CAPITAL MARKET

INTRODUCTION

A good capital market is an essential pre-requisite for industrial and commercial development of a country. Credit is generally, required and supplied on short-term and long-term basis. The long term capital needs are met by the capital market. Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resource into the economic system operating in a country.

The development of a good capital market in a country is dependent upon the availability of savings, proper organisation of its constituent units and the entrepreneurship qualities of its people.

MEANING

A capital market is a market for medium and long term funds. It includes all organisations, institutions and instruments that provide long term and medium term funds. It does not include the instruments or institutions which provides finance for short period (upto one year). The common instrument used in capital market are shares, debentures ,bonds, funds, public deposits etc.

DEFINITION

According to V.K. Bhalla "Capital market can be defined as the mechanism which channelizes savings into investment or productive use . Capital market allocate the resources amongst alternative uses. It intermediates flow of savings of those who save a part of their income from those who wants to invest it in productive assets".

OBJECTIVES AND IMPORTANCE

- Ensures best possible coordination and balance between the flow of savings on the one hand and the flow of investment leading to capital formation on the other;
- Direct the flow of saving into most profitable channels and thereby ensure optimum utilisation of financial resources.
- The mobilisation or concentration of national savings for economic development.
- The mobilisation and import of foreign capital and investment to augment the deficit in the required financial resources so as maintain the expected rate of economic growth.

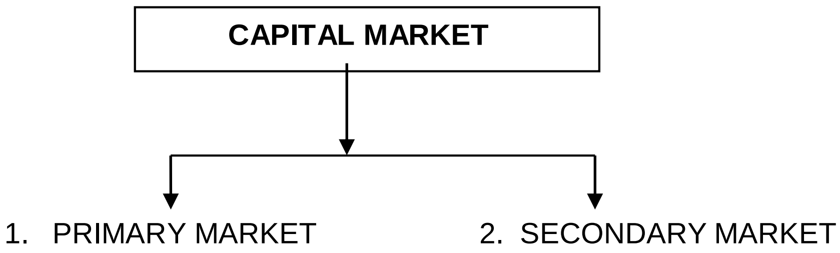
NATURE OR FEATURES OF CAPITAL MARKET

1. Link between savers and investment opportunities.
2. Deals in long term investment.
3. Utilises intermediaries.
4. Determinant of capital formation.
5. Government rules and regulations.

FUNCTIONS OF CAPITAL MARKET

1. Mobilisation of financial resources on a nation-wide scale.
2. Securing the foreign capital.
3. Effective allocation of the mobilised financial resources.

TYPES OF CAPITAL MARKET



PRIMARY MARKET

Primary market is also known as new issue market. As in this market securities are sold for the first time i.e. new securities are issued from the company. Primary market companies goes directly to investor and utilises these funds for investment in building, plants and machinery etc.

The primary market does not includes finance in the form of loan from financial institution because when loan is issued from financial institutions it implies converting private capital into public capital and this process is called as going public.

The common securities issued in primary market are equity shares, debentures, bonds, preference shares and other innovative securities.

Methods of floatation of securities in primary market

1. **Public issue through prospectus :** Under this method company issue a prospectus to inform and attract general public
2. **Offer for sale:** Under this method new securities are offered to general public but not directly by the company but by an intermediary who buys whole lot of securities from the company.
3. **Private placement:** Under this method the securities are sold by the company to an intermediary at fixed price and in second step intermediaries sell these securities not to general public but selected clients at higher price.
4. **Right issue (for existing companies):** This is the issue of new shares to existing shareholders. It is called right issue because it is the pre- emptive right of shareholder that company must offer them the new issue before subscribing to outsiders.
5. **e- IPO (electronic initial public offer) :** it is the new method of issuing securities through on line system of stock exchange . in this company has to appoint registered brokers for the purpose of accepting application and placing orders.

SECONDARY MARKET (STOCK EXCAHNGE)

The secondary market is the market for the sale and purchase of previously issued or second hand securities. In secondary market securities are not directly issued by the company to investors. The securities are sold by existing investors to other investors.

In secondary market companies get on additional capital as securities are bought and sold between investors only so directly there is no capital formation but secondary market indirectly contributes in capital formation by providing liquidity to securities of the company.

