

Question Paper

Security Analysis – II (212) : July 2003

Part D : Case Study (50 Points)

- This part consists of questions with serial number 1 - 6.
- Answer all questions.
- Points are indicated against each question.
- Do not spend more than 80 - 90 minutes on Part D.

Case Study

Read the case carefully and answer the following questions:

1. Perform Michael Porter Analysis on Indian cigarette industry.
(8 points)
2. Perform SWOT analysis of ITC.
(8 points)
3. Based on the financial statements provided in the Annexure I, **estimate** important ratios and comment on the financial health of ITC.
(10 points)
4. Future estimates of growth rate in earnings, payout rate and beta of ITC have been depicted in the figures given in the Annexure II. If the risk free rate of return is 6.00% and the risk premium of the market is 6.75%, you are **required** to calculate the intrinsic value of the ITC stock.
(11 points)
5. From the given information in Annexure II, steep changes can be seen in the trading volume of the shares of the company and also the share prices. **Explain** how trading volume when studied along with the share prices, give valuable insights in the stock price movements.
(5 points)
6. From the data provided in Annexure II, **determine** whether the stock price movement of ITC Ltd exhibit weak form of market efficiency. Use run tests, at levels of significance of 2%, 5% and 10%.
(8 points)

Cigarette Industry

India is the third largest tobacco producer in the world, after the US and China. The country produces an estimated 550 million kg of tobacco annually. It is also one of the world's biggest markets for tobacco. Yet our share in the international trade continues to be less than 1%.

Tobacco is consumed in two ways. viz. smoking and chewing.

Smoke	Chew
Cigarette	Raw tobacco
Cigar	Ghutka
Bidi (Hand rolled, leaf wrapped country cigarettes)	Supari

Cigarettes are the most preferred form of tobacco consumption all over the world except in India. The share of cigarettes now stands at a mere 14% in the basket of tobacco consumption in India, as against an average of 86% in the rest of the world with per capita consumption of cigarettes in India being among the lowest in the world.

Segmentation

Cigarette market in India is at present segmented on the basis of length and filter/nonfilter.

Length	Type	Size of Market
Under 60mm	Non-filter	4.8%
60-70mm	Non-filter	95.2%
Under 70mm	Filter	75.4%
70-75mm	Filter	19.3%
75-85mm	Filter	5.3%

Major players and market shares

ITC is the dominant player with 66% market share. The four major players i.e. ITC, Godfrey Phillips, GTC and VST account for 99% of the market.

Leading Cigarette Brands of Major Players

	ITC	VST	GPI	GTC
Major Filter brands				
Premium	India King	Kingston	Rothmans	Chancellor
	Classic, State Express 555	Legend	Jaisalmer	Harvard, Craven
	Benson & Hedges	Burton	Chesterfield, Marlboro	Dunhill, Cartier
Medium	Wills	Charms Mini	Four Square	Panama Filter, King
	Navy Cut	King, Gold Premium, Charms Virginia Filter	Red & White	Baton
Popular	Gold Flake	Charminar Gold Filter	Red & White Filter	Panama Filter
	Bristol, Capstain		Commando, Originals	
Major non filter brands				
Upper	Scissors	Charminar Gold	Red & White	Flair, Style
Lower	Hero	Charminar, Charms Standard	Cavenders	Panama

Sales in past 5 yrs:

(Figures in million sticks)

	ITC	GTC	VST	GPI	Total	Var.(%)
FY2001-02	60865	7208	9040	8854	85967	-12
FY2000-01	66478	8624	11636	10611	97349	-1
FY1999-2000	66145	8311	11884	12114	98454	-3
FY1998-1999	67753	8367	12873	12797	101790	-6
FY1997-1998	68137	12924	13942	13100	108103	--

Current Scenario:

In India, there are about 200mn tobacco consumers. About 18% of people in India smoke either bidi or cigarette. Among them 25mn smoke cigarettes. The relative share of smokers is higher in rural areas at 18.9%, compared to 15.4% in urban areas. However, penetration of cigarettes is extremely low in rural areas. Only 2.1% of rural adults smoke cigarettes, compared to 6% of urban adults in India. In contrast as high as 16.9% of rural adults smoke bidis, compared to 9.6% of urban adult population. Overall penetration of bidis is 14.8% and that of cigarette is 3.2%. Awareness of these products among adult male population is over 90%.

Non-cigarette forms of tobacco products are largely produced in the unorganized sector characterized by lower rates of tax and ineffective enforcement. Consequently, the tax base of the tobacco sector is rapidly shrinking. The shrinking domestic consumption base of cigarette type Virginia tobacco has also, over time, adversely impacted the export potential of the tobacco sector.

The export prospects were further affected by the uncertainty and diminished market presence caused by the crop holiday in Andhra Pradesh. As a result, the export attractiveness of Indian tobaccos is caught up in a vicious cycle to the growing detriment of the tobacco farmers. This situation has been made worse by the growing inflow of contraband cigarettes that do not use Indian tobacco.

Decline in the Share of Cigarettes in tobacco consumption

1971-72	23%
1981-82	21%
1994-95	19%
1998-99	16%
2001-02	14%

Although non-cigarette forms of tobacco constitute nearly 86% of the tobacco consumption in the country, they contribute barely 10% of revenues to the Exchequer. Discriminatory taxation on cigarettes has led to progressive downgrading of consumption to lower value formats thereby shrinking the effective tax base. While tobacco consumption in the cigarette format has declined, the overall consumption of tobacco in the country continues to grow. It is therefore evident that high rates of taxes on cigarettes have neither imparted buoyancy to tax revenues from the tobacco sector nor curtailed overall consumption.

Stagnant growth:

Discriminatory and high rates of excise and State taxes on cigarettes, advertising and selling restrictions, opening up of market and unrestricted import of cigarettes with lower import duty are posing a challenge to Indian domestic cigarette business.

In addition, certain State Governments have increased local levies such as luxury tax, entry tax and octroi tax on cigarettes. As a result, the industry was left with no choice but to raise prices of most of their brands.

The sharp increase in cigarette prices triggered an unprecedented supply of cheap smuggled cigarettes in abundance from neighboring countries. Most of them were in king size filter format selling in the market for Rs.5 to Rs.10 for a packet of 10 cigarettes while domestic excise duty alone works out to Rs.14.50 for a pack of 10 sticks. Since the smuggled cigarettes offer very high margin for traders, there is always a natural inducement for them to push these products.

This is also discouraging the farmers of flue cured tobacco from making any investment in improving productivity and technological development. It may be worthwhile to note here that the per hectare earnings of farmers from flue cured tobacco is almost twice that of what he can earn by growing other types of tobaccos. This indifferent and impractical approach of the Government has also affected the growth and earnings of the domestic cigarette industry. The lack of clarity and absence of any durable policy of the Government for this sector has also discouraged the Indian industry from making any investments in developing the export market.

Growth Rates:

The year 2001-02 started on an ominous note for the cigarette industry in India after the Finance Minister imposed a very sharp hike in excise duty of as much as 15% in the budget of Feb'01. Corresponding increase in the prices moved many brands out of the convenient price of Re.1 per stick. This encouraged an unprecedented influx of very cheap smuggled cigarettes from neighboring countries. As a result, domestic companies were badly mauled.

During the year 2001-02, cigarettes production witnessed a negative growth of 11%. In fact the industry had registered declining volumes for the fourth consecutive year. However, the market in terms of value had been growing with increasing share of filter cigarettes and price hikes.

Having seen a sharp decline in the industry volume in FY01-02, and consequential loss to the revenue, the Finance Minister did not increase any excise duty on cigarette in his last Budget proposals (of Feb'02). This has helped in bringing stability in the prices.

Even though there was no hike in levies on cigarettes in the 2002 Union Budget, the Industry could not recover lost volumes due to imposition of fresh State taxes, the enacted or proposed ban on outdoor advertising and cigarette smoking in public places by several State Governments, continued availability of cheap smuggled cigarettes, increasing awareness of the health hazards associated with smoking, sluggishness in rural demand and continued recession of Indian industry severely affecting the cigarette industry. Moreover, due to monopolistic market share of multinationals, domestic companies continued to be under pressure.

Driven by the base effect, the growth rate, in the current FY02-03, has slowed over the past three quarters. Industry estimates that cigarette volumes likely grew around 2-3% in Q3, compared with 5-6% in Q1.

