FINANCIAL SERVICES

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CONSUMER FINANCE

Types of Finance Companies

- Consumer finance companies make direct loans to consumers
- Sales finance companies concentrate on purchasing credit contracts from retailers
- Commercial finance companies provide loans to medium and higher risk companies
- Captive finance companies, subsidiaries of manufacturers, lend to support sales of their parent company and other areas

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Sources of Finance Company Funds

- Finance companies use bank loans as a source of funds and consistently renew the loans over time
- Commercial paper
  - A short-term money market source but finance companies roll over their issues to create a permanent source of funds
  - Secured commercial paper allows smaller and medium-sized firms access to the market
  - Well-known firms use direct placement
- Some states allow finance companies to accept customer deposits
- Bonds are used as a long-term source of funds and the use of this source depends on
  - Expectations about future interest rates
  - The balance sheet structure
  - May be subordinated to bank loans
- Capital comes from retained earnings or issuing stock and serves as a base for leveraging

Uses of Finance Company Funds

- Finance companies make many kinds of consumer loans in the form of personal loans
  - Auto loans/leases offered by a finance company owned by the manufacturer: direct or sales financed
  - Home improvement (second mortgage), mobile home and other kinds of personal loans: direct or sales financed
  - Credit cards which can be used at a variety of retail stores
    - Company logo cards operated by finance company
- Credit card loans in which a retailer sells a credit contract to a finance company
  - Customers make payments to the finance company
  - Support "Ninety-days Same As Cash" loans
  - Gives the finance company access to new customers
- Business loans and leasing are used to finance the cash cycle of companies
  - Cash cycle is the amount of time it takes between when inventory is purchased, the product is sold and customers pay
  - This financing is often backed by accounts receivable or inventory
- Leveraged buy-out loans
- Factoring of accounts receivable

Regulation of Finance Companies

- Federal regulations apply if finance companies are acting as bank holding companies or are subsidiaries of bank holding companies
- State regulations apply otherwise
- Subject to interest rate ceilings and a maximum term or amount for the loan in some states

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Risks Faced by Finance Companies

- Liquidity risk
  - Finance companies do not hold assets that can be easily sold in the secondary market
    - May securitize loans
    - Depend on liability liquidity
  - Maintaining access to money and capital market is the primary liquidity management focus
  - Balance sheet structure does not call for much liquidity because of little deposit outflow
- Interest rate risk is less for depository institutions because the maturity of assets and liabilities may be matched closely
- Assets are typically not as rate sensitive as liabilities
- Can use adjustable rates and shorter maturities on their loans to manage risk
- Derivative contracts are used to manage interest rate risk
- Credit risk
  - The major risk faced by finance companies
  - Loan delinquency rates are typically higher than for other kinds of institutions
  - Charge a higher interest rate to compensate for the risk
  - High return, high risk nature of loans makes performance sensitive to prevailing economic conditions

Valuation of a Finance Company

- Economic growth
  - Positive affect because it enhances household demand for consumer goods
  - Economic growth reduces defaults
- Change in the risk-free rates
  - Cash flows inversely related to interest rate movement
  - Short term sources of funds means their rates change as do those of other interest rates
- Change in industry conditions which include regulatory constraints, technology and competition
- Change in management abilities

Interaction with Other Financial Institutions

- Interact in various ways with other financial institutions
- Concentration in commercial lending means they are closely related to commercial banks, savings institutions and credit unions
- Compete with savings institutions and increase market share when their competitors have problems

Participation in Financial Markets

- Participate in a wide range of financial markets
  - Money markets
  - Bond markets
  - Mortgage markets
  - Stock markets
  - Futures markets
  - Options markets
  - Swap markets

Multinational Finance Companies

- Large multinational companies with subsidiaries in many countries
- Reasons why finance companies go global
  - Enter new markets
  - Reduce exposure to the U.S. economy

HOUSING FINANCE

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Conditions that apply when borrowing

1. Amount which may be borrowed.

Usually 2-3 times your annual salary.

If joint, the principle salary is taken into account.

2. Deposit – must have saved approx 10% of amount to be borrowed

3. Income – must supply proof of income

4.Good credit record – no bad debts

5.Term of loan – most loans repaid over 20-25 years, older applicant over shorter term

6.Insurance – must take out life assurance

7.The property – must be in good condition, house surveyed by lending agency

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Types of Mortgage

Annuity-

- Most popular
- Each repayment goes partly to pay off interest on the loan and partly repay principal amount borrowed
- Amount owed declines over the years
- A mortgage protection policy is a condition of an annuity mortgage

Endowment –

- Less popular
- Combination of borrowing and investing
- Pay interest on loan
- Pay money towards a savings type life assurance policy which pays off loan
- Risk – amount saved may not be enough to pay off loan
- No extra mortgage protection policy needed

Pension-linked mortgage

- Popular with the self-employed as better tax relief
- Pays interest on the loan and
- Pays money into a pension scheme
- Loan is repaid from the pension fund upon retirement

Local Authority Housing

- Local authorities provide housing for people who cannot afford it from their own resources.

