INDUSTRIAL FINANCE AND INVESTMENT IN INDIA

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good."

EUGENE BLACK
President, World Bank

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I

The financing of industries can be divided under two main heads — finance required for capital expenditure on industrial projects and finance required for its working, what is called as the Working Capital. In any industrial project, detailed estimates are made of what it costs to have the necessary plant, machinery and building, accessories and equipment. After obtaining reliable estimates of the costs, an estimate of the total cost of capital expenditure is made. Under our laws no company can be floated without the consent of the Controller of Capital Issues. The Controller of Capital Issues is to be satisfied that the capital determined for the new project is sufficient to meet all the capital expenditure. This capital may include provision for the working capital that will be required. Otherwise, the sponsor must indicate the arrangements that will be made, through banks or other parties, for securing adequate working capital for the project.

There are different ideas as to the form the capital should take. It varies with the nature of the project. It may take the form of equity capital or ordinary shares which means that the public is invited to take the risk of the business from the very start. In some cases, the capital is divided into Preference Capital and Ordinary Capital. There is a certain body of investors in this country which does not like to take the risk involved in participating in the equity capital. If it is satisfied with the soundness of an industrial project, it is content to get a fixed return on the money invested. And, therefore, certain promoters of companies divide their initial capital requirements under Preferred Capital and Ordinary Capital.

Generally a sort of ratio is maintained and the ratio of preference to total capital is usually not allowed to exceed 50%.

Preferred Capital is generally issued in the form of what is called Cumulative Preferred Capital. It might take two or three years to complete the project. People who take Preferred Capital are entitled to earn their dividend from the date the shares are allotted to them. In certain cases, where projects are of a large magnitude and are likely to take a longer period to complete, the law provides that with the permission of the State government, the full interest need not be paid on preferred capital. If the preferred capital is at 6%, in the initial period, the company is allowed to pay at only 4% till the project is completed. The payment of interest is treated as part of the capital expenditure so that the company can earn depreciation on this part of the capital expenditure also. In any case, the investor who is interested in buying preference shares is the type which is satisfied with a fixed and assured return when the industry starts earning. As it not infrequently happens, there are fluctuations in the fortunes of any industrial project. If in any particular year the industry does not earn enough to pay the dividend on the preference share, the investor has the assurance that in the following years when the company makes sufficient profits all the arrears of dividend will be paid first before the equity shareholder comes in to share the profits.

The issue of Preference Capital and Ordinary Capital is also influenced by the conditions of the capital market at the time the floatation is made. The rates of taxation are important factors to be considered.

The industrialists, when they float companies, do not generally subscribe to preferred capital. Being sponsors of the project and assured of the soundness of the project, they always prefer to take long-term risk and take only equity capital. The advantage of subscribing to equity capital is obvious. If a company prospers, the returns, though they may vary from year to year, are bound to be much higher than in the case of fixed return on preferred capital. Equity capital provides larger scope for capital appreciation. If the project succeeds and is able to show a consistent return over a period of years, a Rs. 100-share is bound to fetch Rs. 120 or Rs. 150 or even Rs. 200 in course of time.

In some cases, where very large capital is required as in the case of electrical undertakings, a part of the initial capital is raised in the form of Debentures. Since the magnitude of capital involved in such projects is very large, the sponsors have to tackle institutional investors such as insurance companies and investment corporations who like to play more safely and prefer to buy debentures. A debenture is a security which already carries a first lien mortgage on the property of the company. It requires a very delicate balancing in the capital structure as to what extent the capital assets of the company can be mortgaged in advance, and to what extent it can be left to the other type of investors, the usual buyer of preferred capital and buyers of risk capital. By and large, issue of debentures at the first stage is not frequent. It is only in special cases, where very large capital outlays are involved, that this sort of financing has to be resorted to. Mainly it is distributed between preferred capital and ordinary capital.

