

Merchant Banking – Factors Determining It's Shape In India

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INTRODUCTION

Today, perhaps, no country can have an isolated existence and cannot ignore the global and international situation. The collapse of socialism in the Soviet Union, declining of communism in the East European countries and economic reforms undertaken by communist China by opening it's market to the outside world in the name of socialist market economy have influenced India to change it's Nehru-Ian mixed economic policy to a liberalized economic policy followed by restructuring and reforming of the financial sector. Privatization and Globalization have become watch words today. The Government of India has adopted the new liberalized economic policy from July 1991 and one of the main agendas of the new policy is banking reforms. In this process of reforms, the importance of Merchant Banking should not be neglected. The whole banking system in India and abroad is bound to change in the second millennium. Merchant banking cannot be an exception. Following are the various factors which determine the shape of Indian merchant bankers:

1. NEW ECONOMIC POLICY 1991: AN ANGLE FOR MERCHANT BANKING ACTIVITIES

The Indian Financial markets are heading towards globalization, which is defined as a movement towards world wide financial decision making. In addition to domestic public issues, capital market activities need to be redefined to encompass all the fund raising possibilities available, from retail investors either domestically or internationally.

The new-economic policy has brought about a drastic change in the role of merchant bankers. There is a mushrooming development in the field of merchant banking in a very short span of time. More than 1000 merchant bankers are operating today. It is the need of the hour to consider their excellence, competence, quality of service and responsibility towards the investing public rather than their numbers. The merchant bankers should not follow issue management only, but should perform various other activities which provide them a tremendous scope.

Merchant banker's responsibilities under the stringent guidelines set by SEBI are much more today than ever before. Moreover, the merchant bankers more and more are involved in fund based activities along with undertaking activities such as project finance, project appraisal, syndication of loan, mergers and Acquisitions, capital restructuring etc. After the recommendations of Banking Commission 1972, all the Indian Banks got permission for starting Merchant Banking services as part of their multiple services. Almost every industrial house has a finance company today and merchant banking seems to be the first activity they like to do. At present, following Indian Banks have Merchant Banking Divisions: State Bank of India, 1972, Bank Of India, 1977, Syndicate Bank, 1977, Standard Chartered Bank, 1978, Bank Of Baroda, 1978, Union Bank Of India, 1980, Punjab National Bank, Indian Overseas Bank, United Commercial Bank, ICICI, IFCI & IDBI.

Further, the following major causes may definitely offer a bright prospect to Indian merchant banking sector.

2. WORLD TRADE ORGANISATION (new vista for) AND INDIAN MERCHANT BANKING

India has already signed the General Agreement on Trade and Tariffs (GATT) which came into effect on Jan 1, 1995. This agreement provides for gradual reduction of tariffs among the member countries. Today, India bears a negligible part of international trade. GATT provides vast scope for exporting products at comparatively low price since we have advantage of cheap labour force and availability of skilled hands. In fact, there is a "hen and egg" relationship between economic growth and foreign trade.

The policy of decentralizing, delicensing, deregulation etc. has relived the industry from the age old bureaucratic control in India. The crux of this policy is that the Indian industry is being prepared to stand on its own legs so as to be able to compete with others. Merchant bankers can help in many ways for reducing our imports and increasing exports. Expert advisory and fund based services can be rendered by these banks to export oriented industries. Merchant banks can assist them for acquiring sound economic position by raising resources at National and International markets at cheaper rates. These resources can be utilized for modernization and diversification of activities of industries. This is high time for Indian merchant bankers to enter in the field of acceptance and bills discounting. Bills generated in International trade can be accepted and discounted by Indian merchant bankers.

Rapid growth of Merchant banks has given wrong impression in the minds of many persons concerned with this

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profession. One may feel frustrated. It is not uncommon to hear comments in certain quarters that many banks are starting merchant banks as a symbol of status or prestige rather than the fact that such business is self supporting and viable. But this is a very short sighted view. Rapid growth of industrialization, increasing industrial sickness and present Government policy towards cultivating habit to corporate sector for depending upon capital markets for funds, will provide excellent scope for merchant banks in India.

