

# **CHAPTER - I**

## **INTRODUCTION**

### **1.1 Background of the Study**

Due to globalization of economy and market, present world economy has been more competitive and complicated. Every sort of change occurring in one sector of the world affects the other. A healthy economy is dependent on efficient transfers of funds from people who are not savers to firms and individuals who need capital. Without efficient transfers the economy simply could not function and economic efficiency is simply impossible without a good system for allocating capital within the economy. Nepal has predominantly a subsistence agricultural economy which contributes about 40% Gross Domestic product (GDP).

As the Nepalese economy is in developing phase, so in order to speed up this phase of development, financial sectors have crucial roles as they can pool scattered savings for capital formation. The public investors are interested to invest their savings in the common stocks of the financial institutions. As a result such institutions shares are beings traded among the investors in the secondary market in larger volume every day. Every business enterprise requires long-term, short-term intermediate term capital funds form the smooth operation and expansion of organizational activities. Among such funds, long-term funds are highly significant for feature growth and prosperity. Most of the organizations generate these types of funds from financial market.

The purpose of financial market in an economy is to allocate savings efficiently of time a day, a week or a quarter to partners who use funds for investment in real assets or far consumption (Van Horne, 2000: 448). Financial markets facilitate the transfer of funds from savers to those who wish to invest in capital goods. For instance, companies that wish to undertake investment projects offer financial instruments to savers in exchange for funds to finance the projects.

A society improves its welfare through investments. Business owners need outside; capital for investment because even projects of moderate sizes and beyond the reach

of most wealthy individuals. Governments also need funds for public work (investments). Much of that money is channeled through financial markets from savers to borrowers. In doing so, the financial markets provide a link between saving and investment and between the present and the future. As a consequence, savers can earn higher returns from their savings instead of hoarding them, borrowers can execute their investment plans to earn future profits, and both are better off. As a result, the economy also benefits by acquiring better productivity capabilities. Therefore financial markets facilitate real investments by acting as the sources of information. Financial markets can also be defined as the centers or arrangements that provide facilities for buying and selling of financial claims and services. And the role of financial system in economic development has been a much discussed topic among economists. Financial markets perform four important economic functions.

First: - they enable individuals to choose more effectively between current and future consumption. Borrowing enables individuals to consume more, whereas lending enables them to postpone consumption. The economic units that have a surplus (investors) invest in those that have deficit (borrowers). This provides capital to companies in excess of those generated out of business income.

Second: - the interaction between buyers and sellers in a financial market determines the price of the assets, or alternatively, the return demanded by investors to invest in company. Firms can raise further capital if the return on their investments exceeds the return demanded by investors.

Third: - financial markets provide liquidity to investors. That is, the owner of the financial asset can sell off the asset in the market place to realize cash where never required. The degree of liquidity may vary from asset to asset and market to market.

Fourth: - financial market can be disciplined under-performing managements. The prevailing stock price of a company reflects the opinion of all market participants regarding the outlook for the company under the current management.

The economies develop the needs of the users and the providers of financial service change. Informal finance becomes less important and self-financed capital investment gives way first to bank intermediated debt finance and later to the emergence of

capital market as additional instruments for raising capital funds. Although, banks dominate most formal financial systems, the relative importance of the stock market tends to increase with the level of development (WDB 2002 report).

Thus, with the globalization and increasing access to information, a business firm can not rely on its own resources and those of the banks. Increasingly it has to rely on innovative financing scheme with ample use of the capital market (Vaidya, 2002:40).

Capital market is the principal part of financial market. People and organization that want to borrow money are brought together with those having surplus funds in the financial market (Brigham and Huston, 2001: 176).

Financial market (also known as security market) is a market for creation and exchange of financial assets i.e. it is a mechanism designed to facilitate the exchange of financial assets. Financial market is composed of money markets and capital markets. Money markets are the markets for short-term highly liquid debt securities (Such as T bills, commercial paper etc.). Capital markets are the markets for intermediate or mostly long-term debt and business stocks (such as T-notes and bonds, business bonds/debenture equity securities etc). Financial markets also function as primary markets and secondary markets for debt and equity securities. Capital markets are complex of institutions and mechanisms through which intermediate and long-term funds are pooled and made available to business, governments, individuals and institutions. The main objective of the capital market is to create opportunity for maximum number of people to get benefit from the return obtained by directing the economy towards the productive sector by mobilizing the long-term capital. The objective can be fulfilled only by the rational and accountable behavior relating to three factors of the capital market such as institution, mediator and investor (NG, 2001:167). Financial institutions are assumed to be pillar in the capital market.

