Lesson - 5

MERCHANT BANKING SERVICES

5.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Merchant Banking and its Nature and Role

* to know about the functions of Merchant Banking

* to discuss on Managing an Issue

* to understand about Mergers and Restructuring and

* to know about Project Financing.

Structure:

5.1 Merchant Banking - Concept

5.2 Nature of Merchant Banking

5.3 Role of Merchant Banking

5.4 Functions of Merchant Banking

5.5 Managing An Issue

5.6 Pre-issue Management

5.7 Post-Issue Management

5.8 Mergers

5.9 RBI Guidelines for Mergers

5.10 Restructuring

5.10.1 Restructuring Objectives

5.10.2 Restructuring Options

5.11 Project Financing - Concept

5.12 Estimation of Financial Requirements

5.13 Sources of Finance

5.14 Summary

5.15 Self - Assessment Questions

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5.1 Merchant Banking - Concept:

Merchant Banking is defined as an institution which covers a wide range of activities such as management of customer services profolio management, credit syndication, acceptance credit, counselling and insurance etc; Merchant banks are issue houses rendering such services to industrial projects or corporate units as floatation of new ventures and new companies, preparation, planning and execution of new projects, consultancy and advice in technical, financial, managerial and organisational fields. The Ministry of Finance of Government of India defines a merchant banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".

5.2 Nature of Merchant Banking:

Merchant banking was originated through the entering of London merchants in financing foreign trade through acceptance of bills. Later, the merchants assisted the governments of under developed countries in raising long term funds through flotation of bonds in London money market. Over a period of time, they extended their activities to domestic business of syndication of long term and short term finance, under writing of new issues etc;. The post was period witnessed the rapid growth of merchant banking through the innovative instruments like Euro dollar and growth of various financial centres like Singapore, Hong Kong, Kuwait and Dubai etc;

Rapid innovations in the field of banking have resulted in many activities which were hitherto unknown to Indian Banking. One such innovation is the merchant banking facility. Merchant banking is exclusively a service function. A merchant banker has to seek a client, establish good relations with him, offer him the kind of services he needs and maintain a continuing relationship with him. A client will come for advice only if he is convinced the merchant banker knows more than he does. The merchant banker should therefore not only be knowledgeable and efficient but imbued with the spirit of service so that the client may feel that his interests are safe in his hands.

Merchant banking services are activities i.e. couselling corporate clients, who are in need of money, form of capital to be missed, the terms and conditions of issue, underwriting of the issue, timing of the issue and preparation of the prospectus and publicity of growing the issue for the market. They may also relate to the private placement of capital and the raising of long term loans, either in foreign exchange or in rupee currency from the national/state financial institutions and short term working capital from commercial banks. These activities are mainly stock exchange oriented, relating as they do to the issue of trust capital for a new company setting upon enterprise or for the existing ones which want to finance the expansion and diversification of other businesses. A few proposals of mergers and amalgamations have also been handled. In essence, in India, merchant banking services have been looked upon mainly as those consisting of issue house functions connected with the raising of capital from financial institutions and the market. In the past, many of brokers and same of them have recently setup consultancy organisations which function as managers to the issue of capital in the market. Merchant banking activities have an impact on growth, stability and liquidity of money markets.

5.3 Role of Merchant Banking:

The need for specialised merchant banking service was felt in India with the rapid growth in the number and size of the issues made in the primary market. The merchant banking services were started by foreign banks namely, the National Grindlays Bank in 1967 and the Citi Bank in 1970. The Banking Commission 1972 recommended the setting up of merchant banking institutions by commercial banks and financial institutions. The marked the beginning of specialised merchant banking in India. The State Bank of India was the first Indian bank to set up Merchant Banking Division in 1972. Later ICICI set up its merchant Banking division followed by Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and UCO Bank etc;.

To promote the new issue market, there is need for a qualitative improvement in the offer of new issues both in terms of time taken and the cost of floatation. At present the time taken for organising a new issue is between 12 to 18 months and the cost of raising new capital varies from 3 to 8 percent and sometimes even 20 percent. This can be brought down relatively by specialised merchant banking institutions by catering to the requirements of both large and small industrial units. Cost of floatation of equity and preference capital is higher for new companies than for existing companies, indicating thereby the difficulties expressed by new companies, in making a new issue. Merchant banks can help saving in the cost of new companies.

