CAPITAL MARKET BRIEFINGS

PUBLIC EQUITY CAPITAL MARKETS

EMERGING TRENDS AND THIER SIGNIFICANCE FOR STOCK EXCHANGES

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Economics & Research
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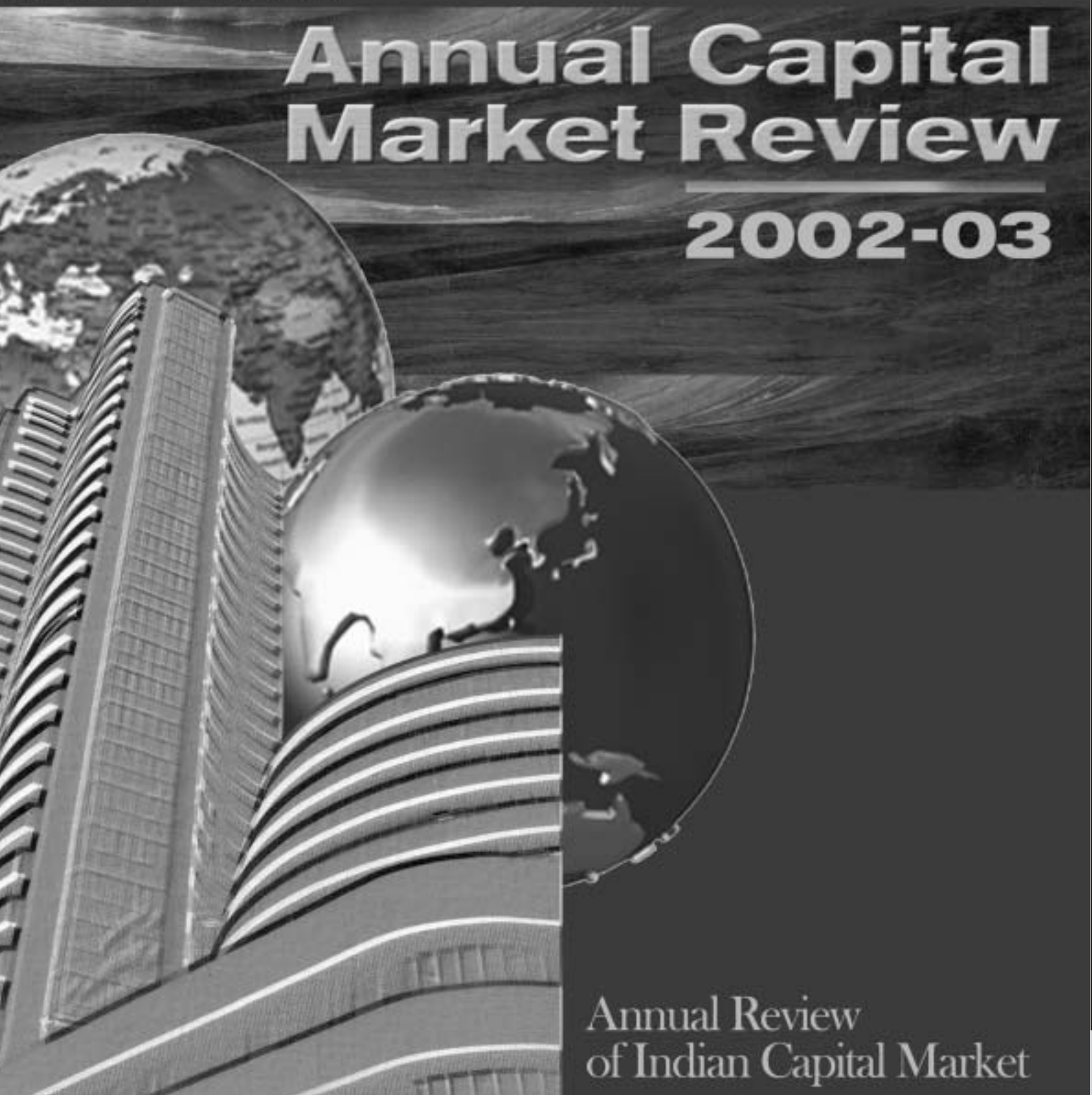
Annual Capital Market Review

2002-03



Annual Review
of Indian Capital Market

Public equity capital has for a long time played a stellar role in the world of finance. These have been predominamt sources of efficient raising of finance by corporates leading to development of the domestic economies and also emerged as major avenues for promoting saving and investment. Public equity capital markets thus are of great significance to the domestic economic growth. The 1990s witnessed tremendous growth of public equity capital markets due to a wide range of factors which include (a) policy thrust on development of domestic securities markets (b) sudden surge in investor interest in the securities markets, (c) rapid pace of privitasation and (d) expansion in corporate activity on the back of deregulation and globalisation. However the pace of its growth has been restrained in the recent years, largely owing to downturn in the equities prices and as also intense competition arising from the private equity capital markets. The recent recovery of the equities markets witnessed a great surge in secondary markets, however the pace in primary markets has not been that robust. For developing economies, the importancs of public equity capital markets is very significant in its growth process. This brief presents an overview of major issues concerning the growth of public equity capital markets including the critical support measures required from the government, regulatory authorities, stock exchanges and other related institutions.

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Introduction

Markets are on the move again. Bourses are bouncing back and the stock prices are soaring. Uncertainties in the economic fundamentals however still linger. There might be some good news in the US, but Europe remains vulnerable and so as Japan. Emerging markets, on the other hand, look pretty promising with a lot of clean up going on in Latin America, Asia fast recouping its economic strength and some parts of Africa showing good signs of progress. Financial stability remained firm despite the last three years of market meltdown and severe erosion in the personal and corporate wealth and a rash of bankruptcies. Concerns continue on the corporate and individual debt, which rising so rapidly, could breach tolerance levels and pose problems to the sustainability of the economic recovery. Mature economies slipping into fiscal deficits could have its own implications in the medium term that might not be desirable.

Nevertheless, stock markets that were in dire straits since the current decade began, are heaving a sigh of relief. Secondary markets are once again in the limelight with prices and volumes rising at a fairly significant pace. Since April this year, Dow Jones Industrials was up by 18 percent, Nasdaq up by 47 percent, FTSE –All World by 15 percent and S&P 500 by 20 percent. This trend is evident in emerging economies too. Spain's Ibex is up 32 percent, India's Sensex by 60 percent, Argentina's Mervel by 117 percent and Thailand's SET by a staggering 104 percent.

Prospects for Primary markets are pretty promising however private equity is providing a keen competition.