Substitute Products:

- Beedis are tobacco wrapped in tendoo leaves. Unlike cigarettes, they are taxed at a very low rate. Beedis consume nearly 55% of the total tobacco produced as against 15-20% for cigarettes. Their sales volume in India is estimated to be over 10 times that of cigarettes.
- The market for beedis is growing at a faster rate than for cigarettes. Excise duty hikes on cigarettes have resulted in a shift in demand from non-filter cigarettes to beedis as the demand for cigarettes in the lower segment is price sensitive.
- A shift in demand from beedis to micro cigarettes is expected due to the increasing price competitiveness of cigarettes as well as due to the growing urbanization and health consciousness regarding the high nicotine content in beedis as compared to cigarettes.

Tax Structure:

Prior to 1987, cigarettes were subject to *ad valorem* rates of duty resulting in administrative problems as well as reduced revenue to the exchequer. The specific excise duty rate on the basis of length of cigarettes introduced in 1987 has resulted in increased excise revenue to the exchequer from Rs.1,300 crore in 1986-87 to over Rs.5,342 crore in 2001-02. This has also reduced litigations considerably and has led to better administration.

It has encouraged tobacco crop development resulting in higher quality products and also helped in providing value added products to the consumers.

Cigarette: Current duty structure

	Excise Duty (Rs. per '000 sticks)		Customs Duty (%)	
	2001-02	2002-03	2001-02	2002-03
Non-filter (<60mm)	115	115	35	30
Non-filter (60-70mm)	390	390	35	30
Filter (<=70mm)	580	580	35	30
Filter (71-75mm)	945	945	35	30
Filter (76-85mm)	1260	1260	35	30
Filter (>85mm)	1545	1545	35	30

The stability of the length related specific excise duty structure throughout the years has encouraged manufacturers to produce international quality products through large investment in technology, crop development and vendor development.

The rationale for maintaining specific rates has been adequately stressed by several high powered committees including the Tax Reforms Committee under the chairmanship of Dr. Raja J Chelliah. While generally recommending a shift from specific duties to *ad valorem* duties, the committee had made a special mention with respect to tobacco products that it would be administratively convenient to subject cigarettes to specific duty.

Subsequently a report of the National Institute of Public Finance and Policy on Reforms of Domestic Trade Taxes in India Issues and Options in April 1994 also had reiterated this point. Saranghi Committee Report on Excise Structure Rationalization set up by the Government in 1999 had also endorsed this view. For similar reasons, Additional Duty of Excise (AED), which is levied in lieu of sales tax, is on specific rates on cigarettes.

Future:

The Indian Govt. has set the ball rolling for VAT after pegging two revenue neutral rates of 10 and 12.5%. In case of items like sugar, textiles and tobacco products, the Ministry has also proposed to amend the AED Act.

The Center has proposed to empower States to levy VAT on these three commodities, with rates ranging from 1% (floor) to 4% (ceiling). The Centre will continue to levy the existing Additional Duties of Excise (AED) on these products. While the amendment would empower States to levy VAT after April 2003, the Centre will simultaneously continue to levy AED on these products.

With the introduction of VAT by the state governments from 1st April 2003, there is likely-hood of removal of AED also and levy of Value Added Tax on commodities attracting AED to enable the industry to take input credit. However, cigarettes, which fall under the category of finished goods should be kept out of VAT and the present system should continue due to the following reasons.

1. Cigarettes are not used as inputs and, therefore, no credit will be available to any manufacturer.
 2. In case of cigarettes, central excise duties amount to as much as 127% of the ex- factory price and together with state level taxes, the total tax burden amounts to 140 – 150%. In fact AED alone accounts for nearly a third of the total excise duty of the value of cigarettes.
 3. Thus even a relatively low duty of 4% would result in a very high incidence of 'tax-on-tax'. This would defeat the very purpose of rationalization of taxes and avoidance of cascading being attempted under VAT.
- Increasing incidence of smuggled brands and easy availability of foreign cigarettes in the market has affected growth of the domestic industry.
- There is lack of clarity on various issues, like the existence of AED, state levies like the luxury tax, octroi, entry tax along with VAT. Co-existence of all these would definitely over burden the cigarette companies. Moreover, the impending phase out of Central Sales Tax along with the non-availability of credits for inter state sale/ transfer of inputs would compound the problem.
- There is an imminent need to rationalize the tax structure whereby the wide differential in the taxation of various tobacco products inter-se is gradually reduced and the States are discouraged from levying tax on cigarettes indiscriminately and differentially. This can be resolved by having a single point of taxation in a harmonized tax structure across the country.
- Industry estimates that VAT will create a cascading effect on cigarettes. In the light of existence of VAT along with AED, a 1% VAT rate will actually mean a levy of 2.3 % on the net value of the product. Similarly a 4% VAT rate will have an impact of 9.2 % on the net value of cigarettes.

ITC

ITC was incorporated on August 24, 1910 under the name of 'Imperial Tobacco Company of India Limited'. Its beginnings were humble. A leased office on Radha Bazar Lane, Kolkata, was the centre of the Company's existence. The Company celebrated its 16th birthday on August 24, 1926, by purchasing the plot of land situated at 37, Chowringhee, Kolkata, for the sum of Rs.3,10,000. This decision of the Company was historic in more ways than one. It was to mark the beginning of a long and eventful journey into India's future. The Company's headquarters building, 'Virginia House', which came up on that plot of land two years later, would go on to become one of Kolkata's most venerated landmarks. The Company's ownership progressively Indianised, and name of the Company was changed to I.T.C. Limited in 1974. Currently British American Tobacco Company (UK) controls 31.7% equity stake in ITC.

Though the first six decades of the Company's existence were primarily devoted to the growth and consolidation of the Cigarettes and Leaf Tobacco businesses, the seventies witnessed the beginnings of a corporate transformation that would usher in momentous changes in the life of the Company.

In 1975 the Company launched its Hotels business with the acquisition of a hotel in Chennai which was rechristened 'Hotel Chola'. The objective of ITC's entry into the hotels business was rooted in the concept of creating value for the nation. ITC chose the hotels business for its potential to earn high levels of foreign exchange, create tourism infrastructure and generate large scale direct and indirect employment. Since then ITC's Hotels business has grown to occupy a position of leadership, with 40 owned and managed properties spread across India. It also has a marketing and reservation arrangement with the Sheraton Corporation, the reputed international hotel chain.

In 1979, ITC entered the Paperboards business by promoting ITC Bhadrachalam Paperboards Limited, which today has become the market leader in India. The Company's technology, productivity, quality and manufacturing processes are comparable to the best in the world. It has also made an immense contribution to the development of 'Sarapaka', an economically backward area in the state of Andhra Pradesh. It is directly involved in education, environmental protection and community development.

In 1985, ITC set Surya Tobacco Co. in Nepal as a joint venture with the reputed Soaltee group. In 1990, ITC acquired Tribeni Tissues Limited, a speciality paper manufacturing company and a major supplier of tissue paper to the cigarette industry. In 1992, leveraging its agri-sourcing competency, ITC set up the International Business Division (IBD) for export of agri-commodities. The Division is today one of India's largest exporters.

Recently, ITC's Packaging & Printing business has launched a line of high quality greeting cards under the brand name 'Expressions'. ITC has also entered the Lifestyle Retailing business with the Wills Sport range international quality relaxed wear for men and women.

During 2002, ITC Bhadrachalam Paper Boards, a subsidiary company was merged with ITC. The shareholders of ITCPBL were allotted one equity share of ITC Ltd for every sixteen held.

ITC is a market leader in India in Cigarettes & Tobacco and also operates businesses like Hotels, Packaging, Speciality Papers and Paperboards. It has recently entered the Lifestyle Retailing business with the launch of the 'Wills Sport' range of relaxed wear. It has also spun off its Information Technology business into a wholly

owned subsidiary to more aggressively pursue emerging opportunities. ITC is one of the largest exporters of Indian agri-commodities.

With its wide range of invaluable brands, it has a leadership position in every segment of the market. Its highly popular portfolio of brands includes India Kings, Gold Flake, Wills, Scissors, Capstan, Berkeley and Bristol.

ITC's leadership is founded on its core strategy of continuously enhancing product values through significant investments in manufacturing and packaging technology, marketing and distribution. In just the last 5 years, ITC has invested Rs.8.5 billion in its cigarettes business. For ITC, one of the pioneers of market research in India, the consumer is still the King. The Company continuously endeavors to provide its consumers products that are benchmarked to international quality. This strategic focus on the consumer has paid ITC handsome dividends. The most important of these is its enriched product mix, unmatched by competition. ITC's share of filter cigarettes in the country is more than 70%.