The new issue market has not succeed fully in mobilising savings partly due to the preference of the public to company deposits and partly due to low yields on equities as compared to those on fixed interest securities. There are certain minimum costs to be incurred in respect of fees to brokers, promoter's expenses, underwriting commission etc;, irrespective of the size of the project. While bigger companies are able to manage this, small units find it extremely difficult to meet this minimum cost with uncertain prospects of their own internal resources in order to avoid the high cost of making public issues.

The merchant bank should have an organisation large enough to deal with a number of applications at a time. The issue house which acts as the merchant banker normally pays visits to the company's plant, ware houses and other physical assets if a company goes for a first issue. The merchant bank also requires a report on the history of the company, details of its business, factories, plant, management, labour, competitors, profit margins, taxation etc;. A merchant bank has to suggest an appropriate time of issue and provisional terms. Once these terms are settled, the share certificates, prospectus and other documents are drafted by the merchant bank with the help of lawyers and accountants. They have to satisfy the companies Act and other requirements of law and listing. The merchant banks' would also relate to the advice to the companies on any rights issue or bonus issue. It may as well advise on mergers and takeovers. Merchant banker must be familiar with the administrative procedures, rules and regulations governing the issue of industrial licence, import licence and a host of other issues with which the corporate sector is concerned. The merchant banks have come to occupy an important place on the financial scene of India. Most of the banks and some of the specialised broking firms have entered this field in recent years.

5.4 Functions of Merchant Banking:

With increasing industrialisation of the country and the growing emphasis in the five year plans on industrialisation, merchant banking in India has a very extensive role to play. The financial institutions in India could not meet the demand for long term funds required by the ever expanding industry and trade. The corporate sector enterprises therefore meet their requirements through issue of shares and debentures in the capital market. To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering various services. Following are functions of Merchant bankers. Chart 5.1 depicts various merchant banking functions and they are discussed hereunder.

* Corporate Counselling
  (Project counselling, capital restructuring, Project Management, Lease Financing)

* Project Counselling
(Preparation of Project reports, deciding upon pattern of finance)

* Loan syndication
(Term loans for projects)

* Issue Management
(Equity Shares, Preference Shares & debentures, Bonds)

* Underwriting of Public Issue

* Managers, Consultants or Advisers to the Issue

* Portfolio Management

* Advisory Services relating to Mergers and Takeovers

* Off shore finance (long term foreign currency loans, financing exports & imports)

* Preparation of economic, technical and financial feasibility reports

* Initial Project preparation, Pre investment surveys and market studies

* Advising on setting up turnkey projects in foreign countries and locating foreign markets.

* Help in financial management and in designing proper capital structure and debt equity ratio etc. of the company.

* Management of investment trusts, charitable trusts etc;

* Management aid and entrepreneurial aid (Management audit providing designs of the complete system operational research and management consultancy)

* Recruitment (Selection of technical and managerial personnel etc;)

It has been aptly said that a merchant bank is what a merchant does. Some of the important categories of functions that it can perform and is performing is corporate advisory services. A list of corporate advisory services is given below.

Corporate Advisory Services of Merchant Bankers:

* Formation of the Company
* Making of Public Issue and Issue Management
* Project Report Preparation and Appraisal
* Liaison with foreign collaborators and making preparation for joint ventures.
* Making valuation and Revaluation of assets
* Mergers & Acquisitions
* Financial Reengineering
* Entrepreneurial Training and Development
* Quality Control and Product Mix
* Market Survey and Research
* Tax Planning etc;

Corporate sector needs the services of the merchant bankers to tackle the problems in technical, financial, managerial and organisational fields. A study by the RBI showed that insufficient project preparation, defective technical planning, indifferent management and financial bottlenecks faced by promoters were primarily responsible for delay in the implementation of projects. Merchant banks have a role to play to rectify these defects.

