

SOURCES OF FINANCE

Question 1

Explain the importance of trade credit and accruals as source of working capital. What is the cost of these sources?
(PE-II-May 2003) (2 marks)

Answer

Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short term source of finance. SSI firms in particular are heavily dependent on this source for financing their working capital needs. The major advantages of trade credit are – easy availability, flexibility and informality.

There can be an argument that trade credit is a cost free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

Question 2

What is debt securitisation? Explain the basics of debt securitisation process.
(PE-II-May 2004, Nov. 2004, May 2006 & May 2007) (6 marks)

Answer

Debt Securitisation : It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables.

Process of Debt Securitisation

- (i) *The origination function* – A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.
- (ii) *The pooling function* – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.

7.2 Financial Management

- (iii) *The securitisation function* – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Question 3

Discuss the risk-return considerations in financing of current assets.

(PE-II-Nov. 2004) (4 marks)

Answer

The financing of current assets involves a trade off between risk and return. A firm can choose from short or long term sources of finance. Short term financing is less expensive than long term financing but at the same time, short term financing involves greater risk than long term financing.

Depending on the mix of short term and long term financing, the approach followed by a company may be referred as matching approach, conservative approach and aggressive approach.

In matching approach, long-term finance is used to finance fixed assets and permanent current assets and short term financing to finance temporary or variable current assets. Under the conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long term financing and hence less risk of facing the problem of shortage of funds.

An aggressive policy is said to be followed by the firm when it uses more short term financing than warranted by the matching plan and finances a part of its permanent current assets with short term financing.

Question 4

Discuss the eligibility criteria for issue of commercial paper.

(PE-II-May 2005)(3 marks)

Answer

Eligibility criteria for issuer of commercial paper

The companies satisfying the following conditions are eligible to issue commercial paper.

- ◆ The tangible net worth of the company is Rs. 5 crores or more as per audited balance sheet of the company.
- ◆ The fund base working capital limit is not less than Rs. 5 crores.
- ◆ The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.

- ◆ The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.
- ◆ The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.
- ◆ For public sector companies there are no listing requirement but for companies other than public sector, the same should be listed on one or more stock exchanges.
- ◆ All issue expenses shall be borne by the company issuing commercial paper.

Question 5

Write short notes on the following:

- (a) *Global Depository Receipts or Euro Convertible Bonds.*
(Final–May 1996, 1998)(PE-II-May 2003, May 2004 & May 2008) (3 marks))
- (b) *American Depository Receipts (ADRs)*
(Final–Nov. 1996)(PE-II-May 2003, May 2004, May 2006 & May 2008) (6 marks)
- (c) *Bridge Finance* (Final–Nov. 1997)(PE-II-May 2003, May 2006 & Nov. 2008) (6 marks)
- (d) *Packing Credit* (Final–Nov. 1998) (6 marks))
- (e) *Methods of Venture Capital Financing* (Final– May 1999)(PE-II-Nov. 2002) (6 marks)
- (f) *Advantages of Debt Securitisation*
(Final–May 2001)(PE-II-May 2003) (3 marks)
- (g) *Deep Discount Bonds vs. Zero Coupon Bonds* (PE-II-May 2004) (3 marks)
- (h) *Venture capital financing* (PE-II-May 2005) (2 marks)
- (i) *Seed capital assistance* (PE-II-May 2005 & Nov. 2008) (3 marks)
- (j) *Global Depository Receipts vs. American Depository Receipts*
(PE-II-May 2007) (4 marks)

Answer

- (a) **Global Depository Receipts (GDRs):** It is a negotiable certificate denominated in US dollars which represents a Non-US company's publically traded local currency equity shares. GDRs are created when the local currency shares of an Indian company are delivered to Depository's local custodian Bank against which the Depository bank issues depository receipts in US dollars. The GDRs may be traded freely in the overseas market like any other dollar-expressed security either on a foreign stock exchange or in the over-the-counter market or among qualified institutional buyers.

By issue of GDRs Indian companies are able to tap global equity market to raise foreign currency funds by way of equity. It has distinct advantage over debt as there is no repayment of the principal and service costs are lower.

7.4 Financial Management

(or)

Euro Convertible Bond: Euro Convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. ECBs offer the investor an option to convert the bond into equity at a fixed price after the minimum lock in period. The price of equity shares at the time of conversion will have a premium element. The bonds carry a fixed rate of interest. These are bearer securities and generally the issue of such bonds may carry two options viz. call option and put option. A call option allows the company to force conversion if the market price of the shares exceed a particular percentage of the conversion price. A put option allows the investors to get his money back before maturity. In the case of ECBs, the payment of interest and the redemption of the bonds will be made by the issuer company in US dollars. ECBs issues are listed at London or Luxembourg stock exchanges.

An issuing company desirous of raising the ECBs is required to obtain prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India, Companies having 3 years of good track record will only be permitted to raise funds. The condition is not applicable in the case of projects in infrastructure sector. The proceeds of ECBs would be permitted only for following purposes:

- (i) Import of capital goods
- (ii) Retiring foreign currency debts
- (iii) Capitalising Indian joint venture abroad
- (iv) 25% of total proceedings can be used for working capital and general corporate restructuring.

The impact of such issues has been to procure for the issuing companies finances at very competitive rates of interest. For the country a higher debt means a forex outgo in terms of interest.

- (b) **American Depositary Receipts (ADRs):** These are depository receipts issued by a company in USA and are governed by the provisions of Securities and Exchange Commission of USA. As the regulations are severe, Indian companies tap the American market through private debt placement of GDRs listed in London and Luxembourg stock exchanges.