The original sale of securities (new issue of securities also called initial public offering) by government and corporation occurs in the primary market i.e. new capital is raised from primary market, where existing and already outstanding securities are

treated in the secondary market. The trading of securities in the secondary market does not involve rising of funds, secondary markets provide the means for transferring ownership of business securities (Stephen and Jordan, 2002:18). Thus secondary markets play the significant role in liquidating the securities. Secondary market is composed of auction markets and dealer markets. Auction market or exchange traded market or popularly known as "Stock Exchange" is characterized by a centralized organization with standard procedures. In the organized exchanges the agents of buyers and sellers operate through the auction process. The equity shares of most of the larger firms are treated in auction markets. Largest such market is the New York Stock Exchange (NYSE); other auction market includes American Stock Exchange (AME), London Stock Exchange (LSE), and Tokyo Stock Exchange (TSE) etc.

In Nepal, Nepal Stock Exchange Ltd. (NEPSE) is only the secondary market in the country' Dealer market popularly known as over-the-counter (OTC) market is an organized, decentralized, market with no physical location, which means that national borders do not present a great barrier and there is now a huge international OTC debt market (Stephen and Jordon:19). In Nepal OTC market is virtually non-existent however; OTC market exists for government bond market.

As a vital part of economic activities and development stock market mobilizes savings as well as protects the interest of investors. It also helps transfer of funds from surplus savings to deficit savings through transactions of long-term financial securities. An efficient stock market offers opportunities for both surplus saving and deficit saving to optimally meet their requirements. The deficit saving is mainly business, government and its agencies, which need to raise large sums of money at the lowest possible case to finance their long-term projects and the surplus saving is mainly the household units seeking opportunities to invest their surplus funds in securities that match their risk and return choices (Pant, 2001:1).

Moreover, the development of an efficient capital market is dependent on the availability of savings, proper organization of intermediary institution, to bring the investor and business ability together for mutual interest, regulation of investments.

Of all the markets, the stock market has probably the greatest glamour and is perhaps the least understood. Some observers consider it a legalized heaven for gambling and many investors including professionals consider stock market investing as a game in which role purpose is picking winners. Such an outlook can lead to neglect to the extremely important role, the capital market play in the real economy (Kimpton, 1985:5).Resource mobilization is assumed to be vital and challenging work in the present day world economy. In this era of financial, economic and political liberalization the task is more complicated than before. Moreover, capital market what is called the life, blood of the liberalized economy is the mechanism through which the resources (savings) are mobilized and flowed from non-productive sector to productive sector (Bhatta, 1995:1).

Financial markets essentially involve the allocation of resources. They can be thought of as the "brain" of the entire economic system, the central locus of decision making. If they fail, not only will the sector's profit be lower than they would otherwise have been, but the performance of entire economic system may be impaired" (Stiglitz 1993:23).

Capital market plays a crucial and effective role in economic development of a nation. The health of the economy as reflected in two wings of capital market i.e. primary market or new issue market and the secondary market/stock market (Agrawal, 1997:240).

Through the well-developed financial system an accelerated rate of investment or capital formation in the economy and consequently the achievement of self-reliant economic growth is possible (Bhattarai, 2002: 1). The capital market has become an unavailable part of today's economic system.

Thus, the existence of an organized security market is considered to be an essential pre-requisite for modern free enterprise as well as for a mixed economy, where private sector has a large role to play (Bhattarai:2). In the changed circumstance of present day world, the role-played by the equity market in financing the business firm is of paramount importance. It is expected to play still more important role in the context of the least developed and capital poor country like Nepal (Joshi 1997:126).

There is no doubt that Nepalese business will have to move along with the world trend. Running the business organization in a systematic and/or successful way is not a luxury but an absolute necessity for Nepalese companies, if they are to establish themselves as serious players in the globalized economic environment.

Although some analysts view stock markets in developing countries as "casinos" that have little positive and potentially a large negative impact on economic growth, recent evidences suggest that stock market can give a big boost of economic development for the developing countries like Nepal (Bhatta, 1997:2).

The history of capital market in Nepal dates back to the era of Rana Prime Minister Juddha Shamsar when Gunjaman Singh, the first secretary at the Nepalese Embassy in England returned back to Kathmandu and set up the "Industrial Council". The council drafted the company Act and Nepal Bank Act for the first time in 1936. Biratnagar Jute Mills Ltd. initiated the first public flotation of shares in the securities market in 1937 (NRB, 2001:1). At that time, participation of ownership structure of the business sector was restricted mostly to the Rana family; however, the capital market got signals of development.

Introduction of the company act in 1951 and the first issue of government bond in 1964 were other developments relating to capital markets (Panthi, 1999:2). The establishment of Securities Exchange Center (SEC) in 1976 was the first and most important attempt made by the government to develop the stock market. The main objective of the establishment of the center was to mobilize public saving and encourage the people to participate in the ownership of industries and business enterprises thereby facilitating and promoting the growth of capital market in Nepal. After the establishment of SEC under the company Act, institutional development of securities market in Nepal was started. At that time there were less than 3000 shareholders in Nepal and there were very few publicly traded companies.

