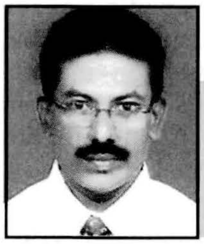
Capital Markets—Overview



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It looks like the global uncertainty and even the disturbing political environment for some time now cannot deter India from its growth trajectory as the grown up Financial system in the Country in all probability has resilience against all odds.

Capital market is an engine of growth and is a catalyst for Capital formation in a Country. The GDP growth of a Country is directly linked to a robust Capital Market. The Country needs 1 trillion US$ in the next five years for various infrastructure projects. It means that the Market will grow further with strong strides though it has already grown in a big way since the liberalisation policies were announced in 1991.

Broadly there is a Financial market with two segments – (i) Capital market (ii) Money market. **While Capital Market** deals with long term market instruments, **Money market deals with** short term instruments (maturity period of less than 12 months). Though an instrument that has maturity period of more than 12 months is dealt with in a Capital market, Instruments with maturity period over 4-5 years will be ideal for a Capital Market.

Investment Climate

Capital formation means the process of mobilisation of **Long term resources** by way of equity or Debt capital resulting in addition to physical assets of the Country. The process results in creating physical infrastructure which in turn generates regular income and employment for a Country.

In the life system the food we eat gets converted into blood and blood after certain cycles gets converted into bones. The bones form the skeleton infrastructure for human body. In a similar manner Capital, regarded as life blood of business, is converted into physical infrastructure for the economy by use of technology.

The investment climate and Capital formation in any country depends on :

1. Growth & quantum of **Domestic savings**.
2. Type & quantum of **Foreign Investment inflows**
3. Size of **Debt Market**.

Domestic Savings

Domestic savings account for 440 Billion US$ (33% of GDP) and consists of

(i) Public sector savings - 7%
(ii) Private sector savings - 23%
(iii) House hold savings - 70%

Household Savings account for 300 billion US$ which is 2/3 of total Domestic Savings. Household savings can be classified into

(i) Physical Savings(investment in Land, Buildings, jewellery etc.)

(ii) Financial Savings.

Financial savings account for 150 billion $ which is 50% of total House hold savings. Financial savings are parked under various categories as :

Financial Assets	Rs. in Crores	Rs. in Billion $	% to total
Currencies	92,640	19	12%
Deposits	362,840	73	47%
Shares & debentures	38,600	8	5%
LIC Policies	154,400	31	20%
PF & Pension Funds	77,200	15	10%
Others	46,320	9	6%
Total	772,000	154	100%

Break up of Domestic Savings

Sl. No.	Item	2007-08	2008-09		2009-10	
		Amount in Billion US$	Amount in Billion US$	Amount in Billion US$	Amount in Rupees	Per of GDP
1	Household Saving	224	266	307	1,536,000	24%
2	Private corporate sector	94	88	106	532,000	8%
3	Public sector	50	6	28	140,000	2%
	Gross Domestic Saving	368	360	442	220,8000	34%
	Gross Capital Formation *of which* :	379	395	469	2,345,000	36%
1	a) Public sector	88	106	120	602,000	9%
2	b) Private corporate sector	173	128	173	865,000	14%
3	c) Household sector	108	146	153	765,000	12%
4	d) Valuables #	11	14	23	113,000	1%
	Household Saving					
a)	Financial Assets	116	120	154	772,000	12%
b)	Physical Assets	108	146	153	765,000	11%

Foreign Investment Inflows

These inflows consist of (i) Foreign Direct investments (ii) Portfolio Investments :

(i) Foreign Direct investment : It is a much talked about subject in India and gathered momentum in the last 10 years as India being a most favoured nation for FDI destination.

There are two ways in which FDI are facilitated in India – a) when Foreign investment is proposed to be made in a priority sector Industry identified by the Government and not more than 51% of equity is sought, the foreign investor can straight away bring in the money through RBI and invest in the Joint venture with an Indian Partner. Indian Partner will bring in the remaining percentage equity. With subsequent changes in the FDI policy, foreign investments are freely allowed n many sectors up to 100% equity participation by foreign investor.

b) Where the investment is proposed to be made in a sector which requires an industrial licensing or in a sector which is not open to Foreign investment or open subject to restrictions, the investment will be approved by the FIPB (Foreign investment promotion Board) on a case to case basis.