In pursuit of international competitiveness, ITC has launched four brands - Checkers, Hi-Val, Royale Classic and Gold Crest - in the extremely competitive US market. These brands are currently notching up sales of over 1 billion sticks a year. ITC's cigarettes are produced in its state-of-the-art factories at Bangalore, Munger, Saharanpur and Kolkata; these factories are known for their high levels of productivity and very contemporary work-environment.

ITC's cigarette business has one of the largest retail networks in the country, consisting of over 2 million retailers. Its reach covers a wide range of the retail spectrum, from premium outlets in the metros to small shops in the interiors of rural India.

ITC employs 12,000 people at over 60 locations across India, and has nearly 150,000 shareholders.

ITC has pioneered the manufacture of cigarettes in India and has, since 1910, maintained its leadership position in the industry. It has diversified its brands across product categories. Its successful brands include Gold Flake, Wills, Classic, Bristol and Scissors. It also sells two luxury filter brands of its parent company, Benson & Hedges and 555.

Growth in ITC's cigarette volume continued to be slow in Q3, on account of the base effect. Estimating that growth in the third quarter was around 2-3% YoY, it is much lower when compared with 4-5% in Q2 and 5-6% in Q1. Growth in earlier quarters was from a low base.

For FY2003 overall, ITC's cigarette volumes are expected to grow at 3%. Volume growth would have been mainly concentrated in the regular size filter (RSFT) category. ITC reported a 5.7% increase in cigarette sales (value) for Q3, which is significantly lower than the 10.0% registered in Q1, and is despite a price increase in select brands at the beginning of the quarter. ITC raised Gold Flake prices in the regular size and king size segments by 8.6% and 5.7%, respectively, in September 2002. The price hike will average 0.9% for FY 2002-03, and volume growth is not likely to be impacted. But future growth prospects are good (As shown in Annexure II)

The improvement in the EBIT margin (of ITC) in the core cigarette business was mainly driven by an improvement in the product mix and the omission of launch expenditure of new brands that was incurred in the previous two quarters. EBIT growth and margins in the cigarette business are likely to continue to improve, driven by a better product mix and the price hike of selected brands in September 2002.

ITC's sales tax burden has increased significantly in the past 4-6 quarters, especially after the high sales tax imposed by Delhi and Tamil Nadu in Q1. While the collection of the taxes has been stayed by various High Courts, the Company provides for the same in the accounts.

ITC has been legally contesting these state levies. High Courts in Kerala, Tamil Nadu and Andhra Pradesh have stayed the collection of the luxury tax. The cases against the Kerala and Andhra Pradesh state governments are pending in the supreme court. However, ITC has been charging this tax in its revenue statements.

In Q3 of FY2002-03 ITC's overall growth of 5.7% in cigarette sales has been aided by a steady 2.5% volume growth. Value growth came from the increase in prices of Gold Flake Kings and Gold Flake Premium Filter. While consumer off-take has likely been 4% and, in the coming quarters, it will fall in line with primary sales. Year-end volumes are expected to stabilize at 4%.

Annexure I
Profit Loss Account

(Rs in Crore)

	2001-2002	2000-2001	1999-2000	1998-1999	1997-1998
INCOME:					
Sales Turnover	9840.09	8682.64	7953.06	7579.17	6834.75
Other Income	146.8	145.27	169.85	169.51	149.05
Stock Adjustments	135.3	31.99	-31.62	-4.27	88.84
Total Income	10122.2	8859.9	8091.29	7744.41	7072.64
EXPENDITURE:					
Raw Materials	1988.89	1512.68	1515.95	1549.38	1406.75
Excise Duty	4817.69	4486.2	4109.49	4059.98	3759.31
Power & Fuel Cost	118.96	74.23	62.43	53.3	49.64
Other Manufacturing Expenses	187.65	140.34	110.19	94.72	96.42
Employee Cost	279.87	243.96	246.95	201.03	204.08
Selling and Administration Expenses	552.07	448.58	422.09	418.93	368.57
Miscellaneous Expenses	148.23	147.86	134.53	136.77	160.32
Less: Preoperative Expenditure Capitalized	27.59	35.56	30.41	18.98	5.76
Profit before Interest, Depreciation & Tax	2056.42	1841.61	1520.07	1249.28	1033.31
Interest & Financial Charges	77.71	101.37	172.59	208.96	155.98
Profit before Depreciation & Tax	1978.71	1740.24	1347.48	1040.32	877.33
Depreciation	198.45	139.94	118.53	102.29	85.85
Profit Before Tax	1780.26	1600.3	1228.95	938.03	791.48
Tax	590.54	594.04	436.51	314.61	265.28
Profit After Tax	1189.72	1006.26	792.44	623.42	526.2
Adjustment below Net Profit	0	0	0	0	0
P & L Balance brought forward	282.5	201.28	187.86	160.95	128.46
Appropriations	1146.35	925.04	779.02	596.51	493.71
P & L Bal. carried down	325.87	282.5	201.28	187.86	160.95
Equity Dividend	334.14	245.42	184.06	134.98	110.44
Preference Dividend	0	0	0	0	0
Corporate Dividend Tax	0	25.03	40.49	14.85	11.04
Equity Dividend (%)	135	100	75	55	45
Earning Per Share (Rs.)	48.48	39.98	30.64	24.8	20.99
Book Value Per Share	177.23	141.44	111.46	88.32	69.02
Extraordinary Items	4.38	-1.48	7.93	4.18	2.73

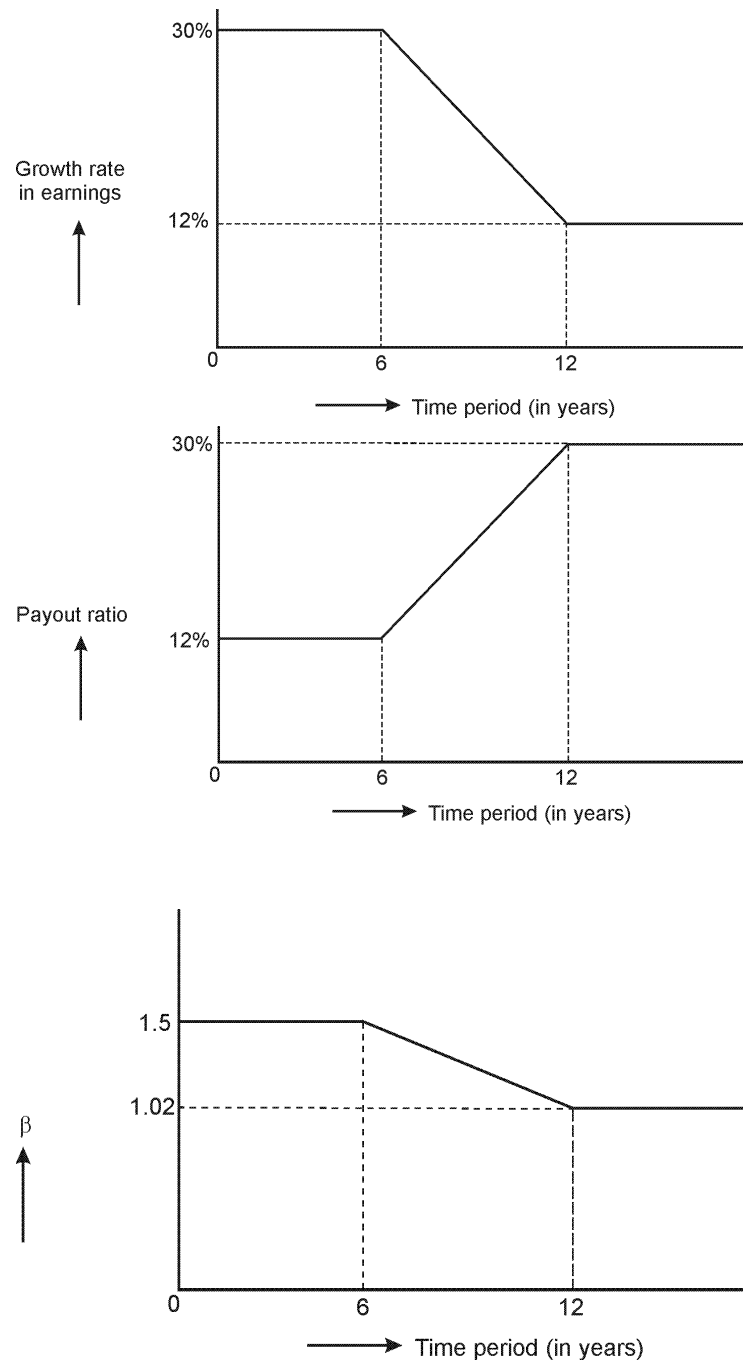
Balance Sheet

(Rs in Crore)