- A range of schemes to help
  - buy or
  - rent or
  - improve existing living conditions

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Local Authority Schemes

Tenant purchase scheme

- Anyone who has been a tenant of a L.A. house for at least 1 year has the option of buying that house
- May be bought outright or through shared ownership scheme
- House priced at market value
- Discount for each year of tenancy up to max of 10 years

Shared ownership scheme

- Must be in need of housing and satisfy income test
- Ownership is shared between shared owner and L.A.
- Applicant must purchase at least 40% of house and rent the remaining 60% from L.A.
- May buy remaining 60% when 40% paid for

Mortgage Allowance Scheme

- A tenant wishing to return their home to L.A. and to buy or build a private home may qualify
- Allowance paid on a reducing scale over 5yrs.

  to the mortgage lender thereby

  reducing payments over initial period
- Makes transition from rent to mortgage easier

LEASE FINANCING

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Definition of a Lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period.

Finance leases Vs Operating leases

Finance Lease

A lease is a finance lease if it **transfers** substantially all the risks and rewards incident to ownership.

Operating Lease

A lease is an operating lease if it **does not transfer** substantially all the risks and rewards incident to ownership.

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Finance lease or Operating lease?

If substantially all of the risks and rewards incident to ownership are transferred from the lessor to the lessee, it is a finance lease. The lessee should recognise finance leases as assets and liabilities in the balance sheet at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments. The lessor should recognise assets held under a finance lease in its balance sheet and present it as a receivable at an amount equal to the net investment in the lease.

If substantially all of the risks and rewards incident to ownership are not transferred from the lessor to the lessee, it is an operating lease: the financed assets remain on the lessor's balance sheet and the lease payments should be recognised in the income statement.

No mathematical thresholds are used to determine whether a lease should be classified as a finance or as an operating lease. An overall analysis of the transaction needs to be performed, at inception of the contract, to determine whether substantially all of the risks and rewards are transferred from the lessor to the lessee.

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Minimum Lease Payments

MLPs comprise the total payments by the lessee plus:

- payment required to exercise the lessee's bargain purchase option if it is reasonably certain that the lessee will exercise the option
- any amounts guaranteed by the lessee or by a party related to the lessee (e.g. the parent)
- any residual value guaranteed to the lessor by the lessee, by a party related to the lessee or by an independent third party

The minimum lease payments are discounted to their present value.

Implicit Discount Rate

The implicit discount rate is the rate that, at the inception of the lease, causes the

present value of the sum of the minimum lease payments

+ plus the unguaranteed residual value

to equal the fair value of the leased asset.

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Operating Lessee Accounting

- Rental expense is recognised on a straight-line basis in the economic outturn account over the lease term
- Irrespective of the form or timing, the cost is recognised on a straight-line basis (e.g. free rent for a certain period at the beginning of the lease contract)
- Cut-off:
  - Accrue if service rendered but invoice not received at year-end
  - Defer if invoice received in advance of the service (to be rendered in the next accounting period)

Finance lessee Accounting – Value at Inception

Recognises the **asset** and the lease obligation on balance sheet at the lower of the **present value of the minimum lease payments** and the fair value of the asset.

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Finance Lessee Accounting – Subsequent Measurement

- Depreciate assets with finite lives over their useful life
  - If it is **not** reasonably certain that ownership will be transferred to the lessee at the end of the lease term, the asset should be depreciated over the shorter of the lease term or its useful life
- Subsequent expenditures – refer to P,P & E
- Impairment – refer to P,P & E

Key Disclosures – Finance Leases (lessees)

- For each class of asset, net carrying amount at the reporting date
- A reconciliation between the total of MLPs at the reporting date and their present value, including disclosure for each of the following periods: no later than 1 year; later than 1 year and not later than 5 years; and later than 5 years
- A general description of significant leasing arrangements
- The total of future MLPs under non-cancelable operating leases for each of the following periods: no later than 1 year; later than 1 year and not later than 5 years; and later than 5 years
- A general description of the lessee’s significant leasing arrangements

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FACTORING

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Definition of Factoring

Factoring is defined as ‘a continuing legal relationship between a financial institution (the factor) and a business concern (the client), selling goods or providing services to trade customers (the customers) on open account basis whereby the Factor purchases the client’s book debts (accounts receivables) either with or without recourse to the client and in relation thereto controls the credit extended to customers and administers the sales ledgers’.

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Different Kinds of Factoring Services

Debt administration:

- The factor manages the sales ledger of the client company. The client will be saved of the administrative cost of book keeping, invoicing, credit control and debt collection. The factor uses his computer system to render the sales ledger administration services.
- **Credit Information:** Factors provide credit intelligence to their client and supply periodic information with various customer-wise analysis.
- **Credit Protection**: Some factors also insure against bad debts and provide without recourse financing.
- **Invoice Discounting or Financing** : Factors advance 75% to 80% against the invoice of their clients. The clients mark a copy of the invoice to the factors as and when they raise the invoice on their customers.

