Choice
Nurturing Financial Excellence

EQUITY FINANCING
A GUIDE TO EQUITY FUND RAISING

Business finance is needed in all types of organizations large or small, manufacturing or trading. The amount of finance differs from one business firm to another depending upon its nature and size. It also varies from time to time. Business finance involves estimation of funds. It is concernedwith raising funds from different sources as well as investment funds for different purposes.

Business owners can utilize a variety of financing resources, typically broken into two broad categories, debt and equity. “Debt” involves borrowing money to be repaid, plus interest. “Equity” involves raising money by selling interests in the company.

Advantages of Equity Financing:

- There is no compulsion to pay dividends. If the firm gas insufficiency of cash it can skip equity dividends without suffering any legal consequences.
- Equity capital has no maturity date and hence the firm has no obligation to redeem.
- Because equity capital provides a cushion to lenders it enhances the creditworthiness of the company. In general others things being equal the larger the equity base the greater the ability of the firm to raise debt finance on favourable terms.
- The equity dividends are usually paid annually, as against interest payments, which are required to be paid either monthly or quarterly.
- Presently, equity dividends are tax exempt in the hands of investors.

Disadvantages of Equity Financing:

- Sale of equity shares to outsiders dilutes the control of existing owners.
- The cost of equity capital is high usually the highest. The rate of return required by equity shareholders is generally higher than the rate of return required by other investors.
- Equity dividends are paid out of profit after tax whereas interest payments are tax deductively expenses. This makes the relative cost of equity more. Partially offsetting this advantage is the fact that equity dividends are tax exempt whereas interest income is taxable in the hands of investors.
- The cost of issuing equity shares is generally higher than the cost of issuing other types of securities. Underwriting commission, brokerage costs and other issue expenses are high for equity issues.

Volatility in Indian Markets:

As we all are aware, the Euro crisis has affected the world economy, and India is no exception to this. In mid-November 2011, the union finance minister Mr. Pranab Mukherjee had said that the financial crisis in Europe is likely to affect the Indian economy. He also said that taking into account the current global economic scenario, the Gross Domestic Product (GDP) growth rate will be less than the targeted nine percent at the end of this fiscal.

In the month of November 2011, foreign funds withdrew over Rs 3,200 crore from the Indian securities market, amid concerns over the worsening debt crisis in the Eurozone. According to the data available with the SEBI, overseas investors purchased stocks and debt securities of Rs 62,296 crore and sold securities of Rs 65,559 crore during the month of November 2011. The market analysts believe that this heavy sale by FIIs was triggered by the debt crisis in the Eurozone. This, coupled with weakening of the rupee, rising inflation and high interest rates have resulted in high volatility in the Indian capital markets.

In light of the above, companies with a more conventional approach to management and/or average credit rating often rely on equity capital for their funding needs. Companies can also opt to obtain equity financing by selling company stock to employees, ESOP, sharing control of the company with them rather than with outside investors. A lowly geared company will be at safe place as dividend has to be paid only when company is making profit; whereas a highly geared company has to pay interest (which is mandatory as per the Company law) each quarter/half year/yearly. The economic situation now where interest rates are going up also increases the problem for highly geared companies. In the recent past, some of the highly geared companies were forced to either sell out its fixed assets or raise fresh equity to meet the interest costs.

Conclusion:

Accordingly, in the current market scenario, raising funds through equity funding is safe as compared to debt, especially for small and medium scale enterprises, requiring funds of uptoRs 100 to 125 crores, to ensure long-term benefits to all stakeholders.

However, before they resume their funding quest, the business owners should identify the different sources of capital and are encouraged to diligently work on meeting the required criteria. This includes ample industry research, the creation of an effective business plan, and credit report maintenance and repairs. While personal savings and money from family and friends can be readily available, it may not be enough to raise capital.

An efficient capital structure creates a balanced system for sustainable value creation for all stakeholders, even in such volatile market conditions.