CMR Institute of Technology
Department of Management Studies
Answer key
III Internal test – III semester MBA (2017-19 Batch)

Subject: Investment Banking & Financial Services **Sub Code: 17MBAFM302**
Date: 10.11.2018 **Time: 9:00-10:30** **Duration: 90 mins**

Part A - Answer Any Two Full Questions (16*02=32 Marks)

1. a) Define Self-help group.

A **self-help group** (**SHG**) is a financial intermediary committee usually composed of 10–20 local women or men. Most self-help groups are located in India, though SHGs can be found in other countries, especially in South Asia and Southeast Asia.SHG is nothing but a group of people who are on daily wages, they form a group and from that group one person collects the money and gives the money to the person who is in need

2.b Explain different types of leasing.

Types of leasing

There are different kinds of lease arrangements. It makes sense to consider them all to see which is best suited to your business, your particular circumstances and the asset that you are acquiring.

The **three main types of leasing** are finance leasing, operating leasing and contract hire.

1. Finance leasing

- A **long-term lease** over the expected life of the equipment, usually three years or more, after which you pay a nominal rent or can sell or scrap the equipment - the leasing company will not want it any more.
- The leasing company recovers the full cost of the equipment, plus charges, over the period of the lease.
- Although you don't own the equipment, you are responsible for **maintaining and insuring** it.
- You must show the leased asset on your balance sheet as a capital item, or an item that has been bought by the company.

- Leases of over seven years, and in some cases over five years, are known as 'long funding leases' under which you can claim capital allowances as if you had bought the asset outright.

For detailed guidance on tax and leasing, see acquire assets and borrow money tax efficiently. You can also read HM Revenue & Custom's Business Leasing Manual.

2. Operating leasing

If you are considering operating leasing, remember the following points:

- it is useful if you don't need the equipment for its entire working life
- the leasing company will take the asset back at the end of the lease
- the **leasing company** is responsible for **maintenance and insurance**
- you don't have to show the asset on your balance sheet

3. Contract hire

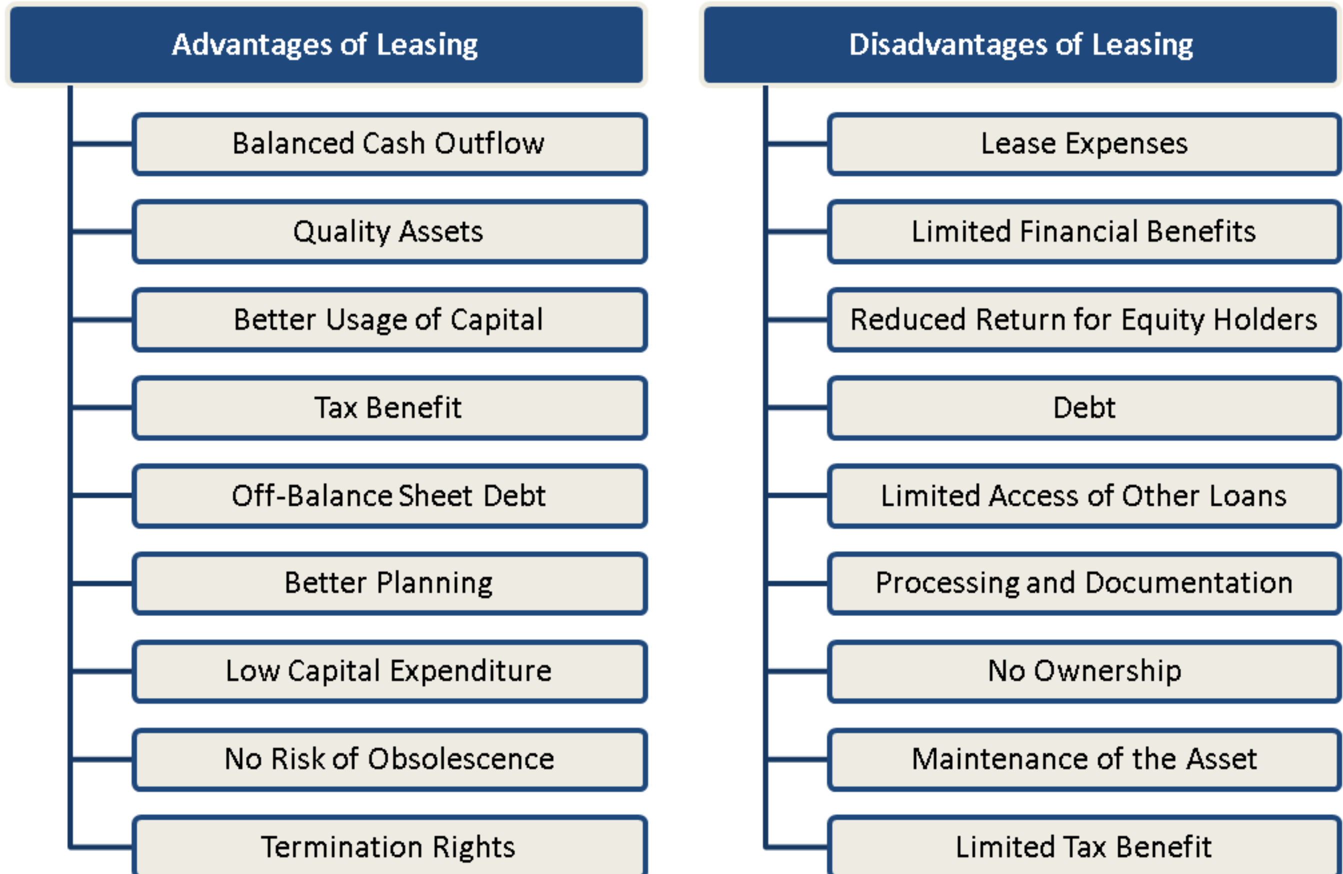
Contract hire is often used for company cars and:

- the leasing company takes some responsibility for management and maintenance, such as **repairs and servicing**
- you don't have to show the asset on your balance sheet

1.c Summarize leasing by highlighting its advantages.

Non-banking financial companies (NBFC) are companies registered under the Companies Act, 1956. They are responsible for providing financial services but are not regulated by a national or international governing body and do not hold a full-fledged license for conducting operations.

The financial services offered by NBFCs include disbursement of loans and advances, acquisition of stocks, shares or bonds etc. They do not accept demand drafts and are not a part of payment/settlement system unlike banks. NBFCs are more commonly known in the forms of microloan organisations, insurance companies, investment houses and more.



2.a Define is private equity?

Private equity **is an alternative** investment **class and consists of** capital **that is not listed on a public exchange.** Private equity **is composed of funds and investors that directly invest in** private **companies, or that engage in buyouts of public companies, resulting in the delisting of public** equity

2.b. **Discuss the advantages and disadvantages of microfinance**

Microfinance is the practice of extending a small loan or other form of credit, savings, checking, or insurance products to individuals who do not have access to this type of capital. This allows individuals

who are living in poverty to work on becoming financially independent so they can work their way into better living conditions.

Since a majority of the world is forced to survive on the equivalent of just $2 per day, microfinance becomes a solution that can help more people be able to improve their living conditions. These are the benefits of microfinance in developing countries and why everyone should consider getting involved in this form of lending.

1. It allows people to better provide for their families.

Microfinance allows for an added level of resiliency in the developing world. Even when households are able to work their way out of poverty, it often takes just one adverse event to send them right back into it. It's often a health care issue that causes a return to poverty. By allowing entrepreneurs to become more resilient through their own efforts at their own business, it gives them the opportunity to make it through times of economic difficulty.

Most of the households that take advantage of the microfinance offers that are available in developing countries live in what would be considered "abject poverty." This is defined as living on $1.25 per day or less – though some definitions extend this amount to $2 per day or more. About 80% of that amount goes to the purchase or creation of food resources.

By offering microfinance products that can be repaid with that remaining 20%, more households have the opportunity to expand their current opportunities so that more income accumulation may occur.

2. It gives people access to credit.

Muhammad Yunus, who is often credited as the modern father of microfinance, once gave $27 to women out of his own pocket because he saw how the cycle of debt affected their work crafting bamboo chairs. Most banks will not extend loans to someone without credit or collateral because of the risks involved in doing so, yet those in poverty do not have any credit or collateral.