Due to keen competition in the open market for funds, skill to innovate new schemes, propagate them and market the same would certainly be the key to success in the future. The opportunities for merchant bankers in India today make it necessary for them to offer clients a range of corporate finance products over and above issue management. Today, corporate sector prefers to raise resources from capital market instead of borrowing them from financial institutions. In such a situation, Merchant Bankers services will be highly demanded in the years to come.

Table: 1 shows the total volume of resources raised by corporate sector. It may be observed from the table that the resources raised by the corporate sector are mainly from the Private placements and Equity issues. The amount raised through Equity issues witnessed a steady growth, while the amount raised through Private Placements led to tremendous growth over the past years. Total resources mobilized by the corporate sector are growing constantly.

Among the various intermediaries in the process of raising resources from capital market, Merchant Bankers sit on the driver's seat. Merchant Bankers can assist in regard to the time of the issue, size of the issue, instruments of the issue, premium determination, capital structuring and restructuring and other services. Private sector is riding high today. Many new companies and business establishments will come in to existence to reap the benefits of privatization. Naturally, Merchant Bankers will get increasing business in future. Today, Merchant Banking is observing quantitative development. But future cry would be for qualitative development of these banks. Issue management has become the sole source of income for major Merchant Bankers. This education must be changed in future and advisory services will have a very bright future. The business and earning of Merchant Banks are likely to be multifold. Modernization, economic enlargement process, the Government's policy of self reliance to enhance capability of reducing International debts by creating own foreign exchange resources, fuller utilization and up gradation of home technology for the expansion of the production base will offer avenues to the Merchant Bankers in raising resources and rendering advisory services.

Table: 1 Resources raised by corporate sector

(Rs. Cr.)

YEAR	DEBT ISSUE				TOTAL RESOURCES MOBILISED (2+5)	SHARE (%) OF PRIVATE PLACEMENTS IN		SHARE (%) OF DEBT IN TOTAL RESOURCE MOBILISATION
	Equity issue*	Public issue	Private Placement**	Total (3+4)		Total Debt	Total Res. Mobilization	
1	2	3	4	5	6	7	8	9
1995-96	14830	5974	13361	19335	34165	69.1	39.1	56.6
1996-97	7979	6357	15066	21423	29402	70.3	51.2	72.9
1997-98	1892	2678	30099	32777	34669	91.8	86.8	94.5
1998-99	9358	4652	49679	54331	63689	91.4	78.00	85.3
1999-00	4566	3251	61259	64510	69076	95.00	88.7	93.4
2000-01	3368	2740	67836	70576	73944	96.1	91.7	95.4
2001-02	1278	6271	64876	71147	72425	91.2	89.6	98.2
2002-03	1257	2613	66948	69561	70818	96.2	94.5	98.2
2003-04	18948	4324	63901	68224	87172	93.7	73.3	78.3
2004-05	24388	3867	83405	87272	111660	95.6	74.7	78.2
2005-06	27382	0	96368	96368	123750	100	77.9	77.9

* includes CCPS and offer to sale

** includes negligible amount of equity

Source: RBI, SEBI

GLOBALIZATION-AN OPPORTUNITY FOR INDIAN MERCHANT BANKS

Raising resources in domestic markets will not meet the growing hunger for capital of Indian corporate sector. Merchant Bankers can assist companies to raise resources at International markets. This includes Euro-

Issues as well as issues in the American market and encompasses issue of equity, bonds, convertibles, disinvestment through secondary market offerings by public sector units. Euro-issues are acid test for Merchant Bankers. The test today for merchant bankers is not the funds they can raise from the domestic markets but their ability to cash in on their repute in markets abroad.