The situation at the primary markets however does not appear that promising. Except a few instances in some exchanges, new issuance remains luke warm. For the recent gains in the secondary markets to sustain over a long term, it is important that the primary markets too revive leading to overall vibrancy in the securities markets.

There is enough scope for the primary markets too pick up the momentum. With economic expansion likely to pick up pace, so will be the demand for financial resources. The Asian economies are once again revving up and that could generate more demand for finance. If Latin America consolidates, demand for finance will surge there and banks with their recent experience in Argentina might not be too willing to chip in. With returns from fixed income markets reaching a plateau, investor interest may once again turn towards equities. Banks with the onset of Basel II, and heavy exposures in the telecom and information technology that are currently facing slowdown, would be less inclined to loan aggressively and might chose more of secure lending options.

All this makes the prospects for primary markets pretty promising. At the same time, constrains face the public equity capital markets in the form of keen competition from other financing mechanism such as private equity, which has emerged as a powerful financing tool in the recent period. Venture capital funds, private equity, leveraged buyouts, mezzanine financing etc., are emerging as more potent forms of competitive financing mechanisms that are eating into the business of the public equity capital markets. The competition could intensify further with greater liberalization of capital markets and the deregulation of cross border flows.

Public equity capital markets for long have played a stellar role in helping the economic growth process by enabling and assisting corporates to raise critical financial resources at fairly lower costs. Their contribution is immense in providing risk capital crucial for the corporates and new businesses. They also have undergone a massive transformation and change in the form of adopting best practices, greater transparency and disclosure, wider and frequent dissemination of information to investors, helping and assisting the regulators in creating a conducive environment of healthy growth of securities markets. It is precisely due to proactive initiatives of the public equity markets that enabled massive entry of retail investors into securities markets in the last two decades and helped policy framework to underline the importance of development

of equity markets as an important aspect of the financial policy both in mature and emerging economies.

It is in this context that it is considered relevant to consider a few aspects of the scope and further development of public equity capital markets. This paper presents a few perspectives in this regard, such as their features, significance, recent growth and prospects and problems in the background of rapid rise in the private equity markets.

The paper is arranged in this manner. The **importance of equity markets** in general is discussed first. This is considered important from the point of view of looking at the present position of equity markets in the international world of financing**.** Then the **key drivers of equity markets growth** are discussed. Features of the **public equity capital markets** are explained followed by the features of the **private equity**. A broad **comparison of public vs. private equity** and issues relating to these two broad segments are covered in which the **costs and returns** in particular are analyzed. And overview of the implications of the **emerging trends and the policy responses alongwith the supporting measures expected from the Government, Regulatory agencies, Stock exchanges and Corporates etc.,** is given as a summing up.

Importance of Equity Markets

Equity markets remained largely public for quite long. Public equity has a long history dating back to about 200 years. The first publicly issued security can be tracked back to the 14th Century in Venice.

In 1693, King William of England raised one million pounds from the public at a fixed interest rate of 10 percent. A year later, the Bank of England was formed. The largest company at that time to get listed was the South Seas Company, which was listed in 1711. The company also set what is termed as the first stock market crash. It was about 60 years ago the first steps in promoting private equity emerged which made rapid progress that intensified in the 1990s.

Stock exchanges world over reported a market capitalization of US$45 trillion, a trading volume of US$41 trillion, listings of about 40,000 companies and mobilized capital to the tune of US $4 trillion during the period 1995 and 2002.

The decade of 1990s has been spectacular for the equity markets. Stock Exchanges were the major platforms through which corporates were raising sizeable portion of their financial requirements. Stock exchanges during the period 1995-2000 together enabled corporates to raise about US$ 4 trillion of capital through public offerings. Total public equity outstanding in the United States has grown from US$1.5 trillion in 1980 to US$17 trillion in 1999 registering more than a 12-fold increase.

Equatization became the hallmark of international finance in the last two decades, during which period, world market capitalization and trading turnover more than doubled as percent of the gross domestic product and exceeded it substantially in several mature and emerging economies. For instance, according to the World Federation of Exchanges, stock exchanges world over reported a market capitalization of US$45 trillion, a trading volume of US$41 trillion, listings of about 40,000 companies and mobilized capital to the tune of US$4 trillion during the period 1995 and 2002. With growing international evidence of equity market liberalization leading to a rise in real economic growth and aided by strong policy support, equity markets showed spectacular growth in the decade of the 1990s with world market capitalization growing by 141 percent and trading volumes by 450 percent. In a quick span of time market capitalization has exceeded the size of the gross domestic product in several countries including the emerging economies.

Equity markets experienced rapid expansion and growth in the decade of 1990s but their share in financing is still relatively low. According to recent data provided by the International Monetary Fund, bonds, equity and bank assets in the world amounted to US150 trillion in 2001. Of this, bank assets account for a major chunk (US$ 79 trillion) followed by debt securities ($41 trillion) and value of stocks ($29 trillion). Stock market capitalization which formed just 19 percent of the total value of bonds, equities and loans in 2001 might have further eroded in the next two years following the depressed conditions in the equity markets. The share of stock market capitalization to the total of bank assets and bonds is relatively low in both mature and emerging economies. For instance, in the US, which is the capital of international finance, the share of stock market capitalization is about 25 percent of the total of bonds, equities and bank assets, where as this ratio for United Kingdom is about 20 percent and interestingly in Japan is it half of that (10 percent). In emerging economies this ratio stood at about 13 percent but in some regions the average is bit higher; 15 percent in Latin America and 14 percent in Asia while it is 12 percent in Middle East. For the world as a whole, where as bank deposits formed more than twice that of the gross domestic product (256 percent) and debt securities nearly one and half times (134 percent), it is just about 93 percent in respect of stock market capitalization, which must have further declined in the last two years.