(ii) Portfolio Investments : Foreign institutional investor is allowed to invest in Indian stocks and this type of investor is not interested in management and control of the Company. As the FIIs sees an opportunity of earning dividend and capital appreciation, they bring in the money and will remain invested.Sooner the FII feels that market is no longer favourable, he will exit from the market. There are no restrictions on this money and they can come in any time and quit the market any time. For this reason this money is called the Hot money and the money can fly overnight and get invested in another global market. But the advantage of Portfolio investment is that they provide the much needed liquidity and boost market sentiments and for this reason Foreign portfolio investments are welcome.

Debt Market or Bond Market

In advanced Countries, Debt market is significantly deeper than equity market. Debt Market is different from the Equity market as the rate of return on Instruments is fixed and Interest & return of Capital is risk free.

Indian debt market is the third largest in Asia.

Debt market instruments

(1) Money market instruments – Commercial Papers, Bills of Exchange, Promissory Notes.

(2) Long term debt instruments –

(i) Government Securities market – Securities of Central and State Governments.

(ii) Bond market – PSU bonds, Corporate Debentures.

Debt market consists of Domestic as well as External Debts. Total Long term Debt Market is estimated at 750 Billion US$ (50% of GDP)

Domestic debt market is put at 500 billion US$. External debt (Long term) is estimated at 250 billion US$. Long term External debt consists of ECBs (40%), NRI deposits (20%), Bilateral/Multilateral credits (30%), Loan from IMF etc.

Government share of External debt is 25%

Government is a major player in a Debt market and in infrastructure development. They also spend heavily on socio- economic development schemes. The size of Union budget is 250 billion US$ and government borrows around 30-40 % of the total budget amount every year to meet their plan expenditure and also to service the Loans already borrowed.

Capital Markets

The evolution of JOINT stock Companies lead to channelizing small savings of invisible investors into Capital Markets. Both Businesses enterprise and the

Foreign Investment Inflows

(US$ billion)

Item	2003-04 1	2004-05 2	2005-06 3	2006-07 4	2007-08 5	2008-09 6	2009-10 7	2010-11 8
A. Direct Investment (I+II+III)	4.32	6.05	8.96	22.83	34.84	37.84	37.76	30.38
I. Equity	2.23	3.78	5.98	16.48	26.86	28.03	27.15	20.30
II. Reinvested earnings	1.46	1.90	2.76	5.83	7.68	9.03	8.67	9.42
III. Other capital	0.63	0.37	0.23	0.52	0.29	0.78	1.95	0.65
B. Portfolio Investment (a+b+c)	11.38	9.32	12.49	7.00	27.27	-13.86	32.38	31.47
a. GDRs/ADRs	0.46	0.61	2.55	3.78	6.65	1.16	3.33	2.05
b. FIIs	10.92	8.69	9.93	3.23	20.33	-15.02	29.05	29.42
c. Offshore funds and others	–	0.02	0.01	0.00	0.30	–	–	–
Total (A+B)	**15.70**	**15.37**	**21.45**	**29.83**	**62.11**	**23.98**	**70.14**	**61.85**

Governments need money for their activities. The need for money may be short term or Long term. While the Short term need s are met from the Money markets, the long term needs like equity capital for Companies and Debt bonds for Governments are met by the CAPITAL MARKETS.

Financial Savings (part of domestic savings), Foreign inflows and external debt market are the sources a Capital market can tap for their resources for capital formation.

Thus Capital market is a market for long term financial Securities and consists of both Debt and equity instruments.

Capital Markets are of two types

(i) Primary market

(ii) Secondary Market

The function of Primary market is to attract investments into a Capital market through diverse Market instruments while that of a Secondary market is to retain the inflows in the system as long as it is required

Primary Market

Primary Market deals with Securities (Debt instruments & equity shares) issued for the first time and directly subscribed by Investing Public. Thus Securities are directly purchased from the Company or the Government. Money raised from these new issues may be used

(i) For setting up new projects by Companies.

(ii) For meeting Plan expenditure by governments.

It is a new issues market (NIM) and takes the form of IPOs, Right & Preferential issues & issue of Government Bonds. The process is also called the Capital formation.