Initially SEC limited its function for trading the government bonds and national savings certificate only, which had predominantly held by Nepal Rastra Bank (NRB), SEC started secondary market for the business securities in 1984. The market was steady over the year. The number of listed companies reached from 11 in 1984/85 to

62 in 1992/93, paid up capital of listed companies from Rs. 273 million to Rs. 1.08 billion and market capitalization from Rs. 360 million to Rs. 3.81 billion and annual turnover from Rs. 2 million to Rs. 80 million (Bhattarai, 2002: 1).

Securities Board Nepal (SEBO/N) was established on 26 May 1993 after the first amendment in the Securities Exchange Act, 1983 became effective. Ensuring regulated and orderly market for the primary issue and secondary trading of securities and fostering the development of stock exchanges by protecting and promoting the interest of investors were the objectives of SEBO/N. Securities Exchange Act mandated SEBO/N to act as a securities market regulator and promoter. After 18 years of incorporation, His Majesty's Government converted SEC into Nepal Stock Exchange (NEPSE) Ltd. on 16 May 1983, under a program initiated to develop a competitive and efficient security market. With the basic objective to impart free marketability and liquidity to government bonds and business securities by facilitating transaction in the trading floor through market intermediaries such as brokers, market makers, NEPSE was established as a non-profit organization. After SEC's conversion into Nepal Stock Exchange, NEPSE appointed 15 brokers and 5 market makers and started open out-cry system of trading through brokers and market makers on 13th January 1994 (Bhattarai:13). Thus, Nepal Stock Exchange is working as a trading (operational) institution; which operates under Securities Exchange act, 1983, whereas Securities Board, an autonomous institution is acting as a focal organization for the development and regulation of the securities market and it is the regulatory body in all aspects of securities market, however, government securities are entirely handled by NRB. At present, Nepal Stock Exchange Ltd. is only the business body having permission from SEBO/N to run the stock exchange business in Nepal (SBN, 2002:6). By this way the origin of Nepalese capital market can be traced back more than five decades but capital market was given a proper structure only in 1993. Through the creation of capital market immediately attracted the interests of retail investors in size and maturity, it has not kept pace with the growth of the private sector, NEPSE presently has 22 stock brokers, 7 issues managers and 2 portfolio managers i.e. securities dealers and no market makers (There were some market makers in the earlier stage).

There were 145 listed companies in 2008. The paid up value of listed companies increased from Rs. 9685.04 million in FY 2000/01 to Rs. 21798.8 million in FY 2006/07, market capitalization reached from Rs. 34703.87 million in FY 2000/01 to Rs. 186301.3 million from FY 2006/07, the percentage contribution of market capitalization on GDP is estimated to be 27.78. NEPSE index in FY 2000/01 was 227.54 which reached to 683.95 in FY 2006/07 which is 297.12 points higher than that of the last FY's index (SBN 2005:29-31, Gorkhapatra Daily,21-12-07). The stock exchange set up in 1994 with only 8 listed companies where it's reached 145 in the research time. However, majority of listed companies remained merely listed; shares of large number of listed companies are not traded.

Thus, the Nepalese security market witnessed interesting ups and downs from its establishment to date. Although the growth of stock market is high relative to the growth of the economy the share of business sector in the national economy is still very low due to the negligible size of business sector. However, there is a room for its substantial development or there are still more potentialities to be explored for the development of stock market in Nepal.

## **1.2 Focus of the Study**

This research study has focused on the following specific research questions/problems.

- ) What is the present status of equity market in Nepal?
- ) What are the factors hindering the development of efficient equity market?
- ) What are the major problems of business firms to maintain a better financing mix?
- ) How far the activities of regulatory bodies have encouraged/contributed to the development of equity market?
- ) What initiatives/implements are needed for the development and well functioning of equity market?
- ) Whether there is liquidity problem of equity securities arising from transfer in the market?



### **1.3 Statement of the Problems**

The availability and access to finance can be a crucial influence on the economic entitlements that economic agents are particularly able to secure, further more the better use of available finance/funds is more crucial aspect for the well functioning of a firm (WB, 2002:75).

The successful and effective performance of a business firm depends largely on the proper selection of available financing alternatives. A firm thus should be able to make better decision regarding the choice of financing alternatives. But for the easy access to get a could range of financing alternatives, the development of sound financing system is essential which further calls for the development of fair and competitive financial market.

In Nepal, where the country is aspiring for economic development there is the continuous increase in the development of business firms, however the optimal level of performance has not achieved, whether it is due to the inability of the business firms to select the better way of financing its expenditures or the lack of efficient capital market, it still remains to be studied.