	2001-2002	2000-2001	1999-2000	1998-1999	1997-1998
SOURCES OF FUNDS:					
Share Capital	247.51	245.41	245.41	245.41	245.41
Reserves & Surplus	4166.47	3289.1	2553.92	1988.79	1516.72
Total Shareholders Funds	4413.98	3534.51	2799.33	2234.2	1762.13
Secured Loans	199.24	565.77	463.92	548.48	718
Unsecured Loans	85.3	293.17	188.95	703.74	581.04
Total Debt	284.54	858.94	652.87	1252.22	1299.04
Total Liabilities	4698.52	4393.45	3452.2	3486.42	3061.17
APPLICATION OF FUNDS:					
Gross Block	3694.58	2521.93	1871.13	1599.04	1355.67
Less: Accum. Depreciation	1101.9	707.42	592.25	484.85	390.86
Net Block	2592.68	1814.51	1278.88	1114.19	964.81
Capital Work in Progress	387.27	146.15	274.36	119.27	82.96
Investments	906.93	1006.94	987.26	1059.76	800.95
Current Assets, Loans & Advances					
Inventories	1180.27	1144.63	932.46	916.05	911.74
Sundry Debtors	194.63	105.54	117.66	338.73	268.89
Cash and Bank Balance	44.21	35.41	27.73	170.38	467.44
Loans and Advances	1951.78	1744.66	1324.08	1256.44	1015.52
Less: Current Liab. & Prov.					
Current Liabilities	2063.12	1261.13	1140.46	1163.51	1147.88
Provisions	496.13	343.26	349.77	324.89	303.26
Net Current Assets	811.64	1425.85	911.7	1193.2	1212.45
Miscellaneous Expenses not w/o	0	0	0	0	0
Total Assets	4698.52	4393.45	3452.2	3486.42	3061.17
Contingent Liabilities	281.42	170.85	383.99	142.28	42.77

Annexure-II

Futures estimates of growth rate in earnings, payout ratio and β of ITC



Stock Price data of ITC during last three years

Date	Prev_Close	Open	High	Low	Close	Traded Qty	Traded Value
3-Apr-00	741.45	739.9	800.8	721.05	797	1720025	13291.65
3-Jul-00	791.8	798	824	765	817.15	1857029	14759.7
3-Oct-00	713.2	712.75	725.95	703	713.35	330000	2357.24
1-Jan-01	896.1	899	908	887.4	893.85	549243	4939.45
2-Apr-01	814	802.25	819.9	783	814.9	460657	3724.16
2-Jul-01	754.3	741	775	741	758.8	77343	590.94
1-Oct-01	579.75	590	601.9	581	595.7	747472	4420.02
1-Jan-02	677.6	678	694	676	684.05	176918	1211.23
1-Apr-02	696.7	694	713	690.1	706.3	84369	595.66
1-Jul-02	640.85	641.95	671.9	639	668.35	539566	3569.84
1-Oct-02	650	660	660	645.2	649.75	95786	621.47
2-Jan-03	659.3	665	670	657.1	660.7	178060	1181.77
1-Apr-03	628.25	629	629.85	623.5	625.9	71252	446.5

END OF PART D

Part E : Caselets (50 Points)

- This part consists of questions with serial number 7 - 14.
- Answer **all** questions.
- Points are indicated against each question.
- Do not spend more than 80 - 90 minutes on Part E.

Caselet 1

Read the following caselet carefully and answer the following questions:

7. The caselet mentions that about a dozen exchanges reported nil turnover during 2001-02, 15 small exchanges put together reported less than 0.01% of total turnover during 2001-02. Do you think that regional stock exchanges which are recording near zero trading should be closed down? Discuss.
(5 points)
8. The caselet mentions that as per the latest data even BSE is facing liquidity crunch with nearly 50% of the listed shares not being traded even once during the year. What according to you are the reasons for this? Discuss.
(5 points)
9. Listing of securities on Indian stock exchanges is governed by a plethora of regulations in addition to rules, bye-laws and regulations of the concerned stock exchange, the listing agreement, and the circulars/guidelines issued by Central Government and SEBI. Do you think that an additional statutory body –Central Listing Authority-is required? Discuss.
(10 points)

Companies listed on multiple stock exchanges are now seeking delisting from regional stock exchanges. The voluntary delisting trend which started after the introduction of screen-based trading first by NSE and then by BSE is gathering momentum in 2003. The Pratip Kar committee on delisting recommended that companies be allowed to decide where to list. Following this, the Finance Ministry informed the stock exchanges that it was withdrawing the mandatory listing norms. In 2002 as many as 88 companies informed the BSE that their respective boards had resolved to delist their stocks from all bourses other than the main stock exchanges. Of the 88 companies, five are from Group A, nineteen from Group B1, fifty two from group B2 and four from Group Z.

Blue-Chip companies that have sought delisting from the smaller exchanges are Asian Paints, LML, Sun Pharma and Tata Telecom. The most prominent B group stocks in the list are Birla Corp, Honda SIEL Power, and Kajaria Ceramics. Most companies are seeking to delist their shares from Ahmedabad and Delhi Stock Exchanges.

The trading volumes on exchanges have been witnessing phenomenal growth for last few years. The growth of turnover has, however, not been uniform across exchanges. About a dozen exchanges reported nil turnover during 2001-02, 15 small exchanges put together reported less than 0.01% of total turnover during 2001-02, and 21 exchanges together reported less than 4% of turnover, while 2 big exchanges accounted for over 96% of turnover. With fall in turnover, the financial health of many exchanges is deteriorating. While the income of the small exchanges is not increasing (rather declined during 2000-01), they continue to incur increasing administrative and maintenance expenses and increased investment on setting up on-line trading and settlement systems. About a dozen exchanges suffered losses during 2000-01. The exchanges (except NSE and BSE) together incurred a total loss of about Rs.17 crore while BSE and NSE earned handsome profits. The data for Q4 of 2002-2003 reveals that even BSE is facing a liquidity crunch. The total number of scrips traded on BSE have declined by almost 20% from Jan to April 2003. Around 50% of the 5000 odd listed shares have not been traded at all during this period. Scrips not traded even once on the exchange have shot up by almost 25% as compared with last year's data. Tech companies alone account for more than 40% of the companies not traded and the remaining are media, telecom, entertainment and other new economy companies. Moreover, almost 70% of the companies not traded are B2 companies, 20% are Z group companies and remaining are B1 companies.

Such poor financial performance is despite the fact that the exchanges earn substantial amount of non-business income (income from listing, interest and rent). Listing contributes nearly Rs.50 crore. This has become a perennial source of income for the exchanges and irrespective of the volume of business; it contributes almost the same amount year after year. The listing income accounted for as high as 84% of total income of Gauhati Exchange and 73% for MP Exchange. Despite zero/negligible turnover, a few exchanges like Bhubaneswar, Cochin, Gauhati, Madhya Pradesh, Madras, Mangalore, Sikkim managed to earn a profit, albeit negligible, only because of their nonbusiness income. Given the speed of technological advances and trend in the market, extinction of a few stock exchanges is not a remote possibility.

Listing of securities on Indian stock exchanges is essentially governed by the provisions in the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956 (SCRA), the Securities Contracts (Regulation) Rules (SCRR), 1957, rules, bye-laws and regulations of the concerned stock exchange, the listing agreement entered into by the issuer with the stock exchange and the circulars / guidelines issued by Central Government and SEBI. The Companies Act, 1956 requires a company intending to issue securities to public to seek permission for dealing with its securities on one or more recognised stock exchanges. The listing agreement requires an issuer to agree that any of its securities listed on an exchange shall remain on the list entirely at the pleasure of the exchange, which has right to suspend or remove from the list, the said securities at any time and for any reason which the exchange considers proper in its absolute discretion. As a precondition for continuous listing, an issuer undertakes to forthwith comply with such future conditions as may be prescribed by the exchange. A government circular requires that the companies wishing to list their securities must get listing on the regional (an exchange is considered regional for the state / Union Territory where it is located) stock exchange nearest to their registered office. If they so wish, they can seek listing on other exchanges also. Thus an issuer willy-nilly has to list its securities on a regional stock exchange.

For all practical purposes, listing agreement is a one sided agreement, rather an undertaking, requiring the issuer to agree to all the conditions prescribed at the time of signing the agreement or to be prescribed subsequently. The agreement is also amended unilaterally. The issuer has absolutely no choice in the matter, as none of the terms is negotiable. The issuer is deemed to have agreed to comply with anything that may be prescribed at any time in future. Even the stock exchange does not have any freedom to vary any of the terms of the agreement. There are about 10,000 companies listed on Indian exchanges. Assuming that each company is listed on average on four exchanges (BSE has 9810 listed companies as against 1812 primary listings at the end of March 2001), there are 40,000 compliances by companies and the exchanges monitor 40,000 companies.