STOCK EXCHANGE

The Securities Contract and Regulation Act defines a stock exchange as “An organisation or body of individuals, whether incorporated or established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities.”

Every stock exchange has a specific location. In India there are 24 recognised stock exchanges.

TYPE OF OPERATION IN STOCK EXCHANGE

1. **Brokers:** A broker is a member of stock exchange. He buys and sells securities on behalf of outsiders who are not the members. He charges brokerage or commission for his services.
2. **Jobbers:** A jobber is a member of stock exchange. He buys and sells securities on his own behalf. He is specialised in one type of security and he makes profits by selling the securities at a higher price.
3. **Bulls:** A bull is a speculator who expect rise in price. He buys securities with a view to selling them in future at a higher price and making profit out of it.
4. **Bears:** A bear is a speculator who expects fall in price. He sells securities which he does not possess.
5. **Stag:** A stag is also a speculator who applies for new securities in expectation that price will rise by the time of allotment and he can sell them at premium.

Functions of Stock Exchange / Secondary Market

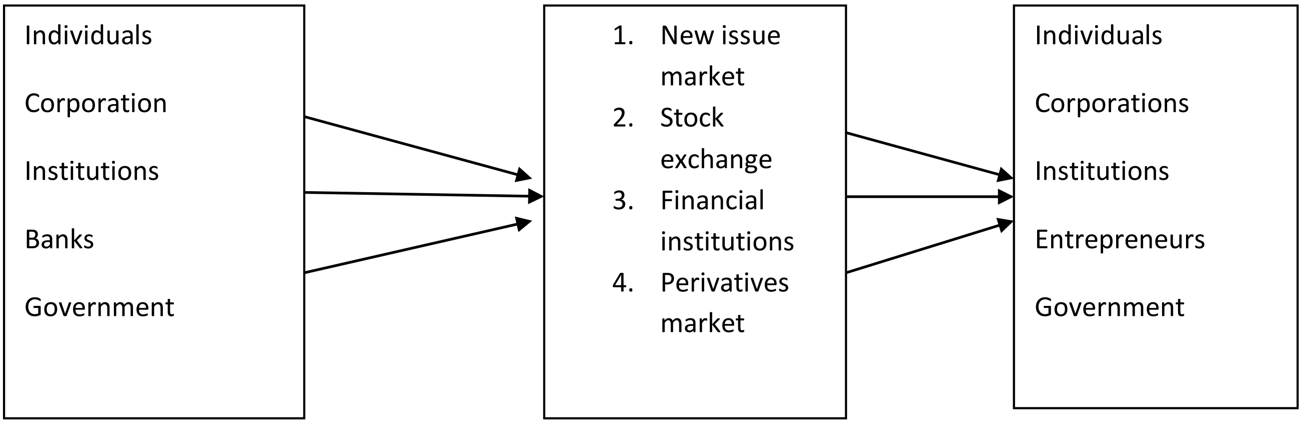
1. **Economic Barometer :** It is a reliable barometer to measure the economic condition of the country. The rise or fall in the share prices indicates the boom or recession cycle of the economy
2. **Pricing of Securities :** The stock market helps to value the securities on the basis of demand and supply factors.
3. **Safety of Transactions :** In stock market only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of company.
4. **Contributes to Economic Growth :** In stock exchange securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital

5. **Spreading of Equity Cult :** Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and educating public about investment.
6. **Providing Scope for Speculation:** To ensure liquidity and demand of supply of securities the stock exchange permit healthy speculation of securities.
7. **Liquidity :** The main function of stock market is to provide ready market for sale and purchase of securities. The investors can invest in long term investment projects without any hesitation, as because of stock exchange they can convert long term investment into short term and medium term.
8. **Better allocation of capital.**
9. **Promotes the habits of savings and investment.**

Component of capital markets

The following are the three main component of a capital market.