5.5 Managing An Issue:

Management of issue involves marketing of corporate securities i.e, equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it. The issue function may be broadly divided into pre issue management and post issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be coordinated.

5.6 Pre Issued Management:

It consists of the following three aspects discussed here.

(i) Public Issue through prospectus: The most common method of public issue is through prospectus. To bring out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. They have to ensure that the information required by the companies Act and SEBI are furnished in the prospectus and get it verified by reputed solicitor. The copies of consent of experts, legal adviser, attorney, solicitor, bankers to the issue, brokers and under writers are to be obtained from the company making the issue, to be filed along with prospectus to the Registrar of companies. After the prospectus is ready, it has to be sent to SEBI for vetting. It is only after clearance by SEBI, the prospectus can be filed with the Registrar of companies.

Brokers to the issue canvass subscription by mailing the literature to the clients and undertaking wide publicity. Members of stock exchange are appointed as brokers to issue. They devise strategy for success of the public issue, keep liaison between merchant bankers and stock exchanges. Sometimes, they also undertake centralised mailing of prospectus, application forms and other publicity material at the instance of merchant bankers. Bankers to the issue accept applications along with subscriptions tendered at their designated branches and forward them to the registrar.

(ii) Marketing and Underwriting: After dispatch of prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing data of board meeting to approve and sign prospectus and pass the necessary resolutions. Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the Press, Radio, TV, investors conference etc. The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear.

The Merchant banker’s role is limited to deciding the number of copies to be printed, checking accuracy of statements made and ensure that the size of the application form and prospectus conform to the standard prescribed by the stock exchange. The Merchant banker has to ensure that the material is delivered to the stock exchange atleast 21 days before the issue opens and to brokers to the issue, branches of brokers to the issue and underwriters on time.

Security issues are underwritten to ensure that in case of under subscription the issues are taken up by the underwriters. SEBI has made underwriting mandatory for issues to the public. The underwriting arrangement should be filed with the stock exchange particulars of underwriting arrangement should be mentioned in the prospectus. The various activities connected with pre issue are a time bound programme which has to be promptly attended to. The execution of the activities with clock work efficiency would lead to a successful issue.

(iii) Pricing of Issues: The SEBI guidelines 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. Pricing of issue is part of pre issue management. An existing listed company and a new company set up by an existing company with five year track record and existing private closely held company and existing unlisted company going in for public issues of the first time with two and half years track record of constant profitability can freely price the issue. The premium has to be decided after taking into account net asset value, profit earning capacity and market price. Justification of price has to be stated and included in the prospectus.

5.7 Post Issue Management:

The post issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in the post management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the board, the auditor/company secretary has to certify that the allotment has been made by the company as per the basis of allotment approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent with in 70 days of the close of the issue. The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by coordinating the above activities.

5.8 Mergers:

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offerce and offeror. Being a professional expert, they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approved from the government/RBI, draft scheme of amalgamation and obtains approval from financial institutions.

Mergers and acquisitions are the part of financial services sector and they assume special significance in the context of the changes in the MRTP Act which has made merger of business enterprise substantially simpler. Immediately after the announcement of the MRTP changes there has been some kind of a merger manior. It appears that the mergers that have been done so far did not take into consideration the synergy of operations and they have been doing more for the sake of convenience, except in one or two cases where the merger has resulted in integration of operations.

There would appear good scope to advise those business houses to seriously look at mergers & acquisitions as a possibility. It may be necessary to get some internationally well known companies to offer the basic package with which Indian Companies can start the M & A exercise.

5.9 RBI guidelines for Mergers:

The RBI has laid down certain guidelines in May 2005 for the process of merger proposal, determination of swap ratios, disclosures, the stages at which boards will get involved in the merger process and norms of buying and selling of shares by the promoters before and during the process of mergers. It is also necessary that the decision on merger is approved by two third majority of the total board of directors and not of those present alone. The guidelines cover two situations of mergers and amalgamations, an amalgamation of two banking companies and merger of a non banking finance company (NBFC) with a banking company. When an NBFC is proposed to be merged into a banking company, the banking company should obtain the approval of the RBI after the scheme of merger is approved by its board of directors. The RBI also has decided that the insider trading norms (ITN) stipulated by the Securities and Exchange Board of India (SEBI) will be applicable for bank mergers and acquisitions.