Apart from legal impediments, ADRs are costlier than Global Depositary Receipts (GDRs). Legal fees are considerably high for US listing. Registration fee in USA is also substantial. Hence ADRs are less popular than GDRs.

- (c) **Bridge Finance:** Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial institutions, normally it takes time for the financial institution to finalise procedures of creation of security, tie-up participation with other institutions etc. even though a positive appraisal of the project has been made. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of

the principal term loans. It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally rate of interest on bridge finance is higher as compared with that on term loans.

- (d) **Packing Credit:** Packing credit is an advance made available by banks to an exporter. Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Thus Packing Credit is essentially a short-term advance.

Normally, banks insist upon their customers to lodge the irrevocable letters of credit opened in favour of the customer by the overseas buyers. The letter of credit and firms' sale contracts not only serve as evidence of a definite arrangement for realisation of the export proceeds but also indicate the amount of finance required by the exporter. Packing Credit, in the case of customers of long standing may also be granted against firm contracts entered into by them with overseas buyers. Packing credit may be of the following types:

- (i) *Clean Packing credit:* This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighted according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.
 - (ii) *Packing credit against hypothecation of goods:* Export finance is made available on certain terms and conditions where the exporter has pledgeable interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilising the advance, the exporter is required to submit, along with the firm export order or letter of credit, relative stock statements and thereafter continue submitting them every fortnight and whenever there is any movement in stocks.
 - (iii) *Packing credit against pledge of goods:* Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and are kept under its lock and key.
- (e) **Methods of Venture Capital Financing:** The venture capital financing refers to financing and funding of the small scale enterprises, high technology and risky ventures. Some common methods of venture capital financing are as follows:
- (i) *Equity financing:* The venture capital undertakings generally require funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of

7.6 Financial Management

equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur.

- (ii) *Conditional Loan*: A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India Venture Capital Financiers charge royalty ranging between 2 to 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some Venture Capital financiers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound.
 - (iii) *Income Note*: It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's Venture Capital Fund provides funding equal to 80-87.5% of the project's cost for commercial application of indigenous technology or adopting imported technology to domestic applications.
 - (iv) *Participating Debenture*: Such security carries charges in three phases- in the start-up phase, no interest is charged, next stage a low rate of interest is charged upto a particular level of operations, after that, a high rate of interest is required to be paid.
- (f) **Advantages of Debt Securitisation**: Debt securitisation is a method of recycling of funds and is especially beneficial to financial intermediaries to support lending volumes. Simply stated, under debt securitisation a group of illiquid assets say a mortgage or any asset that yields stable and regular cash flows like bank loans, consumer finance, credit card payment are pooled together and sold to intermediary. The intermediary then issue debt securities.

The advantages of debt securitisation to the originator are the following:

- (i) The asset are shifted off the Balance Sheet, thus giving the originator recourse to off balance sheet funding.
- (ii) It converts illiquid assets to liquid portfolio.
- (iii) It facilitates better balance sheet management, assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.
- (iv) The originator's credit rating enhances.

For the investors securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

- (g) **Deep Discount Bonds vs. Zero Coupon Bonds**: Deep Discount Bonds (DDBs) are in the form of zero interest bonds. These bonds are sold at a discounted value and on maturity face value is paid to the investors. In such bonds, there is no interest payout during lock-in period.

IDBI was first to issue a Deep Discount Bonds (DDBs) in India in January 1992. The bond of a face value of Rs.1 lakh was sold for Rs. 2,700 with a maturity period of 25 years.

A zero coupon bond (ZCB) does not carry any interest but it is sold by the issuing company at a discount. The difference between discounted value and maturing or face value represent the interest to be earned by the investor on such bonds.

- (h) **Venture Capital Financing:** The term venture capital refers to capital investment made in a business or industrial enterprise, which carries elements of risks and insecurity and the probability of business hazards. Capital investment may assume the form of either equity or debt or both as a derivative instrument. The risk associated with the enterprise could be so high as to entail total loss or be so insignificant as to lead to high gains.

The European Venture Capital Association describes venture capital as risk finance for entrepreneurial growth oriented companies. It is an investment for the medium or long term seeking to maximise the return.

Venture Capital, thus, implies an investment in the form of equity for high-risk projects with the expectation of higher profits. The investments are made through private placement with the expectation of risk of total loss or huge returns. High technology industry is more attractive to venture capital financing due to the high profit potential. The main object of investing equity is to get high capital profit at saturation stage.

In broad sense under venture capital financing venture capitalist makes investment to purchase debt or equity from inexperienced entrepreneurs who undertake highly risky ventures with potential of success.

- (i) **Seed Capital Assistance:** The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme. The project cost should not exceed Rs. 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoters contribution or Rs 15 lacs whichever is lower.

The seed capital Assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter.

- (j) **Global Depository Receipts and American Depository Receipts:** Global Depository Receipts (GDR) are basically negotiable certificates denominated in US dollars, that represent a non-US company's publicly traded local currency equity shares. These are created when the local currency shares of Indian company are delivered to the depository's local custodian bank, against which the depository bank issues Depository Receipts in US dollars.

Whereas, American Depository Receipts (ADR) are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. ADRs are

7.8 Financial Management

issued by an approved New York bank or trust company against the deposit of the original shares. These are deposited in a custodial account in the US. Such receipts have to be issued in accordance with the provisions stipulated by the SEC USA which are very stringent.

The Indian companies have preferred the GDRs to ADRs because the US market exposes them to a higher level of responsibility than a European listing in the areas of disclosure, costs, liabilities and timing.