With the Euro-issues, they float or the funds they can gather with the private placements should make with the Foreign, Institutional Investors (FII's), now active in the country. Unlike the offer to NRI's that is a part of public finances, the Euro-issue is floated abroad for the foreign investors in several countries and listed abroad. While the equity subscribed by the NRIs in Indian issues are quoted in domestic stock exchanges only, the papers floated to raise foreign currency funds, by GDR or bonds are treated only on stock exchanges abroad, where they are listed. According to the guidelines of SEBI, 75% of the issue size is to be reserved for financial institutions (FIs), mutual funds, FII's and others. It has brought about a shift of focus from small investors to large investors. The marketing efforts will now have to be aimed at these large investors. The new SEBI guidelines are likely to trigger off a greater desire among Indian corporate to go in for private placement with FII's. The biggest attraction is the premium, as FIIs are ready to buy good and potentially high value shares at market prices. Through private placements, the companies save substantial amounts usually required for domestic issues. If issues are to be placed privately with FII's, companies may prefer foreign Merchant Banker because of their access.

INFLOW OF FOREIGN INVESTMENT AND MERCHANT BANKS IN INDIA

The process of Liberalization of Indian economy will definitely invite more and more multinational corporations (MNCs). Multinational corporations have traditionally been the vehicle for the transfer of private foreign investment. But after the Second World War, their investment and production activities have increased rapidly due to Liberalization of controls over International direct investment by most of the industrialized countries.

Table: 2 shows the foreign investment inflow in India. The Indian financial market was opened to the Foreign Institutional Investors in 1992 to widen and broaden the Indian Capital Market. Table: 2 clearly shows that, FII total investment in the last three years have grown significantly. Several factors are responsible for increasing confidence of FII on Indian Capital Market which include, inter alia, strong macro-economic fundamentals of the economy, transparent regulatory system, abolition of long term capital gains tax and encouraging corporate results.

As far as the trend of FII's investment in India is concerned, it is evident from Table: 3 that, Net investments by FII's in India have been positive every year except in 1998-99. During the last three years, there has been a phenomenal increase in the portfolio investment by the FII's in the Indian market. The gross purchase of debt and Equity together by FIIs increased by 59.9% to Rs 346978 Cr in 2005-06 from Rs 216953 in 2004-05. However the net investment decline by 9.6% from Rs 45881 Cr in 2004-05 to Rs 41467 Cr in 2005-06.

In the recent years, MNCs have played a major role in the export-led growth of countries like Brazil, South Korea, Taiwan etc. To cope with MNCs, Indian corporate sector has only two alternatives, one is to improve their competitive ability and the second is to collaborate with them. Indian Merchant Bankers can help by various ways for improving the competitiveness of the Indian corporate sector. Merchant Bankers can raise adequate capital for the purpose of modernization, expansion and diversification. The corporate sector would depend on the Merchant Bankers for advice on choice of cost effective funding and efficient capital structure and use of innovative

Table: 2- Foreign Investment Inflows in India

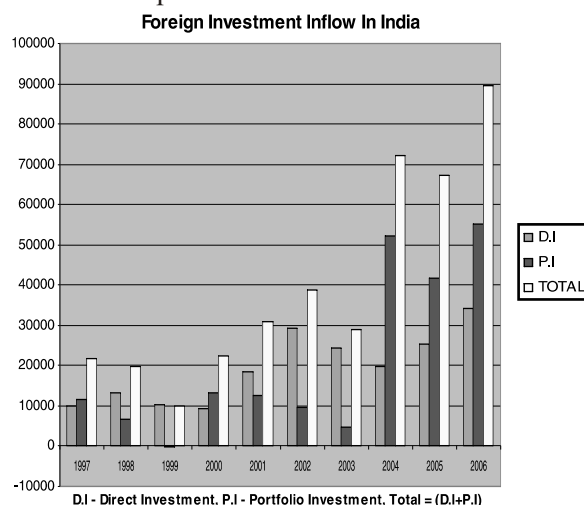
(As on 31st march)

YEAR	DIRECT INVESTMENT (Rs. Cr.)	PORTFOLIO INVESTMENT (Rs. Cr.)	TOTAL (D.I + P.I) (Rs. Cr.)
1997	10015	11758	21773
1998	13220	6696	19916
1999	10358	-257*	10101
2000	9338	13112	22450
2001	18406	12609	31015
2002	29235	9639	38874
2003	24367	4738	29105
2004	19860	52279	72139
2005	25395	41854	67249
2006	34316	55307	89623

Source: RBI

Note: *negative sign indicates outflows

Data on FDI has been revised since 2000-01



financial products. It will ultimately help the Indian corporate sector to improve its competency and efficiency.