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Importance of Capital Markets (USD billion)

	GDP	Stock Market Capitalization	Debt	Bank Assets	Total	Percentage of GDP
World	32,163.70	22077.4	43357.6	85002.5	150,437.50	467.7
European Union	8652.8	5524	12603.3	34712.8	52840.1	610.7
Euro Area	6,672.90	3467.5	10071.5	25899.2	39438.2	591
North America	11,182.40	11625.8	19829.6	24329.1	55784.5	498.9
Canada	736.1	570.2	814.9	1200	2585.1	351.2
United States	10,446.30	11055.6	19014.7	23129.1	53199.4	509.3
Japan	3992.9	2069.3	7005.1	15348.6	24423	611.7
EU Countries						
Austria	204.8	33.6	308.8	564.1	906.5	442.7
Belgium	246.2	127.5	555.9	2352.9	3036.3	1233
Denmark	172.6	76.7	334.4	646.3	1057.4	612.7
Finland	131.2	138.8	130.4	360.9	630.1	480.2
France	1,438	905	1789.3	6420.9	9115.2	633.9
Germany	1991	686	3204.6	8391.6	12282.2	616.9
Greece	133.3	66	173	181.4	420.4	315.4
Ireland	122.5	59.9	107	422.1	589	480.9
Italy	1188.4	477.1	2026.6	2538.7	5042.4	424.3
Luxembourg	20.6	24.6	29.4	592.2	646.2	3137.2
Netherland	419.3	442.6	870.9	2350.6	3664.1	873.8
Portugal	122.1	44.8	159.4	340.5	544.7	446.1
Spain	655.4	461.6	716.2	1383.3	2561.1	390.8
Sweden	241.1	179.1	339	769.3	1287.4	534.1
United Kingdom	1566.3	1800.7	1858.4	7398	11057.1	706
Emerging Market Countries:	7,297.80	1806.1	2524.1	10612	14942.2	204.7
Asia	3447.5	1259.8	1472.7	6997.8	9730.3	282.2
Latin America	1640.2	308.5	652.1	1667	2627.6	160.2
Middle East	810.3	52.5	18.9	840.8	912.2	112.6
Africa	448	116.5	68.5	589.1	774.1	172.8
Europe	951.7	68.6	311.9	517.3	897.8	94.3

Source : International Monetary Fund

As a source of mobilization too the share of equity markets is relatively lower. Between 1997-2001, in the major emerging markets, of the US$3430 billion domestic finance mobilized, most of it came from bonds (69 percent) and bank loans (26 percent) with only a little coming from the equity markets (5 percent). Similarly in the financial resources raised in the international markets of $598 billion, once again it is the most that came through bonds (51 percent) as compared to 36 percent from bank loans and the only 13 percent from equities.

The developments in the last three years have been particularly difficult for securities markets in several ways. A few instances of market abuses have eroded credibility of the securities markets but also led to massive retrenchment of investors. Securities markets witnessed huge erosion in the market cap and trading volumes. Some of the newly established exchanges that are primarily built around the listing of new generation companies in the technology and telecommunication such as Neuer Markt (Germany) and Jasdaq (Japan) have even ceased their operations. Among those adversely affected by the fall out of the market meltdown is the growth of public equity markets (primary markets), which are still appearing listless. To sustain the recent revival of the secondary markets, it is important that the public equity markets too show a strong revival, but the signals in this regard are not strong.

Revival of the primary markets and resurgence of new issuance forms crucial aspects that govern the significance of the securities markets in the immediate future. It should also form a major agenda of the strategies and solutions that could be evolved for ensuring sustainable growth of the securities markets worldwide.

Key Drivers of Public Equity Markets

Growth of public equity markets was fuelled by major factors, which include;

- Greater thrust on development of local securities markets in the overall financial policy of the economies and in pursuing the agenda of economic reforms
- Better performance of equity markets in respect of returns on investments.
- Rapid economic growth in the 1990s that resulted in a large number of corporates accessing equity markets for financial resources.
- Equity markets emerged as an important alternative to investors to expand and diversify risk and rewards.
- Liberalization and deregulation of financial markets provided greater access to cross border financial flows that expanded the scope of the equity markets and enhanced their reach.
- Large-scale privatization programmes/and allowing state owned companies to access equity markets for part of their resource mobilization programme in a large number of mature and emerging economies that led to sizeable spurt in the equity market activity.
- Rapid transformation in the operations of the stock exchanges with greater thrust on disclosure and transparency.
- Introduction of efficient processes such as book building that substantially reduces the costs.
- Rapid progress in on-line trading and electronic trading platforms, which made trading in securities instant and more transparent.
- Securities settlements which shrank from anywhere upto 15 to 2 days at present (T+2)
- Greater focus on better monitoring and surveillance to avoid deviances in the market practices.
- Primary market issuance emerging as an important avenue for investment banks. For instance, investment bank in the US earned anywhere upto $75 billion only from underwriting alone in a good year (2000)

PUBLIC EQUITY CAPITAL

Public equity markets are those where corporates raise resources through IPOs by getting listed in the stock exchanges. Public equity markets are subjected to a wide range of governance, disclosure, transparency and compliance norms set by the securities exchanges commissions/ government agencies and also the self-regulatory functions set by the exchanges themselves. Institutional and retail investors mostly use this channel.

The distinct advantages of the public equity capital are:

a. Lower cost of capital for the firm

b. Provide liquidity for current stockholders

c. Shift monitoring costs for private lenders

d. Firm can learn from information contained in the stock price movements.

However, public equity capital has some costs too. These include

a. Disclosure of proprietary information

b. Agency costs of outside equity

c. Costs of reporting/filing with regulators/exchanges

d. Costs of corporate control

e. Underpricing

A few features generally observed in the respect of the IPO markets include:

Number of New Issues		
	Jan-01	Jun-03
Euro	106	18
UK	399	201
Japan	206	94
Korea	5	25
India	107	22

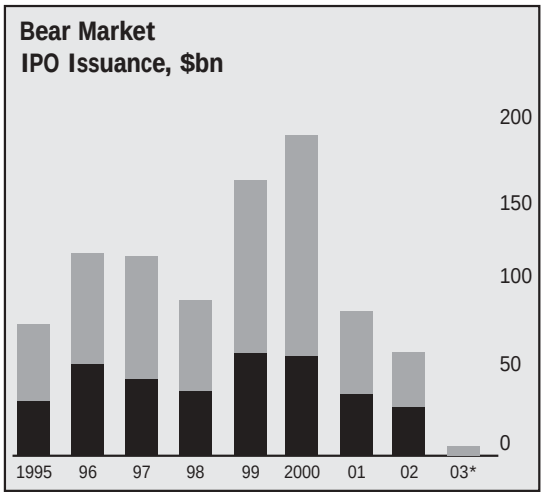
- Typically, IPO prices are below the level that they reach on the market a few days or weeks later, when more public information is available (under pricing). However the extent of underpricing will narrow with several companies coming up for listing.
- Each IPO generates beneficial information externalities for other companies that are about to go public.
- Privatized companies tend to list in public equity markets that offering better legal protection of shareholders.
- The decisions to go public are affected by firms' ownership structure. When company has only one owner or when banks holds majority shares, companies are less likely to prefer public equity.

