CAPITAL MARKET INSTRUMENTS

A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market). The capital market is characterized by a large variety of financial instruments: equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc.

1. SECURED PREMIUM NOTES

SPN is a secured debenture redeemable at premium issued along with a detachable warrant, redeemable after a notice period, say four to seven years. The warrants attached to SPN gives the holder the right to apply and get allotted equity shares; provided the SPN is fully paid.

There is a lock-in period for SPN during which no interest will be paid for an invested amount. The SPN holder has an option to sell back the SPN to the company at par value after the lock in period. If the holder exercises this option, no interest/ premium will be paid on redemption. In case the SPN holder holds it further, the holder will be repaid the principal amount along with the additional amount of interest/ premium on redemption in installments as decided by the company. The conversion of detachable warrants into equity shares will have to be done within the time limit notified by the company.

Ex-TISCO issued warrants for the first time in India in the year 1992 to raise 1212 crore.

2. DEEP DISCOUNT BONDS

A bond that sells at a significant discount from par value and has no coupon rate or lower coupon rate than the prevailing rates of fixed-income securities with a similar risk profile. They are designed to meet the long term funds requirements of the issuer and investors who are not looking for immediate return and can be sold with a long maturity of 25-30 years at a deep discount on the face value of debentures.

Ex-IDBI deep discount bonds for Rs 1 lac repayable after 25 years were sold at a discount price of Rs. 2,700.

3. EQUITY SHARES WITH DETACHABLE WARRANTS

A warrant is a security issued by company entitling the holder to buy a given number of shares of stock at a stipulated price during a specified period. These warrants are separately registered with the stock exchanges and traded separately. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends.

Ex-Essar Gujarat, Ranbaxy, Reliance issue this type of instrument.

4. FULLY CONVERTIBLE DEBENTURES WITH INTEREST

This is a debt instrument that is fully converted over a specified period into equity shares. The conversion can be in one or several phases. When the instrument is a pure debt instrument, interest is paid to the investor. After conversion, interest payments cease on the portion that is converted. If project finance is raised through an FCD issue, the investor can earn interest even when the project is under implementation. Once the project is operational, the investor can participate in the profits through share price appreciation and dividend payments

5. EQUIPREF

They are fully convertible cumulative preference shares. This instrument is divided into 2 parts namely Part A & Part B. Part A is convertible into equity shares automatically /compulsorily on date of allotment without any application by the allottee.

Part B is redeemed at par or converted into equity after a lock in period at the option of the investor, at a price 30% lower than the average market price.

6. SWEAT EQUITY SHARES

The phrase `sweat equity' refers to equity shares given to the company's employees on favorable terms, in recognition of their work. Sweat equity usually takes the form of giving options to employees to buy shares of the company, so they become part owners and participate in the profits, apart from earning salary. This gives a boost to the sentiments of employees and motivates them to work harder towards the goals of the company.

The Companies Act defines `sweat equity shares' as equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

7. TRACKING STOCKS

A tracking stock is a security issued by a parent company to track the results of one of its subsidiaries or lines of business; without having claim on the assets of the division or the parent company. It is also known as "designer stock". When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock. Oftentimes, this is done to separate a subsidiary's high-growth division from a larger parent company that is presenting losses. The parent company and its shareholders, however, still control the operations of the subsidiary.
Ex- QQQQ, which is an exchange-traded fund that mirrors the returns of the Nasdaq 100 index

8. DISASTER BONDS

Also known as Catastrophe or CAT Bonds, Disaster Bond is a high-yield debt instrument that is usually insurance linked and meant to raise money in case of a catastrophe. It has a special condition that states that if the issuer (insurance or Reinsurance Company) suffers a loss from a particular pre-defined catastrophe, then the issuer's obligation to pay interest and/or repay the principal is either deferred or completely forgiven.

Ex- Mexico sold $290 million in catastrophe bonds, becoming the first country to use a World Bank program that passes the cost of natural disasters to investors. Goldman Sachs Group Inc. and Swiss Reinsurance Co. managed the bond sale, which will pay investors unless an earthquake or hurricane triggers a transfer of the funds to the Mexican government.