By extending microfinance opportunities, people have access to small amounts of credit, which can then stop poverty at a rapid pace.

Yunus has always believed that credit is a fundamental human right. There are certainly some financial institutions which may disagree with his assessment. Yet without credit, it can be difficult, if not impossible for someone in poverty, to pursue an idea that could bring about a giant payday one day. Microfinance makes that pursuit possible.

3. It serves those who are often overlooked in society.

In many developing nations, the primary recipient of microloans tends to be women. Up to 95% of some loan products are extended by microfinance institutions are given to women. Those with disabilities, those who are unemployed, and even those who simply beg to meet their basic needs are also recipients of microfinance products that can help them take control of their own lives.

Women are key figures in leadership roles in business, even in the developed world. Catalyst has reported that companies with female board directors are able to obtain returns that are up to 66% better in returns on invested capital and 42% better in terms of sales returns than companies with male board members only.

Women also develop others more frequently when it comes to entrepreneurial roles. This comes from coaching, feedback, or investments. Even in the developed world, women helping women is an economic force that poverty can’t stop.

4. It offers a better overall loan repayment rate than traditional banking products.

When people are empowered, they are more likely to avoid defaulting on a loan. Women are also statistically more likely to repay a loan than men are, which is another reason why women are targeted in the microfinance world. There’s also the fact that for many who receive a microloan, it is their only real chance to get themselves out of poverty, so they’re not going to mess things up.

Zenger Folkman published a survey regarding ratings of high integrity and honesty in leadership roles that was separated by gender. The mean percentile of women displaying these traits was 55%, while for men, it was just 48%. In business, the bottom line is this: integrity matters. Microfinance institutions have recognized this and approached women because of this.

As a side effect of this approach, many developing countries are taking a new look at what role women should play in society. Instead of treating a woman as a second-class citizen, or the "barefoot in the kitchen and pregnant" attitude that has been prevalent in the past, the success of women in bring their households out of poverty is evidence that proves women not only have an initiative to get things done, but they produce consistent results.

For these reasons, microfinance institutions see total repayment rates of higher than 98%, though there can be several accounts that are overdue at any given time.

5. It provides families with an opportunity to provide an education to their children.

Children who are living in poverty are more likely to have missed school days or to not even be enrolled in school at all. This is because the majority of families who live in poverty are working in the agricultural sector. The families need the children to be working and productive so their financial needs can be met. By receiving microfinancing products, there is less of a threat of going without funding, and that means more opportunities for children to stay in school.

This is especially important for families with girls. When girls receive just 8 years of a formal education, they are four times less likely to become married young. They are less likely to have a teen pregnancy. In return, this makes girls more likely to finish schooling and then either obtain a fair-paying job or go onto a further educational opportunity.

6. It creates the possibility of future investments.

The problem with poverty is that it is a cycle that perpetuates itself. When there is a lack of money, there is a lack of food. When there is a lack of clean water, there is a lack of sanitary living conditions. When people are suffering from malnutrition, they are less likely to work. A lack of sanitation creates the potential of illness that prevents working days.

Microfinance changes this by making more money available. When basic needs are met, families can then invest into better wells, better sanitation, and afford the time it may take to access the health care they need.

As these basic needs are met, it also means that there are fewer interruptions to the routine. People can stay more productive. Kids can stay in school more consistently. Better healthcare can be obtained. This creates a lower average family size because there are more guarantees of survival in place.