Services rendered by Factor

- Factor evaluated creditworthiness of the customer (buyer of goods)
- Factor fixes limits for the client (seller) which is an aggregation of the limits fixed for each of the customer (buyer).
- Client sells goods/services.
- Client assigns the debt in favour of the factor
- Client notifies on the invoice a direction to the customer to pay the invoice value of the factor.

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Services rendered by Factor (Contd.)

- Client forwards invoice/copy to factor along with receipted delivery challans.
- Factor provides credit to client to the extent of 80% of the invoice value and also notifies to the customer
- Factor periodically follows with the customer
- When the customer pays the amount of the invoice the balance of 20% of the invoice value is passed to the client recovering necessary interest and other charges.
- If the customer does not pay, the factor takes recourse to the client.

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Benefits of Factoring

- The client will be relieved of the work relating to sales ledger administration and debt collection
- The client can therefore concentrate more on planning production and sales.
- The charges paid to a factor which will be marginally high at 1 to 1.5% than the bank charges will be more than compensated by reductions in administrative expenditure.
- This will also improve the current ratio of the client and consequently his credit rating.
- The subsidiaries of the various banks have been rendering the factoring services.
- The factoring service is more comprehensive in nature than the book debt or receivable financing by the bankers.

Forfaiting

- The forfaiting owes its origin to a French term 'forfait' which means to forfeit (or surrender) one's rights on something to some one else.
- Under this mode of export finance, then exporter forfaits his rights to the future receivables and the forfaiter loses recourse to the exporter in the event of non-payment by the importer.

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Parties to Forfaiting

- There are five parties in a transaction of forfaiting. These are :

1. Exporter
2. Exporter's bank
3. Importer
4. Importer's bank and
5. Forfaiter

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Methodology of Forfaiting

- It is a trade finance extended by a forfaiter to an exporter/seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.
- Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms
- The exporter has recourse to forfaiting usually in cases where the credit is extended for long durations but there is no prohibition for extending the facility where the credits are maturing in periods less than one year.
- Credits for commodities or consumer goods is generally for shorter duration within one year. Forfaiting services are extended in such cases as well.

Documentation & Cost of Forfaiting

- Forfaiting transaction is usually covered either by a promissory note or bill of exchange. In either case it has to be guaranteed by a bank or, bill of exchange may be 'avalled' by the importer' bank.
- The 'Aval' is an endorsement made on bill of exchange or promissory note by the guaranteeing bank by writing 'per aval' on these documents under proper authentication.
- The forfeiting cost for a transaction will be in the form of 'commitment fee', 'discount fee' and 'documentation fee'.

Process of Factoring

- Client makes a credit sale with a customer.
- Client sells the customer's account to the Factor and notifies the customer.
- Factor makes partly payment (advance) against account purchased, after adjusting for commission and interest on the advance.
- Factor maintains the customer's account and follows up for payment.
- Customer remits the amount due to the Factor.
- Factor makes the final payment to the Client when the account is collected or on the guaranteed payment date.

Charges for Factoring Services

- Factor charges Commission (as a flat percentage of value of Debts purchased) (0.50% to 1.50%)
- Commission is charged up-front.
- For making immediate partly payment, interest charged. Interest is higher than rate of interest charged on Working Capital Finance by Banks.
- If interest is charged up-front, it is called *Discount*.

Types / Forms of Factoring

1. Recourse Factoring:

- ✓ Factor does not assume credit risks associated with receivables.
- ✓ Credit Risk is borne by the Client.
- ✓ *In India, Factoring is done with recourse.*

2. Non-Recourse Factoring:

- ✓ Factor assumes credit risks associated with receivables. Charges a higher commission
- ✓ Credit risk is assumed by Factor
- ✓ *In USA/UK, Factoring is commonly done without recourse.*

3. Advance Factoring:

- ✓ Factor pays a specified portion (75% to 90%) in advance.
- ✓ Balance being paid upon collection from the customer. The client has to pay interest on advance payment.

Types / Forms of Factoring (Contd.)

4. Maturity Factoring / Collection Factoring:

- ✓ Factor does not make any advance payment to the Client.
- ✓ Factor Pays on date of collection/agreed future date.
- ✓ Less RISK for Factor and charges nominal commission.

5. Full Factoring / Old Line Factoring:

- ✓ Features of almost all the factoring services.
- ✓ Entire spectrum of services; collection, credit protection, sales ledger administration, short-term finance.

6. Disclosed Factoring:

- ✓ Name of factor is disclosed in sales invoice.

7. Undisclosed Factoring:

- ✓ Name of factor is NOT disclosed in sales invoice.

8. Domestic Factoring:

- ✓ Buyer, Seller, Factor domiciled in the same country.

Types / Forms of Factoring (Contd.)