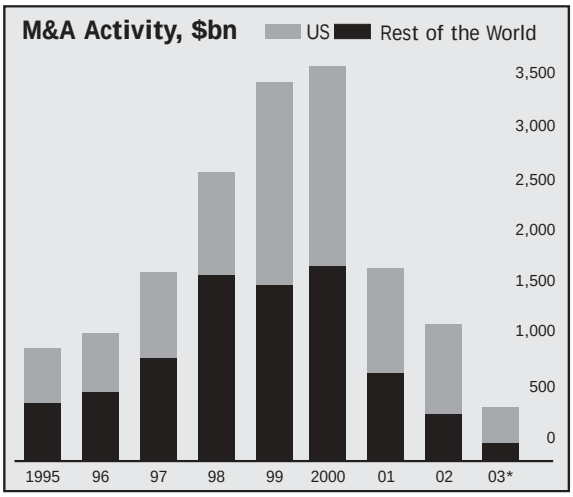
Deregulation of the cross border financial flows that particularly intensified the pace of portfolio and foreign direct investment flows have greatly encouraged the growth of the public equity capital markets worldwide. Aided by technology, design and distribution of innovative products and services, real time data generation and dissemination enabled rapid growth of stock exchanges. The very forces of deregulation and globalization that enabled the public equity capital markets to grow at astounding rates have also unleashed intense competition that generated alternatives that now pose a great challenge to their future.

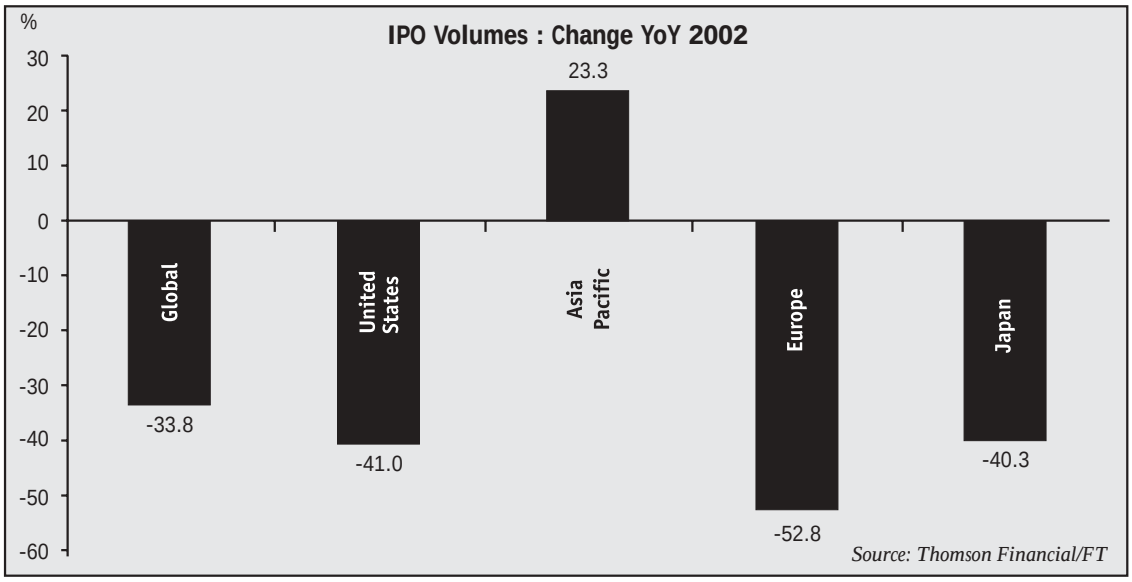
Recent Performance

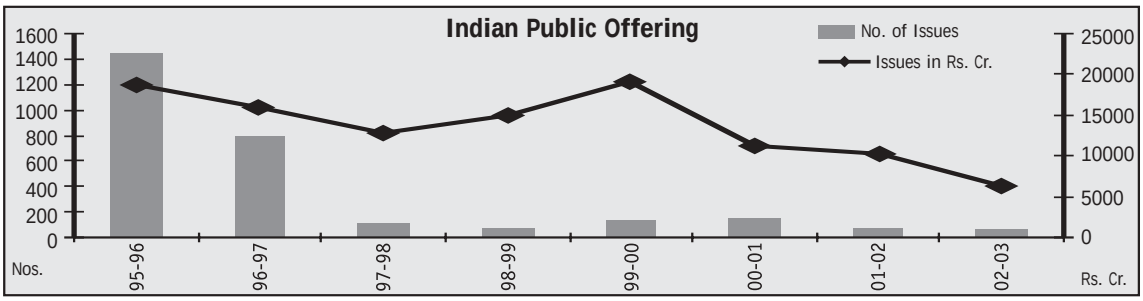
The performance of the public equity capital markets has been adversely affected in the recent period due to a host of factors, which include;

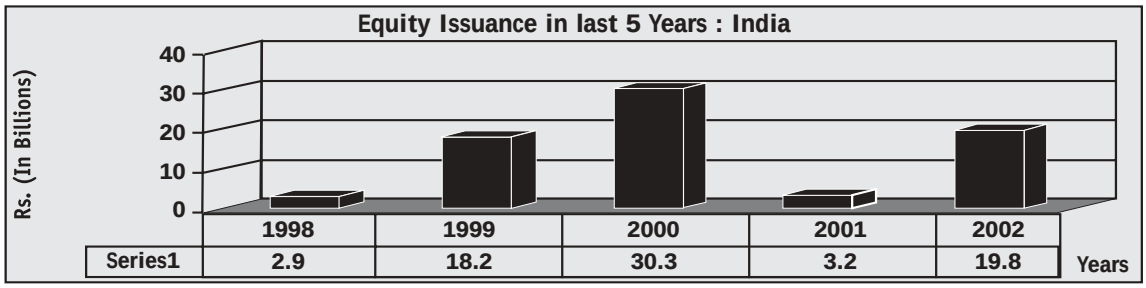
- General decline in the secondary market activity and equity prices owing to cyclical downturn
- A spate of investigations into the conduct of investment banks and corporates on the processes involved in the IPO management and share allocations.
- A large number of firms that emerged in telecom and technology sectors were not able to fit into the framework of conventional IPO guidelines that induced them to look at alternative financial markets. Private equity, venture funds etc., emerged as the most effective financing mechanisms that eroded the scope of the public equity capital markets in the new generation products and services.
- Stringent listing norms and regulatory compliance that made listing in the public equity capital markets costly and cumbersome. Recent developments such as enforcement of Sarbanes Oxley Act that puts greater onus on the company directors responsible for the corporate conduct made the public equity markets more vulnerable.