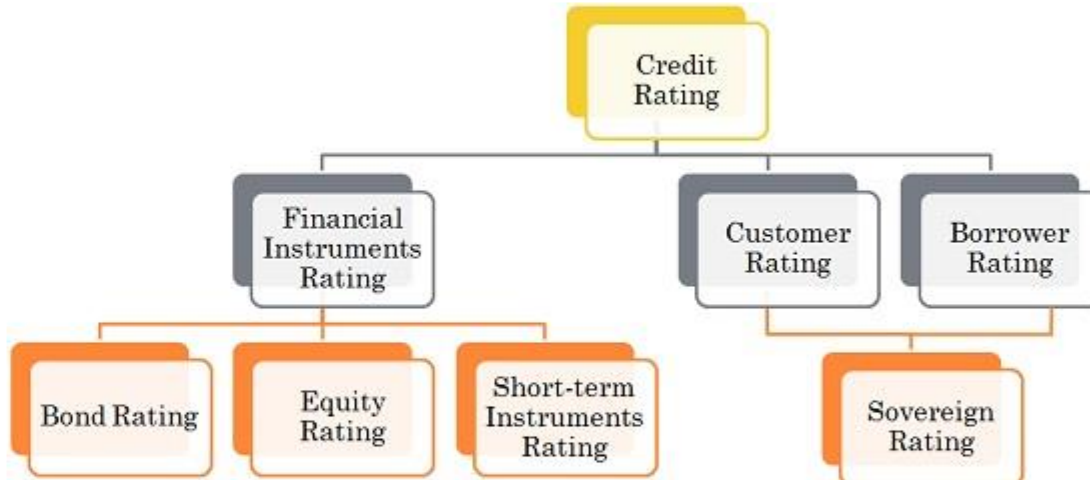
And when that happens, the possibility of future investments will occur because there is more confidence in being able to meet basic needs.

2.c Explain the various steps followed by credit rating agencies in rating process.

Credit Rating

Definition: Credit Rating can be defined as the assessment of the ability of the borrower, to discharge their financial obligations. It is an approximation of the creditworthiness of an individual, entity or commercial instrument, considering various factors, representing the capability and willingness, to pay financial commitments in time.

Credit rating is instrument specific and is meant to grade various commercial instruments, with respect to the credit risk and the obligator's ability to make good the debt obligations, as per the terms of the agreement. The different types of credit ratings are depicted in the figure below:



Types of Credit Rating

Simply put, credit rating refers to the expression of opinion concerning debt instrument, based on credit risk evaluation, given by rating agency as on a particular date, indicating the probability of principal plus interest to be met by the borrower in a timely manner. There are three factors which are to be considered during default risk assessment and quality rating, they are:

1. Issuers ability to pay.
2. Strength of the instrument owner's claim on the issue.

3. Economic importance of the marketplace of the issuer.

Expression of Credit Rating is in alphabetical or alphanumerical symbols, that enables the investor to distinguish the debt instruments, as per their underlying credit quality.

Steps Involved in Credit Rating

Steps involved in Credit Rating

- **Request from issuer and analysis**: The first step to credit rating is that the enterprise applies to the rating agency for the rating of a particular instrument. Thereafter, an expert team interacts with the firm's those charged with governance and acquires relevant data. Factors which are considered includes:
  - Historical performance
  - Financial Policies
  - Business Risk profile
  - Competitive Position, etc.
- **Rating Committee**: Based on the information gathered and evaluation performance, the presentation of the report is made by the expert's team to the Rating Committee, in which the issuer is not permitted to take part.

- **Communication to management and appeal**: The decision of the rating is shared with the issuer and if he/she does not agree with the decision, then an opportunity of being heard is given. The issuer is required to provide material information, so as to appeal against the decision. The decision is reviewed by the committee, but that does not make any change in the ratings.
- **Pronouncement of the rating**: When the issuer agrees to the rating decision, the agency make a public announcement, of the rating.
- **Monitoring of the assigned rating**: The agency which rates the issue, overlooks the performance of the issuer and the business environment in which it operates.
- **Rating Watch**: On the basis of continuous critical observation undertaken by the rating agency, it may place a rated security on Rating Watch.
- **Rating Coverage**: Credit Ratings are not confined to particular debt instruments, but also covers public utilities, transport, infrastructure, energy projects, Special Purpose Vehicles etc
- **Rating Scores**: Rating scores are given by the credit rating agencies like CRISIL, ICRA, CARE, FITCH.

3.a Define venture Capital?

Venture capital is financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. Venture capital generally comes from well-off investors, investment banks and any other financial institutions. However, it does not always take just a monetary form; it can be provided in the form of technical or managerial expertise.

3.b Distinguish between leasing and hire purchase.