9. Export / Cross Border / International Factoring:

- ✓ Usually Four Parties Involved Viz. the Exporter, Importer, Export Factor, Import Factor.
- ✓ Two Agreements.
- ✓ Import Factor Provides Link Between Export Factor and Importer.
- ✓ Import factor underwrites customer trade credit risk, collects receivables and transfers fund to export factor.

WHY FACTORING HAS NOT BECOME POPULAR IN INDIA?

- Banks’ unwillingness to provide factoring services
- Problems in recovery.
- Factoring requires assignment of debt which attracts Stamp Duty.
- Cost of transaction becomes high.
- Lack of awareness.

Factoring in INDIA: Major Players

- SBI Factors and Commercial Services Pvt. Ltd.
- Canbank Factors Limited
- Global Trade Finance Limited
- Foremost Factors Limited
- HSBC Bank
- CITI Bank NA, India
- Standard Chartered Bank
- SIDBI
- ECGC Ltd.

WHY FORFAITING HAS NOT DEVELOPED…

- Relatively new concept in India.
- High Rupee Fluctuation
- High cost of funds
- High minimum cost of transactions (USD 250,000/-)
- RBI Guidelines are unclear.
- Very few institutions offer such services in India. Exim Bank is one of the major player and very few other co's involved.
- Lack of awareness.

List of some Forfaiters

- Standard Bank, London
- Hong Kong Bank
- ABN AMRO Bank
- Meghraj Financial Services
- Triumph International Finance India Ltd.,
- Natwest Bank
- Meridian Finance Group

Characteristics of Forfaiting

- Converts Deferred Payment Exports into cash transactions, providing liquidity and cash flow to Exporter.
- Discharge Exporter from Cross-border ***Political*** OR ***Exchange Risk*** associated with Export Receivables.
- Finance available upto 100% (as against 75 - 80% under conventional credit) without recourse.
- Acts as additional source of funding and hence does not have impact on Exporter's borrowing limits. It does not reflect as debt in Exporter's Balance Sheet.
- Provides Fixed Rate Finance and hence risk of interest rate fluctuation does not arise.
- Exporter is freed from credit administration.
- Simple Documentation as finance is available against bills.
- Forfait financer is responsible for each of the Exporter's trade transactions. Hence, Export business can be done more efficiently.
- Forfait transactions are confidential.

FORFAITER'S CHARGES

- The DISCOUNT charged by the Forfaiter depends upon:

  ✓ Cost of Forfaiting
  ✓ Margin to cover risk
  ✓ Management charges
  ✓ Fees for delayed payment
  ✓ Period of Forfaiting contract
  ✓ Credit rating of Avalling Bank
  ✓ Country/Currency Risk of the importer

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MERCHANT BANKING

What is a ‘Merchant Bank’?

- As Investopedia defines it, a Merchant Bank is a company that deals mostly in international finance, business loans for companies and underwriting. These banks are experts in international trade, which makes them specialists in dealing with multinational corporations.
- However, it does not provide regular banking services to the general public.
- Perform underwriting, loan services, financial advising and fund raising services
- Serve large corporations (operating in more than one country) and high net worth individuals
- These do not provide regular banking services, such as offering checking accounts to the general public. In fact, merchant banks don’t take deposits.
- A vast majority of activity involves international transactions

Role of Development Banks

- Promote the development of industry or agriculture.
- Provide medium and long term loans.
- Offering concessional loans for setting up industrial units in backward areas.
- Evaluating investment proposals.
- Identifying possibilities for economies of scale in production.

Functions of Merchant Banking

- **1. Corporate Counseling**
  - ❖ Free of charge service to a corporate units
  - ❖ Render advise
  - ❖ Help to improve performance and build better image among investors.
  - ❖ Counseling is provided in the form of opinions, suggestions.
- Areas of counseling includes-
  - ❖ It guides the corporate units as to area of diversification.
  - ❖ Detailed market analysis.
  - ❖ Help in reviving the old line projects.
  - ➢ It offers help to the sick units in the following ways-

    i. Conducts detailed studies.

    ii. Make an assessment of the revival prospects.

    iii. Providing help in raising loans.

    iv. Help in getting approval of financial institutions or banks for schemes of rehabilitation.

    v. Monitors rehabilitation schemes

    vi. Finds out possibility of takeover of sick units

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CAPITAL RESTRUCTURING SERVICES

Merchant banks render different Capital Restructuring Services to the corporate units depending upon the circumstances a particular unit is facing.

It include the following services:

- Examination of the corporate's capital structure to decide the extent of capitalization
- Render advise on mergers, takeovers and amalgamations
- Identify areas of diversification of existing production systems

PORTFOLIO MANAGEMENT

Merchant banks provide services to the investor of advising on the optimum investment mix taking into consideration the following factors-

I. Objectives of investment
II. Tax bracket applicable to the investor
III. Need for maximising return
IV. Capital appreciation,etc.

