has also entered into medium and long term and short term borrowing agreements to supplement its ordinary resources.

## **INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)**

### **Introduction**

The **International Bank for Reconstruction and Development (IBRD)** is an international financial institution that offers loans to middle-income developing countries. The IBRD is the first of five member institutions that compose the World Bank Group, and is headquartered in Washington, D.C. in the United States. It was established in 1944 with the mission of financing the reconstruction of European nations devastated by World War II. The IBRD and its concessional lending arm, the International Development Association, are collectively known as the World Bank as they share the same leadership and staff. Following the reconstruction of Europe, the Bank's mandate expanded to advancing worldwide economic development and eradicating poverty. The IBRD provides commercial-grade or concessional financing to sovereign states to fund projects that seek to improve transportation and infrastructure, education, domestic policy, environmental consciousness, energy investments, healthcare, access to food and potable water, and access to improved sanitation.

The IBRD is owned and governed by its member states, but has its own executive leadership and staff which conduct its normal business operations. The Bank's member governments are shareholders which contribute paid-in capital and have the right to vote on its matters. In





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In addition to contributions from its member nations, the IBRD acquires most of its capital by borrowing on international capital markets through bond issues. In 2011, it raised \$29 billion USD in capital from bond issues made in 26 different currencies. The Bank offers a number of financial services and products, including flexible loans, grants, risk guarantees, financial derivatives, and catastrophic risk financing. It reported lending commitments of \$26.7 billion made to 132 projects in 2011.

## History

The International Bank for Reconstruction and Development (IBRD) and International Monetary Fund (IMF) were established by delegates at the Bretton Woods Conference in 1944 and became operational in 1946. The IBRD was established with the original mission of financing the reconstruction efforts of war-torn European nations following World War II, with goals shared by the later Marshall Plan. The Bank issued its inaugural loan of \$250 million (\$2.6 billion in 2012 dollars) to France in 1947 to finance infrastructure projects. The institution also established its first field offices in Paris, France, Copenhagen, Denmark, and Prague in the former Czechoslovakia. Throughout the remainder of the 1940s and 1950s, the Bank financed projects seeking to dam rivers, generate electricity, and improve access to water and sanitation. It also invested in France, Belgium, and Luxembourg's steel industry. Following the reconstruction of Europe, the Bank's mandate has transitioned to eradicating poverty around the world. In 1960, the International Development Association (IDA) was established to serve as the Bank's concessional lending arm and provide low and no-cost finance and grants to the poorest of the developing countries as measured by gross national income per capita.

While the IBRD and the IDA historically prioritized funding infrastructure projects, since the 1990s, the Bank has directed less lending to infrastructure projects in favor of other development projects such as fighting climate change, eradicating poverty and ensuring good governance.

## Governance

The IBRD is governed by the World Bank's Board of Governors which meets annually and consists of one governor per member country (most often the country's finance minister or treasury secretary). The Board of Governors delegates most of its authority over daily matters such as lending and operations to the Board of Directors. The Board of Directors consists of 25 executive directors and is chaired by the President of the World Bank Group. The executive directors collectively represent all 189 member states of the World Bank. The president oversees the IBRD's overall direction and daily operations. As of





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July 2012, Jim Yong Kim serves as the President of the World Bank Group. The Bank and IDA operate with a staff of approximately 10,000 employees.

## Services

The IBRD provides financial services as well as strategic coordination and information services to its borrowing member countries.

The Bank only finances sovereign governments directly, or projects backed by sovereign governments.

The World Bank Treasury is the division of the IBRD that manages the Bank's debt portfolio of over \$100 billion and financial derivatives transactions of \$20 billion.

The Bank offers flexible loans with maturities as long as 30 years and custom-tailored repayment scheduling.

The IBRD also offers loans in local currencies. Through a joint effort between the IBRD and the International Finance Corporation, the Bank offers financing to sub-national entities either with or without sovereign guarantees.

For borrowers needing quick financing for an unexpected change, the IBRD operates a Deferred Drawdown Option which serves as a line of credit with features similar to the Bank's flexible loan program.

Among the World Bank Group's credit enhancement and guarantee products, the IBRD offers policy-based guarantees to cover countries' sovereign default risk, partial credit guarantees to cover the credit risk of a sovereign government or sub-national entity, and partial risk guarantees to private projects to cover a government's failure to meet its contractual obligations.

The IBRD's Enclave Partial Risk Guarantee to cover private projects in member countries of the IDA against sovereign governments' failures to fulfill contractual obligations.

The Bank provides an array of financial risk management products including foreign exchange swaps, currency conversions, interest rate swaps, interest rate caps and floors, and commodity swaps.