The People who facilitate capital formation are called "UNDER WRITERS OR INVESTMENT BANKERS". Underwriters provide variety of services and procure subscription for Companies and Governments for a Commission.

The issue price of securities may be Fixed Price or a Premium price.

The issue price of equity shares is determined by a "BOOK BUILDING PROCESS". Simply, It is defined as the average of bid prices received from interested parties. It helps the Company to take advantage of the viability of funded projects and reputation of the Management.

The following are the market Participants in the primary Market :

Items	2009-10		2010-11	
	Amount	Amount	Amount	
	(RsCrore)	(Billion US$)	(Rs. Crore)	(Billion US$)
PRIMARY MARKET				
A. Public and Rights Issues	32,607	6.52	37,620	7.52
1. Private Sector (NG PLCs)	25,479	5.10	24,830	4.97
2. Public Sector (PSUs+Banks)	7,128	1.43	12,790	2.56
B. Euro Issues (ADRs and GDRs)	15,967	3.19	9,441	1.89
C. Private Placement-equity & debt (Pvt.&Public)	34,3279	68.66	2,38,394	47.68
D. Mutual fund Mobilsation (net)	83,080	16.62	-49,406	-9.88
Total	**4,58,966**	**91.79**	**2,26,608**	**45.32**

As per SEBI guidelines, a Public issue requires a rating from a Credit rating Agency. For e.g, if Fixed deposits are issued by a Company, minimum rating required is adequate safety ('A') and for Debentures D2 rating is required. Even equity issues have to be graded and published.

Private placements which include preferential issues(though subject to SEBI guidelines), investments by Private equity, long term borrowings from Banks etc. do not require any formal rating from CRAs. Private placements are between two known parties and are structured to meet each other's requirements. Whenever the Market conditions are not favourable, resource requirements of Capital market are met from Private placements.

Mutual funds are quite popular now in India. An investor who neither has the time nor the knowledge nor amount of money required to operate in a stock market, pool their resources into Mutual funds. The fund invests the money into the equities or debt funds and is managed by professional experts. An NAV (indicator of market value of investments) is calculated at the end of each day at which redemptions and re-purchase of units take place. The fund may be of various types viz. Based on (i) Risk perception: Equity oriented, debt oriented or Balanced funds. (ii) Objective : Growth oriented, income oriented, taxation funds (iii) Others : sector funds or area funds.

Indian Mutual funds have a mix of Private, foreign, Joint ventures and Bank sponsored operators and offer 300-400 schemes and the AUM (corpus) is estimated at US$ 50 billion whileUSA has more than 7,000 funds and AUM is US$ 6 trillion. Gap show the way forward for India.

Capital Market Instruments

The resources generated by the Capital Market come through diverse Market Instruments and through chain of intermediaries.

Equity, preference shares, Debentures are evergreen Capital market instruments but there are several other instruments that are tailored to the requirements of the Market. Some of the Market Instruments are :

Non Voting Shares : Quasi equity instruments with no voting rights. Nonvoting shares cannot exceed 25% of total ordinary shares with normal voting rights. Terms of issue of NVS may provide for payment of higher rate of Dividend. Holders shall have the Voting rights if Company fails to pay Dividends for certain Period. Ideal for small investor s and financial institutions.

ADRs&GDRs : These are Indian stocks floated in a foreign Market. Rupee denominated shares and the dividend is payable in rupee listed in a foreign stock exchange. Holders are not interested in Management and control of the Indian company. It is an Investment for earning dividend and capital appreciation.

Deep Discount Bonds or Zero Coupon Bonds : These are Bonds with a longer Maturity Period (say 25-30 years), issued at hefty discount and no interest will be paid during currency of Bond. The gain for the Investor shall be Face value of Bond less Cost of acquisition. eg., IDBI DDBs.

Security Premium Notes : These are Debentures with a lock-in-period (say for 3 years) and no interest is payable during LIP and thereafter redeemed by paying Principal and a premium in instalments (say over 4 years), e.g, TISCO SPNs.

Foreign Bonds : Bond issued in the currency of the country where sold by a foreign borrower and governed by regulations of the country where issued. These Bonds come with a lower rate of Interest and payable in foreign currency. e.g. Yankee Bonds, Bull-dog Bonds, Samurai Bonds etc.

Foreign Currency Convertible Bonds(FCCBs) : Equity linked debt bonds with right to convert into equity at predetermined prices. Carry fixed rate of Interest payable in Foreign currency.