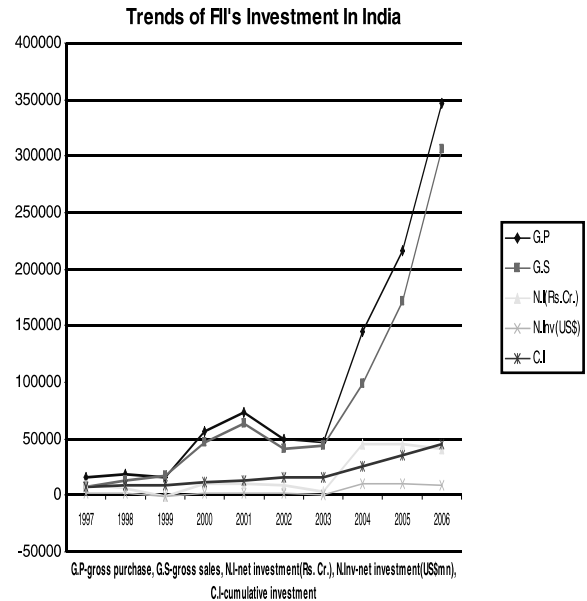
Table: 3- Trends of FII's Investment in India

(As on 31st march)

YEAR	GROSS PURCHASE (Rs.Cr.)	GROSS SALES (Rs.Cr.)	NET INVESTMENT (Rs.Cr.)	NET INVESTMENT (U.S \$ mn)*	CUMULATIVE NET INVESTMENT
1997	15554	6979	8574	2432	7634
1998	18695	12737	5957	1650	9284
1999	16115	17699	-1584	-386	8898
2000	56856	46734	10122	2339	11237
2001	74051	64116	9934	2159	13396
2002	49920	41165	8755	1846	15242
2003	47061	44373	2689	562	15804
2004	144858	99094	45765	9950	25755
2005	216953	171072	45881	10172	35927
2006	346978	305512	41467	9332	45259

Source: RBI

Note: *Net Investment in U.S \$ mn at monthly exchange rate



With the Liberalization process and the economic reforms, Merchant Banking activities have become attractive to domestic banks, consultant firms and share brokers who have now entered the field to reap the advantages of the expanding capital market.

The list of registered market Intermediaries in SEBI after the liberalization process is portrayed in Table: 4. It is evident from the table that during 2005-06, there was a marginal rise in the number of Intermediaries belonging to the group of bankers to an issue, corporate brokers and derivatives brokers. As on 31st march 2006, the number of portfolio managers was 132 as against 84 a year ago, an increase of 57% over the year. The number of underwriters, on the other hand declined in 2005-06 over the previous year. During 2005-06, 554 new brokers were registered with SEBI, the total no. of brokers registered with SEBI as on 31st march, 2006, was 9335 as compared to 9128, a year ago, a rise of 207 over the previous year. The share of corporate brokers was 42.4 % of the total brokers as on 31st march, 2006 as against 41.3 % in the previous year. The entry of certain new intermediaries in the market during 2005-06 could be attributed to good business opportunities in the securities market and rise in investors need for different types of services.

AMALGAMATION, MERGERS AND JOINT VENTURES WILL PROVIDE BRIGHT OPPORTUNITIES TO MBs IN INDIA

The factors mentioned above have encouraged a large number of companies to raise finance directly through the

Table: 4- Market Intermediaries in India

(As on 31st march)