Supply of money capital



Investors lenders seller of money capital
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Clearing house for long-term capital

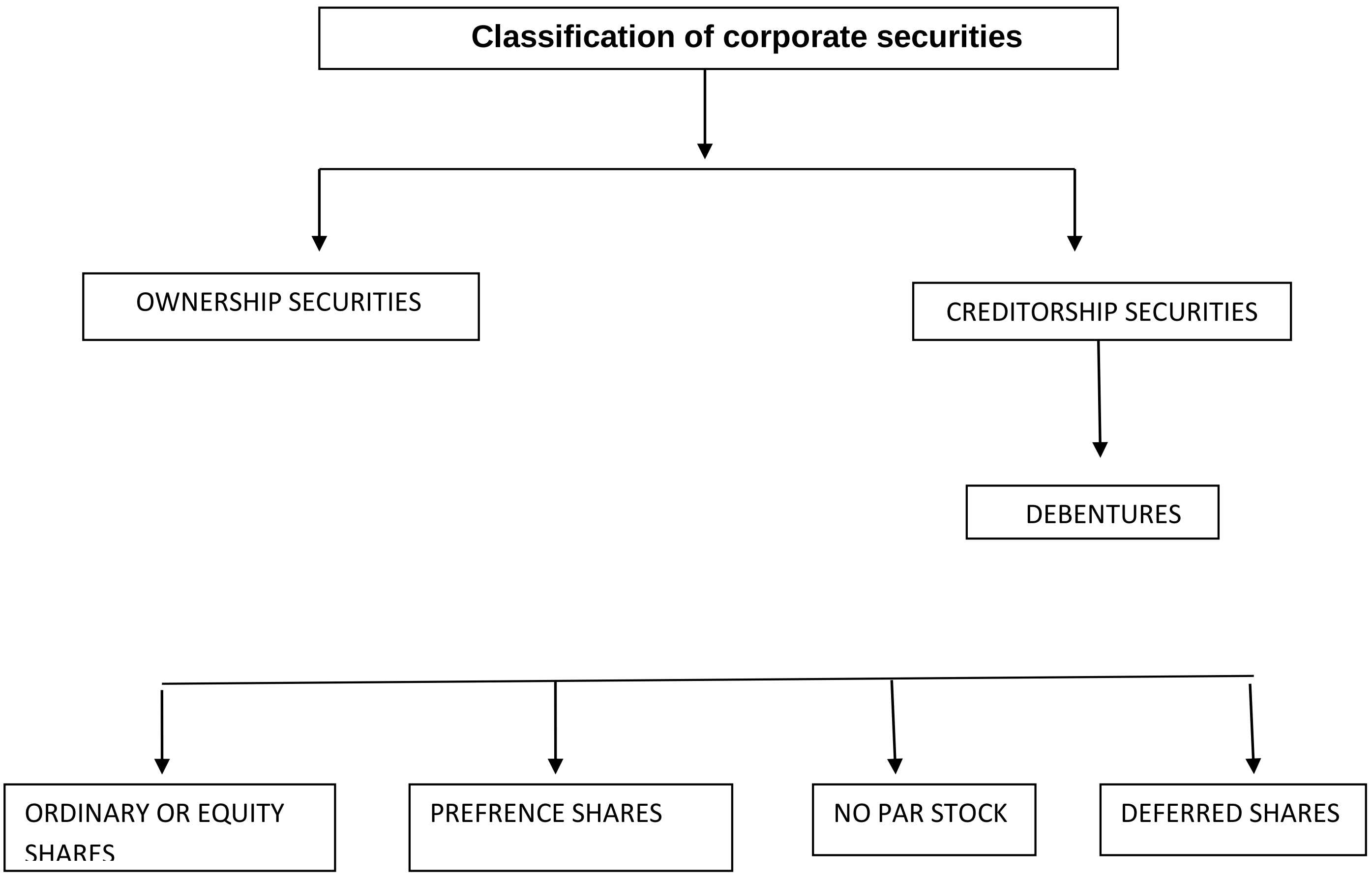
borrowers buyers of money-capital

1. New Issue Market or Primary Market
2. Stock Market or Secondary Market
3. Financial Institutions.

Capital Market Instrument

The corporate securities that are dealt in primary market can classified under two categories:

1. Ownership securities or capital stock.
2. Creditorship securities or debt capital



A. OWNERSHIP SECURITIES

Ownership securities, also known as capital stock or shares, are the most common methods used by corporates, government, and other big companies to raise funds to help finance their operations.