Exchanges	Newly Listed Companies			Delistings		
	2002	2001	%	2002	2001	%
TSX Toronto	106	84	26.2	118	181	-34.8
NYSE	151	144	4.9	145	215	-32.6
Nasdaq	121	144	-16	535	815	-34.4
Sao Paulo	13	10	30	42	36	16.7
Deutsche Borse	6	21	-71.4	na	na	na
JSE South Africa	9	11	-18.2	69	85	-18.8
London	201	245	-18	261	287	-9.1
BME	514	__	__	33	___	__
Hong Kong	117	88	33	6	11	-45.5
Jakarta	22	31	-29	6	2	200
Korea	25	16	56.3	34	30	13.3
Kuala Lumpur	56	20	180	2	3	-33.3
Mumbai	23	33	-30.3	168	91	84.6
Thailand	24	10	140	11	6	83.3
Tokyo	94	93	1.1	82	48	70.8

SOURCE: WORLD FEDERATION OF EXCHANGES

DELISTINGS : REASONS

COMPULSARY DELISTING	VOLUNTARY DELISTING
Non-payment of listing fees	Listing fees payable to the Stock Exchange is burdensome and disproportionate to the benefits accruing
Non-compliance with listing requirements	Number of public holders of the securities is reduced to so low a level (due to private placement issue or otherwise) that it does not justify the securities to continue to be listed
Non-compliance with provisions of the Listing Agreement	Regional imbalance of the holders of the securities either due to shifting of the companies registered office or location of manufacturing unit
Absence of trading or negligible trading	Negligible trading or total absence of trading for a considerably long period of time
Whereabouts of the company not known	The company has either suspended its business or is under closure or has become a sick industrial company
Unfair trading practices	Small capital base or failure to comply with the requirement of increasing the capital, not justifying listing to be continued
Reduction in the number of public holders of securities	Mergers, demergers, amalgamations, takeovers, etc
Non-redressal of investors' complaints despite repeated reminders	
Other malpractices such as fake originals or duplicate share certificates deliberately issued by the management	

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Private Equity

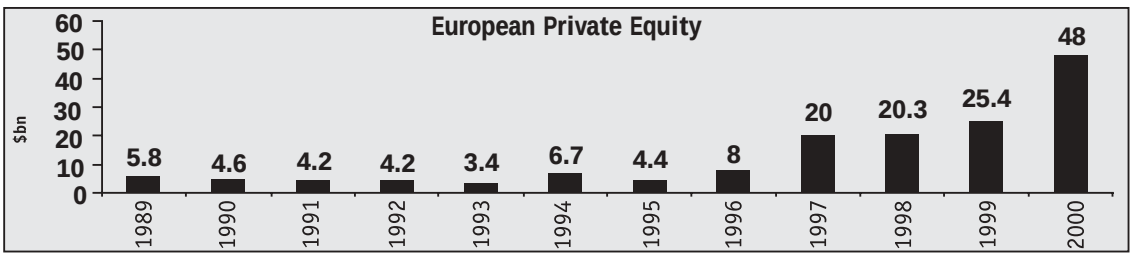
Private Equity is the ownership of shares or other equity in the companies that do not trade publicly on stock exchange. Usually private equity is more evident in companies with intangible assets, expecting negative earnings for a period. Private equity markets are more suitable for large institutional investors having holding power lasting longer durations to maximize their investment returns. Private equity houses specializes in transactions in which they have particular expertise or the sectors, which they are well aware of. Private equity houses work closely with banks and mezzanine houses since most of the larger private equity transactions involve more of debt than equity.

The competition to public capital began with the first private equity firm coming into existence in 1946, making investment in emerging companies. In 1958, the first Venture Capital limited partnership came into being. By the late 1970s private equity gathered momentum with liberalization of pension fund investments allowing them to invest in private equity funds, the mid 1980s witnessed sharp surge on the back of intense leveraged buyout activity, and a rash of merger activity that required quick and confidential resources flows. Financial policy framework that removed many restrictions also induced the private equity segment to register sharp growth across the developed world. Eighty percent of the total of all funds raised by the European private equity sector were raised between 1997-2001. During the period 1980 and 1999, private equity registered a 80-fold increase from about $5 billion market in the 1980s to about $400 billion market by the end of the 1990s.[1] Funds raised by private equity funds in the UK rose from about $6 billion in 1989 to about $ 60 billion in the year 2000. Private equity funds also invested heavily in buying up assets in Asia Pacific particularly after the financial crises in the South East Asia in 1998. For instance in South Korea, US$ 7bn assets held by private equity funds far exceeds the US$ 5.62 billion of net portfolio investments. Sizeable private equity investments were also evident in other South East Asian economies.[2]

The sources of funding include; banks, insurance companies, corporates, pensions funds and private high net worth individuals.

The types of private equity consist largely the following:

- Venture Capital
- Leveraged Buyouts and Acquisition Financing
- Merchant Banking Capital through products such as mezzanine debt financing, subordinated debt, distressed debt etc.,
- Public to Private transactions
- Internal expansion of the established businesses Company turnarounds.



E.B.Chip, October 2001, Private Equity: A Global Perspective, Invesco

[1] *Under Secretary of the US Treasury Gary Gensler, June 2000,on Merchant Banking & Private Equity Markets to the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises*

[2] *Song Jung-a, September 9, 2003, Private Equity Funds Return to Feast, Financial Times, London*

Public VS Private Equity

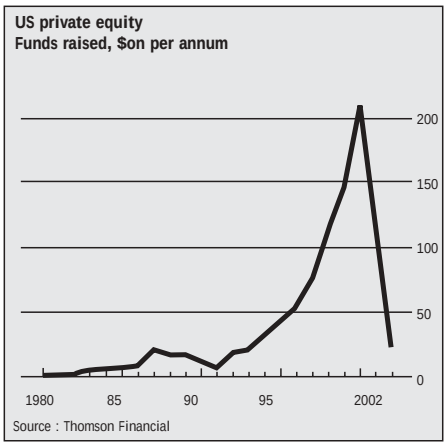
PUBLIC VS PRIVATE EQUITY A brief comparison of the Public vs. Private equity markets is described below.	
PUBLIC VS PRIVATE EQUITY CAPITAL MARKETS	
PUBLIC EQUITY CAPITAL	**PRIVATE EQUITY CAPITAL**
Listing and Compliance	
Companies should fulfill norms for stock exchange listing Capital mostly subscribed by retail and institutional investors. More number of investors Compliance of Listing Norms/Governance Norms Continuous and elaborate disclosure of information Scope of business and management might not change	No listing norms. Only a few and select investors should be satisfied Very few investors. Large institutional investors, banks, pension funds etc., Norms specific to what is committed to the investors Limited disclosures Possibilities of changes in the managements and even lines of business
Costs and Returns	
Returns could be quicker right from the day of listing Moderate returns but could be continuous and consistent Less riskier, protection to investors could be available to limited extent in case of their investments Total returns moderate in the long run Cost of equity could be lower Higher regulatory and compliance costs	Long gestation for returns sometimes going up to even 10 years Higher returns, but could be more risky and uncertain More risk, no protection available Total returns appear to be higher in the long run Cost of equity may be higher Lower regulatory and compliance costs
Choices and Options	
Focus on expanding business Mostly preferred in developing markets in case of privatizations Investments in established sectors High visibility to the corporate	Develop business or make business turnaround and sell Preferred in most mature markets Investments in high tech sectors and emerging products/services Lower visibility