MARKET INTERMEDIARY	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Brokers (cash seg.)	8867	9005	9069	9192	9782	9687	9519	9368	9128	9335
Corporate brokers (cash seg.)	2360	2976	3173	3316	3808	3862	3835	3746	3733	3961
Sub-brokers(cash segment)	1798	3760	4589	5675	9957	12208	13291	12815	13684	23479
Brokers(derivatives)	----	----	----	----	519	705	795	829	994	1120
Bankers to an Issue	80	72	66	68	69	68	67	55	59	60
Underwriters	38	43	17	42	57	54	43	47	59	57
Credit Rating Agencies	----	----	----	4	4	4	4	4	4	4
Venture Capital Funds	----	----	----	----	35	34	43	45	50	80
Foreign Venture Capital Investors	----	----	----	----	1	2	6	9	14	39
Registrar to an Issue	386	334	251	242	186	161	143	78	83	83
Portfolio Managers	16	16	18	23	39	47	54	60	84	132
Mutual Funds	37	38	41	38	39	38	38	37	39	38

Source: RBI, SEBI

flotation of new issues. As a result, new issue market has witnessed sharp growth during the 1980's and 90's. This is attributable both to the entrepreneurial class availing the funds provided by the market on the one hand and emergence of a growing community of investors willing to take direct investment risk in exchange of a prospect of higher earnings, on the other. Raising funds from the market calls for expert guidance and advice particularly regarding type of issue, timing of issue, preparation of prospectus, allotment of shares, refunds etc. Merchant Bankers with their professional knowledge and expertise can be very helpful to the issuing companies.¹

Amalgamation and Mergers are assuming greater significance because of the present high cost of money, long gestation period and other problems in setting up new projects further, rebates in income tax granted to a healthy unit taking over a sick unit have made Acquisitions more attractive. The much needed expertise on restructuring companies or Acquisitions or Mergers can be provided by Merchant Bankers.

The policy of decentralization and encouragement of small and medium industries will further increase the demands for technical and financial services which can be provided by Merchant Bankers.

ABOOST IN INSTITUTIONAL INVESTORS

The other important catalyst in the changing role of the Merchant Bankers is the Institutional Investors, thanks to the advent of private mutual funds, private placements of shares with FII's and SEBI's prescription of mandatory proportionate allotment for all public offerings of shares. The institutional investors are the king of the capital market.

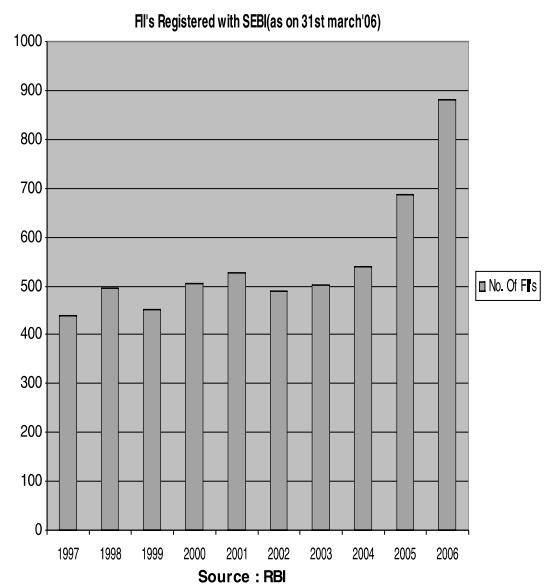
Table- 5 shows the number of FII's being registered with SEBI. From the table, we can conclude that, FII's consider India as a preferred investment destination which is evident from rapid increase in their numbers in the recent years. During 2005-06, 224 new FII's were registered with SEBI and a few were de-registered. As a result, the number of FII's registered with SEBI as on march 31st, 2006 stood at 882 as compared to 685 as on march 31st, 2005. Continuing the trend, institutions from across the globe channeled their funds to the Indian Securities Market for investments.