Till a few years ago, the law permitted the issue of Deferred Capital, which was almost always a small proportion of the total capital issued. The sharing of profits by deferred capital was as follows: A fixed return on preferred capital had to be paid first. The Articles of Association used to provide for the payment of certain return on the ordinary capital after which came the deferred shareholder. A certain proportion of the balance of profits would again be divided between the ordinary shareholder and the deferred shareholder. Generally this type of capital was issued for mining companies where the risk was larger and also the prospect of profits was very large too. In India, the most prominent case was in respect of the Tata Iron and Steel Company where a small proportion of the initial capital was in the form of Deferred shares of Rs. 30. When Tata Iron and Steel Co. after a few years prospered, particularly during the First World War, these 30-rupee shares went up to as high as Rs. 1,600. One year they earned a dividend of Rs. 160. This illustrates that deferred capital is one which carries the maximum risk and has also the maximum scope for large returns and large capital acquisition. Unfortunately, this practice led to very extensive speculative activities on the stock exchange. Shares were quoted at one time as high as Rs. 1,600 and at another time as low as Rs. 30. The issue of Deferred Capital is now abolished. Companies which had deferred capital were given a certain period of time to convert their deferred capital into ordinary capital.

This is the usual form in which capital is raised. Let us now consider the sources from which capital for industrial projects is obtained in India. Generally, the sponsors of projects make themselves responsible for raising all the capital. In Western countries, there are Issue Houses and Underwriting Firms. For a commission which varies from ½% to 2½%, the Issue House will undertake to raise all the capital. They will underwrite in the sense that to the extent to which the public response is not adequate they make good the capital requirement.

In India, unfortunately, except in a very sporadic sort of way, we have not got large Issue or Underwriting Houses. The result is that the sponsors of industrial projects have the additional responsibility of raising all the capital they require. In recent years, certain developments have taken place in the financing of industries through the creation of special agencies. For instance, in 1955, the Industrial Credit and Investment Corporation of India was started. It is a very unique type of organisation. For the first time in Indian history, there was a corporation in which 10% of the capital was subscribed by private American investors, 20% by private British investors and 70% was raised in India. Of this, the bulk came from banks and insurance companies. Another special feature of I.C.I.C.I. is that from the very start the Government of India gave it an interest free deposit of Rs. 7½ crores repayable in instalments in 15 years.

The main objective of forming I.C.I.C.I. was to do in a large way the underwriting of new issues. When new issues are made, after a close scrutiny of the soundness of the project, I.C.I.C.I. underwrites the issue. During the course of the last five years, a number of sugar companies, paper companies and engineering works have been started in India with the assistance of I.C.I.C.I.

The difficulty of raising capital in India is great. The investor is shy and generally goes by the name under whose sponsorship the issue is made. If the investor feels that the promoter is a person who has experience of successfully running an industry, that issue gets a ready response. Where the promoter is a person who is not sufficiently known to the investing public, the response is comparatively very poor. The unsuccessful issue of a company dealing in rayon which did not get adequate response in spite of the bright future held for the Rayon industry is a case in point. Any number of examples could be given of even small issues, essentially sound, which have not been able to collect the entire sum required.

Our banks, like many other institutions in this country, have developed on British lines. Therefore, they are essentially commercial banks. The main feature of a commercial bank is that, since the major part of its working resources is based on current deposits which are repaid on demand, it pursues the conservative method of investing funds in a way in which they would be readily available if there is a demand for withdrawal. However, the big banks in India today have built up a position whereby they enjoy sufficient credit with the public. They have also been able to build up sufficient reserves. The Reserve Bank Committee on Finance for the Private Sector, of which I was the Chairman, felt that a little change in the outlook of our banks was needed. The Committee suggested the formation of a consortium of banks, insurance companies and investment corporations which could fill the gap in underwriting facilities for industrial issues. This idea has not yet taken practical shape.

If India, particularly the Private Sector, is to develop on a large scale, underwriting facilities of this type are imperatively needed.