The sudden surge in the private equity raised concerns on the scope and prospects of the public equity capital markets. Though both these segments have shown immense contraction in the last two years, stock exchanges are increasingly concerned about the steep decline in the new issuance in the public capital markets.

Stock exchanges provide two major and key functions. Providing liquidity and promoting new listings. While there appears to be not much concern in respect of liquidity, since most of the exchanges showed rapid improvement in trading volumes and prices beginning the second quarter of this year, similar rise is not evident in the new issuance front. A few issues that could be pertinent from the point of view of policy and practice in this regard are discussed separately.

The private equity which showed rapid rise in the recent period suffered sharp drop following the market meltdown. This has been the case of public equity markets as well, but the expectation is that the current lull in the private equity is a cyclical correction and could rebound at a fairly good pace once the market sentiment improves.

In spite of rapid growth in private equity markets the relative shares and importance in financing public equity markets continue to hold significant share in the buyout deals. For instance in the United Kingdom, the proportion of the average MBO/MBI finance by the equity fell from 42%



between the second half of 1996 and the first half of 1998.[3] This trend was reversed during the second half of 1998 and early 1999, as banks became more cautious about lending for highly leveraged transactions and the high-yield debt market became inactive. Though the movement towards lower equity resumed during 1999, there does appear to be a resistance level at around 25 to 35 percent.

The experience with the privatization provides interesting perspectives on the choice of public vs private equity markets. The choice between the use of private or public capital market in privatizations is influenced by economic, political and institutions factors; market consideration, political and legal environment and firm specific factors. A study[4] on the choice of public vs private markets in respect of privatizations that raised US$719 billion between 1977 and 1998 showed that:

- Share issue privatization (SIP), sale of shares in public capital markets, are more likely in less developed capital market, to help develop the markets and for larger and more profitable state owned enterprises.
- SIP would be more expensive in countries with greater income inequality since governments would have to underprice share offerings. Less developed capital markets find it more costly to use SIP due to underpricing.
- SIPs are more expensive for smaller firms where information costs are higher
- Privatizing through SIP creates incentive for current regime to support market oriented economic policies and offers disincentives for subsequent governments to reverse the privatization process.
- Asset sales, sales to small group of investors through private capital markets are more likely to occur where governments respect property rights, and are thus not expected to expropriate the privatized assets ie renationalize later. If this threat looms, then asset sale process will be a non-starter.
- Companies with brightest futures should be divested by SIP while ones with more questionable ones should be privatized by asset sales.

Statistics for Privatization (1977-mid 1998)

	Full Sample	SIPS	Asset Sales
Number of privatizations	1992	767	1225
Number of countries	92	67	84
Average (median) % of enterprise sold in privatization	60.5 (60%)	36.9% (27%)	75.3% (98.3%)
Average (Median) amount of offering and sales in US $ million	361.2 (36.3)	649 (82)	180.95 (24)
Average value of total enterprise in US $ million	1434.1 (75)	3182 (401.3)	339.78 (36)
Total value of all offerings and sales in US $ million	3719483	497822	221661

Source: Privatization International & World Bank

Statistics for Privatisation by Industry *(value in $ million)*

	All Privatisation				SIPs				Asset Sales			
Industry	N	AVO	TVO	IV%	N	AVO	TVO	IV%	N	AVO	TVO	IV%
Telecom	111	2101	233355	32.4	68	3030	206026	41.4	43	635	27329	12.3
Finance	263	407	106940	14.9	135	466	62957	12.6	128	344	43983	19.8
Transportation	185	308	57025	7.9	55	793.1	43619	8.8	130	103	13406	6
Utilities	223	584	130350	18.1	74	844	62456	12.5	149	456	67894	30.6
Manufacturing	1175	159	187358	26	419	289	121219	24.3	756	87.8	66138	29.8
Others	35	127	4454	0.6	16	96	1544	0.3	19	153	2910	1.3
Total	1992	361.2	719483	100	767	649	497822	100	1225	181	221661	100

Source: Privatization International, World Bank
Where: N = Number; AVO = Average Value of Offering; TVO = Total Value of Offers;IV % = Industry Value as % of Total

[3] *Ian Peacock, Stuart Cooper, Private Equity: Implications for Financial Efficiency & Stability, Bank of England Quarterly Bulletin: February 2000*

[4] *William Megginson, 2000, The Choice of Private versus Public Capital Markets: Evidence from Privatization, London Business School. September.*

Costs And Returns

It might be rather difficult to clearly state the cost and returns advantages between the public and private equity markets, However, some general information on the cost of equity, that could have significant bearing on the public equity markets as well are given below.

The cost of equity is the cost to be paid to attract investors in the stock of a company and to keep them interested in retaining their investment. The returns are composed on the basis of dividends paid on the shares and any change in the market value of the shares. The returns expected of any risky stock consist of three major components: (a) a return that commensurate with a risk free security (*what is currently available from a risk free security, say a T-bill)*; (b) a return that incorporates the market risk associated with common stocks as a whole (*what market returns are currently available from and what risks are associated with stocks in general*) (c) a return that incorporates the business and financial risks specific to the stock of the company (*how risky is the type of business the firm does and how risky is the financial structure or leverage of the firm*.), which reflects company's beta. A wide range of mathematical models are currently available that reflect the risk and returns prominent of which are (a) Capital Asset Pricing Model (b) Discounted Cash Flows (c) World CAPM (d) JP Morgan Modified World CAPM (e) Bank of America's Total Risk Approach (f) Goldman's Country Spread Model (g) Comparable Accounting Earnings Model etc.