“section 2(46) of the companies act 1956 defines it is a “a share in the share capital of a company ,and including stock except where a distinction between stock and shares is expressed or implied.”

Kinds of Ownership Securities or Shares

Three two of shares

1. **Preference shares**
2. **Equity shares**

1. EQUITY SHARES

An equity share, normally known as ordinary share is a part ownership where each member is a fractional owner and initiates the maximum entrepreneurial liability related with a trading concern. These types of shareholders in any organization possess the right to vote.

Features of Equity Shares Capital

- Equity share capital remains with the company. It is given back only when the company is closed
- Equity Shareholders possess voting rights and select the company’s management
- The dividend rate on the equity capital relies upon the obtainability of the surfeit capital. However, there is no fixed rate of dividend on the equity capital.

CHARACTERSTICS OF EQUITY SHARES

1. Maturity
2. Claims / right to income
3. Claim on assets
4. Right to Control or Voting Right
5. Pre-emptive Right

6. Limited liability

Advantages of Equity Shares Capital

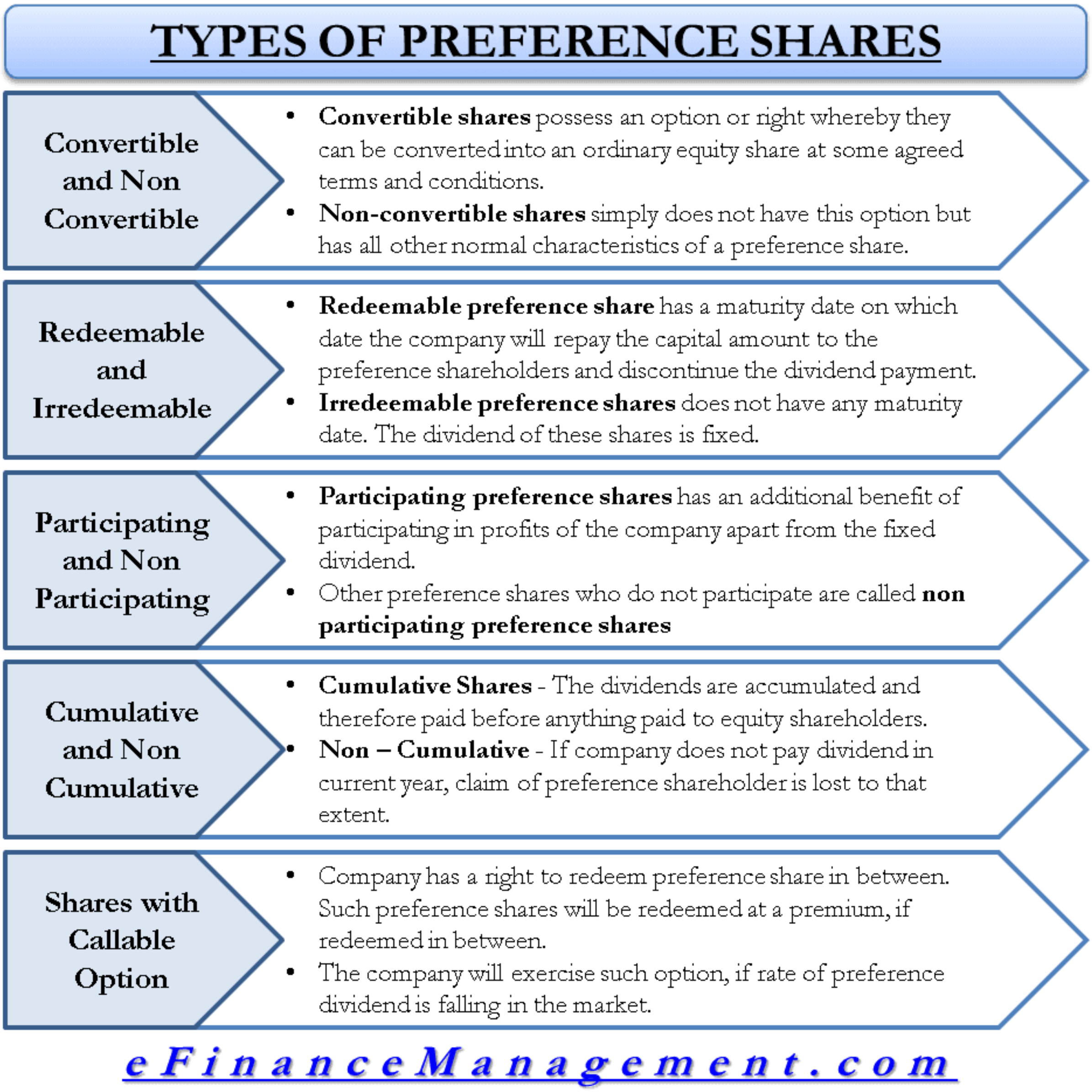
- Equity Shares does not create a sense of obligation and accountability to pay a rate of dividend that is fixed.
- Equity Shares can be circulated even without establishing any extra charges over the assets of an enterprise.
- It is a perpetual source of funding and the enterprise has to pay back; exceptional case – under liquidation.
- Equity shareholders are the authentic owners of the enterprise who possess the voting rights.