It is interesting to study how, coupled with certain statutory laws, these difficulties of raising capital affect the medium and small-scale industries. One of the most obnoxious features in our taxation law is Section 23-A(I). It says that if more than 50% of the shares are held by less than six people, then a certain percentage of the profits must be distributed. Many medium-scale industries are set up with the greatest difficulty by people with small means. They are unknown to the public and, therefore, unable to attract adequate public capital. They are started and made prosperous with the assistance of friends, banks and the like. They come under the mischief of Section 23-A(I). Whereas, normally an industry like this will be satisfied distributing 10% or 20% of its distributable profits, they are compelled under the law to distribute 50% of the profits. It must be appreciated that it is this type of people who should plough back into their industry the maximum they can out of the profits they make. Capital formation is impeded both at the stage of the company expanding its resources and also at the stage where the individual shareholders have to give away under the higher slabs of super tax a large proportion of the dividends which they earn from these companies. If medium and small-scale industries are to be promoted in this country, either Section 23-A(I) will have to be completely done away with or suitably modified to make it possible for these industries to plough back as much of the profits as they can.

So far as working capital is concerned, it is not a matter of difficulty except in case of very small establishments. Working capital is generally supplied by banks on what is called hypothecation. Stocks of raw-materials, stores, spare parts and finished goods are hypothecated to a commercial bank. Varying with the nature of the goods, the bank will demand a margin of about 15% to 25% and against that advance cash credit. Interest is not paid by the party on the maximum limit but on the amounts drawn under that limit. There has not been any marked dearth of working capital for industries except in cases of emergencies. For instance, in the case of the cotton textile industry, where stocks of finished goods accumulated to an unusual level a couple of years ago, the companies found it difficult to get all the working capital within the limits prescribed by the banks.

The extent of working capital varies with different industries. In the case of an egineering industry, the requirement is much larger than in the case of a consumer goods industry like shoe-making. This is because the amount of raw-material that has to be carried is larger and the processing time is much longer. The amount of working capital in relation to the total amount of output in the year is much larger in the case of the engineering industry than in the case of, say, the cotton textile industry. With exceptions like this, the general principle is to provide for about Rs. 30 to Rs. 35 as working capital for every Rs. 100 of output. This amount allows for stocks of necessary raw-materials, finished goods, stores and spares.

II

Investment as an art is not a very simple or easy subject to deal with. I can recall how as a young boy I watched my father discuss an investment of Rs. 2,000 with his broker. The broker looked very serious, and explained to my father the wide range of investments available then – 3½% Government of India loan and 4% Bombay Port Trust bonds. He was telling my father that these 3½% Government of India loans had pulled up to Rs. 100-1-6; but the Port Trust Bonds were still cheaper to buy at Rs. 98-8-0, even allowing for risk. Investment has completely changed since those days.

It is after the First World War that we saw the real beginnings of industrialisation in this country. A number of new industrial issues were made in those days, and many of them flopped too after a little while. Perhaps, there is some similarity between the conditions which have prevailed on the investment market during the last few months in India and of the experiences of the days soon after the end of the First World War with, of course, one very important difference. The difference is that today recognised stock exchanges in India are working fairly efficiently. There is a wide-spread and increasing interest in investments among the general public and there is a much greater variety and range of investments to pick and choose from.

I have been connected with the investment market in one way or another since 1924. One thing which I have learnt and which every stockbroker and every big investor learns is that there are no hard and fast rules about investment. Investments, the desirability of investments and the selection of investments – all these vary with the status and the needs of the person who is investing.

What may be considered as good, sound and first-class investment for one person need not be quite suitable for another. For instance, and more especially now with high levels of taxation, people who have a fairly large income do not make their investments in order to add to their income which with the differential scale of taxation on unearned income leaves very little in the end with the investor. And, therefore, the attitude of such people towards investment is something very different from the attitude of a person who invests his money with the avowed object of earning an income.

It has been rightly said that an intelligent investor must know the technique and the operations of the stock exchange. Unless he knows that, he is more likely to go wrong than right, even allowing for all the other necessary qualifications one must have to be able to make the right investments.

About two years ago, the Prime Minister said that the stock exchanges are noisy places and the sooner they are abolished the better. The Prime Minister has acquired a reputation for saying things about questions on which he is not particularly qualified to speak. If ever he made a wrong and ignorant statement, it was this, because, if the present economy continues and we do not become a communist country in all but name stock exchanges will continue to play a very useful and important role in the economy of the country.