Most of the exchanges are "Association of Persons" which was considered beneficial in terms of tax benefits and matters of compliance. However, Securities and Exchange Board of India (SEBI) has already approved a uniform model of corporatization and demutualization for all stock exchanges. In view of the above, it is being argued in some circles that since the exchanges have failed to discharge responsibilities associated with listing of securities efficiently, a new mechanism in the form of a central listing authority (CLA) may be evolved. The question is if the CLA also fails to discharge these responsibilities, should we evolve another mechanism?

Caselet 2

Read the following caselet carefully and answer the following questions:

10. The caselet mentions that with the earnings yield curve moving upwards and the interest rates maintaining a southward movement the yield gap is widening. What is implied by this? Discuss.

(6 points)

11. The caselet mentions that despite support from RBI the floating rates bonds didn't become popular with Indian investors, though given that interest rates are now market determined, floating rates seem to be the only alternative. What according to you are the reasons that floating rate bonds didn't become popular? Discuss.

(7 points)

12. The debt markets have been doing well over the last two years whereas the equity markets have disappointed one and all. Do you think that debt markets can repeat their performance once again? Discuss.

(7 points)

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Caselet 3

Read the following caselet carefully and answer the following questions:

- 13.** The caselet mentions that the Indian capital markets have moved from T+5 rolling settlement to T+2 settlement in just 20 months, when some of the developed markets are still functioning on T+3 settlement cycle. What according to you are the challenges of such shorter settlement cycles? Discuss.

(6 points)

- 14.** Shorter settlement cycle reduces the risk inherent in trading and so investors should get attracted to the stock markets. But, the caselet mentions that despite the introduction of T+2 settlement cycle, the capital markets are still pervaded by pessimism. What according to you are the reasons for this lack of optimism? Discuss.

(4 points)

The SEBI Chairman, Mr. G.N. Bajpai's dream to have the T+1 trading system in the Indian stock exchanges may take time. But T+2 trading system is already a reality. In a move that would take the Indian stock trading system ahead of some of the developed equity markets, the Securities and Exchange Board of India (SEBI) has decided to further reduce the settlement cycle from T+3 to T+2 from April 1, 2003. This means that, settlement of stock deals, including payment and paper work, will be completed in two trading days after the trade is executed.

SEBI's decision to move towards T+2 settlement is a bold decision as some of the developed markets like the US, Japan and Britain are still functioning on T+3 settlement. US is planning to move towards T+1, but is not able to do so due to difficulty in implementing the Straight Through Processing (STP), a key system for T+1 settlement.

But looking at the Indian perspective, moving from weekly settlement to T+2 in just 20 months is a great achievement. This has been achieved without affecting the trading volume.

After having gained experience from T+3 rolling settlement and also taking further steps such as introduction of straight through processing (STP), it was now felt appropriate to further reduce the settlement cycle to T+2, thereby reducing the risk in the market and to protect the interest of investors.

SEBI had introduced T+5 rolling settlement in the equity market from July 2001, and subsequently shortened the settlement cycle to T+3 from April 2002. After the implementation of T+2 settlement cycle, Indian equity markets are now among the very few markets to have shorter settlement cycle. Some of the stock exchanges that have already moved towards T+2 settlement are the Korea Stock Exchange and the Toronto Stock Exchange. The Taiwan Stock Exchange that claims to be the first exchange in the world to move towards T+1, however, has not been able to successfully implement it and for all practical purpose settlement takes place on T+2 basis.

Even though market players still complain that the rolling settlement had led to fall in volumes, actual volume over the last 18 months does not show this. In fact, the volume is almost same and the liquidity in top 10

securities has increased. The turnover before the introduction of rolling settlement was averaging around Rs.5,000-6,000 crore daily (combined for BSE and NSE). The turnover in the last few months is around Rs 6,500 crore and this includes the turnover on the derivatives segment, which cannot be ignored as the same players are in both the markets.

Under the T+2 rolling settlement, the confirmation of the institutional trades by the custodians had to be done latest by 11.00 a.m. on T+1. A provision of an exception window would be available for late confirmations. The time limit and additional charges for the exception window would be decided by the exchanges. The stock exchanges' clearing corporation would process and download the obligation files to the brokers' terminals latest by 1.30 p.m. on T+1. Depository Participants (DPs) shall accept instructions for pay-in of securities by the investors in physical form at least up to 4 p.m. and in electronic form by 6 p.m. on T+1. The depositories would accept the requests from DPs till 8:00 p.m. for 'same day processing'. The depository would permit the downloading of the pay-in files of securities and funds till 10:30 a.m. on T+2 from the broker pool accounts. The depository would process the pay-in requests and transfer the consolidated pay-in files to the clearing house/clearing corporation by 11:00 a.m. on T+2.

However, even the introduction of T+2 settlement system in the country has not been able to combat a sense of extreme pessimism pervading the capital markets. It is still not clear when this would give way for a positive outlook. Shall we wait till 2004, when the T+1 system is planned to become operational?

END OF PART E

END OF QUESTION PAPER

Suggested Answers

Security Analysis - II (212) : July 2003

Part D : Case Study

1. Michael Porter Analysis of Cigarette Industry:

Threat of Entry: Several rules and regulations imposed by government on establishment of a new manufacturing unit make the threat of entry low. This industry faces big threat from health organizations who demand banning the smoking for improvement of life expectancy of the people. Several types of tax imposed by the government also act as entry barrier to entry. Because of heavy tax burden imposed by the government the profitability of the firms come down. This industry faces some threat from the unorganized players who produce sub standard product.

Bargaining Power of Buyers:

Bargaining power of buyers is very less as they are scattered and buy in small quantity. Buyers cannot exercise their power, as many people who are addicted to smoking cannot overcome their temptations easily and will be always willing to pay the demanded price to the cigarette manufacturers

Bargaining power of Suppliers:

The bargaining power of suppliers is moderate in this industry. The most prominent raw material of the cigarette industry is tobacco and its cost constitutes a major portion of the total manufacturing cost. Tobacco producers are the biggest suppliers to this industry however, generally tobacco farmers are not organized and therefore they do not possess high bargaining power.

Competition among existing players.

Competition is very intense in this industry because players in this market are striving hard to increase their market share. Again, the existing players are equally balanced and very few in this industry and this also makes the competition very tough among the existing players.

Threat of substitution

Threat of substitution is very high in this industry because of availability of cheaper alternative in the form of Beedi. For premium brands, lower and less costly brands can be considered as alternative. Overall threat of barrier is very high in the cigarette industry.

2. SWOT analysis of ITC

Strength : ITC is the market leader in the Indian Cigarette Industry. Cigarette brands produced by ITC are very famous and almost household name for smoking persons. ITC manufactures cigarettes for all kinds of customers and caters the need for all people. The company's market share in filter cigarettes is more than 70%. The company has got largest retail networks in the country, consisting of over 2 million retailers. Through this huge retail network the company can reach all types of customers in metros or rural village in the country. The management of ITC is very strong and people at the helm of main affairs are considered to be pioneers in the Indian Corporate world.

Weakness

The company's main weakness can be found in the vigorous diversification started by the company in almost all fields. If any of the new ventures do not succeed the company's profitable business will have to bear the losses. This will definitely create a big dent in its strong financial base. Diversification in various unrelated business may prove to be harmful to the company's strong brand value in its core business.

Opportunities

The company can enter in tobacco related product business and it can even produce some more cheap products to counter the cheap alternative beedi. Export market of cigarettes is also an important opportunity to the company where ITC can tap lucrative international market.

Threats

Growing health concerns and banning of several tobacco products and banning smoking in the public places can be viewed as threat to the company. In recent years, the share of cigarettes in the total consumption has been declining in India and has gone down to 14% as against an average of 86% in the rest of the World. This lower consumption of cigarettes in India is also posing a threat to the company. Even entry of premium international brands is a threat to the company's core business.

3.