9. MORTGAGE BACKED SECURITIES(MBS)

MBS is a type of asset-backed security, basically a debt obligation that represents a claim on the cash flows from mortgage loans, most commonly on residential property. Mortgage-backed securities represent claims and derive their ultimate values from the principal and payments on the loans in the pool. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages as they are classified under the MBS.

- Mortgage originators to refill their investments
- New instruments to collect funds from the market, very economic and more effective
- Conversion of assets into funds
- Financial companies save on the costs of maintenance of the assets and other costs related to assets, reducing overheads and increasing profit ratio.
- Kinds of Mortgage Backed Securities:
- Commercial mortgage backed securities: backed by mortgages on commercial property

  Collateralized mortgage obligation: a more complex MBS in which the mortgages are ordered into tranches by some quality (such as repayment time), with each tranche sold as a separate security

  Stripped mortgage backed securities: Each mortgage payment is partly used to pay down the loan's principal and partly used to pay the interest on it
- Residential mortgage backed securities: backed by mortgages on residential property

10. GLOBAL DEPOSITORY RECEIPTS/ AMERICAN DEPOSITORY RECEIPTS

A negotiable certificate held in the bank of one country (depository) representing a specific number of shares of a stock traded on an exchange of another country. GDR facilitate trade of shares, and are commonly used to invest in companies from developing or emerging markets. GDR prices are often close to values of related shares, but they are traded and settled independently of the underlying share.

Listing on a foreign stock exchange requires compliance with the policies of those stock exchanges. Many times, the policies of the foreign exchanges are much more stringent than the policies of domestic stock exchange. However a company may get listed on these stock exchanges indirectly – using ADRs and GDRs.

If the depository receipt is traded in the United States of America (USA), it is called an American Depository Receipt, or an ADR. If the depository receipt is traded in a country other than USA, it is called a Global Depository Receipt, or a GDR.

But the ADRs and GDRs are an excellent means of investment for NRIs and foreign nationals wanting to invest in India. By buying these, they can invest directly in Indian companies without going through the hassle of understanding the rules and working of the Indian financial market – since ADRs and GDRs are traded like any other stock, NRIs and foreigners can buy these using their regular equity trading accounts!

Ex- HDFC Bank, ICICI Bank, Infosys have issued both ADR and GDR

11. FOREIGN CURRENCY CONVERTIBLE BONDS(FCCBs)

A convertible bond is a mix between a debt and equity instrument. It is a bond having regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stock. *FCCB is issued in a currency different than the issuer's domestic currency*.

The investors receive the safety of guaranteed payments on the bond and are also able to take advantage of any large price appreciation in the company's stock. Due to the equity side of the bond, which adds value, the coupon payments on the bond are lower for the company, thereby reducing its debt-financing costs.

Advantages

- Some companies, banks, governments, and other sovereign entities may decide to issue bonds in foreign currencies because, as it may appear to be more stable and predictable than their domestic currency
- Gives issuers the ability to access investment capital available in foreign markets
- Companies can use the process to break into foreign markets
- The bond acts like both a debt and equity instrument. Like bonds it makes regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stock
- It is a low cost debt as the interest rates given to FCC Bonds are normally 30-50 percent lower than the market rate because of its equity component
- Conversion of bonds into stocks takes place at a premium price to market price. Conversion price is fixed when the bond is issued. So, lower dilution of the company stocks

Advantages to investors

- Safety of guaranteed payments on the bond
- Can take advantage of any large price appreciation in the company’s stock
- Redeemable at maturity if not converted
- Easily marketable as investors enjoys option of conversion in to equity if resulting to capital appreciation

Disadvantages

- Exchange risk is more in FCCBs as interest on bond would be payable in foreign currency. Thus companies with low debt equity ratios, large forex earnings potential only opted for FCCBs
- FCCBs means creation of more debt and a FOREX outgo in terms of interest which is in foreign exchange
- In case of convertible bond the interest rate is low (around 3 to 4%) but there is exchange risk on interest as well as principal if the bonds are not converted in to equity

- If the stock price plummets, investors will not go for conversion but redemption. So, companies have to refinance to fulfill the redemption promise which can hit earnings
- It remains a debt in the balance sheet until conversion

13. DERIVATIVES

A derivative is a financial instrument whose characteristics and value depend upon the characteristics and value of some underlying asset typically commodity, bond, equity, currency, index, event etc. Advanced investors sometimes purchase or sell derivatives to manage the risk associated with the underlying security, to protect against fluctuations in value, or to profit from periods of inactivity or decline. Derivatives are often leveraged, such that a small movement in the underlying value can cause a large difference in the value of the derivative.