This fact is forgotten by the critics of the stock exchange because their criticism arises out of ignorance of the work of stock exchanges. It is the stock exchange which provides both mobility and liquidity of capital. Unless liquidity of capital is assured, an investor would hesitate to invest as freely as he is doing today. There may be faults and weaknesses in the working of some of our stock exchanges, but by and large the Bombay Stock Exchange at any rate may be described as a model stock exchange for us in India.

We do not often remember that stock exchanges are very delicate institutions. Stock exchanges do not move upwards and downwards mechanically and in accordance with rigid rules or laws. They are influenced by a large number and variety of forces.

There is the classic instance of the London Stock Exchange. The news of the death of Queen Anne brought about a complete collapse of the market. More recently the news that the then President Eisenhower had caught cold immediately produced repercussions on the New York Stock Exchange. The New York Stock Exchange is such an important and potent factor in the investment market of the world, that any excitement there is soon reflected on other exchanges of international importance.

Discreet and indiscreet pronouncements by Ministers, which unfortunately are too frequent in this country, very quickly and sometimes very deeply affect the operations on the stock exchanges. The gentlemen who make these pronouncements do not perhaps have the foggiest idea as to the consequences of the statements that they make and how they might affect the fortunes of thousands of people in the country.

Humble and innocent men who have made their investments on the best advice available, and who are not speculators in any sense of the word, may get up one morning to find that the value of their investments had fallen disastrously consequent on the appearance in the newspapers of some ill-considered statement by someone in authority.

It is highly desirable that investors as a class should know something about the working of the stock exchanges. I have been a member of the Bombay Stock Exchange for more than 15 years and I am very proud of the Bombay Stock Exchange. There is one suggestion though I wish to offer. I have the good fortune of meeting a number of members of the Bombay Stock Exchange every day and, therefore, perhaps I am in a position to assess the character, knowledge and intelligence of the average stockbroker.

If the habit of investment is to spread in this country, the average broker has to change his attitude to the investment business. The broker has to be a very well-informed person. It annoys me to find a broker who comes and asks, as they often do, what I think of a particular share. What is expected of a broker is that he should go to his client and tell him what his opinion is of a particular share.

During a recent tour of the United States, I visited a number of brokers' offices. I was much impressed with one thing which I saw. Almost every office had a research organisation of its own. The literature which they produced was so intelligent, well-informed, and well-thought out that they could give a real lead to the investing clients. With very few exceptions, our brokers in Bombay have yet to acquire such an attitude.

The average client, of course, cannot be expected to be well informed about shares. What the investor expects, therefore, is a proper lead from a member of the stock exchange. And that lead can be relied upon only if the broker himself runs an organisation in his office where they collect the necessary statistical and other relevant information not only in respect of the individual units in an industry but also give the client some idea of the state of the industry as a whole. When a client is told that the cotton textile industry has been doing extremely well during the last few months, he rushes to buy any textile share he can lay his hands on without sufficient knowledge as to the reliability of the investment he makes.

It is, therefore, very necessary that brokers on stock exchanges ought to build research organisations of their own through which they could not only keep the investing community well-informed about the state of the companies whose scrips are recommended, but also provide it with general information about various industries.

Under present conditions the choice of investment is a very difficult and complicated business.

Apart from the financial standing of the industrial unit whose scrip is recommended, there are many other considerations which one has to take into account.

For instance, Government actions and international developments affect directly or indirectly the profitability of business everywhere, including this country. Considerations of this nature, unless they are brought pointedly to the notice of the clients, will be missed out, and what on the basis of isolated bits of information may be regarded as a good and sound investment may ultimately turn out to be not so.

As a matter of fact, there is a very clear distinction between speculation and gambling. In the first place, those who are in the habit of criticising speculators do not sufficiently appreciate the meaning of speculation.

Speculation is really nothing else than taking a view of things, so to speak; and this is just what the key men in business or industry are doing all the time – taking a view. Speculation is not, therefore, a piece of extraneous devilry but something that is inherent in normal business. Speculation, however, degenerates into gambling when the man who takes the view in the way we have described enters into transactions which he has not the capacity to support. It is only at this level that speculation can be said to degenerate into gambling.