Year	2002	2001	2000	1999	1998
Leverage ratios					
Debt-Equity Ratio	0.64	0.70	0.77	1.23	1.56
Liquidity ratio					
Current Ratio	1.32	1.89	1.61	1.80	1.84
Quick Ratio	0.86	1.17	0.97	1.19	1.21
Turnover Ratios					
Fixed Assets	3.795	4.78	6.22	6.80	7.08
Inventory	8.34	7.59	8.53	8.27	7.50
Debtors	50.56	82.27	67.59	22.37	25.42
Profitability ratios					
NPM (%)	12.1	11.6	9.96	8.23	7.7
RONW (%)	26.95	28.47	28.31	27.90	29.86

The debt-equity ratio is continuously declining. Though the equity base is more or less constant, the company's debt is continuously declining. Debt reduced drastically from 1999 to 2000 and further from 2001 to 2002. The liquidity position of the company is not good as reflected by the constantly reducing current ratio and quick ratio, particularly from 2001 to 2002. Fixed assets turnover is also declining. This is probably due to the increasing sales without a matching increase in fixed assets. Inventory turnover ratio is more or less constant. Debtors turnover ratio increased in the year 2001 but declined again in 2002 depicting inefficient management of the fixed assets. Net profit margin has increased continuously which is a healthy sign.

4. Three growth phase would be experienced by ITC in the next 12 years

High growth phase

Growth rate = 30%

Beta during this period = 1.50

Payout rate = 12%

$$\begin{aligned}\text{Cost of equity} &= 6 + 6.75 \times 1.50 \\ &= 8.10 + 6.00 \\ &= 16.13\%\end{aligned}$$

EPS = 48.48

Growth rate will decline linearly from 30% to 12% in 6 year period i.e. each year growth rate will decline = $\frac{30-12}{6} = \frac{18}{6} = 3\%$

Payout rate will increase linearly during this period from 12% to 30% i.e., each year it will increase by $\frac{30-12}{6} = 3\%$

Every year beta will decline by $\frac{1.5-1.02}{6} = 0.08$.

As beta will change, cost of equity will also change every year cost of equity during 7th – 12th year

$$\begin{aligned}7^{\text{th}} \text{ year} &= 6 + 1.42 \times 6.75 = 15.59\% \\ 8^{\text{th}} \text{ year} &= 6 + 1.34 \times 6.75 = 15.05 \\ 9^{\text{th}} \text{ year} &= 6 + 1.26 \times 6.75 = 14.51 \\ 10^{\text{th}} \text{ year} &= 6 + 1.18 \times 6.75 = 13.97 \\ 11^{\text{th}} \text{ year} &= 6 + 1.10 \times 6.75 = 13.43 \\ 12^{\text{th}} \text{ year} &= 6 + 1.02 \times 6.75 = 12.89\end{aligned}$$

EPS = 48.48

Year	EPS (Rs.)	Payout	DPS (Rs.)	Cost of Equity
1	$48.48 \times 1.30 = 63.02$	0.12	7.56	16.13%
2	$63.02 \times 1.30 = 81.93$	0.12	9.83	16.13%
3	$81.93 \times 1.30 = 106.51$	0.12	12.78	16.13%
4	$106.51 \times 1.30 = 138.46$	0.12	16.62	16.13%
5	$138.46 \times 1.30 = 180$	0.12	21.6	16.13%
6	$180 \times 1.30 = 234$	0.12	28.08	16.13%
7	$234 \times 1.27 = 297.18$	0.15	44.58	15.59%
8	$297.18 \times 1.24 = 368.50$	0.18	66.33	15.05%
9	$368.50 \times 1.21 = 445.89$	0.21	93.64	14.51%
10	$445.89 \times 1.18 = 526.15$	0.24	126.28	13.97%
11	$526.15 \times 1.15 = 605.07$	0.27	163.37	13.43%
12	$605.07 \times 1.12 = 677.68$	0.30	203.3	12.89%

A. Present value of dividend

$$\begin{aligned}
 & \frac{7.56}{1.1613} + \frac{9.83}{(1.1613)^2} + \frac{12.78}{(1.1613)^3} + \frac{16.62}{(1.1613)^4} + \frac{21.60}{(1.1613)^5} + \frac{28.08}{(1.1613)^6} + \frac{44.58}{(1.1559)^7} + \\
 & \frac{66.33}{(1.1505)^8} + \frac{93.64}{(1.1451)^9} + \frac{126.28}{(1.1397)^{10}} + \frac{163.37}{(1.1343)^{11}} + \frac{203.30}{(1.1289)^{12}} \\
 & = 6.51 + 7.289 + 8.15 + 9.14 + 10.23 + 11.59 + 16.17 + 21.61 + 27.66 + 34.15 + 40.85 + 47.45 \\
 & = 230.80
 \end{aligned}$$

B. Present value of the stock price

$$\begin{aligned}
 & \frac{203.3 \times 1.12}{0.1289 - 0.12} \times \frac{1}{(1.1613)^6} \times \frac{1}{(1.1559)^7} \times \frac{1}{(1.1505)^8} \times \frac{1}{1.1451} \times \frac{1}{1.1397} \times \frac{1}{1.1343} \times \frac{1}{1.1289} \\
 & = 4693.29
 \end{aligned}$$

The intrinsic value of ITC stock = A + B

$$= 230.80 + 4693.29$$

$$= \text{Rs.} 4924.09.$$

- Volume is simply the number of shares (or contracts) traded during a specified time frame (e.g., hour, day, week, month, etc). The analysis of volume is a basic yet very important element of technical analysis. Volume provides clues as to the intensity of a given price move.

Low volume levels are characteristic of the indecisive expectations that typically occur during consolidation periods (i.e., periods where prices move sideways in a trading range). Low volume also often occurs during the indecisive period during market bottoms.

High volume levels are characteristic of market tops when there is a strong consensus that prices will move higher. High volume levels are also very common at the beginning of new trends (i.e., when prices break out of a trading range). Just before market bottoms, volume will often increase due to panic-driven selling.

Volume can help determine the health of an existing trend. A healthy up-trend should have higher volume on the upward legs of the trend, and lower volume on the downward (corrective) legs. A healthy downtrend usually has higher volume on the downward legs of the trend and lower volume on the upward (corrective) legs.

Volume is used for two major purposes:

1. To confirm price changes: if a trend is not accompanied by an increase in volume it is considered to be weak and lacking commitment.
2. To anticipate changes in price: increases in volume often precede changes in price. Low volumes do not necessarily signal the end of a down-trend. Commitment from buyers is necessary to drive up prices. Prices can fall due to a lack of interest from both buyers and sellers.

Short-term**Trend confirmation:**

- Rising prices and rising volume signal a healthy up-trend.
- Falling prices and rising volume signal a healthy down-trend.

Trend weakness:

- Rising prices and falling volume signal trend weakness.
- Falling prices and falling volume may signal trend weakness.
- A large range with low volume indicates a lack of interest from sellers (if price is rising) or buyers (if price is falling).

Long-term**Trend confirmation:**

- Higher peaks with higher volume at peaks signal a healthy up-trend.
- Lower troughs with higher volume at troughs signal a healthy down-trend.

Trend weakness:

- Higher peaks with lower volume at peaks signal that the up-trend is weakening.
- Lower troughs with lower volume at troughs signal that the down-trend is weakening.

6. Run test using closing price of ITC

Date	Price	Up	Down
April, 2000	797.00	-	
July, 2000	817.15	Up (+)	
October, 2000	713.35		Down (-)
January, 2001	893.85	Up (+)	
April, 2001	814.90		Down (-)
July, 2001	758.80		Down (-)
October, 2001	595.70		Down (-)
January, 2002	684.05	Up (+)	
April, 2002	706.03	Up (+)	Down (-)
July, 2002	668.35		Down (-)
October, 2002	649.75		
January, 2003	660.70	Up (+)	
April, 2003	625.90		Down (-)

No. of positive price change = 5 = n_1

No. of Negative price change = 7 = n_2

Total price change = $r = 8$

$$\mu_r = \frac{2n_1 n_2}{n_1 + n_2} + 1 = \frac{2 \times 5 \times 7}{5 + 7} + 1 = 6.83$$

$$\text{Standard error} = \sigma_r = \sqrt{\frac{2n_1 n_2 (2n_1 n_2 - n_1 - n_2)}{(n_1 + n_2)^2 (n_1 + n_2 - 1)}}$$

$$\begin{aligned}
&= \sqrt{\frac{2 \times 5 \times 7 (2 \times 5 \times 7 - 5 - 7)}{(5 + 7)^2 - (5 + 1 - 7)}} \\
&= \sqrt{\frac{70 \times (58)}{144 \times 11}} \\
&= \sqrt{2.563} \\
&= 1.6
\end{aligned}$$

At 2% significance

Lower limit $6.83 + 2.718 \times 1.6 = 11.18$

Upper limit $6.83 - 2.718 \times 1.6 = 2.4812$.

