Unit II

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MERCHANT BANKING

In India prior to the enactment of Indian Companies Act, 1956 managing agents acted as issue houses for securities, evaluated Project reports, planned capital structure and to some extent provided venture capital for new firms. Few share broking firms also functioned as merchant bankers. 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 offered along with other traditional banking services. In the mid-eighties, the Banking Regulations Act was amended permitting commercial banks to offer a wide range of financial services through the subsidiary rule. 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. The merchant banking gained prominence during 1983-84 due to new issue boom.

MERCHANT BANKS AND COMMERCIAL BANKS

There are differences in approach, attitude and areas of operations between commercial banks and merchant banks. The differences between merchant banks and commercial banks are summarised below:

1. Commercial banks basically deal in debt and debt related finance and their activities are appropriately arrayed around credit proposals, credit appraisal and loan sanctions. On the other hand, the area of activity of merchant bankers is ‘equity and equity related finance’. They deal with mainly funds raised through money market and capital market.
2. Commercial banks are asset oriented and their lending decisions are based on detailed credit analysis of loan proposals and the value of security offered against loans. They generally avoid risks. The merchant bankers are management oriented. They are willing to accept risks of business.

3. Commercial bankers are merely financiers. The activities of merchant bankers include project counselling, corporate counselling in areas of capital restructuring,

amalgamations, mergers, takeover etc., discounting and rediscounting of short term paper in money markets, managing, underwriting and supporting public issues in new issue market and acting as brokers and advisers on portfolio management in stock exchange. Merchant banking activities have impact on growth, stability and liquidity of money markets.

SERVICES OF MERCHANT BANKS

The various services of merchant bankers are :

(i) **Corporate Counselling -** Corporate counselling covers the entire field of merchant banking activities viz. project counselling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, lease financing, acceptance credit etc. The scope of corporate counselling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

(ii) **Project Counselling -** Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. The financing mix is to be decided keeping in view the rules, regulations and norms prescribed by the government or followed by financial institutions. The projects are appraised, as to the location, technical, commercial and financial viability of the project. Project counselling also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

(ii) **Loan Syndication** - Loan syndication refers to assistance rendered by merchant banks to get mainly term loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium. Merchant Bankers help corporate clients to raise syndicated loans from commercial banks.

(iv) **Issue Management** - Management of issue involves marketing of corporate securities viz., 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 dividend 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. The pre-issue management is divided into: (i) Issue through prospectus, offer for sale and private placement. (ii) Marketing and underwriting. (iii) Pricing of Issues.

(i) Public Issue through Prospectus

(a) The most common method of public issue is through prospectus.

(b) Offers for sale are offers through the intermediary of issue house or firm of stock broker. The company sells the entire issue of shares or debentures to the issue house at an agreed price which is generally below the par value.

(c) The direct sale of securities by a company to investors is called private placement. The investors include LIC, UTI, GIC, SFC etc.

To bring out a public issue, merchant bankers have to co-ordinate 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 vetted by reputed solicitor.

(ii) **Marketing** – After despatch 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 date 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.

(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 for 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.

(iv) **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 post issue 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 within 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 co-ordinating the above activities.

(v) **Underwriting of Public Issue -** Underwriting is a guarantee given by the underwriter that in the event of under subscription the amount underwritten, would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well-known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly. All public issues have to fully underwritten. Only Category I, II and III merchant bankers are permitted to underwrite an issue.

(vi) **Managers, Consultants or Advisers to the Issue -** The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies are free to appoint one or more agencies as managers to the issue. SEBI guidelines insist that all issues should be managed by atleast one authorised merchant banker. Ordinarily, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over Rs.100 crores, upto a maximum of four merchant bankers could be associated as managers.

(vii) **Portfolio Management** - Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

(viii) **Advisory Service Relating to Mergers and Takeovers** - A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over 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 offeree 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 approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

(ix) **Off Shore Finance -** The merchant bankers help their clients in the following areas involving foreign currency. (i) long term foreign currency loans (ii) joint venture abroad (iii) financing exports and imports and (iv) foreign collaboration arrangements.

The bankers render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

(x) **Non-Resident Investment** - The services of merchant bankers include investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management etc. They also take care of the operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

QUALITIES REQUIRED OF MERCHANT BANKERS

Merchant bankers play a significant role as a catalyst to transform the project ideas into industrial ventures. They help promotion of the enterprise by undertaking various activities such as market surveys, choice of suitable location and its size, preparation of documents and obtaining consent from various authorities. They help in taking important decisions such as financing mix, management of public issues, credit syndication etc. The success of the merchant bankers depends on the quality of service and soundness of advice to clients. To perform these services effectively the merchant bankers are expected to possess certain qualities which are described below:

1. Ability to analyse various aspects such as technical, financial and economic aspects concerning the formation of an industrial project.

2. Knowledge about the various aspects of capital markets, trends in stock exchange, psychology of investing public, change in the economic and technological environment in the country.

3. Ability to build up the bank-client relationship and live upto the clients expectations with total involvement in the project assigned to them.

4. Innovative approach in developing capital market instruments to satisfy the ever changing needs of investing public.

5. Integrity and maintenance of high professional standards are the essential requisites for the success of merchant bankers present scenario.