To enable to RBI to determine the value, the amalgamated banking company should submit a report on the valuation of the share of the amalgamated company made for this purpose by the values appointed for the determination of the swap ratio and detailed computation of such valuation. Where the shares of the merged company are quoted on the stock exchange, the RBI needs the details of the monthly high and low of the quotation on the exchange where the shares are most widely traded together with number of shares traded during the six months immediately preceding the date on which the scheme of merger is approved by the boards of directors.

5.10 Restructuring:

An appropriate financial structure is crucial if growth of the business is to be sustained. The financial structure needs to provide for maximum flexibility, need for cash flows and a return on investment. A Company also needs to build in protection against risks such as interest and exchange rate fluctuations, seasonal economic changes, slow paying debtors etc; The financial restructuring of a company or bank refers to the complete reformulating the composition of capital structure.

5.10.1 Restructuring Objectives: Financial restructuring involves restructuring the assets and liabilities of a company/bank, in line with their cash flow needs, in order to promote efficiency, support growth, and maximise the value to shareholders, creditors and other stakeholders. Achieving the optional capital structure in line with the earning capacity of the enterprise i.e; there should exist a proper debt equity mix that is best suited for the company with respect to its cash flows. It is to be ensured that cash flows are sufficient to meet financial obligations with a margin of safety so as to enable the company to focus on the new business plan. Financial restructuring enables the company to achieve an optimal capital structure and help in maintaining its cash flows. It is necessary to restore investors/creditors and other stakeholders faith in the company and its management. A company has to make proper decisions regarding the appropriate financial structure.

5.10.2 Restructuring Options: Financial restructuring involves restructuring the assets and liabilities of a company and refinancing at every level of capital structure as given below:

* Securing asset based loans (accounts receivables, inventories and equipment)

* Securing institutional private placement of equity
* Achieving strategic arrangements or merger
* Sale of Non Core assets
* Obligation assets on lease
* Equity infusion
* Dilusion of equity
* Tax incentives by central/state govt.
* Concession/freezing of power rates by State Electricity Boards
* Soft loans from State Development Institutions/Central/State govt.

While assessing the restructuring options available for the company, short term and long term goals are to be taken into consideration. One needs to prioritise restructuring options by analysing impact on share holders, company and creditors. Therefore, arranging finance in appropriate mix of debt and equity at flexible terms is essential to make the financial restructuring exercise a viable and profitable proposition for the company.

5.11 Project Financing:

Concept: Project financing refers to deciding upon the financing pattern to meet the cost of the project and appraising the project report with the financial institutions or banks. The financing mix for a project has to be decided keeping in view of the rules, regulations and norms prescribed by the government and the Reserve Bank of India. Corporate management has not only to conceive the project in realistic and comprehensive terms but also to ensure that the project will have the continuous ability to serve the providers of funds with satisfactory returns and generate internal resources to support growth. The sourcing and the composition of funds and their cost have a significant bearing on the earning power of the enterprise. Enterprises can obtain funds for the project from a wide range of sources at varying costs. They have to evolve an appropriate capital structure or combination of sources of finance in order to minimise the risk perception and the cost of capital thereby enhancing the profits.

5.12 Estimation of Financial Requirements:

The capital cost of a large project has diverse components. The purchase cost of plant and equipment and the cost of buildings and facilities are part of the capital cost. In addition, the project office expenses and the cost of investigation studies etc. get capitalised and absorbed in the project capital cost before the commencement of commercial operations. Detailed information has to be obtained on current end expected cost of equipment and materials.