At 5% significance

Lower limit: $6.83 + 2.201 \times 1.6 = 10.35$

Upper limit: $6.83 - 2.201 \times 1.6 = 3.31$

At 10% significance

Lower limit: $61.83 + 1.796 \times 1.6 = 9.7$

Upper limit: $6.83 - 1.796 \times 1.6 = 3.96$

At all level of significance number of run falls within the upper and lower limit therefore, we can conclude that prices are independent at all levels of significance.

Here table should be used with $(5 + 7 - 1) = 11$ degrees of freedom

Part E: Caselets

Caselet 1

7. Most of the transactions on small exchanges, which were positions across exchanges to gain from different settlement-cycles have disappeared because of uniform settlement cycles now. Further, the business would keep on shifting from small exchanges to more sophisticated and big exchanges, which provide quality processing of transactions. Small exchanges would become smaller and smaller and big exchanges would become bigger and bigger. This would reduce business income further for small exchanges. The listing income, which has been a fixed component is only likely to decline in future once the process of delisting of securities gains momentum. Besides, many issuers find it difficult to keep on paying listing fees and complying with the listing requirements of a number of exchanges without any corresponding gains in terms of volume of transactions. The new issuers, who are few, prefer exchanges with nationwide network. Besides, as turnover decreases, the custodial deposits with exchanges will also decline and hence interest earned on such deposits. While all the income (business, listing and interest) decline, expenditure won't decline proportionately.

Given this scenario, it seems quite logical that these regional exchanges be closed down as any other economic unit facing a financial crisis. Some argue that exchanges are not purely economic units- they are SRO's and a trustee for investors also. If they disappear, a listing authority disappears and a trading platform disappears. But, the question is where is the trading volume? Further, BSE and NSE are providing nationwide reach and alternative trading systems are also available through internet. So the question of providing trading facility in each region can be taken care of through technology.

8. BSE is facing a severe liquidity crunch with nearly 50% of the listed shares not being traded even once during the year 2002-2003. Some of the reasons for this are as follows:
 - a. NSE is proving to be tough competition for BSE. Real time trading on NSE is possible through VSATs scattered all over the country. As a result of this business has shifted from BSE to NSE.
 - b. Most of the stocks not being traded on BSE are new economy stocks with 40% being the technology companies alone. The reason for this is the tech-bubble burst and investors including institutional investors like MFs are keeping themselves away from such stocks after having burnt their fingers once.

9. Yes, a central listing authority is very much required. The reasons are:

- i. Given the speed of technological advances and trend in the market, extinction of a few stock exchanges is not a remote possibility. Quite a few exchanges will disappear sooner than later. There is nothing unusual in this. It is a normal market phenomenon that economic units come up and disappear due to market forces. But the exchange is just not an economic unit; it is also a SRO, a trustee for investors and a listing authority. If an exchange, where a security is listed, disappears, the listing authority as well as the trading platform for the security disappears. How can a regulatory entity disappear for commercial reasons? How can the trading platform for a listed security disappear? This reinforces the argument that securities should be listed, but not listed on/by a particular stock exchange, but by a third party which would not be extinct for commercial reasons and once listed, it should be available for trading on any exchange.
- ii. Listing signals that the issue has been properly supervised. The unwary investors take it as some kind of qualitative rating of the company, despite disclaimers to the contrary. Listing also casts onerous responsibilities on the exchange in the sense that it acts as a trustee for investors and ensures compliance of certain standards by a listed company. The issue is that are these exchanges, given their financial health and organizational structure, in a position to supervise such large number of listed companies (9644 companies listed on exchanges as at end of March 2002)? Given their dependence on listing income, can they discharge listing function efficiently? Can they easily deny a listing request? Can they suspend/delist a security without a second thought? Can they ruthlessly ensure compliance of obligations? No, as they can not easily offend a listed company in view of their interest. Take the recent case of declaration of interim dividend. When tax exemption on dividend was withdrawn, the companies tried to make pay out to investors in the form of interim dividend before the budget provisions were effected. This required relaxation of one of the terms of listing agreement. No exchange liked to refuse relaxation. They refused only at the behest of Government and SEBI. This therefore suggests the need for listing and supervision of a listed company through an independent authority who would not depend on listing income for survival.
- iii. Most of the exchanges are "Association of Persons" which was considered beneficial in terms tax benefits and matters of compliance. They are now having a re-look at the way they conduct business and are gearing up to demutualise themselves by converting themselves into a public limited companies. They will also be accessing securities market to finance their ever expanding trading network and would be interested to list their securities. This would create an anomalous situation where a stock exchange would admit its own securities for trading. A satisfactory solution would be to vest the listing powers with a body separate from the stock exchanges.
- iv. Under the current dispensation, while it is mandatory to list a security on a regional exchange, it can be listed on any number of exchanges. The issuer has option to list its securities on any one or more of the exchanges. Unless the regional exchange agrees to list a security, it can not be listed on any other exchange. The issue fails if the regional exchange refuses listing. The issue also fails if any of the exchanges, to which application for listing has been made, refuses to list the security. This arrangement generates unhealthy competition. There is a competition among the issuers to list securities on as many exchanges as possible to attract investors from all over the country and waste resources to comply with the listing requirements of a number of exchanges simultaneously. Similarly there is a competition among the exchanges to attract as many issuers as possible at times leading to dilution of listing standards particularly when listing constitutes a major source of income for many of them.
- v. A corollary to the above is that there is a lot of avoidable waste. For all practical purposes, listing agreement is a one sided agreement, rather an undertaking, requiring the issuer to agree to all the conditions prescribed at the time of signing the agreement or to be prescribed subsequently. The agreement is also amended unilaterally. The issuer has absolutely no choice in the matter as none of the terms is negotiable. The issuer is deemed to have agreed to comply with anything that may be prescribed at any time in future. Even the stock exchange does not have any freedom to vary any of the terms of the agreement. Why should we call it an agreement if both the parties to it have to blindly abide by it? Why should there be separate agreements for each security if it is the same agreement? Why should an issuer sign the same agreement with a number of exchanges? Or why should the request for listing be considered by different exchanges separately? Why should a company comply with listing agreement with different exchanges? Or why should a number of exchanges monitor compliance by a company? There are about 10,000 companies listed on Indian exchanges. Assuming that each company is listed on average on four exchanges (BSE has 9810 listed companies as against 1812 primary listings at the end of March 2001), there are 40,000 compliances by companies and the exchanges monitor 40,000 companies. It is just a waste of resources, as the terms are uniform across

securities and across exchanges. These wastages can be avoided if the issuers of securities are asked to comply with a standard set of requirements with a third entity so that duplication/triplication of efforts in terms of processing of request for listing, signing of listing agreement, multiple compliances by companies and multiple monitoring by exchanges are avoided.

- vi. Every exchange exercises powers of listing/denial of listing, suspending/delisting of securities independently. As a result, a security not found suitable for listing on an exchange gets listed on a different exchange, as they follow different criteria for listing a security. It may be noted that though the criteria for listing of securities differ across exchanges, the compliance requirements are essentially same. A prospective issuer informally gets a feedback from an exchange if the latter would consider listing of his security favourably. If he does not get an encouraging response, he tries his luck with other lenient exchanges. This creates an anomalous situation that a security, which is not suitable for investors in one locality, is suitable for investors in another locality. A security should either be suitable for listing on all exchanges or not suitable at all for listing on any exchange, that is, it should be suitable for all investors or not for any. Similarly, securities can be delisted by the company from all exchanges except the regional exchange. This means that the investors living in the locality of the regional exchange are closer than those living in other locations to the hearts of regulators. Thus we have an anomalous situation where an exchange lists/suspends/delists a particular security, while other exchanges do not do so.

This anomaly came up for consideration before the Securities Appellate Tribunal (SAT) in an appeal (Lunkad Media and Entertainment Limited Vs. The Stock Exchange, Mumbai). In order to take care of such anomalies, the SAT suggested government and SEBI to consider the feasibility of providing a centralised mechanism to grant listing of securities on the stock exchanges. It felt that some sort of uniformity in deciding application for listing by exchanges would be in the interest of investors. It observed: “It does not stand to reason that a public issue found unacceptable by one exchange for the reason that the issuer company’s credibility is doubtful, is acceptable to another exchange, though both the exchanges are supposed to be concerned about the interests of the investors. Investor protection measures should not be confined to territorial jurisdiction of exchanges. It should be at national level. Decision by a centralised set up may perhaps help to provide transparency and also help to maintain consistency and uniformity in the field of listing.”