Portfolio Management Services

A. To Indian Nationals-

- Sale and purchase of securities
- investing and purchase of securities
- Investing and managing fixed deposits
- Safe custody of securities in India and overseas , etc.

To Non-Resident Indians-

- Advice on selection of investment
- Critical evaluation of investment portfolio
- Hold securities in safe custody
- Providing tax counseling and filing tax returns , etc.

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Issue Management

Besides being a sponsor of issues , merchant banks now provide the following services to ensure success in marketing of securities-

- Preparation of prospectus
- Preparation of a budget
- Preparation of (Controller of Capital Issues)CCI application
- Selection of issue house
- Appointment of registrar, broker and bankers to issue
- Advertising and arranging publicity agency for post and pre-issue.
- Selection of institutional and broker underwriters .
- Compliance of listing requirements of stock exchange etc.

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Loan/Credit Syndication

Credit Syndication involve following services-

- Estimation of total cost on project
- Preparation of financial plan to meet total cost of project
- Assistance of clients in preparation of loan application
- Making selection of institutions
- Follow up of the term loan application with financial institutions.
- Helping in expediting legal documentation formalities
- Help in estimating working capital requirements
- Arrange bridge finance.

Arranging Working Capital Finance

- Earlier working capital finance – not merchant bank activity rather commercial bank's activity.
- Merchant Banks which started this activity :
  - Canara Bank
- - Grindlays Bank
  -Central Bank of India
- Finance for working capital is provided usually through issue of debentures.

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Role of Merchant Banker

- Promoter – identification of projects ,obtaining govt. approval , raising funds etc
- Coporate advisor – financial planning , tax planning etc
- Managerial economist – organisational goals , locational factor , size & operational scale etc.
- Financial & investment expert – working capital requirement , financial requirement etc

- Rehabilitator – at the time of merger , acquisition etc

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Merchant Banking in India

1. At present merchant banking services in india are provided by commercial banks,ICICI,IFCI etc.
2. Merchant banking can be categorised into four broad sections
3. A.providing long term sources of funds
4. B.project counselling
5. C.Capital structuring
6. D.Portfolio management

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ROLE OF MERCHANT BANKERS IN ISSUE MANAGEMENT

The management of public issue of securities is core of merchant banking

i. Pre-issue activities

ii. Post-issue activities

iii. Issue marketing

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Issue Marketing by Merchant Banker

The merchant banker has to undertake the marketing of issues.

The ultimate aim of issue marketing is to persuade the investors to subscribe the issue made by the company.

<u>Merchant banker advises client to go for</u>:

a) fresh issue b) bonus issue

c) additional issue d) right issue

MERCHANT BANKING SCENARIO

In 1996-97 the number of merchant bankers went down to 65 from 234.

In 1997-98 structural changes have been brought in merchant banking activities.

Segregation has been brought up in the activities and merchant bankers have been prohibited from carrying fund based activity.

VENTURE CAPITAL

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What is Venture Capital?

- Private or institutional investment (capital) in relatively early-stage companies (ventures)
- Recently focused on technology-heavy companies:
  - Computer and network technology
  - Telecommunications technology
  - Biotechnology
- Types of VCs:
  - Angel investors
  - Financial VCs
  - Strategic VCs

Angel Investors

- Typically a wealthy individual
- Often with a tech industry background, in position to judge high-risk investments
- Usually a small investment (< $1M) in a very early-stage company (demo, 2-3 employees)
- Motivation:
  - Dramatic return on investment via exit or liquidity event:
    - Initial Public Offering (IPO) of company
    - Subsequent financing rounds
  - Interest in technology and industry

Financial VCs

- Most common type of VC
- An investment firm, capital raised from institutions and individuals
- Often organized as formal VC funds, with limits on size, lifetime and exits
- Sometimes organized as a holding company
- Fund compensation: carried interest
- Holding company compensation: IPO
- Fund sizes: ~$25M to 10's of billions
- Motivation:
  - Purely financial: maximize return on investment
  - IPOs, Mergers and Acquisitions (M&A)

Strategic VCs

- Typically a (small) division of a large technology company
- Examples: Intel, Cisco, Siemens, AT&T
- Corporate funding for strategic investment
- Help companies whose success may spur revenue growth of VC corporation
- Not exclusively or primarily concerned with return on investment
- May provide investees with valuable connections and partnerships
- Typically take a “back seat” role in funding

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The Funding Process: Single Round

- Company and interested VCs find each other
- Company makes it pitch to multiple VCs:
  - Business plan, executive summary, financial projections with assumptions, competitive analysis
- Interested VCs engage in due diligence:
  - Technological, market, competitive, business development
  - Legal and accounting
- A lead investor is identified, rest are follow-on
- The following are negotiated:
  - Company valuation
  - Size of round
  - Lead investor share of round
  - Terms of investment
- Process repeats several times, builds on previous rounds

Terms of Investment

- Initially laid out in a term sheet (not binding!)
- Typically comes after a fair amount of DD
- Valuation + investment → VC equity (share)
- Other important elements:
  - Board seats and reserved matters
  - Drag-along and tag-along rights
  - Liquidation and dividend preferences
  - Non-competition
  - Full and weighted ratchet
- Moral: These days, VCs extract a huge amount of control over their portfolio companies.