Sweat Equity Shares : These are employee stock options wherein holder receives shares from the company in return for their expertise/know how. The consideration received for allotment of these shares is not cash but a measure of recognition of loyal services from employees

Private Equity : High net worth Investors pool their resources into a private equity and often invest in "distressed securities". The Objective is to earn above ordinary returns by way of Capital gains and Dividend from their investment by providing management expertise and injecting adequate capital. They exit from the Investment as when the Project has attained maturity.

As mentioned, there are **several Intermediaries** in channelising small savings of **Invisible investors** into the Capital Market. One of the Important Intermediary is an **Underwriter**. An Underwriter is a professional expert and provides variety of services. He can evaluate an issue in terms of their risk & return and his services can be considered as a Credit enhancement tool as he offers to commit funds only for those projects that have a financial viability. Underwriting is a risk management tool in that it guarantees "Minimum Subscription" as required under the Companies Act. In addition underwriter agrees to manage public Issues either as Lead Manager or Consultant to the Issue. He can Offer advice on capital restructuring, fixing issue prices and determining premium for issue etc. **Hence an Underwriter is not to be considered as an ordinary middle man**

Secondary Market

Capital Market Securities like equity are life time investments or Debts with long term maturity. Original investors who wish to exit from the Securities purchased from the Primary market can offload these securities in the Secondary market. **This gave birth to Stock exchanges**.

Secondary Market is an innovative supplement for the Primary Market securities. The migration of securities from Primary to Secondary market is DONE through a process called"LISTING".

– Stock Exchanges – Provides liquidity of Capital and a continuous market for outstanding securities.

– Mechanism for constant evaluation of value of shares and setting their prices close to their investment worth.

Stock Exchanges in India

The Country has 23 stock exchanges in addition to NSE and OTCEI. Five primary stock exchanges are National SE, Bombay SE, Madras SE, Kolkatta SE and Delhi SE. NSE &BSE account for bulk of Market turnover (over 95%) :

– Mumbai stock exchange is the oldest Exchange in India. It was established in 1875. It has price index called "SENSEX" and is based on 30 Shares. NSE was established in 1992. It is a nationwide market through V-SAT based Screen based trading and its Price Index CNX Nifty is based on 50 Scrips. NSE has both debt market as well as Equity Market segment.

Price Index of Stock exchanges both Sensex & Nifty is a measure of return on equity shares and their volatility in prices.

Trading in Stock Market

Thanks to the e-revolution, trading in stock market is now simple and effective through Internet trading. All you need to do is to open a DEMAT account. The agencies involved in stock market trading are :

(i) Stock Exchange (BSE/NSE)

(ii) Depository (NSDL/CSDL)

(iii) Depository Participant (DP)

The Investor opens a Trading with the DP and through him a DEMAT account with Depository. Stocks in DEMAT form are held by the Depository. All the three agencies have connectivity with each Other and trade (buy/sell order) from the investor is executed real time.

The advantages that may arise to an investor in stock market are in the following forms :

(a) Tax free Dividend

(b) Capital appreciation

(c) Long term Capital gains on stock sold is exempt from tax

d) Short term Capital gains are subject to tax at a reduced rate @15%.

Stock market has two primary segments :

(i) Cash Market (ii) Derivative Market

(i) Cash market

Trading in Cash market are of two types :

(a) Intraday or Day trade—Investor will take a position to buy or sell and settle the position by end of the market closing hours. Margin money provided is 5 times and brokerage is 0.10% on every buy & sell.

(b) Delivery based trade —Investor buys the shares and keeps it for any period and sell it whenever they wish. There is no margin provided by the broker and brokerage is 0.50% on every buy & sell.

(ii) Derivative Market

Trading in Derivatives is now allowed in Indian stock exchanges from the year 2000.

Derivative Instruments—These are Instruments that derive their value from the underlying Securities like Commodities, Shares/Securities, Foreign Exchange, Treasury bills which are traded in the Cash Market.

Derivatives include Stock futures/Index futures and Stock Options/Index Options. Index Futures and Options are traded on the basis of Index of Stock exchange i.e. SENSEX & NIFTY.