GUIDELINES FOR MERCHANT BANKERS

Merchant banking has been statutorily brought within the framework of the Securities and Exchange Board of India under SEBI (Merchant Bankers) Regulations, 1992.

(1) In terms of the guidelines issued during April 1990, all merchant bankers will require authorisation by SEBI to carry out business.The criteria for authorisation include:

(i) Professional qualification in finance, law or business management; (ii) infrastructure like adequate office space, equipment and manpower; (iii) employment of two persons who have the experience to conduct business of merchant bankers;(iv) capital adequacy;(v) past track of record, experience, general reputation and fairness in all transactions.

(2) SEBI issued further guidelines classifying the merchant bankers into four categories based on the nature and range of activities and their responsibilities to SEBI investors and issuers of securities. SEBI has issued revised guidelines on December 22, 1992 classifying the activities of merchant bankers as follows:

The **first category consists of merchant bankers who carry on any activity of issue management which** will inter alia consists of preparation of prospectus and other information relating to the issue, determining financial structure, tie-up of financiers and final allotment and refund of subscription and to act in the capacity of managers, advisor or consultant to an issue, portfolio manager and underwriter. The **second category** consists of those authorised to act in the capacity of co - manager/advisor, consultant, underwriter to an issue or portfolio manager. The **third category** consists of those authorised to act as underwriter, advisor or consultant to an issue.

The **fourth category** consists of merchant bankers who act as advisor or consultant to an issue.

Minimum networth for first category is Rs.1 crore, second category Rs.50 lakhs, third category Rs.20 lakhs and fourth category is nil.

(2) An initial authorisation fee, an annual fee and renewal fee may be collected by SEBI.

(4) All issues must be managed at least at one authorised banker, functioning as the sole manager or the lead manager. Ordinarily not more than two merchant bankers should be

associated as lead managers. But, for issues over Rs.100 crores and above, the number of lead managers may go upto a maximum of four. The specific responsibilities of each lead manager must be submitted to SEBI prior to the issue.

(5) The lead merchant banker holding a certificate under category I shall accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs.25 lakhs whichever is less.

(6) Each merchant banker is required to furnish to the SEBI half yearly unaudited financial results when required by it with a view to monitor the capital adequacy of the merchant banker.

(7) SEBI has prescribed a code of conduct to the merchant bankers. The banker must perform his duties with highest standards of integrity and fairness in all his dealings. He will render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgement. The merchant banker and his personnel will act in an ethical manner in all his dealings with the investors, clients and fellow bankers. All merchant bankers must adhere to the code of conduct.

(8) The above guidelines will be administered by SEBI and it will supervise the activities of merchant bankers.

(9) SEBI has been vested with power to suspend or cancel the authorisation in case of violation of the guidelines.

(10) To ensure transparency and accountability in the operation of merchant bankers and to protect the investors, a number of obligations and responsibilities have been imposed on them. It has been decided to ask merchant bankers to enter into agreement with corporate body setting out their mutual rights, liabilities and obligations relating to an issue particularly on disclosure, allotment and refund, maintenance of books of accounts and submission of half-yearly reports to SEBI.

(11) Inspections will be conducted by SEBI to ensure that provisions of the regulations are properly complied with and to investigate the complaints from customers. It is obligatory on the part of merchant bankers to furnish all the details sought by the investigating team. The regulations, however, indicate that the Board would give reasonable notice to merchant bankers before undertaking inspection. On the basis of inspection report, the Board will communicate the contents of the report to the concerned merchant banker to give him/her an opportunity to put forth his/her submissions. On receipt of the explanations, if any, of the merchant bankers, the SEBI would advise merchant bankers to take any measures that it may deem fit, and to comply with the provisions of the regulations.

The notification procedure relating to action to be initiated against merchant banks in case of default. The regulations empower SEBI to take action against defaulting banker such as suspension/ cancellation of registration. In case of deliberate manipulation, or price rigging or cornering activities or deterioration in the financial position, the Board is empowered to cancel the registration of the merchant banker. Under the regulation, the SEBI is empowered to suspend a registration of a member banker in case the merchant banker furnishes wrong or false information, fails to resolve the complaints of the investors, etc. The penalty or suspension or cancellation of registration can be imposed by SEBI only after holding an enquiry and giving sufficient opportunity to the merchant banker of being heard. Any merchant banker aggrieved by an order of SEBI, can, however, appeal to the Union Government.

PROBLEMS OF MERCHANT BANKERS

1.SEBI guidelines have authorised merchant bankers to undertake issue related activities only with an exception of portfolio management These guidelines have made the merchant bankers either to restrict their activities or think of separating these activities from the present one and float new subsidiary and enlarge the scope of its activities.

2. SEBI guidelines stipulate a minimum net worth of Rs.1 crore for authorisation of merchant bankers. Small but professional and specialised merchant bankers who do not have a net worth of Rs.1 crore may have to close down their business. The entry is denied to young, specialised professionals into merchant banking business.

3. Non co-operation of the issuing companies in timely allotment of securities and refund of application money is another problem of merchant bankers. The guidelines have put the responsibility on the merchant bankers. They have to seek the co-operation of the issuing company to shoulder the responsibility.