Equity Culture in Indian Capital Market



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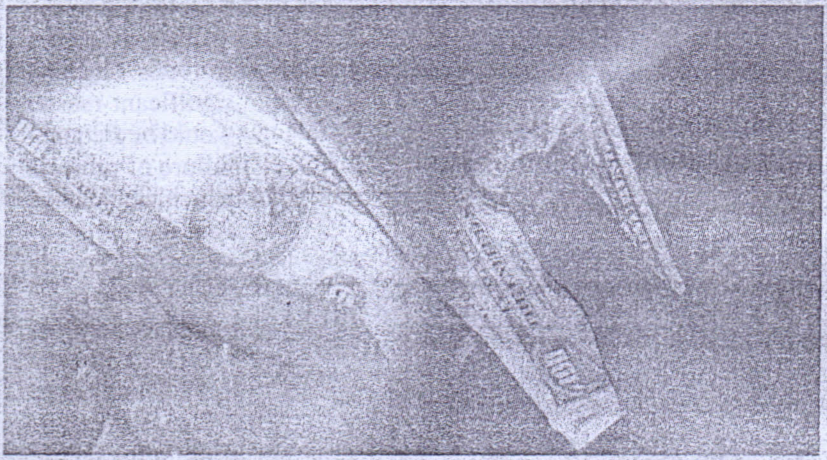


The need for promoting equity culture deserves special attention for the development of economic growth. The current downturn in the percentage share of equity is symptomatic of loss of faith of equity investors. This paper discussed in some detail the current trend of equity culture, its implications and its revival and remedial measures. The suggestion includes intervention by GOVT,SEBI & RBI and evaluation of suitable credit policy for projects. Once the investors are assured of safety of their investment in equity in primary market and adequate returns thereon, their confidence will be restored. The economic growth of our country would be smooth and stable.

The Capital Market is used as a main vehicle to mobilize funds for economic growth of our country. It performs crucial functions like the conversion of savings of households and institutions into investment, creation of financial assets and development and use of asset-related products. The Indian Capital Market witnessed unprecedented euphoria in the early nineties and it won critical appreciation from various quarters [1]. In the same way Professor Malcom Adiseshiah expressed satisfaction on the trends in Indian Capital Market observing that as against the average of Rs.200 to Rs.300 crore per annum being raised in the stock market, currently Rs.2500 to Rs.3000 crore per annum are being raised [2].

The Indian companies mainly raise funds through capital market. Two types of capital are essentially raised viz, Equity and Debt. The debt capital includes its various kinds of debts and bonds. It is true that there is considerable difference in the quality of capital raised through equity than that of debt. The equity forms part of 'networth' the key determinant of capital stock while the debt forms part of 'outside liability' of the firm.

Significance of Equity Capital

The following are select significance of equity capital

- The debt fund reduces the borrowing power of the firm while Equity enhances the borrowing power of the firm from banks and financial institutions. This is highly desirable for the overall growth of an economy.
- If a firm is able to mobilize sizable amount of equity capital through primary market, it can approach banks to fund long term investment.
- Banks generally would be much willing to finance all such firms, which are able to arrange required capital through public issue of equity. In other words, banks will be reluctant to finance firms which fail to raise capital through public issue.
- The capital raised through equity is of superior capital rather than that of debt capital.

Investors' Confidence

Success of new equity issue through primary market is totally dependent on the confidence of investors. In other words investment in equity is the result of high confidence of investors. If investors perceive high profitability prospects, they will invest in the equity issues. On the other hand, investment in a debt is made as it is committed to pay a guaranteed rate of return. Therefore, the confidence of investors on the industries is vital for sustained growth of equity culture.

Trend of Equity Capital in India

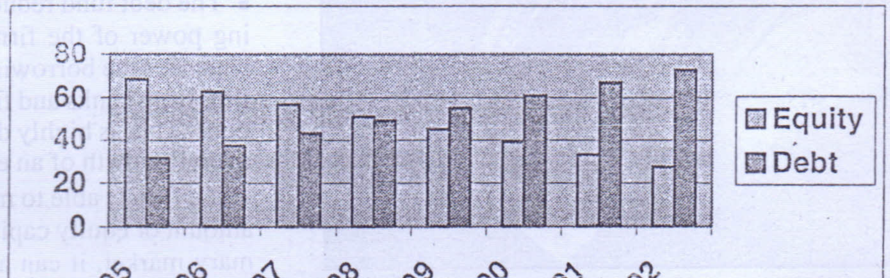
It is true that with the creation of SEBI in 1992 to regulate the functioning of the capital market with emphasis on the protection to the investing public, the Indian economy witnessed considerable upsurge of interest in the new issue markets. The new issue market became very active and on an average 130 public issues were launched each month. Further out of 130 issues per month, around 70 were initial public offerings (IPOs). The share of IPOs in the new issue market of India at 53.8% was one of the highest in the world.[3]