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Basics of Valuation

- Pre-money valuation V: agreed value of company prior to this round's investment (I)
- Post-money valuation V' = V + I
- VC equity in company: I/V' = I/(V+I), not I/V
- Example: $5M invested on $10M pre-money gives VC 1/3 of the shares, not ½
- Partners in a venture vs. outright purchase
- I and V are items of negotiation
- Generally company wants large V, VC small V, but there are many subtleties…
- This round's V will have an impact on future rounds
- Possible elements of valuation:
  - Multiple of revenue or earnings
  - Projected percentage of market share

Board Seats and Reserved Matters

- Corporate boards:
  - Not involved in day-to-day operations
  - Hold extreme control in major corporate events (sale, mergers, acquisitions, IPOs, bankruptcy)
- Lead VC in each round takes seat(s)
- Reserved matters (veto or approval):
  - Any sale, acquisition, merger, liquidation
  - Budget approval
  - Executive removal/appointment
  - Strategic or business plan changes
- During difficult times, companies are often controlled by their VCs

Other Typical VC Rights

- Right of first refusal on sale of shares
- Tag-along rights: follow founder sale on pro rata basis
- Drag-along rights: force sale of company
- Liquidation preference: multiple of investment
- No-compete conditions on founders
- Anti-dilution protection:
  - Recompute VC shares based on subsequent "down round"
  - Weighted ratchet: use average (weighted) share price so far
  - Full ratchet: use down round share price
  - Example:
    - Founders 10 shares, VC 10 shares at $1 per share
    - Founder issues 1 additional share at $0.10 per share
    - Weighted ratchet: avg. price 10.10/11, VC now owns ~10.89 shares (21.89 total)
    - Full ratchet: VC now owns 10/0.10 = 100 shares (out of 111)
  - Matters in bridge rounds and other dire circumstances
- Right to participate in subsequent rounds (usually follow-on)
- Later VC rights often supercede earlier.

Why Multiple Rounds and VCs?

- Multiple rounds:
  - Many points of valuation
  - Company: money gets cheaper if successful
  - VCs: allows specialization in stage/risk
  - Single round wasteful of capital
- Multiple VCs:
  - Company: Amortization of control!
  - VCs:
    - Share risk
    - Share DD
  - Both: different VC strengths (financial vs. strategic)

CREDIT RATING

History of Credit Rating In India

- The concept came in India in 1987 with the setting up of CRISIL.
- As the scope of credit rating widened ICRA & CARE was set up in 1991 & 1993 respectively.
- The first private sector credit rating company was Duffs & Phelps Credit Rating India Pvt. Ltd formed in 1995.

Credit Rating: Meaning and Definition

- “Fitch 's credit ratings provide an opinion on the relative ability of an entity to meet financial commitments, such as interest, repayment of principal, insurance claims or counterparty obligations. Credit ratings are used by investors as indications of the likelihood of receiving their money back in accordance with the terms on which they invested.”
- A rating simply helps investor to determine the relative likelihood that they might lose money on a given fixed income investment.
- A **CREDIT RATING** assesses the credit worthiness of an individual, corporation, or even a country. Credit ratings are calculated from financial history and current assets and liabilities.
- **“**Credit rating is a simple and easy to understand symbolic indicator of the opinion of a credit rating agency about the risk involved in a borrowing programme of an issuer with reference to the capability of the issuer to repay the debt as per terms of issue.
- This is neither a general purpose evaluation of the company nor a recommendation to buy, hold or sell a debt instrument.” – ICRA

CRISIL Credit Rating Symbols

AAA : Highest Safety
AA : High Safety
A : Adequate Safety
BBB : Moderate Safety
BB : Inadequate Safety
B : High Risk
C : Substantial Risk
D : Default
NM : Not Meaningful

Need For Credit Rating…

- Growing number of cases of DEFAULTS in Payment of Interest and Repayment of Principal Sum borrowed by way of Fixed Deposits, Issue of Debentures or Preference Shares or Commercial Papers.
- To Maintain the investors' confidence, since defaults break the confidence of investors in corporate instruments.
- Protect the interest of investors who are not in a position to analyze the prospects of co's business.
- Motivate savers to invest their fund into Industries.

Who Can Use Credit Rating Services?