Derivatives are usually broadly categorised by:

- The relationship between the underlying and the derivative (e.g. forward, option, swap)
- The type of underlying (e.g. equity derivatives, foreign exchange derivatives and credit derivatives)
- The market in which they trade (e.g., exchange traded or over-the-counter)

<u>Futures</u>

A financial contract obligating the buyer to purchase an asset, (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price. Futures contracts detail the quality and quantity of the underlying asset; they are standardized to facilitate trading on a futures exchange. Some futures contracts may call for physical delivery of the asset, while others are settled in cash. The futures markets are characterized by the ability to use very high leverage relative to stock markets.

Some of the most popular assets on which futures contracts are available are equity stocks, indices, commodities and currency.

<u>Options</u>

A financial derivative that represents a contract sold by one party (option writer) to another party (option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (excercise date).

A call option gives the buyer, the right to buy the asset at a given price. This 'given price' is called 'strike price'. It should be noted that while the holder of the call option has a right to demand sale of asset from the seller, the seller has only the obligation and not the right. For eg: if the buyer wants to buy the asset, the seller has to sell it. He does not have a right. Similarly a 'put' option gives the buyer a right to sell the asset at the 'strike price' to the buyer. Here the buyer has the right to sell and the seller has the obligation to buy.

So in any options contract, the right to exercise the option is vested with the buyer of the contract. The seller of the contract has only the obligation and no right. As the seller of the contract bears the obligation, he is paid a price called as 'premium'. Therefore the price that is paid for buying an option contract is called as premium.

The primary difference between options and futures is that options give the holder the right to buy or sell the underlying asset at expiration, while the holder of a futures contract is obligated to fulfill the terms of his/her contract.

14. PARTICIPATORY NOTES

Also referred to as "P-Notes" Financial instruments used by investors or hedge funds that are not registered with the Securities and Exchange Board of India to invest in Indian securities. Indian-based brokerages buy India-based securities and then issue participatory notes to foreign investors. Any dividends or capital gains collected from the underlying securities go back to the investors. These are issued by FIIs to entities that want to invest in the Indian stock market but do not want to register themselves with the SEBI.

RBI, which had sought a ban on PNs, believes that it is tough to establish the beneficial ownership or the identity of ultimate investors.

15. HEDGE FUND

A hedge fund is an investment fund open to a limited range of investors that undertakes a wider range of investment and trading activities in both domestic and international markets, and that, in general, pays a performance fee to its investment manager. Every hedge fund has its own investment strategy that determines the type of investments and the methods of investment it undertakes. Hedge funds, as a class, invest in a broad range of investments including shares, debt and commodities.

As the name implies, hedge funds often seek to hedge some of the risks inherent in their investments using a variety of methods, with a goal to generate high returns through aggressive investment strategies, most notably short selling, leverage, program trading, swaps, arbitrage and derivatives.

Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year.

16. FUND OF FUNDS

A "fund of funds" (FoF) is an investment strategy of holding a portfolio of other investment funds rather than investing directly in shares, bonds or other securities. This type of investing is often referred to as multi-manager investment. A fund of funds allows investors to achieve a broad diversification and an appropriate asset allocation with investments in a variety of fund categories that are all wrapped up into one fund.

17. EXCHANGE TRADED FUNDS

An exchange-traded fund (or ETF) is an investment vehicle traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day. Most ETFs track an index, such as the S&P 500 or MSCI EAFE. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features, and single security can track the performance of a growing number of different index funds (currently the NSE Nifty)

18. GOLD ETF

A gold Exchange Traded Fund (ETF) is a financial instrument like a mutual fund whose value depends on the price of gold. In most cases, the price of one unit of a gold ETF approximately reflects the price of 1 gram of gold. As the price of gold rises, the price of the ETF is also expected to rise by the same amount. Gold exchange-traded funds are traded on the major stock exchanges including Zurich, Mumbai, London, Paris and New York There are also closed-end funds (CEF's) and exchange-traded notes (ETN's) that aim to track the gold price.

References:-
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