To help borrowers protect against catastrophes and other special risks, the bank offers a Catastrophe Deferred Drawdown Option to provide financing after a natural disaster or declared state of emergency.

It also issues catastrophe bonds which transfer catastrophic risks from borrowers to investors.



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## INTERNATIONAL FINANCE CORPORATION

### Introduction

The **International Finance Corporation (IFC)** is an international financial institution that offers investment, advisory, and asset-management services to encourage private-sector development in less developed countries. The IFC is a member of the World Bank Group and is headquartered in Washington, D.C. in the United States. It was established in 1956, as the private-sector arm of the World Bank Group, to advance economic development by investing in for-profit and commercial projects for poverty reduction and promoting development. The IFC's stated aim is to create opportunities for people to escape poverty and achieve better living standards by mobilizing financial resources for private enterprise, promoting accessible and competitive markets, supporting businesses and other private-sector entities, and creating jobs and delivering necessary services to those who are poverty stricken or otherwise vulnerable.

Since 2009, the IFC has focused on a set of development goals that its projects are expected to target. Its goals are to increase sustainable agriculture opportunities, improve healthcare and education, increase access to financing for microfinance and business clients, advance infrastructure, help small businesses grow revenues, and invest in climate health.

The IFC is owned and governed by its member countries but has its own executive leadership and staff that conduct its normal business operations. It is a corporation whose shareholders are member governments that provide paid-in capital and have the right to vote on its matters. Originally, it was more financially integrated with the World Bank Group, but later, the IFC was established separately and eventually became authorized to operate as a financially-autonomous entity and make independent investment decisions. It offers an array of debt and equity financing services and helps companies face their risk exposures while refraining from participating in a management capacity. The corporation also offers advice to companies on making decisions, evaluating their impact on the environment and society, and being responsible. It advises governments on building infrastructure and partnerships to further support private sector development.



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## History

The World Bank and International Monetary Fund were designed by delegates at the Bretton Woods conference in 1944. The World Bank, then consisting of only the International Bank for Reconstruction and Development, became operational in 1946. Robert L. Garner joined the World Bank in 1947 as a senior executive and expressed his view that private business could play an important role in international development. In 1950, Garner and his colleagues proposed establishing a new institution for the purpose of making private investments in the less developed countries served by the World Bank. The U.S. government encouraged the idea of an international corporation working in tandem with the World Bank to invest in private enterprises without accepting guarantees from governments, without managing those enterprises, and by collaborating with third party investors. When describing the IFC in 1955, World Bank President Eugene R. Black said that the IFC would only invest in private firms, rather than make loans to governments, and it would not manage the projects in which it invests. IFC became operational under the leadership of Robert L. Garner.

## Governance

The IFC is governed by its Board of Governors which meets annually and consists of one governor per member country (most often the country's finance minister or treasury secretary). Each member typically appoints one governor and also one alternate. Although corporate authority rests with the Board of Governors, the governors delegate most of their corporate powers and their authority over daily matters such as lending and business operations to the Board of Directors. The IFC's Board of Directors consists of 25 executive directors who meet regularly and work at the IFC's headquarters, and is chaired by the President of the World Bank Group. The executive directors collectively represent all 184 member countries. When the IFC's Board of Directors votes on matters brought before it, each executive director's vote is weighted according to the total share capital of the member countries represented by that director. IFC's Chief Executive Officer oversees its overall direction and daily operations. Although the IFC coordinates its activities in many areas with the other World Bank Group institutions, it generally operates independently as it is a separate entity with legal and financial autonomy, established by its own Articles of Agreement. The corporation operates with a staff of over 3,400 employees, of which half are stationed in field offices across its member nations.



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## **Functions:**

### **Investment Services:**

The IFC's investment services consist of loans, equity, trade finance, syndicated loans, structured and securitized finance, client risk management services, treasury services, and liquidity management. In its fiscal year 2010, the IFC invested \$12.7 billion in 528 projects across 103 countries. Of that total investment commitment, approximately 39% (\$4.9 billion) was invested into 255 projects across 58 member nations of the World Bank's International Development Association (IDA).

The IFC makes loans to businesses and private projects generally with maturities of seven to twelve years.

It determines a suitable repayment schedule and grace period for each loan individually to meet borrowers' currency and cash flow requirements.

The IFC may provide longer-term loans or extend grace periods if a project is deemed to warrant it. Leasing companies and financial intermediaries may also receive loans from the IFC.

Though loans have traditionally been denominated in hard currencies, the IFC has endeavored to structure loan products in local currencies.