Points of Distinction	**Leasing**	**Hire Purchase**
Ownership	Lessor is the owner until the end of the agreement	Hirer has the option of purchasing the asset at the end of the agreement
Duration	Done for longer duration	Done for a shorter duration
Depreciation	Lessor claims the depreciation	Hirer claims the depreciation
Payments	Rental payments are the cost of using the asset	Payments include the principal amount and the effective interest for the duration of the agreement
Tax Impact	Lease rentals categorized as expenditure by the lessee	Only interest component is categorized as expenditure by the hirer
The Extent of Financing	Complete financing	Partial financing

Repairs and Maintenance	Responsibility of the lessee in the financial lease, and of the lessor in operating lease	Responsibility of the hirer

3.c Discuss the different stages in Venture Capital financing?

The Stages in Venture Capital (VC) Investing

Angel investors are most often individuals (friends, relations or entrepreneurs) who want to help other entrepreneurs get their businesses off the ground - and earn a high return on their investment. The term "angel" comes from the practice in the early 1900s of wealthy businessmen investing in Broadway productions. Usually they are the bridge from the self-funded stage of the business to the point that the business needs true venture capital. Angel funding usually ranges from $150,000 to $1.5 million. They typically offer expertise, experience and contacts in addition to money.

1. ***Seed*** - The first stage of venture capital financing. Seed-stage financings are often comparatively modest amounts of capital provided to inventors or entrepreneurs to finance the early development of a new product or service. These early financings may be directed toward product development, market research, building a management team and developing a business plan.

   A genuine seed-stage company has usually not yet established commercial operations - a cash infusion to fund continued research and product development is essential. These early companies are typically quite difficult business opportunities to finance, often requiring capital for pre-startup R&D, product development and testing, or designing specialized equipment. An initial seed investment round made by a professional VC firm typically ranges from $250,000 to $1 million.

   Seed-stage VC funds will typically participate in later investment rounds with other equity players to finance business expansion costs such as sales and distribution, parts and inventory, hiring, training and marketing.
2. ***Early Stage*** - For companies that are able to begin operations but are not yet at the stage of commercial manufacturing and sales, early stage financing supports a step-up in capabilities. At this point, new business can consume vast amounts of cash, while VC firms with a large number of early-stage companies in their portfolios can see costs quickly escalate.
   - **Start-up** - Supports product development and initial marketing. Start-up financing provides funds to companies for product development and initial marketing. This type of financing is usually provided to companies just organized or to those that have been in business just a short time but

have not yet sold their product in the marketplace. Generally, such firms have already assembled key management, prepared a business plan and made market studies. At this stage, the business is seeing its first revenues but has yet to show a profit. This is often where the enterprise brings in its first "outside" investors.

    - **First Stage** - Capital is provided to initiate commercial manufacturing and sales. Most first-stage companies have been in business less than three years and have a product or service in testing or pilot production. In some cases, the product may be commercially available.

3. ***Formative Stage*** **-** Financing includes seed stage and early stage.
4. ***Later Stage*** - Capital provided after commercial manufacturing and sales but before any initial public offering. The product or service is in production and is commercially available. The company demonstrates significant revenue growth, but may or may not be showing a profit. It has usually been in business for more than three years.
    - **Third Stage** - Capital provided for major expansion such as physical plant expansion, product improvement and marketing.
    - **Expansion Stage** - Financing refers to the second and third stages.
    - **Mezzanine** **(bridge)** - Finances the step of going public and represents the bridge between expanding the company and the IPO
5. ***Balanced-stage*** financing refers to all the stages, seed through mezzanine.

Part B

4.a ABC machine tool company Ltd considering the acquisition of a large equipment to set up its factory in a backward region for Rs.12,00,000. The equipment is expected to have an economic life time of 8 years. The equipment can be financed either with an 8 year term loan at 14% interest, repayable in equal installments of Rs. 2,58,676 per year or by equivalent amount of lease rent per year. In both the cases, payments are due at the end of the year. The equipment is subjected to straight line method of depreciation for tax purpose. Assuming no salvage value after 8 years uselife and 50% tax rate, which of the following alternative should it select?