Disadvantages of Equity Shares Capital

- The enterprise cannot take either the credit or an advantage if trading on equity when only equity shares are issued.
- There is a risk or a liability over capitalization as equity capital cannot be reclaimed.
- The management can face hindrances by the equity shareholders by guidance and .systematizing themselves.
- When the firm earns more profits, then, higher dividends have to be paid which leads to raising in the value of the shares in the marketplace and its edges to speculation as w

2. PREFRENCE SHARES

Preference shares are a long-term source of finance for a company. They are neither completely similar to equity nor equivalent to debt. The law treats them as shares but they have elements of both equity shares and debt. For this reason, they are also called ‘hybrid financing instruments’. These are also known as preferred stock, preferred shares, or only preferred in a different part of the world. There are various types of preference shares used as a source of finance.



Features of preference shares

1. Maturity
2. Claim on income
3. Claim on assets
4. Control
5. Hybrid from securit

Advantages:

1. **Appeal to Cautious Investors:** Preference shares can be easily sold to investors who prefer reasonable safety of their capital and want a regular and fixed return on it.

2. **No Obligation for Dividends:** A company is not bound to pay dividend on preference shares if its profits in a particular year are insufficient. It can postpone the dividend in case of cumulative preference shares also. No fixed burden is created on its finances.

3. **No Interference:** Generally, preference shares do not carry voting rights. Therefore, a company can raise capital without dilution of control. Equity shareholders retain exclusive control over the company.

4. **. Trading on Equity:** The rate of dividend on preference shares is fixed. Therefore, with the rise in its earnings, the company can provide the benefits of trading on equity to the equity shareholders.

5. **No Charge on Assets:** Preference shares do not create any mortgage or charge on the assets of the company. The company can keep its fixed assets free for raising loans in future.

6. **Flexibility:** A company can issue redeemable preference shares for a fixed period. The capital can be repaid when it is no longer required in business. There is no danger of over-capitalisation and the capital structure remains elastic.

7. **Variety:** Different types of preference shares can be issued depending on the needs of investors. Participating preference shares or convertible preference shares may be issued to attract bold and enterprising investors.

Disadvantages:

1. Fixed Obligation: Dividend on preference shares has to be paid at a fixed rate and before any dividend is paid on equity shares. The burden is greater in case of cumulative preference shares on which accumulated arrears of dividend have to be paid.

2. Limited Appeal: Bold investors do not like preference shares. Cautious and conservative investors prefer debentures and government securities. In order to attract sufficient investors, a company may have to offer a higher rate of dividend on preference shares.

3. Low Return: When the earnings of the company are high, fixed dividend on preference shares becomes unattractive. Preference shareholders generally do not have the right to participate in the prosperity of the company.

4. No Voting Rights: Preference shares generally do not carry voting rights. As a result, preference shareholders are helpless and have no say in the management and control of the company.

5. Fear of Redemption: The holders of redeemable preference shares might have contributed finance when the company was badly in need of funds. But the company may refund their money whenever the money market is favourable. Despite the fact that they stood by the company in its hour of need, they are shown the door unceremoniously.