Stock futures are an agreement to buy or sell an underlying asset at a future date at a pre-specified price. The Contract is settled either by delivery of the Stock on the expiry date or by cash for the difference between strike price and prevailing price on the expiry date.

Stock options in a similar manner give the holder the right (but not an obligation) to buy or sell a particular stock from the seller/writer of the stock for a premium. It can be settled either on the expiry date or before either by delivery of the stock or by cash for the difference in prices.

The operation of Derivatives and Cash market under the same roof of Stock exchange can be clearly understood with a hypothetical situation as :

	Derivatives Market		**Cash Market**	
Assumptions	Futures	Options	Delivery	Intraday
Share (eg)	Reliance	Reliance	Reliance	Reliance
Qty	Lot size	Lot size	single unit	single unit
Qty (eg)	1	1	1	1
	(100	(100		
	shares)	shares)		
Price	Strike price	Strike price	Unit price	Unit Price
Price (eg)	1,000	1,000	1,000	1,000
Expiry Period	1-3 months	1-3 months	Nil	End of day
Short-selling	allowed	allowed	Not allowed	allowed
Margin (say)	20%	20%	100%	20%
Investment	20,000	20,000	100,000	20,000
trade (type)	B&S/S&B	B&S/S&B	B&S only	B&S/S&B
Premium (Y/N)	No	yes	No	No
Premium (say)	–	100	–	–
i) Settlement Price (e.g)	1,200	1,200	1,200	1,200
Profit	20,000	10,000	20,000	20,000
Return On investment	100%	50%	20%	100%
ii) Settlement Price (e.g)	800	800	800	800
Profit	-20,000	-10,000	-20,000	-20,000
Return On investment	-100%	-50%	-20%	-100%
iii) Settlement Price (e.g)	700	700	700	700
Profit	-30,000	-10,000	-30,000	-30,000
Return On investment	-150%	-50%	-30%	-150%

Derivatives Market Cash Market

Derivative trading is an emerging market and the market volume has already exceeded the market turnover of Cash market and is set to increase manifold.

Stock Market in future may mean only the derivative Market due to high volume of turnover. Derivative market and Intraday under a cash market are primarily speculative as there is no delivery and transaction is settled through Price differences.

The advantage of a Regulated Speculative market, is that it provides the much needed liquidity for the Scrips and helps in boosting market sentiments.

SEBI (Security Exchange Board of India)

It is a powerful autonomous body established in 1992 to regulate and promote stock markets and protect interest of investors.

SEBI has issued various guidelines relating to LISTING of securities, Corporate Governance, Insider Trading etc.

Underwriters, Brokers, Mutual Funds have to take registration from SEBI for operating in Capital Market.

Stock market development in a Country is characterised by two Parameters

(i) Market Capitalisation
(ii) Market Turnover.

Market Capitalisation for a Company is the product of Market price at a given point multiplied by No. of shares offered for listing.

Market Turnover is the Volume of trading in terms of value of shares purchased and sold during a period.

Listed Companies and Market Capitalisations

Dec 2010

Country	No. of Listed Companies	Market Capitalisation	Market Turnover	Market Turnover as a % to Market Capitalisation
		US$ In Billion	US$ In Billion	
India	9,870	1.20	0.87	73%
US	7,650	18.00	19.00	106%
UK	1,950	3.70	2.75	74%
Japan	2,500	4.60	3.80	83%
Germany	950	1.90	1.60	84%
China	950	3.10	3.50	113%

India has the highest no. of Listed Companies in the World followed only by USA. But the difference in Market capitalisation between India and USA shows the gap to fill for India as a way forward. This is in spite of the significant improvement in Market Capitalisation since 2002-03. During 2002-03, the Market capitalisation for India was only 0.27 trillion US$ (270billion US$). India entered the select group of Billion $ Countries (in terms of Market Capitalisation) only in the last 5 years.

Market Turnover as a percentage of Market Capitalisation shows if the Stock market in a Country is active. Ratio over 90% may be considered as an aggressive market. India's market turnover ratio has still to be considered good due to the fact that many Companies are listed but their stocks are not traded by the public. This may be because Companies have not adequately promoted their scrip to be investment-worthy. ❐

References

- Wikipedia
- Reserve Bank of India – Annual Report Publications
- The figures have been expressed in billion US$ for the sake of convenience though they do not have the forex dimensions like Domestic savings etc.