Liberalization, economic reform, market integration tend to reduce cost of equity.

Liberalization of markets, introduction of country funds and depository receipts reported a decline of five to 90 basis points in the cost of equity in the emerging markets according to a study. Another study[5] showed that various measures of liberalization and economic reforms increased the return from equity by 39 percent in a sample of 12 emerging economies.

Market integration also tends to reduce the cost of equity. Equity markets are broadly viewed as segmented in which foreign capital cannot enter and exit easily. Legal restrictions, transaction costs, adverse taxation etc tend to increase risk premium and so affect the returns in the local markets. A perfectly integrated market signifies the capital is free to enter and exit. Studies[6] point out that equity market returns movements with the world market returns is positively related to the degree of market integration. If markets are fully integrated, then their volatility would be highly correlated to world factors and so as savings in the cost of capital. The study in this regard estimated that benefit from reduction of the cost of capital in the European Union of 0.5 percent could lead to a cumulative increase in GDP between 5 and 10 percent. Integration has also great influence on the asset allocation strategies with sectors gaining greater importance than the countries.

A study also showed that globalization will lead to decrease in the cost of capital. The argument is that increased integration leads to international risk sharing and as result lowers of the cost of equity capital. Another study that examined the impact of globalization on the equity cost of capital showed that over the 1990s the cost of equity within the European Union fell by 0.5 and 3 percentage points. The study also found strong evidence of convergence in the cost of equity across different countries in the same sector.

[5] *Vihang Errunza & Darius Miller, 1998, "Market Segmentation and the Cost of Capital in International Equity Markets", Journal of Banking*

[6] *Gikas Hordouvelis, Impact of Globalization on Equity Cost of Capital, Foundation Banque de France*

Available data on the performance of the Public and Private equity capital market reveals that it is in the long run that the private equity could score over public equity. For instance over a 20 year period, where as the US public equity gave a return of 9 percent 12 percent, the similar figures for the private equity range between 12 to 16 percent. It should also be noted that private equity financing mostly is restricted to very specialized companies which may find it difficult to enter public equity markets because of their size, history of profitability or major share holding by banks and high net worth investors. The risks too are higher in the private equity markets as compared to the public equity markets.

Performance of private equity vs. public equity

Asset Class	Index/Proxy	Annualized Rate of Return (%)			
		1 Year	5 Years	10 Years	20 Years
Canadian public equity	S&P/TSX Composite	-0.3	0.5	7.8	8.2
	S&P 500	-10.4	-3.2	10.7	12.7
U.S. public equity	NASDAQ	-0.4	-4.5	9.4	9.0
	Russell 3000	-9.9	-2.7	10.4	12.2
	Russell 2000	-12.1	-0.7	8.8	9.0
Private equity*	Buyouts	-13.4	0.2	8.1	12.0
	Venture capital	-29.1	25.7	26.4	16.5
	All private equity	-18.5	6.4	14.1	14.1

** Venture Economics data as of March 31, 2003*

Several risk factors are evident in the private equity markets.

A few of these included:

- The lack of liquidity in private company shares i.e. there is no ready market for the buying and selling of shares in private companies.
- The higher entry and exit costs that attach to making an investment in private company shares as opposed to public quoted shares (e.g. legal and due diligence costs).
- Major requirement of most private equity investors will be for a clear and defined strategy to exit from the business. Common forms of exit for equity investors in private companies are: Trade sale, IPO, refinancing
- Smaller companies compared to larger companies. Small companies have less scale and are more likely to suffer from issues such as lack of competitive advantage, lack of market power and insufficient management depth.
- Uncertainty about future of company – whether to invest in one go or in tranches
- Asymmetric information: entrepreneurs knows more about business and can misuse this position and take up projects detrimental to business
- Nature of assets: if lots of physical assets exist then can get traditional funds
- Marketing conditions

Policy And Market Responses

Development of both public and private equity markets is beneficial for the overall financial markets. At the same time, since public equity capital markets are more transparent with a greater focus on compliance, sustainability of this segment of financing is extremely relevant and useful for building an orderly and strong institutional framework for development of markets. Moreover, rich domain experience and knowledge of these markets in providing efficient capital along with promoting better corporate responsibility are desirable features that go a long way in promoting efficient and vibrant markets.

Notwithstanding the growth of private equity markets or undermining its growing influence and presence, it is important to consider a few policy options and perspectives that help further growth of the public equity capital markets. Regulatory agencies, stock exchanges, brokerages, banks and other related institutions and most important of all the retail investors, will be the one which have a lot to gain from the growth of the public equity markets. A few of the perspectives in this regard are mentioned below.

Extend Realm and Intensity of Regulation

One of the major factors behind the rapid growth of private equity markets is the limited regulatory regime and compliance requirements. The funds mobilized in the private equity are usually out of the regulatory purview, making this segment faster to respond to the business opportunities, which is not so the case with public equity capital markets. In view of the globalization of the markets, with major implications on financial stability, it is important that the realm of regulation should be extended to a broad spectrum of markets that could complement the unified financial regulation that is gaining prominence in a number of countries.

Promote New Issuance by Small Cap Companies

Most of the private equity arose because of lack of adequate opportunities for the new companies that were started on new generation ideas or products, to raise resources from the formal markets. Though stock exchanges/ development institutions in many countries created separate platforms for this purpose (say Small Cap listings) progress is sporadic. For instance, in India the OTCEI which was specially created for listing of the small cap stocks remained dormant. Stock exchanges may evolve competing strategies and solutions to provide new windows to provide suitable services to the new generation companies. Such things are already happening in respect of trading (small cap trading), risk management (variable margining) and it may be required to explore alternative possibilities in this regard to induce larger number of companies. Due to such windows, compliance may become costly and complicated, but the trade offs should be weighed in the background of costs and opportunities.

Integrated and Coordinated Efforts by the Exchanges

Integration of regulation across regions/countries could narrow the possibilities for growth of alternative financing. Evidence abounds on how regional and international integration could reduce the cost of equity by sharing of risk. Despite growth in the recent period, stock markets in many emerging economies are highly segmented leading to higher costs of equity. The very fact of higher segmentation, structural rigidities, and varying legal frame works that increased the costs and risks in the equity markets, which led to sprouting of a wide range of statistical models to assess risks and rewards. Varying degrees of integration and regulatory norms provide scope for the growth of alternative markets that over a period evolve into keen competitive forces. International

work could be essential in this regard with active cooperation of the stock exchanges. International institutions like World Federation of Exchanges could also facilitate this process.