But speculation by itself is something which is essential to and unavoidable in modern business. As explained earlier, whether you are trading on the stock exchange or commodity markets or running an industry, you cannot successfully operate unless you are prepared to take a view of things, to assess, to evaluate.

The man who runs the cotton textile industry has to take a certain view of the cotton market, and, has to secure his cotton requirements at the right time.

Similarly, in selling his products, he has to take the right view of conditions in the cotton market. So taking a view, right or wrong, which is inherent in business, is something that cannot be stigmatised as gambling; it is speculation, and a right and healthy kind of speculation.

The average investor, unfortunately, is not sufficiently well informed about the working of the stock exchange. When as a broker I recommended a scrip to my lay client I was often faced with the query: "If this scrip is as good as you say it is, it will not be offered for sale. No one will want to sell it." This is exactly where investment turns into an art.

There are on the stock exchange at any given time, on any day, two sets of opinion. The most interesting thing about the stock exchange is that with the same set of facts before them, two sections take quite opposite views. It is because of the existence and continuance of these two sections, that the stock exchanges operate efficiently.

Because there are two sections of antithetical opinion at any given time pulling in different ways, the stock exchange provides a ready market and liquidity of investments.

When I tell someone that the production of two million tons of Tata Steel is a bullish factor and, therefore, I would buy Tata Steel Shares, another operator working on the same set of factors takes a wholly different view and argues that if Tatas have expanded their capacity to two million tons, the Government has also put up three steel factories; and this means that there will be overproduction in steel, and, therefore, Tatas cannot make the same amount of money as they have hitherto made.

It is because two contrary views in the same set of circumstances operate at any given time that the liquidity of investment becomes possible. If this was not so my lay client would be fully justified in asking me why if Tata Steel is good, anybody would want to sell Tata scrips?

With the wide range of securities which are offered today on the stock exchanges, both in India and abroad, and the multiplicity and complexity of factors which affect operations, investment has become a specialised business.

Investment is not something the knowledge of which one can pick up over-night and straightway proceed to claim that he has become an authority. If you come across someone who tells you that he has *always* bought his investments at the lowest and sold them at the highest, you would be right in putting him down as a boaster or a cheat. There is nothing like infallibility in investment.

As a matter of fact, investment is called an art and not a science precisely because there is no one who has always bought at the lowest and sold at the highest. The stock market provides enormous scope for skill in buying and selling at all ranges and levels.

There are two other things which I have learnt about the business of investment during my long career of 37 years. One is that the profit taken is never lost. I know of people who have made a decent profit on their investments, and still regret that they did not wait to sell at a higher price. But profit taken is profit taken; it is never lost.

Similarly, the man who has learnt to cut his losses will never find himself in the insolvency court. Of course, it is difficult to know when to cut the losses. More people have come to grief because they have not developed the courage and capacity to take their losses than from any other single cause. These are two very simple and useful lessons which one learns from one's experience on the stock exchange.

It is my belief that if I have made an investment and a decent profit of 20% on my capital, I have done an excellent piece of business. Similarly, if I cut my losses at 10%, 15% or 20%, I feel I should be satisfied. It is people who have not yet developed the sort of courage that comes only from experience, that cannot take their losses. It should be the business of a good and experienced broker to take care to see that his client is advised at the right time to cut his losses.

Of course, it is very difficult to go to a client to whom you have recommended a scrip at Rs. 120 now quoted at Rs. 110 to advise him to sell it out. Human nature being what it is, the client might look askance at your advice. All the same it is the business of a good broker to see that the client cuts his losses at the right time.

There is however one special reason more than any other why we call investment an art. Investment, which is a highly specialised business today, is something which cannot be consciously learnt. It is something which comes to a man as though by intuition.

To succeed one must have a natural flair for speculation. One must be able to sense as if by instinct the movements of the market. It is only when one has acquired this ability that one can hope for a reasonable degree of success. This is also true of bankers. Bankers have to exercise a lot of discretion and discrimination; but they have learnt to do this because they know by intuition how to react to a given set of circumstances at a given time.

