B.Com II, Sem IV, Capital Market Paper – II	
Module I	**Contemporary Issues in Finance** 1.1 Venture Capital –Meaning, features and scope 1.2 Importance of venture capital. 1.3 Merchant Banking in India 1.4 Services of Merchant Banks

1.1 Venture Capital : Concept, Characteristics and Functions:

Concept of Venture Capital:

Narrowly speaking, venture capital refers to the risk capital supplied to growing companies and it takes the form of share capital in the business firms. Both money provided as start-up capital and as development capital for small but growing firms areincluded in this definition.

In developing countries like India, venture capital concept has been understood in thissense. In our country venture capital comprises only seed capital, finance for high technology and funds to turn research and development into commercial production.

In broader sense, venture capital refers to the commitment of capital and knowledge for the formation and setting up of companies particularly to those specialising in new ideas or new technologies. Thus, it is not merely an injection of funds into a new firm but also a simultaneous input of skills needed to set the firm up, design its marketing strategy, organise and manage it.

In western countries like the USA and UK, venture capital perspective scans a much wider horizon along the above sense. In these countries, venture capital not only consists of supply of funds for financing technology but also supply of capital and skills for fostering the growth and development of enterprises.

Much of this capital is put behind established technology or is used to help the evolution of new management teams. It is this broad role which has enabled venture capital industry in the West to become a vibrant force in the industrial development. It will, therefore, be more meaningful to accept broader sense of venture capital.

Characteristics of Venture Capital:

Venture capital as a source of financing is distinct from other sources of financing because of its unique characteristics, as set out below:

1. Venture capital is essentially financing of new ventures through equity participation. However, such investment may also take the form of long-term loan, purchase of options or convertible securities. The main objective underlying investment in equities is to earn capital gains there on subsequently when the enterprise becomes profitable.

2. Venture capital makes long-term investment in highly potential ventures of technical savvy entrepreneurs whose returns may be available after a long period, say 5-10 years.

3. Venture capital does not confine to supply of equity capital but also supply of skills for fostering the growth and development of enterprises. Venture capitalists ensure active participation in the management which is the entrepreneur's business and provide their marketing, technology, planning and management expertise to the firm.

4. Venture capital financing involves high risk return spectrum. Some of the ventures may yield very high returns to more than Compensates for heavy losses on others which may also have earning prospects.

In nut shell, a venture capital institution is a financial intermediary between investors looking for high potential returns and entrepreneurs who need institutional capital as they are yet not ready/able to go to the public.

Dimensions of Venture Capital:

Venture capital is associated with successive stages of the firm's development with distinctive types of financing, appropriate to each stage of development. Thus, there are four stages of firm’s development, viz., development of an idea, start up, fledgling and establishment.

The first stage of development of a firm is development of an idea for delineating precise specification for the new product or service and to establish a business-plan. The entrepreneur needs seedling finance for this purpose. Venture capitalist finds this stage as the most hazardous and difficult in view of the fact that majority of the businessprojects are abandoned at the end of the seedling phase.

Start-up stage is the second stage of the firm’s development. At this stage, entrepreneursets up the enterprise to carry into effect the business plan to manufacture a product or to render a service. In this process of development, venture capitalist supplies start-up finance.

In the third phase, the firm has made some headway, entered the stage of manufacturing a product or service, but is facing enormous teething problems. It may not be able to generate adequate internal funds. It may also find its access to externalsources of finance very difficult. To get over the problem, the entrepreneur will need alarge amount of fledgling finance from the venture capitalist.

In the last stage of the firm’s development when it stabilizes itself and may need, in some cases, establishment finance to explicit opportunities of scale. This is the final injection of funds from venture capitalists. It has been estimated that in the U.S.A., theentire cycle takes a period of 5 to 10 years.

1.2 Importance/ Functions of Venture Capital:

Venture capital is growingly becoming popular in different parts of the world because of the crucial role it plays in fostering industrial development by exploiting vast and untapped potentialities and overcoming threats.

Venture capital plays this role with the help of the following major functions: Venture capital provides finance as well as skills to new enterprises and new ventures of existing ones based on high technology innovations. It provides seed capital to finance innovations even in the pre-start stage.

In the development stage that follows the conceptual stage, venture capitalist developsa business plan (in partnership with the entrepreneur) which will detail the market opportunity, the product, the development and financial needs.