Create New Windows for New Segments

The major factor governing the growth of private equity in the 1980s and 1990 is due to inaccessibility of the public equity capital markets for new generation products/ideas. Either the public equity markets were not able to incorporate emerging requirements in their line of business plans or the entrepreneurs and innovators are not comfortable with dealing with the formal markets. The result however is that the new generation entrepreneurs with new generation ideas in telecom; biotech; information technology flocked to the private equity markets thereby giving them a greater leverage to grow at a faster pace.

Industry wide Consultation and Cooperation

Most of the focus of the international cooperation in securities markets was directed towards issues such as securities settlement, payments systems, surveillance and risk management, tracking market abuse etc., In the back ground of growing challenges to the public equity capital markets, it is important that international cooperation considers some major areas of collaborative work in respect of listing norms, creating suitable listing and trading platforms for new generation companies/products , harmonization of compliance norms etc.,

Today's Private Equity is Public Equity Tomorrow

A company with private equity today may be the company, which might want to get listed tomorrow in the public equity markets. The ultimate option of any firm financed with private equity is to realize the gains of its investment through public equity. Stock Exchanges may consider suitable mechanisms that will enable them to recover a part of the gains that would have accrued to them, if the company would have accessed public equity markets in the beginning. It could be something like a conversion tax that would be only applicable to the companies with private equity markets entering the public equity market.

Seek Fiscal Incentives for Contribution to Society

Equally important is the question whether it is only the costs that should determine the role and responsibility of public equity capital markets. It is surely cost efficiencies that should govern the future growth of any market segments. At the same time, their overall contribution to the development of the financial systems must not be overlooked. Public equity capital markets assume greater responsibility towards development of overall financial markets in general and capital markets in particular. Stock exchanges could seek special fiscal incentives on tax reliefs that could partly compensate for the erosion of business in public equity markets and also could act as a disincentive for the firms going to the private equity markets.

Fiscal Incentives for Corporates going to Public Equity Markets

Simultaneously, stock exchanges could also suggest extending some sort of fiscal incentives for the firms going to the public equity capital markets since these provide much larger support to disclosure and transparency that would be beneficial from the point of view of orderly growth of overall financial markets. The advantages of well functioning financial markets could far outweigh some tax reliefs and fiscal incentives.

Towards a Policy that Supports Public Good

Policy responses taking into consideration the overall contribution of these markets is essential rather than assessing these only on costs and returns.

Consolidation of Stock Exchanges

Consolidation of stock exchanges which at present is regional (such as Europe) in nature is expected to lead to greater gains in cost efficiencies. The existing and emerging regional economic and political trade blocks could also consider extending their cooperation into establishing well integrated financial systems that could enable the capital markets in these countries to gain greater efficiencies. This could prompt consolidation of the stock exchanges at a global level which could redefine the cost patterns of the public equity capital markets. This however entails close-knit cooperation across the governments, regulatory authorities and international and domestic financial institutions.

Examine the Issue more elaborately

Since cost of the public equity capital markets on their own and in comparison with the private equity markets is rather hazy, a regional/international study under the aegis of the international organizations such as IOSCO/WFE/NASD could be useful in throwing up of pertinent information. Experience of various countries in this respect would also help the study in coming out with some specific solutions in regard to stock exchanges retaining their preeminent position in resource mobilization and helping corporates to raise financial resources at economical and sustainable rates of growth.

In addressing this issue, it is not the stock exchanges but a wide range of institutions and communities that could play an important role. It becomes responsibility of the various stakeholders to preserve mechanisms and institutions of public good by extending suitable support to withstand the competition and also promote better practices that promote efficiencies.

A broad framework of concerted action that could be expected from different stakeholders to strengthening the role and responsibility of the public equity capital markets is given below.

Governments:

Biggest beneficiaries of the public equity capital markets. Public equity markets extended enormous support in the Government's economic agenda in particular efficient resource allocation. The scope of government in further development of public equity markets could consist of:

- Extend the realm of regulation to other markets as well
- Extend fiscal support to corporates accessing public equity markets
- Evolve policy framework that will streamline compliance requirements and thereby costs of regulation
- Refine regulation so as to make it cohesive, comprehensive and more integrated.
- Choice of public equity markets in case of privatization and divestment process of government stake.

Regulatory Institutions:

The quality of regulation determines the quality and character of institutions and intermediaries. The very reason for the regulation to progress at such faster pace is the cooperation and willingness of the institutions to adopt practices that are considered prudent and practical. In this context it may be important for the regulatory institutions to:

- To create a level playing field in respect of regulation for various types of markets to the extent possible.
- Keep costs of regulation and compliance not to be too heavy and overlapping

- Encourage Exchanges to design new options in new issuance
- Prepare industry wide studies for comparison of costs and returns and assessing them in terms of compliance, transparency and disclosure norms.
- Assess and indicate emerging risks in different types of markets that could keep investors aware of the outcome of their choices.
- In case of a crisis not to be too harsh that could severely damage prospects of the markets for the deviations committed by a few.

Stock Exchanges:

- Create new windows that could enable new generation and small companies to access new issuance markets.
- Create a separate mechanism that continuously examines and assesses emerging trends in new issuance products
- Consider levying a conversion tax when companies with private equity support access public equity markets to cash on the gains.
- Create databases that could establish the efficacy and efficiencies of the public equity capital markets.
- Create continuous and focused awareness and education campaigns for investors on the importance and advantages of public equity markets.
- Promote inter exchange cooperation to share the experiences and evolve mutually rewarding strategies and solutions.
- Evolve specific task forces with the help and support of the government and regulators to study implications on key and emerging developments in financial markets.

Corporates:

Public equity capital markets supported in a massive way the corporate growth in the world. Listing with the stock exchanges enabled them to gain regulatory and investor recognition that helped them in a long way. Corporates could contribute to the development of public equity markets by way of:

- Adopting better practices in corporate governance that could give way for least deviances from stipulated norms
- Improving and adopting internally accepted accounting and audit norms that leaves little scope for any malpractices that could turn into major corporate crisis that was evident in the recent period
- Greater interaction and better provision of information to investors that will ensure their confidence in the corporates
- Better compliance of listing and other regulatory norms that will reduce the scope for enhanced deployment of resources that could have been otherwise used more productively.
- Sharing information on costs and returns of public and private equity markets that could provide useful insights to the regulators and capital markets.

Coordinated efforts of the stakeholders in various aspects would be of great significance in the furthering the interests and the growth prospects of the public equity capital markets.

BSE

The Stock Exchange, Mumbai