3. Deferred shares

Deferred shares are also called as founder shares because these shares were normally issued to founders. The shareholders have a preferential right to get dividend before the preference shares and equity shares. No Public limited company or which is a subsidiary of a public company can issue deferred shares. This shares are issued to the founder shares to control over the management by the virtue of their voting rights.

4. No Par Share or Stock

According to Indian Companies Act, the shares issued by a company must have a definite face value. The face value of the share indicates the extent of interest in and the liability of the shareholder to the company.

5. Sweat Equity

Sweat equity is the non-monetary investment that owners or employees contribute to a business venture. Startups and entrepreneurs often use this form of capital to fund their businesses by compensating their employees with stock rather than cash, which also helps to align risk and rewards. In real estate, it refers to value-enhancing improvements made by homeowners to their properties.

B. Creditorship securities

DEBENTURE

Meaning of Debenture

Debenture is used to issue the loan by government and companies. The loan is issued at the fixed interest depending upon the reputation of the companies. When companies need to borrow some money to expand themselves they take the help of debentures.

Important features of Debentures

- Debentures are instruments of debt, which means that debenture holders become creditors of the company
- They are a certificate of debt, with the date of redemption and amount of repayment mentioned on it. This certificate is issued under the company seal and is known as a Debenture Deed
- Debentures have a fixed rate of interest, and such interest amount is payable yearly or half-yearly
- Debenture holders do not get any voting rights. This is because they are not instruments of equity, so debenture holders are not owners of the company, only creditors
- The interest payable to these debenture holders is a charge against the profits of the company. So these payments have to be made even in case of a loss.

Advantages of Debentures

- One of the biggest advantages of debentures is that the company can get its required funds without diluting equity. Since debentures are a form of debt, the equity of the company remains unchanged.
- Interest to be paid on debentures is a charge against profit for the company. But this also means it is a tax-deductible expense and is useful while tax planning
- Debentures encourage long-term planning and funding. And compared to other forms of lending debentures tend to be cheaper.
- Debenture holders bear very little risk since the loan is secured and the interest is payable even in the case of a loss to the company
- At times of inflation, debentures are the preferred instrument to raise funds since they have a fixed rate of interest

Disadvantages of Debentures

- The interest payable to debenture holders is a financial burden for the company. It is payable even in the event of a loss
- While issuing debentures help a company trade on equity, it also makes it to dependent on debt. A skewed Debt-Equity Ratio is not good for the financial health of a company
- Redemption of debentures is a significant cash outflow for the company which can imbalance its liquidity
- During a depression, when profits are declining, debentures can prove to be very expensive due to their fixed interest rate

Types of Debentures

There are various types of debentures that a company can issu.

1. ***Secured Debentures:*** These are debentures that are secured against an asset/assets of the company. This means a charge is created on such an asset in case of default in repayment of such debentures. So in case, the company does not have enough funds to repay such debentures, the said asset will be sold to pay such a loan. The charge may be fixed, i.e. against a specific assets/assets or floating, i.e. against all assets of the firm.
2. ***Unsecured Debentures:*** These are not secured by any charge against the assets of the company, neither fixed nor floating. Normally such kinds of debentures are not issued by companies in India.
3. ***Redeemable Debentures***: These debentures are payable at the expiry of their term. Which means at the end of a specified period they are payable, either in the lump sum or in installments over a time period. Such debentures can be redeemable at par, premium or at a discount.
4. ***Irredeemable Debentures:*** Such debentures are perpetual in nature. There is no fixed date at which they become payable. They are redeemable when the company goes into the liquidation process. Or they can be redeemable after an unspecified long time interval.
5. ***Fully Convertible Debentures:*** These shares can be converted to equity shares at the option of the debenture holder. So if he wishes then after a specified time interval all his shares will be converted to equity shares and he will become a shareholder.
6. ***Partly Convertible Debentures***: Here the holders of such debentures are given the option to partially convert their debentures to shares. If he opts for the conversion, he will be both a creditor and a shareholder of the company.
7. ***Non-Convertible Debentures***: As the name suggests such debentures do not have an option to be converted to shares or any kind of equity. These debentures will remain so till their maturity, no conversion will take place. These are the most common type of debentures.