- Commercial Banks
- Mutual Fund Co's
- Corporates
- Financial Institutions
- Insurance Companies
- Public/Development Fin. Institutions etc…

Importance of CREDIT RATING in India

- Establish a link between RISK and RETURN
- Superior – Low Cost Information to Investors
- To guide investors in making investment decisions
- Helps merchant bankers, brokers, regulatory authorities, etc., in discharging their functions related to debt issues
- Required by the regulators
- Build up market reputation
- Lower cost of funding
- Differentiate oneself from the competitors
- Easy and faster way of raising capital
- Increased investors' acceptance
- Acts as a Marketing Tool

Benefits of Credit Rating : To Investors

- ✓ Safeguards against bankruptcy
- ✓ Recognition of Risk and/or Return
- ✓ Credibility/Reputation of the issuer
- ✓ Easy understandability (Ratings) of the investment proposal
- ✓ Savings of resources (Time And Money)
- ✓ Quick investment decision
- ✓ Choice of Investments
- ✓ Superior Information at Low cost

Benefits of Credit Rating : To Issuers

- ✓ Low cost of borrowing
- ✓ Wider audience for borrowing *(Increase the investor population/interest)*
- ✓ Rating as a marketing tool
- ✓ Reduction of cost in public issues (attract investors with least efforts)
- ✓ Source of Motivation for Investors
- ✓ Sources of additional certification
- ✓ Warning Signals (About Risk Profile)
- ✓ Merchant bankers job made easy
- ✓ Foreign collaborations made easy

Benefits of Credit Rating : To Brokers/MB

- ✓ Saves time, money, energy, and manpower in convincing their clients about investments.
- ✓ Less effort in studying company's credit position to convince their clients.
- ✓ Easy to select profitable investment security
- ✓ Helps to improve business

Methodology For CREDIT RATING

- BUSINESS RISK
- FINANCIAL RISK
- MANAGEMENT EVALUATION
- BUSINESS ENVIROMENT ANALYSIS

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Rating Process: Indian Scenario

1. Initial Contact
2. Meeting Company Executives
3. Meeting the Management
4. Assignment to Analyst Team
5. Preparation of Rating Profile (Depends of Business Type/Detailed Analysis)
6. Presentation Before The Committee
7. Rating Decision
8. Notification of Rating
9. Issue's Representation in the Market
10. Periodical Review By Rating Committee

Credit Rating Considerations/Methodology

- Industry Risk (Industry Life-cycle)
- Market Position and Share
- Extent and Status of Ownership
- Status of Managing Body
- Accounting quality
- Earnings and profitability
- Business Risk (Product Life-cycle)
- Capital Structure and Cost of Capital
- Liquidity
- Demand, Supply and Nature of Product/Services
- Additional Factors for Financial Institutions…

Examples of Credit Rating Companies

- **In USA:**

1. Moody's investors service
2. Standard and poor's corporation
3. Fitch Rating service

- **In INDIA:**

1. CRISIL - Credit Rating Information Services Limited
2. ICRA - Investment Infn. and Credit Rating Agency of India
3. CARE - Credit Analysis and research
4. BRICKWORK
5. ONICRA etc..

Disadvantages of Credit Rating

- Biased Rating and Misrepresentation,
- Static Study,
- Concealment of Material Information,
- No Guarantee For Soundness of The Company,
- Human Bias,
- Reflection of Temporary and Adverse Conditions,
- Present Rating May Change (Down Grade),
- Differences in Rating of Two Agencies.

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Credit Rating Information Services Limited (CRISIL)

- The first credit agency floated on January 1, 1988, jointly started by ICICI and UTI with an equity capital of Rs. 4 crores, as public Ltd company.
- CRISIL is India's leading rating agency, and is the fourth largest in the world.
- With over a 60% share of the Indian Ratings market, CRISIL Ratings is the agency of choice for issuers and investors.

CRISIL RATING SYMBOLS

Debenture Rating Symbols

- ✓ High Investment Grades:
  - AAA (triple A): Highest Safety
  - AA (double A): High Safety
- ✓ Investment Grades:
  - A: Adequate Safety
  - BBB (triple B): Moderate Safety
- ✓ Speculative Grades:
  - BB: Inadequate Safety
  - B: High Risk
  - C: Substantial Risk
  - D: Default

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CRISIL RATING SYMBOLS

- ✓ **Fixed Deposit Rating Symbols**
  - FAAA (triple A): Highest Safety
  - FAA (double A): High Safety
  - FA: Adequate Safety
  - FB: Inadequate Safety
  - FC: High Risk
  - FD: Default
- ✓ **Ratings for short-term instruments**
  - P-1: Timely payment very strong
  - P-2: Strong
  - P-3: Adequate Safety
  - P-4: Minimal
  - P-5: Expected to be in default on maturity or is in default

RATING METHODOLOGY OF CRISIL

- ✓ Key factors considered for rating are:
  1. Business Analysis,
  2. Financial Analysis,
  3. Management evaluation,
  4. Regulatory and competitive environment, and
  5. Fundamental analysis.

- ✓ Factors listed above at serial numbers 1, 2, and 3 are evaluated for manufacturing companies, while 4 and 5 factors are used to evaluate finance companies apart from the 1, 2 and 3 factors.