Plant outlay, structural requirements; building sizes, roads, railway sidings, parking areas, drainage, fencing, pumping stations, cooling towers, power sub stations etc; will have to be estimated taking note of the site conditions. Current quotations can be secured for principle equipment items to guide price estimation. Note also has to be taken on freight costs, import duties and impact of exchange rate variations on foreign exchange commitments. Labour costs will be influenced by the location and the categories of the skills required. Construction equipment allowances for rental, fuel, maintenance etc; of major items such as cranes, bulldozers can be substantial and have to estimated carefully. Manpower for project administration and implementation at the managerial and operational levels is a critical cost factor that has to be worked out in detail using best judgement. Associated costs such as design engineering, procurement and field construction costs can also be sizable and require special attention.

In the post construction phase of the project, the emphasis shifts to forecasting and control of project operating costs and revenues. Raw materials, utilities, emoluments, suppliers, royalties, rentals, contingencies, fixed costs including taxes, insurance etc, loading packing and shipping expenses will all require to be carefully considered and estimated. Depreciation depletion as may be relevant, will have to be calculated and reckoned. Administration, sales, corporate office and general expenses will have to be estimated in detail.

Funds requirements for working capital with reference to inventories of raw materials and supplies, work in process and inventories of finished goods, trade credits to customers etc; have to be assessed in detail and provided for in the estimates. Having determined the expected capital costs of the project and its operating costs at the operational phases, the expected return on investment needs to be computed and reviewed. The financial analysis of the project involves the examination of its cash flows. It is a process of review of costs and benefits, where cost constitutes cash outflows and benefits are measured in terms of cash inflows. The cash outflows on fixed assets and working capital requirements are then compared with the cash inflows less the expense outflows over the economic life of the project.

5.13 Sources of Finance:

In project financing, long term sources of finance would become primary sources which are as follows:

* Equity Capital
* Preference Capital
* Convertible debentures
* Non convertible debentures
* Term loans in Rupees
* Term loans in foreign currencies
* Euro Issues
* Bill Rediscounting Scheme
* Supplier's line of Credit
* Seed capital Assistance.
* Unsecured loans and deposits and
* Lease and Hire Purchase Finance

Project finance can flow from the two categories of financial institutions. (1) All India financial Institutions i.e; Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Development Bank of India (IDBI), Industrial Reconstruction Bank of India (IRBI), Unit Trust of India (UTI), General Insurance Corporation (GIC), Life Insurance

Corporation (LIC), National Small Industries Corporation (NSIC), Small Industries Development Bank of India (SIDBI) and (2) State Level Institutions i.e.; State Financial Corporation (SFCS) and State Industrial and Investment Corporations (SIICS).

5.14 Summary:

Merchant Banking essentially involves selling an issue for a company and handling related work. Merchant banking industry which remained almost stagnant for over two decades, witnessed an astonishing growth after the process of economic reforms and deregulation of Indian economy in 1991. In addition to Indian merchant bankers, a large number of reputed international merchant bankers like Merrill Lynch, Morgan Stanley, Goldman Sachs, Jardie Fleming etc; are operating in India under SEBI regulations. As a result of proliferation, Indian merchant bankers are faced with severe competition not only among themselves but also with the well developed global players. The mushroom growth of merchant banks has given rise to unethical means, to sell shares. For a healthy growth of the market operation, the SEBI should enforce strict control on merchant banks for their effective functioning and delivering transparent services. Stipulation of proper checks and regulation will raise the confidence of investing public in the dynamic and vibrant market mechanism which will be in the larger interests of the society as well as of the economy.

5.15 Self - Assessment Questions:

1. Define Merchant Banking and Explain the Nature and Role of Merchant Banking.
2. Examine the Functions and other Advisory Services of Merchant Banking.
3. Briefly write on Managing an Issue.
4. What do you understand by Mergers and Explain the guidelines of RBI with regard to Mergers.
5. What are the objectives of Restructuring and discuss on various restructuring options.
6. Define Project Financing? Discuss the procedure for the estimation of financial requirements of a project.
7. Write short notes on:
    (i) Merchant Banking
    (ii) Mergers
    (iii) Project Financing
    (iv) Underwriting an Issue.

5.16 Reference Books:

1. *Marketing of Financial Services* : V.A. Avadhani, Himalaya Publishing House, Mumbai, 2004.
2. *Financial Markets and Services* : Gordon. E & Natarajan. K, Himalaya Publishing House, Mumbai, 2000.

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