Although the IFC's shareholders initially only allowed it to make loans, the IFC was authorized in 1961 to make equity investments, the first of which was made in 1962 by taking a stake in FEMSA, a former manufacturer of auto parts in Spain that is now part of Bosch Spain.

The IFC invests in businesses' equity either directly or via private equity funds, generally from five up to twenty percent of a company's total equity. IFC's private equity portfolio currently stands at roughly \$3.0 billion committed to about 180 funds.

The portfolio is widely distributed across all regions including Africa, East Asia, South Asia, Eastern Europe, Latin America and the Middle East, and recently has invested in Small Enterprise Assistance Funds' (SEAF) Caucasus Growth Fund, Aureos Capital's Kula Fund II (Papua New Guinea, Fiji, Pacific Islands) and Leopard Capital's Haiti Fund.



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Other equity investments made by the IFC include preferred equity, convertible loans, and participation loans.

The IFC prefers to invest for the long-term, usually for a period of eight to fifteen years, before exiting through the sale of shares on a domestic stock exchange, usually as part of an initial public offering. When the IFC invests in a company, it does not assume an active role in management of the company.

Through its Global Trade Finance Program, the IFC guarantees trade payment obligations of more than 200 approved banks in over 80 countries to mitigate risk for international transactions.

The Global Trade Finance Program provides guarantees to cover payment risks for emerging market banks regarding promissory notes, bills of exchange, letters of credit, bid and performance bonds, supplier credit for capital goods imports, and advance payments.

In 2009, the IFC launched a separate program for crisis response, known as its Global Trade Liquidity Program, which provides liquidity for international trade among less developed countries. Since its establishment in 2009, the Global Trade Liquidity Program assisted with over \$15 billion in trade in 2011.

The IFC operates a Syndicated Loan Program in an effort to mobilize capital for development goals. The program was created in 1957 and as of 2011 has channeled approximately \$38 billion from over 550 financial institutions toward development projects in over 100 different emerging markets.

To service clients without ready access to low-cost financing, the IFC relies on structured or securitized financial products such as partial credit guarantees, portfolio risk transfers, and Islamic finance.

The IFC committed \$797 million in the form of structured and securitized financing in 2010. For companies that face difficulty in obtaining financing due to a perception of high credit risk, the IFC securitizes assets with predictable cash flows, such as mortgages, credit cards,



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loans, corporate debt instruments, and revenue streams, in an effort to enhance those companies' credit.

Financial derivative products are made available to the IFC's clients strictly for hedging interest rate risk, exchange rate risk, and commodity risk exposure. It serves as an intermediary between emerging market businesses and international derivatives market makers to increase access to risk management instruments.

The IFC fulfills a treasury role by borrowing international capital to fund lending activities. It is usually one of the first institutions to issue bonds or to do swaps in emerging markets denominated in those markets' local currencies.

The IFC Treasury actively engages in liquidity management in an effort to maximize returns and assure that funding for its investments is readily available while managing risks to the IFC.

## **Advisory Services:**

In addition to its investment activities the IFC provides a range of advisory services to support corporate decision making regarding business, environment, social impact, and sustainability.

The IFC's corporate advice targets governance, managerial capacity, scalability, and corporate responsibility.

It prioritizes the encouragement of reforms that improve the trade friendliness and ease of doing business in an effort to advise countries on fostering a suitable investment climate.

It also offers advice to governments on infrastructure development and public-private partnerships.



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The IFC attempts to guide businesses toward more sustainable practices particularly with regards to having good governance, supporting women in business, and proactively combating climate change.

### **Asset Management Company:**

The IFC established IFC Asset Management Company LLC (IFC AMC) in 2009 as a wholly owned subsidiary to manage all capital funds to be invested in emerging markets.

The AMC manages capital mobilized by the IFC as well as by third parties such as sovereign or pension funds, and other development financing organizations.

Despite being owned by the IFC, the AMC has investment decision autonomy and is charged with a fiduciary responsibility to the four individual funds under its management.

It also aims to mobilize additional capital for IFC investments as it can make certain types of investments which the IFC cannot. As of 2011, the AMC managed the IFC Capitalization Fund (Equity) Fund, L.P., the IFC Capitalization (Subordinated Debt) Fund, L.P., the IFC African, Latin American, and Caribbean Fund, L.P., and the Africa Capitalization Fund, Ltd. The IFC Capitalization (Equity) Fund holds \$1.3 billion in equity, while the IFC Capitalization (Subordinated Debt) Fund is valued at \$1.7 billion.

The IFC African, Latin American, and Caribbean Fund (referred to as the IFC ALAC Fund) was created in 2010 and is worth \$1 billion. As of March 2012, the ALAC Fund has invested a total of \$349.1 million into twelve businesses.