RATING METHODOLOGY OF CRISIL (Contd.)

1. **Business Analysis** – Industry risk, market position and operating efficiency of the company, legal position.
2. **Financial Analysis** – Accounting quality, earnings position, adequacy of cash flows, and financial flexibility.
3. **Management Evaluation** – Goals, philosophy, strategies, ability to overcome adverse situations, managerial talents and succession plans, commitment, consistency and credibility.
4. **Regulatory and Competitive Environment** -
5. **Fundamental Analysis** – Liquidity management, assets quality, profitability and financial position, interest and tax sensitivity.

Investment Information and Credit Rating Agency of India (ICRA)

- ✓ ICRA was set up by IFCI on 16th January 1991.
- ✓ ICRA Limited is an Associate of Moody's Investors Service and an independent and professional company.
- ✓ It is a public limited company with an authorized share capital of Rs.10 crores, Rs. 5 crores is paid up.
- ✓ ICRA’s major shareholders IFCI (26%), and the balance by UTI, LIC, GIC, PNB, Central Bank of India, Bank of Baroda, UCO Bank and banks (SBI).

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OBJECTIVES OF ICRA

- ✓ To access the credit instrument and award it a grade consonant to the risk associated with such instrument.
- ✓ To assist investors in making well informed investment decision
- ✓ To assist issuers in raising funds from a wider investors base
- ✓ To enable banks, investment bankers and brokers in placing debt with investors by providing them with a marketing tool
- ✓ To provide regulators with a market driven system to encourage the healthy growth of the capital markets in a disciplined manner without costing an additional burden on the Government for this purpose.

RATING METHODOLOGY OF ICRA

✓The rating methodology comprises the study of industry as well as the company's SWOT analysis.

- Marketing strategies,
- Competitive edge,
- Level of technological development,
- Operational efficiency,
- Competence and effectiveness of management,
- HRD policies and practices,
- Hedging of risks,
- Cash flow trends and potential,
- Liquidity,
- Financial flexibility,
- Asset quality and past record of servicing debts and obligations, and
- Government policies and status affecting the industry.

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Investment Information and Credit Rating Agency of India (ICRA)

✓ Long term Debentures, Bonds and Preference shares-Rating Symbols:

LAAA	:	Highest Safety
LAA	:	High Safety
LA	:	Adequate Safety
LBBB	:	Moderate Safety
LBB	:	Inadequate Safety
LB	:	Risk prone
LC	:	Substantial Risk
LD	:	Default, Extremely speculative

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Investment Information and Credit Rating Agency of India (ICRA) (Contd.)

- ✓ **Medium term including Fixed deposits Rating Symbols**

MAAA: Highest Safety MAA: High Safety

MA : Adequate Safety MB : Inadequate Safety

MC : Risk prone MD : Default

- ✓ **Short-term including CPs**

A-1: Highest Safety A-2: High Safety

A-3: Adequate Safety A-4: Risk prone

A-5: Default

Credit Analysis and Research Limited (CARE)

- ✓ Incorporated in April 1993, is a credit rating, information and advisory services company promoted,
- ✓ By Industrial Development Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other leading banks and financial services companies. In all CARE has 14 shareholders. Canara Bank, UTI, Credit Capital Venture Fund (I) Ltd, Sundaram Finance Ltd, The Federal Bank Ltd, The Vysya Bank, First Leasing Company of India, ITC Classic Finance Ltd, Kotak Mahindra Finance Ltd, IFB Leasing and Finance Ltd, Kalimati Investment Company Ltd, The Investment Corporation of India Ltd, Varuna Investments Ltd, and 20the Century Finance Corporation Ltd.

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Services offered by CARE are…

1. Credit Rating
2. Information Services
3. Equity Research, and
4. Project Advisory Services
5. Financial Restructuring
6. Assets Valuation
7. Credit Appraisal System etc..

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Credit Analysis and Research Limited (CARE)

- ✓ Long term debt instruments-Rating Symbols

  CARE AAA : Highest Safety

  CARE AA: High Safety

  CARE A : Adequate Safety

  CARE BB : Inadequate Safety

  CARE B : High Risk

- ✓ Medium term debt instruments-Rating Symbols

  CARE AAA : Highest Safety

  CARE AA: High Safety

  CARE A : Adequate Safety

  CARE BB : Inadequate Safety

  CARE C : High Risk

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Credit Analysis and Research Limited (CARE) (Contd.)

- ✓ Short term debt instruments Rating Symbols
  - PR 1: Superior capacity
  - PR 2: Strong capacity
  - PR 3: Adequate capacity
  - PR 4: Minimal degree of safety
  - PR 5: Default or likely in default on maturity
- ✓ Credit Analysis Rating
  - CARE 1: Excellent Debt Management Capacity
  - CARE 2: Very good Debt Management Capability
  - CARE 3: Good capability for Debt Management
  - CARE 4: Barely satisfactory capability for debt management
  - CARE 5: Poor capability for debt management