Table-I shows the growth of equity capital in Indian capital market during the period from 1994-95 to 2001-02. The percentage share of equity constantly declined to 15.34 in 1998-99, which was very low during the study period, from 70.58 in 1994-95. But the year 1999-2000 witnessed reversal of trend and accounted for 58.41. Later it again started decreasing to 16.88% in 2001-2002. In the case of debt, its percentage has increased from 29.42 in 1994-95 to 83.12 in 2001-02 with wide fluctuations. The lowest percentage of debt (27.61) was recorded in 1995-96 while the highest percentage (84.66) was recorded in 1998-99. The overall analysis of above Table vividly reveals that the debts have dominated the public issues than that of equity in the Indian Capital market. However, no clear trend is visible in the recent past. But it can be assumed a general trend that there was a decline in the growth of equity capital in the Indian Capital Market.

The trend of Equity Vs Debt in Indian Capital Market is given Table-II. The growth of debt/decline of equity is calculated by using linear trend (y=a + bt) method. The Table shows that the rate of decline of equity was recorded at 5.27% every year while rate of growth debt was registered at 5.28%. This decline of equity may continue in future too. Then the share of equity will be about 1.04 by the year 2006-07. This will have serious implication on the economy of our country. The diagram-I shows the trend of Equity in Indian Capital Market during the period from 1994-95 to 2001-02.

Diagram-I

Trend of Equity VS Debt in Indian Capital Market.



Decline of Equity Issue: Implications

The decline of equity Issues in Indian capital market may have some adverse implications on the Indian economy, which are essentially of two types- Short-Term Implication and Long Term Implication.

a. Short Term Implication: It relates to the protection of interest of investors of existing equity issues. Indeed the promoters/entrepreneurs who raised funds through primary market are using equity funds for their own needs. The investors of the failed issues are in the dark and most of them are not even aware as to what to do and how to retrieve their money.

b. Long Term Implication. It relates to the economic growth of a country. The failure of primary market will no doubt retard economic growth of a country. The decline of equity culture is directly associated with the rate of return in the capital market. The higher rate of return may result in growth in equity culture. On the contrary, lower rate of return affects growth of equity. The rate of return to equity is also affected due to failure of projects, which in turn affect economic growth of a country. Hence, it becomes inevitable to improve the share of equity capital in the Indian economy. Before listing such suggestion for improving equity share of funds, it is worth looking into the reasons why the equity market has relatively failed in the 1990s. First and significant reason would be frequent failure of projects which would have damaged the investors' confidence & psychology (investors' investment behaviors). There could be several reasons for the failure of projects which are briefly discussed below.

Reasons for Failure of Projects

The main reasons include 1. Increased Cost of Capital,2. Anomaly in Project Evaluation 3. Delayed Commencement of Projects 4. Increased Cost Burden 5. Market Related Constraints. 6. Low Realization of Cash flow and 7. Product Quality & Demand.

1. Increased Cost of Capital

In order to raise funds through primary capital market, massive

Table - I
Growth of Equity Capital in Indian Capital Market.

Year	Percentage of Share		Total
	Equity	Debt	
1994-95	70.58	29.42	100.00
1995-96	72.39	27.61	100.00
1996-97	55.99	44.01	100.00
1997-98	41.17	58.33	100.00
1998-99	15.34	84.66	100.00
1999-00	58.41	41.59	100.00
2000-01	52.79	47.21	100.00
2001-02	16.88	83.12	100.00

Source: Computed from the various issues of Indian Securities Market – A Review, NSE, Bombay.

expenses are earmarked for advt., publicity campaigns, conferences, press releases in news papers etc.,. These are called pre-operative expenses which sometimes exceed 10% of total cost of projects. This high cost is almost taken as accepted and is a permanent feature of raising equity capital. This needs to be curbed if high return from project is to be ensured.

2. Anomaly in Project Evaluation

One of the reasons for failure of new issues is dichotomy in appraisal of projects in the present system. The SEBI has to accord administrative approval of the projects before launching public issue. Based on the appraisal of financial institutions/banks, SEBI accords administrative approval. The appraisal criteria for the sanction of term loan and cash loan differ from each other. It is true that the longer the period of loan or life of project, the higher the rate of return. In respect of term loan, longer life is assumed by financial institutions while appraising the project. The Debt Service Coverage Ratio (DSCR) is the base for cash loan by bankers. The higher the DSCR the greater the viability of projects. The service to debt is ensured through cash accruals (Net Profit and Depreciation). In order to increase amount of depreciation (i.e., high service to debt), the life of project is compressed.

The dichotomy in project appraisal is that financial institutions have a tendency to assume longer life while commercial banks compress life of the project. This affects the cash flows projected which do not materialize and company becomes sick.