In this crucial stage, the venture capitalist has to assess the intrinsic merits of the technological innovation, ensure that the innovation is directed at a clearly defined market opportunity and satisfies himself that the management team at the helm ofaffairs is competent enough to achieve the targets of the business plan.

Therefore, venture capitalist helps the firm to move to the exploitation stage, i.e., launching of the innovation. While launching the innovation the venture capitalist will seek to establish a time frame for achieving the predetermined development marketing,sales and profit targets.

In each investment, as the venture capitalist assumes absolute risk, his role is not restricted to that of a mere supplier of funds but that of an active partner with total investment in the assisted project. Thus, the venture capitalist is expected to perform not only the role of a financier but also a skilled faceted intermediary supplying a broad spectrum of specialist services- technical, commercial, managerial, financial and entrepreneurial.

Venture capitalist fills the gap in the owner’s funds in relation to the quantum of equity required to support the successful launching of a new business or the optimum scale of operations of an existing business. It acts as a trigger in launching new business and asa catalyst in stimulating existing firms to achieve optimum performance.

Venture capitalists role extends even as far as to see that the firm has proper and adequate commercial banking and receivable financing. Venture capitalist assists the entrepreneurs in locating, interviewing and employing outstanding corporate achievers to professionalize the firm.

1.3 Merchant Banking

Merchant banking is a combination of **banking** and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters. Consultancy **means** to provide advice, guidance and service. It helps a business person to start a business. It helps to raise (collect) helps finance .It helps to expand and modernize the business .It help in restructuring of a business . It helps to review sick business units. It also helps companies to register, buy and sell share at the stock exchange.

Definition

Merchant banking can be defined as a skill-oriented professional service provided by merchant banks to their clients, concerning their financial needs, for adequate consideration, in the form of fee.

Merchant banks are a specialist in international trade and thus, excel in transacting with large enterprises

The industrial boom in India has led to major growth in the need for merchant bankers. Merchant banking is an amalgam of banking and consultancy services. Although, the word merchant banking has a different meaning in different countries. In the U.S. merchant, bankers are called "Investment Banks," in the U.K., they are called "accepting and issuing houses."

In India, a merchant banker is defined as "an individual who is who is involved in the business of issue management either by making arrangements regarding buying, selling or subscribing to the securities as a manager, advisor, consultant in relation to such an issue management."

Merchant banks render numerous financial services, advice, consultation, management, counseling, and solutions to big corporate houses. They are pretty different from normal commercial banks in several ways.

For example, commercial banks generally accept deposits and give loans, but merchant banks only offer consultation and management for a certain charge. They only accept deposits and offer loans only to a few clients and not to the general public.

Merchant bank helps a business person to commence a business and raising finance. Furthermore, they help them to expand, modernizing, and restructuring the business. They also grant support in registering, buying, and selling shares at the stock exchange.

OBJECTIVES

Here are some of the objectives of merchant banks:

1. **Provide funds to companies** — this usually includes loans for startup companies. They decide how much money a company needs to function through proposals created by these companies. They also help their clients raise funds through the stock exchange and other activities. Merchant banks act as a foundation for small scale companies in terms of their finances.
2. **Underwriting** — this is like insurance where banks sign into documents that agree to provide financial payment to their clients in case of any damage or losses. This is very important for clients to ensure that the bank will help them gain more income. If not, in case they would incur losses, the bank will pay them for the losses.
3. **Manage their portfolios** — the bank will look into the companies' assets and will do the computation of their credits and debits to ensure they are not incurring any losses. They also provide other kinds of services to check on the liquidation of assets to track the income made by these companies and study how they can make it better.
4. **Offering corporate advisory** — they offer advises especially to starting companies and those that would want to expand. This advice involves financial aid to ensure that the company will be successful and will not have any problems along the way.
5. **Managing corporate issues** — help incorporate securities management, they also serve as an intermediary bank in transferring capitals.

CHARACTERISTICS OF MERCHANT BANKING

- High proportion of decision makers as a percentage of total staff.
- Quick decision process.
- High density of information.
- Intense contact with the environment.
- Loose organizational structure
- Concentration of short and medium term engagements
- Emphasis on fee and commission income.
- Innovative instead of repetitive operations
- Sophisticated services on a national and international level.
- Low rate of profit distribution.
- High liquidity ratio

Merchant banking in India began in 1967 by National Grindlays; later, Citi Bank started it in 1970. In the year 1972, SBI became the first commercial bank to set up a distinct division for merchant banking. Then it was followed by ICICI in 1973, and then various banks started these services such as PNB, Bank of India, UCO Bank, etc.