Table: 5 - FII's Registered with SEBI

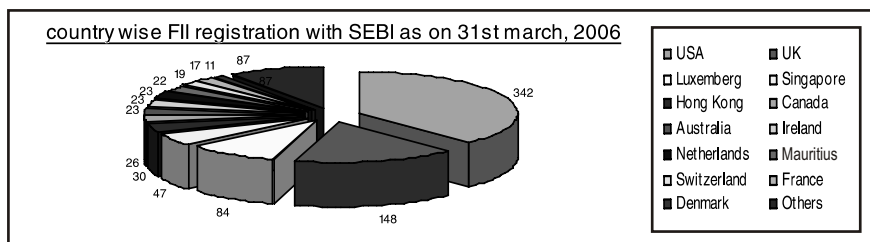
(As on 31st march, 2006)

YEAR	NO. OF FII's
1997	439
1998	496
1999	450
2000	506
2001	527
2002	490
2003	502
2004	540
2005	685
2006	882

Source: RBI



As on march 31st, 2006 SEBI has registered FII's from 37 countries. The highest number of FII's was from USA (342), followed by UK (148). About 90% FII's come from the top 13 countries. There has been increase in the no. of FII registrations from non-traditional countries like, Malaysia, Australia, Belgium, Saudi Arabia, Trinidad, Canada, Sweden, Ireland etc. Following chart presents the country wise FII registration with SEBI as on march 31st, 2006.



The Merchant Banker has now to satisfy the needs of a totally different class of investors, and this is a global phenomenon.² Merchant Bankers have to acquire update knowledge of international markets. With the process of globalization and privatization, the number of these investors will increase and will provide more business to Merchant Bankers.

Nature of competition in this industry is going to change the range of services offered by the existing Merchant Bankers. Merchant Bankers cannot depend entirely on activities like public issues, rights issues, underwriting etc. as this is not going to provide enough business to all Merchant Bankers. As a result of this, role of Merchant Bankers in India is going to change drastically and their new areas of activities would be project appraisal, advising on corporate capital restructuring, corporate counseling, venture capital etc. With the entry of multinationals in the country that are more experienced in this field, Indian Merchant Bankers must improve on all aspects in order to compete with them. New innovations in financial products are also going to see light with sophistication and institutionalization of markets.³

Failure of primary capital market in raising funds through public and right issues again proved the limitations of Indian Merchant Banking depending upon certain activities for their incomes. Depression in certain industries throughout the world, collapse of many East-Asian country's share markets, high premium charged by issuers in India, low returns on investment in shares and other instruments, unethical role played by Indian Merchant Bankers etc. have badly affected the primary capital market and Merchant Banking business in the country.

Table: 6 shows the list of resources mobilized from the Primary Market. It may be observed from the table that Public issues experienced huge increase (612%) during 2003-04. Rights issue and IPO experienced mixed growth rate. The abolition of CCI's office, and free pricing of public and rights issue led to tremendous growth of capital market after 1991-92, however, Indian Primary Capital Market has miles to go to acquire stability and International standards.

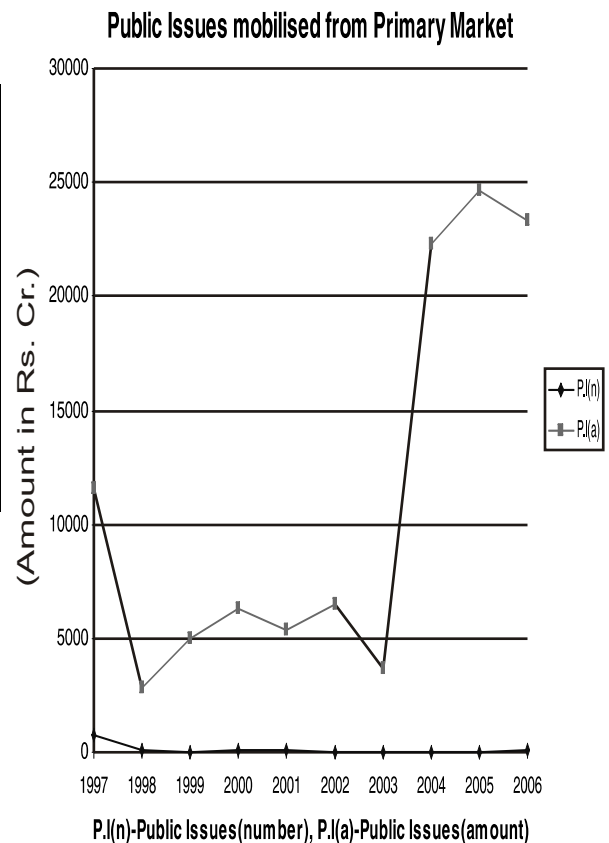
The Indian Merchant Bankers have already taken effective steps to ensure a smooth graduation. A Merchant Banker should not forget his increased social responsibility in an economy with growing investor class. The investor relies on the recommendation of the Merchant Bankers in deciding where to put his hard earned money. It is the correctness of these recommendations which builds up the credibility of a Merchant Banker, and it is this credibility which ensures his success.