3. Delayed Commencement of Projects

Many a time delay in implementation of project occurs. The delay results in decline in profitability; sometimes failure of the projects due to overburden of interest on loan may occur. Further, delay leads to decline in the rating of units. Once the rating of a unit declines, banks revise upward the interest rate on loan. In toto the project has to bear the cumulative burden of cost.

Table-II
Trend of Equity VS Debt in India Capital Market.

Year	Equity	Debt
1994-95	68.48	31.52
1995-96	62.62	37.39
1996-97	56.745	43.26
1997-98	50.875	49.13
1998-99	45.005	55
1999-2000	39.135	60.87
2000-01	33.265	66.87
2001-02	27.395	72.61

Source: Computd form Table.1.

4. Increased Cost Burden

There is usual price rise in capital equipment, transport cost, raw materials etc., It is true that delay in starting the project results in cost burden due to the usual price rise.

5. Market Related Constraints

The marketing constraints/ challenges also affect the projects. They include lower price realization of products, poor demand, failure of the company to meet the quality standards, lack of knowledge on marketing system and other factors.

6. Low Realization of Cash flow

The cash flow of the project is not comfortable as the project evaluation is made by different assumptions on price of the products & by products. This leads to low price realization.

7.Product Quality & Demand

The prospects of project sometimes are affected by its products which run into problems like poor demand and poor quality. In the present era of globalization, the quality standards of ISO 9000, ISO 9001, ISO 9002 and ISO 14000 service are to be adhered by a firm.

Revival of Equity Culture: Remedial Measures

Revival of equity culture in the new issue market is one of the most challenging tasks. The investors are to be attracted to invest in the equity shares of the new issue. This is possible only when the new firms comply with all promises given through prospects. But it is a fact that the equity shares of new firms are not traded frequently or the thinly traded. On the contrary, the equity market of the old firm is driven by the speculative factors. The remedial measures to review equities culture in the new issue include (a) review of investors confidence (b) appraisal of the projects and (c) credit policies and equity culture.

a. Review of Investors Confidence

It is true that existing equity investors of unsuccessful firm through IPOs are helpless. Hence necessary steps are required to restore

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uniform in all states to lessen or stop tax evasion, besides, giving good signal to the consumers.

Finally, all the three sectors of our economy i.e. agriculture, industry and service should pay as per their growing income or output. Presently agricultural sector pays direct tax revenue less than its proportional increase in income. So all the three sectors of economy should pay direct tax proportionale to their rising revenue or income.

The tax payers should be properly informed and educated. For this, symposium, seminar, disussions to are necessary What is more important for the tax payer is that any change in rules and procedure should be properly communicated to that tax payers so that they can do tax planning & management timely.

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their confidence. The following are some of the aspects, which should be reviewed by GOVT,SEBI or RBI who are responsible for policy, planning and implication to restore confidence.

- For all such failure issue, a review should be undertaken as to what the concerned firm is planning to do with the investors' money.
- How and when the project would be launched?
- Whether, the debt component of the project has been linked up?
- What are the chances of completing the projects?
- In what manner failure firm plans to assure a reasonable return to the investors.

b. Appraisal of the Projects

The SEBI revised its guidelines for public issues 3 times in 1996 alone i.e., SEBI guidelines – April 1996, SEBI Guidelines – June 1996 and SEBI Guidelines- Oct 1996. As a result of above revisions, the appraiser of the projects should be the financier who finances in the forms of loan or equity participation to the extent of 5% of the total projects. However, this change does not ensure a realistic appraisal of project and the kind of anomaly which continues. Hence SEBI should take upon itself the responsibility of project appraisal and evolve norms in regard to life of various types of projects.

c. Credit Policies and Equity Culture

In addition to equity funds, the projects require credit from banks. Hence credit is an integral part of projects launched in the primary market for equity. Every bank lies down and follows different credit policies, while financing projects, in respect of quantum of loan, interest rate, margin money, repayment period, gestation period etc. The longer the repayment period, the higher is the interest rate charged by banks in respect of large industrial and agro industrial projects (This is not so in case of priority sector). The incidence of higher rate may be substantial but it runs counter to the object of promoting equity culture in the primary market. Therefore RBI in consultation with commercial banks may develop a suitable policy on interest rate applicable to projects launched through primary market.

Conclusion

The need for promoting equity culture deserves special attention for the development of economic growth. The current downturn in the percentage share of equity is symptomatic of loss of faith of equity investors. This paper discussed in some detail the current trend of equity culture, its implications and its revival and remedial measures. The suggestion includes intervention by GOVT,SEBI & RBI and evaluation of suitable credit policy for projects. Once the investors are assured of safety of their investment in equity in primary market and adequate returns thereon, their confidence will be restored. The economic growth of our country would be smooth and stable.

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