I have claimed that investment is a very specialised type of business. Unfortunately, this is not a truth which is generally recognised in our country. But if you consider the developments in the last 25 or 30 years, in particular in the U.S. and the U.K., or more recently in West Germany and Holland, you will find that investment has come to be increasingly recognised as a new profession and a highly specialised art.

That is why in the U.S. during the last 20 years there has been a great development in Mutual Funds. Mutual Funds are called Unit Trusts in the U.K. or West Germany.

The idea works out in some such way as this. There are the sponsors, who are always specialists in investment. They form a body of management and make a portfolio. They select 15 or 20 or 25 different stocks and make a portfolio out of that. Let us suppose the portfolio is $100,000. These 100,000 dollars are split up into 10,000 or 20,000 units of 10 dollars or 5 dollars each. And the units are then offered to the public.

The buyer of a five-dollar unit immediately acquires some interest in a wide range of industrial stocks of which the management makes a portfolio. The buyer of a 5-dollar unit has the confidence that his interests are being looked after by a body of experts who have made investment their profession. The institution has grown rapidly in the United States.

A couple of years ago, we had a visit from a very distinguished man who played an important part in the development of Mutual Funds in America. He controlled through his Mutual Fund a sum of money amounting to $2.7 billion. When he started he had a mere $50,000. Mutual Fund is a very sound idea.

The average investor in the U.S. is not less ignorant than the average investor in India. But he has come to recognise that investment is so expert a business that he should leave his savings to some reliable sponsors who could look after his investments more intelligently than he could. Mutual Fund gives the small man the sense of satisfaction that with his small capital of $100 or $500, he has acquired an interest in most of the leading industrial stocks in the country.

From the country's point of view, it has a tremendous advantage, in that it makes possible the mobilisation of small and medium capital on an increasingly large scale. The funds which are accumulated by the Mutual Funds in the United States to the extent of over $30 billion have served as a sort of pipeline assuring a continuous flow of capital for the expansion of industries.

These Mutual Funds have now come to occupy a very important and influential position in the investment markets of the U.S. so much so that the managers of the Mutual Funds are very anxiously sought after by Wall Street people. If any big new issue is to be made, the first thing the big issue houses on Wall Street do is to get into touch with the managers of the Mutual Funds, who at any given time have large amounts of funds to invest.

These funds are the aggregate of the contributions of thousands of people made through their 5 dollar and 10 dollar investments a month. The same sort of development is taking place in the U.K.

In 1959, I met a very interesting person who happened to be the first to write about Unit Trusts. Till then there were no authoritative publications on this subject. The author is a Member of Parliament and an investor by profession. He started with £300 and in three years' time his Unit Trust was worth £4 billion.

I think the Unit Trust would be a useful institution in our own country. Because of the low level of education in India the small man's savings either remain uninvested or go into small savings certificates or Government bonds. I suggest that these savings need to be mobilized to the highest degree for the large-scale development of the national economy.

The dividends are paid to the investors every year after management charges – which are only ½% in the U.S. (and in some of the big mutual funds it is as low as ⅜%) – are deducted. The entire income is distributed among members of the mutual fund. It is the individual who, if he comes within the purview of direct taxation, pays the taxes.

The idea of Unit Trusts is being discussed in Delhi and the first reaction is most unfavourable. Our short-sighted tax-gatherers do not favour the idea because they fear that the government would lose a lot of revenue since Unit Trusts could claim exemption. Then there are also other men who feel that if Unit Trusts are encouraged in India, the Government will not be able to get money for the small savings schemes.

These men might be told that the experience in the U.S. and the U.K. is very different. The savings-cum-deposits in the U.S. during the last 20 years has percentagewise not been affected by Unit Trusts, although over $30 million have been collected by the Mutual Fund. As a matter of fact, Mutual Fund serves as a direct encouragement to the saving habit. A discreet and deserving investor gradually develops the attitude that if he puts Rs. 500 in a Unit Trust, he would also like to keep Rs. 200 in a savings bank.

The fillip which has been given to the saving habit in the U.S. and the U.K. is so phenomenal that Governments themselves are encouraging the starting and working of Unit Trusts and Mutual Funds in those countries.

"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

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