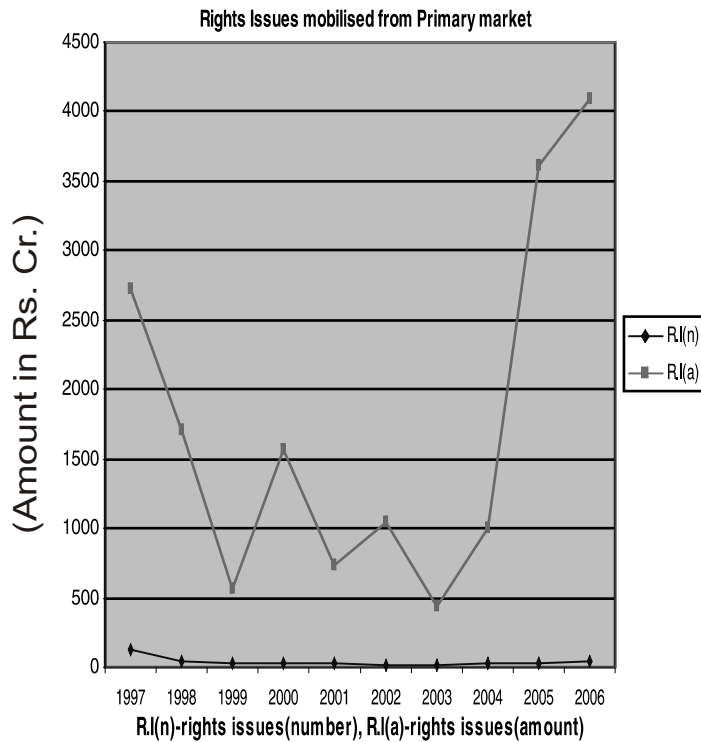
Table: 6 - Resources mobilized from Primary market

(Amount in Rs.cr)

YEAR	PUBLIC ISSUES		RIGHTS ISSUES		PO's	
	Number	Amount	Number	Amount	Number	Amount
1997	751	11557	131	2719	717	5959
1998	62	2862	49	1708	52	1048
1999	32	5019	26	568	18	404
2000	65	6257	28	1560	51	2719
2001	124	5378	27	729	114	2722
2002	20	6502	15	1041	7	1202
2003	14	3639	12	431	6	1039
2004	35	22265	22	1007	21	3434
2005	34	24640	26	3616	23	13749
2006	103	23294	36	4088	79	10936

Source: RBI, SEBI





CONCLUSION

The establishment, growth, functioning of these banks depends upon the Government policy to the large extent. For the all-round development of these banks, sound policy is the basic requirement. Merchant Banking in England could develop due to the appropriate decisions taken by the British Government time to time.