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The Africa Capitalization Fund was set up in 2011 to invest in commercial banks in both Northern and Sub-Saharan Africa and its commitments totaled \$181.8 million in March 2012

## Criticism

IFC comes under frequent criticism from NGOs that it is not able to track its money because of its use of financial intermediaries. For example, a report by Oxfam International and other NGOs in 2015, "The Suffering of Others," found the IFC was not performing enough due diligence and managing risk in many of its investments in third-party lenders.

Other criticism focuses on IFC working excessively with large companies or wealthy individuals already able to finance their investments without help from public institutions such as IFC, and such investments do not have an adequate positive development impact. An example often cited by NGOs and critical journalists is IFC granting financing to a Saudi prince for a five-star hotel in Ghana.

## MULTINATIONAL CORPORATIONS

Large corporations having investment and business in a number of countries, known by various names such as multinational corporations, transnational corporations, international corporations and global corporations have become a powerful driving force in the world economy.

## EVOLUTION

In 1860, an English company set-up its production facilities in Australia.

In 1862, US based Singer Sewing Machines established production facility in England.

The first MNC came to India in 1921.





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In the earlier days US was the home for many MNCs.

## DEFINITION

Definition as per Jacques Maisonroque President of IBM defines it as a company that meets the following 5 criteria.

- It operates in many countries at different levels of economic development.
- Its local subsidiaries are managed by nationals.
- It maintains complete industrial organizations, including R&D and manufacturing facilities in many countries.
- It has a multinational central management.
- It has multinational stock ownership.

## ADVANTAGES OF MNCS

- MNCs help increase the investment level
- It helps increase the national income and employment in the host country.
- Technology transfer to developing countries.
- Kindle managerial revolution.
- Increase export and decrease import.
- Equalize cost of factors of production around the world.
- Efficient R&D systems leads to innovations and inventions.
- Stimulate domestic enterprises by outsourcing.
- Breaking Domestic Monopoly.

## DISADVANTAGES OF MNCS

- In reality MNCs technology targets only world wide profitability.



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- It is not for the development of poor and underdeveloped countries.
- Against national interest.
- Unfavourable effect on the Balance of Payments.
- It destroys local competition.
- It acquires monopoly powers.
- Threatens the sovereignty of the nations
- It retards growth of employment.
- Causes depletion to the non renewable natural resources of the country.
- Manipulates prices, evades taxes on intra company transactions.
- Invest in the low priority and high profit sectors in the developing countries.

## RECENT TRENDS

There has been a considerable change in the attitude towards the multinationals. They are not subject to severe criticisms as in the past. Streeten points out the following trends suggest that the role of the MNCs has to be reassessed.

- Many more nations are now competing with US multinationals in setting up foreign activities. Japanese and European firms figure more prominently in the new multinationals.
- Developing countries themselves are nowadays establishing MNCs.
- Large multinationals are replaced by smaller and more flexible firms.

## MULTINATIONALS IN INDIA



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Very little foreign investment has taken place in India due to several reasons like the dominant role of the public sector in the industrial policy and the restrictive governmental policy towards FDI. Some companies have even left India as some terms were not acceptable to them.

Some common criticism on MNC is that it tends to invest in the low priority and high profit sectors in the developing countries. However in India the government policy is confined to high priority areas, firms invested in non priority areas before this policy are allowed to continue.

FERA Act (1973) required the foreign companies to dilute their holding to the extent of 40%, except in certain cases and industries.

Multinationals drain the foreign exchange resources of the developing country.

At the end of 1995, there were 619 foreign companies in India. Several Indian outfits of MNCs like Ponds, Johnson and Johnson, Lipton, Brook Bond, Colgate-Palmolive etc, are in the low-tech consumer goods. Hindustan Lever, while popular in the low-tech consumer goods has diversified into high technology and export oriented sectors.

Domestic products outsell the MNC brand like Nirma, Rasna and Asian Paints.

### **FOREIGN COLLABORATION**

#### **Definition**

“Foreign Collaboration is an alliance incorporated to carry on the agreed task collectively with the participation (role) of resident and non-resident entities.” Foreign collaboration is such an alliance of domestic (native) and abroad (non-native) entities like individuals, firms, companies, organizations, governments, etc., that come together with an intention to finalize a contract on some tasks or jobs or projects.

In finance the definition of foreign collaboration can be specified as follows;

“Foreign collaboration includes ongoing business activities of sharing information related to financing, technology, engineering, management, consultancy, logistics, marketing, etc. which



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are generally offered by a non resident (foreign) entity to a resident (domestic or native) entity in exchange of cheap skilled and semi-skilled labour, inexpensive high quality raw materials, low cost high tech infrastructure facilities, strategic (favourable) geographic locations, and so on with an approval from the governmental authority like the ministry of finance of a resident country.