It was in 1973 when FERA came into existence that helped increase merchant banking activities in India. After that, various banks such as IDBI and IFCI entered the market.

Reasons for growth of Merchant Banking

There are a few reasons that accelerated the growth of these banks in India. Some of the reasons are:

1. Globalization: After the 1991 reforms, the Indian economy saw a drastic change as it opened gates for foreign companies. It helped in getting funds from abroad; thus, it led to the growth of merchant banks.

2. Elevated Competition: Because of the globalization of the economy, the market scenarios became lucrative, and business options became favorable for various individuals. This pivoted the Indian corporate sector, and a huge expansion was seen in this sector. This motivated the Merchant Bankers to play an important role by offering specialized services to corporate.

3. Switch in consumer trends: There was a huge transformation in the industrial and corporate sectors because of the foreign players in the market.

The major benefit was that the Indian massed started getting better quality products as the Indian companies also started working on quality to match the foreign products. In such prevailing environments, financial products and instruments became more prominent.

4. Government Reforms: Government intervention was reduced, and privatization was increased. It also raised the limits of investment and lessened direct interventions that led to an increase in the proposition of foreign players.

These were some of the causes that hastened the increase of **Merchant Banking in India.** Let us also know the services that merchant banking offers to corporate and big business houses.

1.4 Services of Merchant Banking

1. Portfolio Management: It refers to decreasing the risk and maximizing the profits. This expression is usually used in connection to shares and debentures only. Merchant bankers offer these services to their customers and guide the investors in selecting the right securities as per their needs. Thus, merchant bankers ensure that they are updated with the complete market information.

2. Corporate Counseling: This is the basic service that merchant banks offer as all industrial units, whether new or existing, require this service. There is a wide range of services that come under corporate counseling, such as project counseling, capital restructuring, project management, working capital management, public issue management, loan syndications, fixed deposit, and lease financing.

3. Management of Capital Issues: This service comprises selling securities, equity shares, debentures, preference shares, etc., to the investors. The role of the merchant banker here is to make an action plan and budget for expenses for coordinating with underwriters, the expense for the issues, choosing the advertising agency for pre and post-issue.

For doing this, they have to be in touch with agencies that are involved in public issues.

4. Underwriting services: This is one of the most important services given by merchant banks as in this, the bank gives a guarantee that states that if the agreement is below the specified level, then the bank would have to contribute to the stated expense.

5. Loan Syndication: This service is pretty unusual from what the other banks offer. Here the merchant banks arrange a loan for a borrower who can be a big company, a government department, or a local authority. But, there are a lot of measures that a merchant banker has to take before a loan.

Firstly, they check and analyze the cost of the project, then they design the capital structure, see how much the promoter is contributing, and then decides on the amount of loan and approaches the financial institution for a loan. They also have to ensure that the company adheres to all the guidelines.

Other services that merchant banks offer are:

- Project Counseling
- Issue Management
- Foreign Currency Financing
- Advisory Services to Mergers and Takeovers
- Broking Corporate Advisory Services Leasing
- Consultancy to Sick Industrial Units
- Providing Venture Capital Financing
- Act as Debenture Trustee

Merchant Bankers in India

There are more than 130 merchant bankers who are registered with SEBI. Here is the list of some significant ones:

Public Sector Merchant Bankers

- State Bank of Bikaner and Jaipur
- Karur Vysya Bank
- SBI Capital markets Ltd.
- IFCI Financial Services Ltd.
- Punjab National Bank
- Bank of Maharashtra

Private Sector Merchant Bankers

- Yes, Bank Ltd.
- ICICI Securities Ltd.
- Kotak Mahindra Capital Company Ltd.
- Axis Bank Ltd.
- Tata Capital Markets Ltd.
- Reliance Securities Ltd.
- Bajaj Capital Ltd.
- ICICI Bank Ltd.

Foreign Players in Merchant Banking

- FedEx Securities Ltd.
- Goldman Sachs (India) Securities Pvt. Ltd.
- DSP Merrill Lynch Ltd.
- Deutsche Equities India Private Limited
- Morgan Stanley India Company Pvt. Ltd.
- Citigroup Global Markets India Pvt. Ltd.
- Barclays Securities (India) Pvt. Ltd.
- Barclays Bank Plc
- Deutsche Bank