In view of the foregoing, it is desirable that there is only one agency which considers all requests for listing and grants listing if it finds a security suitable for investors across the country. A security granted listing by the agency would be available for trading on all exchanges who will not waste resources in terms of duplication of efforts on listing and monitoring compliance. The security should also be monitored, and suspended and withdrawn from trading centrally by the listing agency. All the decisions of the agency relating to listing, suspension from trading, delisting etc. should be appealable to SAT. The investors and market participants would get all the company related information, which are mandatorily required to be filed by companies, at one central location preferably a web site maintained by the CLA. The exchanges should concentrate on trading only while pre-trading activity (listing and compliance of terms of listing) is managed by CLA and post trading activity (clearing and settlement of trades) is managed by clearing corporations. The CLA should be another intermediary like clearing corporation or depository and subject to regulatory discipline of SEBI.

Caselet 2

10. If interest rates are headed downwards, it should be accompanied by a fall in earnings yield making stocks more expensive. The upward moving earnings yield curve seems to show that the markets have an expectation of slow growth or to say it differently, markets still don’t have the confidence in growth. If these two yields are not moving in absolute tandem in terms of trend, atleast the two sets of yield would come closer if their markets had sensed that a recovery is round the corner. For when the earnings and the bond yields come closer, it signals that there is no price risk but only a time risk/ Viewed from this angle, a large and increasing gap between bond yields and the earnings yield is a macroeconomic imbalance. It essentially shows that the stock market and the bond market are in a state of disequilibrium, which can be quantified by measuring the yield gap. Since stocks offer earnings growth prospects, a negative gap is normal. The more negative the yield gap, the less stocks pay in uncertain earnings in relation to what bonds pay as guaranteed income. But the more negative the yield gap, the less is the possibility of growth.

11. Reasons why floating rate bonds have not become popular are as follows:

India has, only post-liberalization, broken free from an administered interest rate mechanism. In such an environment, the State rather than market forces and economic realities determined interest rates. A fixed interest rate regime has continued since. Without exception, most borrowers tap debt markets through security offerings bearing fixed coupons or mobilize bank/institutional finance at prime lending rates plus a spread representing their creditworthiness.

Simply put, there is no floating interest rate market in India. An attempt to recognize at least the term structure of interest rates was made with banks/institutions permitted to quote separate short term, medium term and long term prime lending rates. The markets also experienced tremendous volatility with several revisions in rates over the last few years. Having come this far, the next logical progression to a scenario where interest rates float off an index has strangely not taken place. A large part of this is attributable to an unfinished quest for a suitable benchmark. Let us examine four available options:

1. Commercial Paper (CP) Rate

The biggest drawback of this rate is that it is highly company specific and largely driven by credit risk. A weighted average of CP rates for companies with varying creditworthiness and risk perceptions would mean nothing.

2. Prime Lending Rate (PLR)

This is unsuitable because it is very bank specific and largely influenced by every bank's cost of funds. It is also single dimensional, as there is no bid and offer on PLR.

3. Treasury Bill (T-Bill) Rate

This is superior to the former two since these instruments represent the most liquid segment of debt markets in India with daily quotes available. However, its major drawback is that the Reserve Bank of India and not purely market determined largely influence it.

4. Mumbai Interbank Offered Rate (MIBOR)

This represent interbank call rates and enjoys distinct advantages over the preceding three. MIBOR is purely driven by market forces and reflects economic reality. However, an area of concern is in virtual absence of a term market for interbank funds in India. Thus, only an overnight MIBOR rate is available and quotes of 3 month, 6 month MIBOR, etc. are hard to come by in the absence of a liquid market for such periods. Overnight MIBOR is obviously highly volatile.

In spite of these inherent limitations, MIBOR is the most suitable floating rate benchmark available in India. However, the financial community must learn to accept MIBOR as a benchmark and develop a sense of familiarity and comfort with floating interest rates. Without this change even the first generation of notes comprising the FRN and its variants will not see light of day. In conclusion, the transition from fixed to floating rates remains the most significant challenge and priority for Indian financial markets.

12. No, it is highly unlikely that debt markets will repeat the performance. Interest rates in India have historically followed the direction given by policymakers coupled with a supportive environment. In the next fiscal 2003-2004 we expect the broad trend of lower interest rates to continue.

We also expect policy to continue to strive to direct interest rates lower. Both policy makers, the government of India and the Reserve Bank of India, have clearly indicated their bias for soft interest rates.

Before moving forward to expectations it would be useful to note that there are a number of ' interest rate that exist in the Indian economy.

Gilt yields, corporate bond yields, lending rates, deposit rates, contractual savings rates and the RBI reference rates, are all part of the interest rate structure.

The gilt market being the most deep and liquid is quick to reflect market expectations of future interest rate movements. This market, however, at times also lags interest rate moves by the RBI.

We expect gilt yields to move in a narrow range. We expect the yield curve to be steeper as the curve starts reflecting the market's acknowledgement that long bond yields offer limited upside in the coming months.

The current US-Iraq war and its impact on oil prices could keep inflation high in India. This, coupled with strong local growth, could increase the upward pressure on rates.

An upside or rally in the fixed income markets could, however, be possible if the slow global growth starts affecting India.

Monsoons are also a wildcard. Another interesting change the Indian fixed income market is witnessing is

on the currency front.

The exchange rate historically had been a negative for the fixed income markets, as rate hikes by the RBI followed periods of sharp depreciation in the rupee/dollar exchange rate.

This is now a worry of the past and recent developments indicate a reversal in trend. The exchange rate is now stronger; the rupee has appreciated against the dollar in the past year and is expected to stay strong.

Rising reserves have also prompted policy makers to prepay external debt. Unsterilised purchases of forex by the RBI have translated into a sharp increase in domestic liquidity, which should benefit the fixed income markets.

The corporate sector is expected to continue to benefit from soft interest rates as they keep lowering interest costs as both lending rates and corporate bond yields move lower.

The government has also started to restructure their liabilities to benefit from the current level of interest rates.

State governments have already initiated a debt swap scheme where loans of around 13-14 per cent will be swapped by market loans around 7 per cent and small savings collections at a cost of around 8 per cent.

For investors in debt products, they need to align return expectations to current levels as most of the returns would now come from accruals rather than the capital gains seen in most mutual fund investments.

They should also consider hedging their exposures to fixed income products so as to minimise risk from any marginal rise in rates.

Caselet 3

13. Basically there are two areas which pose a challenge in shorter settlement cycles. These are:

- The payment system between the broker and the customer. SEBI should ensure that it works smooth and fast. Under the T+2 system, the exchange, the clearing corporation, the clearing banks and the depository would complete their work on a transaction by early afternoon. But, thereafter, a faster flow of payments and credits for purchases from the brokers to the investors must be ensured. SEBI could well specify tighter time-frames. Accelerating the payment part to the even T+2 day in the hands of investors should not pose any problems as banks have electronic payment systems in place, at least in the major cities. Even in outlying areas, the banking systems have advanced enough to ensure payments within a day or two.
- The other area where SEBI needs to show quick progress is in stock market surveillance, enforcement and stringent penal action for violations. If in this vital area, SEBI's track record can be half as good as it has been in pushing the trading and settlement systems, it would make the stock market a better and more even-handed place for retail and institutional investors. Price manipulation, insider and informed trading are rampant despite some improvements in disclosure norms. For SEBI, this is the more difficult task, and firm progress here would enhance its credibility

Further in Indian Stock Markets, which are driven by speculation, shorter settlement cycles may also mean a decline in trading volumes resulting into illiquidity. So, SEBI should take care of this aspect also.

14. Shorter settlement cycles definitely reduce the risk but still the Indian retail investors are shying away from the market and volumes are not picking up. Some of the reasons for this lack of optimism are as follows:

- i. There is overall economic slowdown. Even the last quarter financial results were not upto the expectations of investors. Even companies like Infosys and Reliance were not able to satisfy the investors expectations.
- ii. The investors have lost confidence in the Indian capital markets as so many incidences of scams and companies going bust. Many investors have burnt their fingers and now are not interested in repeating the mistake.
- iii. The shorter settlement cycles are a recent phenomena. Investors are still not very sure of whether they will work. Further, the investors before entering into the new system want to observe the risks and rewards of the system.
- iv. There are apprehensions whether the financial (read payment) system will be up to the task. The move towards the T+2 system means the settlement should take place two days after trading day. This puts enormous pressure on the brokers, who will have to transfer the money within two days. This will be difficult, especially for investors in far-flung areas.

- v. The larger malaise of price manipulation, and insider and informed trading may not disappear because of shorter settlement cycles. Unless SEBI can make a dent here, the positive effects of systemic improvements will not flow to investors. Despite considerable improvements in the framework for disclosure, virtually every corporate action is still accompanied by informed trading and/or price manipulation.