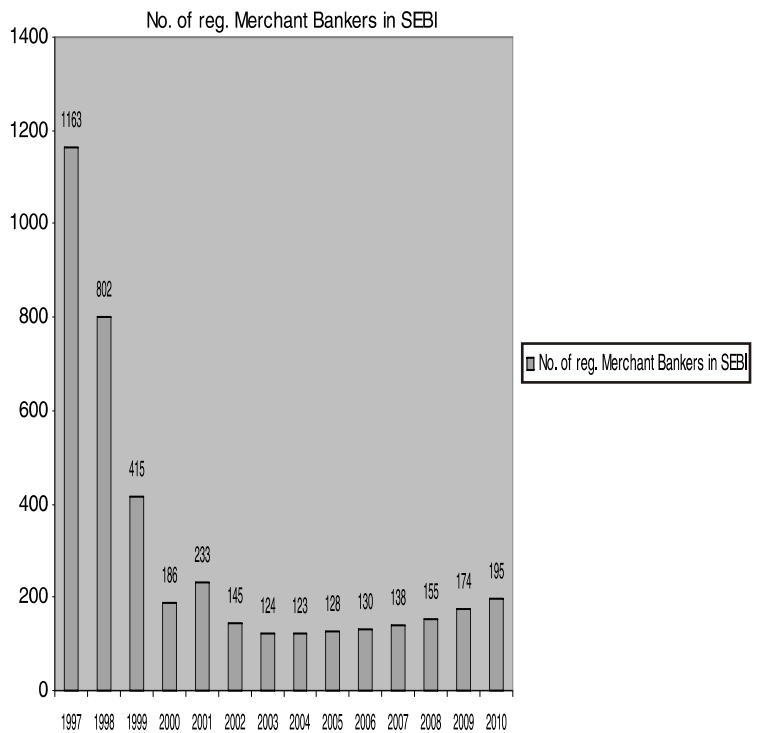
Taking into consideration all the above mentioned factors, projections regarding number of Merchant Bankers in India are being provided in the Table: 7.

Table 7-Projection for Merchant banking in India by 2010

(As on 31st march)

YEAR	NUMBER OF REGISTERED MERCHANT BANKERS IN SEBI
1997	1163
1998	802
1999	415
2000	186
2001	233
2002	145
2003	124
2004	123
2005	128
2006	130
2007	138*
2008	155*
2009	174*
2010	195*

Source: RBI, SEBI
 Note: * represents the projected data



Note: 2007 onwards represents projected data's

The table discloses registration of Merchant Bankers with SEBI up to 31st march, 2006. The keen observation of the data reveals that the percentage of registered Merchant Bankers is showing declining trends, but it may be on A/c of heavy amount of net-worth (Rs. 5Cr.) for category I Merchant Banks and lack of getting sizeable business to retain in the profession. It is also because of guidelines issued by SEBI. According to these amendments, Merchant Bankers were required to segregate their fee-based Activities from Fund based Activities. Obviously, category II, III and IV Merchant Banks will lose their existence.

The past few years have seen major changes in India's economic policies making a new phase in India's development strategy. The reform's aim at reducing the extent of Government controls over various aspects of the domestic economy, increasing the role of the private sector regarding scarce public sector, resources to areas where the private sector is unlikely to enter and opening up the economy to trade and foreign investment. The objectives of the current reforms are based on a much clear recognition of the need to integrate with the global economy through trade, investment and technology flows and to create conditions which will give healthy environment for entrepreneurs.

Our country has good infrastructure facilities base. It is expected that India would be a leading lender in the 21st century. For setting up new companies, expansion of the existing and modernization will require huge amount. The corporate sector will largely depend upon primary capital market for raising the funds. Merchant Bankers have to manage these issues; it will increase the number of Merchant Bankers in India. Indian capital market is leading towards maturity. More investors are trying to invest their funds in securities; it will provide increased business to Merchant Bankers in the country. Many private Mutual Funds are likely to set up in near future; these mutual funds may demand securities of corporate sector and Merchant Bankers will try to exploit the situation. FII's are increasing their stake in the investment in Indian securities; it will also provide a good business opportunity to the Merchant Bankers. Also the primary capital market of India is less volatile as compared to other countries markets. Indian corporate sector will encash this opportunity, by the help of Merchant Bankers. It will lead towards increase in number of Merchant Bankers. Today, Merchant Bankers are rendering their services in Metropolitan cities only. In the end of 21st century, these banks may be established in medium cities also to meet the needs of services of the corporate sector. It will automatically increase the number of Merchant Bankers in the country. It is thus clear that Merchant Bankers have bright future in India. The demand for Merchant Banking services will be ever expanding due to promotion of new companies, expansion and renovation schemes of existing units, mergers and acquisitions, nursing of sick units etc. All these causes will definitely increase the number of Merchant Bankers, so there is a bright future for the Merchant Bankers in the upcoming years.

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