Examples:

ING Vysya Bank Ltd. is a financial collaboration formed between ING Netherlands and Vysya Bank from India.

## Objectives of Foreign Collaboration

1. Improve the financial position of both the companies.
2. Occupy a major market share for the collaborating entities.
3. Reduce higher operating cost to a non resident entity.
4. Make optimum and effective use of resources available in the resident entity's country.
5. Generate employment in the resident entity's country.

## ADVANTAGES OF FOREIGN COLLABORATION

### 1. Optimal use of natural resources:

Foreign trade helps each country to make optimum use of its natural resources. Each country can concentrate on production of those goods for which its resources are best suited. Wastage of resources is avoided.

### 2. Availability of all type of goods:

It enables a country to obtain goods, which it cannot produce or which it is not producing due to higher costs, by importing from other countries at lower costs.

### 3. Specialisation:

Foreign trade leads to specialization and encourages production of different good in different countries. Goods can be produced at comparatively low cost due to advantages of division of labour.



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#### **4. Advantages of large-scale production:**

Due to foreign trade, goods are produced not only for home consumption but for exports to other countries also. Nations of the world can dispose of goods which they have in surplus in the foreign markets. This leads to production at large- scale and the advantages of large-scale production can be obtained by all the countries of the world.

#### **5. Stability in prices:**

Foreign trade irons out wild, fluctuations in prices. It equalizes the prices of goods throughout the world (ignoring cost of transportation etc.).

#### **6. Exchange of technical know-how and establishment of new industries:**

Underdeveloped countries can establish and develop new industries with the machinery equipment and technical know-how imported from developed countries. This helps in the development of these countries and the economy of the world at large.

#### **7. Increase in efficiency:**

Due to the foreign competition the producers in a country attempt to produce better quality of goods and at the minimum possible cost. This increases the efficiency and benefits the consumers all over the world.

#### **8. Development of the means of transport and communications:**

Foreign trade requires the best means of transport and communication. For the advantages of foreign trade development in the means of transport and communication is also made possible.

#### **9. International co-operation and understanding:**

The people of different countries come in contact with each other. Commercial intercourse amongst nations of the world encourages exchange of ideas and culture. It creates co-operation, understanding and cordial relations amongst various nations.



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## **10. Ability to face natural calamities:**

Natural calamities such as drought, floods, famine, earthquake etc., affect the production of a country adversely. Deficiency in the supply of goods at the times of such natural calamities can be met by imports from other countries.

## **11. Other advantages:**

Foreign trade helps in many other ways such as benefits to consumers, international peace and better standard of living.

## **DISADVANTAGES OF FOREIGN COLLABORATION**

The important disadvantages of foreign trade that you might not know are listed below:

### **1. Impediment in the Development of Home Industries:**

Foreign trade has an adverse effect on the development of home industries. It poses a threat to the survival of infant industries at home.

Due to foreign competition and unrestricted imports the upcoming industries in the country may collapse.

### **2. Economic Dependence:**

The underdeveloped countries have to depend upon the developed ones for their economic development. Such reliance often leads to economic exploitation. For instance most of the underdeveloped countries in Africa and Asia have been exploited by European countries.

### **3. Political Dependence:**

Foreign trade often encourages subjugation and slavery. It impairs economic independence which endangers political dependence. For example, the Britishers came to India as traders and ultimately ruled over India for a very long time.

### **4. Mis-utilisation of Natural resources:**

Excessive exports may exhaust the natural resources of a country in a shorter span of time than it would have been otherwise. This will cause economic downfall of the country in the long run.



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## **5. Import of Harmful Goods:**

Import of spurious drugs, Luxury articles, etc. adversely affects the economy and well being of the people.

## **6. Storage of Goods:**

Sometimes the essential commodities required in a country and in short supply are also exported to earn foreign exchange. This results in shortage of these goods at home and cause inflation. For example, India has been exporting sugar to earn foreign exchange; hence the exalting prices of sugar in the country.

## **7. Danger to Internal Peace:**

Foreign trade gives an opportunity to foreign agents to settle down in the country which ultimately endangers its internal peace.

## **8. World Wars:**

Foreign trade breeds rivalries amongst nations due to competition in the foreign markets. This may event fully lead to wars and disturbs world peace.

## **9. Hardships in times of wars:**

Foreign trade promotes lopsided development of a country as only those goods which have comparative cost advantage are produced in a country. During wars or when good relations do not prevail between nations, many hardships may follow.