Nepalese business firms are lacking the practice of maintaining the better mix of financing. There are some companies, which are on the way of profitability by following better mix of financing. For example, an Indian company, Arvind Mills had excessive debt (of Rs. 2700 crore in 1999). It was reeling under pressure of global slow down in its main product Denim, and the company was almost towards bankruptcy. Later, after painful two years, the promoters sold off some real estate, brought in equity and reduced debt from Rs. 2700 crore to Rs. 1,600 crore and interest cost Rs. 360 crore to Rs. 180 crore per annum. The company is now well on it's way too profitability (Vaidya Nathan, 2002:1-12). Why Nepalese business firms have not learned such practice? This study will diagnose and identify the problems related with those matters too.

Development of equity market has a key role to attract the investors and entrepreneurs for the resources mobilization towards productive venture in the economy. In Nepal the equity 1554 dated back to 1937, and the exchange of equities in the trading floor

commenced only in 1994. The history shows that rising of capital through public issue is not new in Nepal. Nepalese business bodies have been raising equities through public issues for the last seventy years; however the equity market in Nepal has not been properly developed and is still in primitive form (Khadka, 2002:6) over the years, various efforts have been made, but the equity market in Nepal is not yet efficient to allocate the available resources. So, there are still numerous problems existed in the Nepalese equity market, identification of actual factors hindering the growth of the market along with suggested solution is the need of the present time.

Nepal has a small equity market that commands less than 12 percent of GDP and features a low 5 percent of liquidity. Listed firms are 145, which is less than 1 percent of all companies and 10% of public limited companies. In Nepal business debt instruments are almost absent and holding in the equity market are heavily concentrated with family groups (Vaidya, 2002:31), which means there is a trend of close ownership, which has not facilitated or encouraged the flow of individual savings towards productive sector. Most of Nepalese business firms (non-finance enterprises, especially manufacturing and trading sector) in the country have been financed by heavily through bank debt/borrowing, thereby increasing leverage. Such firms have suffered huge loss (for example, Salt Trading Corporation Ltd.), which is an issue about debt driven financing pattern of the companies. Companies that have gradually lowered their debt (thereby making D/E ratio optimal) are becoming able to improve their profitability (for example, Shree Ram Sugar Mill). Here another issue arises, could other companies in a similar position adopt such strategy.

The problem related to investors is that they have the tendency to hoard fixed asset (such as gold, silver) because the companies are not providing good return, profit is manipulated, which discourage them to involve in equity investment." (Bhattarai) The interested investors have not found place to involve in equity investment of business bodies. Rural poor have no saving and if some have saved they have no access to the stock market because of the lack of information, logistics and other provisions. There are inadequate facilities for servicing investors located outside Kathmandu, although it is estimated that one third of all investors are in other towns and cities.

Individuals who purchased, equity securities are city-dwellers', small unit of savings has not been attracted by the equity market because of which the flow of domestic resources to pour into productive investments has not been facilitated. To secure maximum returns investors should have opportunities to invest in long-term business equities rather than depositing on the bank. However, because of various problems of stock market and the business firms, both individuals and institutions are putting far more of their savings into bank deposits and fixed interest government securities even at very low or negative (-ve) interest rate, than they would if the markets were working properly. Thus, long-term savings that should be invested in the stock market are going into short-term instruments.

A fairly developed equity market requires the on-going support of the market economy but number of factors such as undue government interference, inconsistent or incomplete legal and regulatory structure, and lack of good governance, lack of adequate and qualified human resources etc. has served to present further market development in Nepal. To sum up the following problems have been identified in Nepalese business sector/equity market.

- ) There is a tendency of credit-oriented investment. Most of the companies (especially manufacturing and trading sector) do not have satisfactory debt equity ratio.
- ) There is less competitive and transparent transaction of security in the secondary market. Public limited companies are lacking theoretical and practical knowledge regarding the better way of business financing.
- ) There are still various market imperfections, like limited number of buyers and sellers, stringent government policies and asymmetry of information, which have hindered market forces to determine a fair equity price in NEPSE. Thus, equity market in Nepal is not yet efficient to allocate resources.
- ) Studies have found that the cost of equity issue to the public is very high in comparison to that of the neighboring country India.
- ) Nepalese equity market is becoming unable to move with the global front. Nepal government has at ready announced to open up the secondary market to the foreigners but still nothing has happened and in this area.

Above discussions and points make it clear that, there are still numerous problems existed in the Nepalese business sector, regarding business financing and equity

market development. However, there exists a solution to each of these problems with which this research is concerned.

This study has tried to answer the following questions:

1. What are the problems of equity market in Nepal?
2. What are the prospects of Nepalese equity market?

#### **1.4 Objectives of the Study**

The principal objectives of the study is to identify and explore the development of equity market in Nepal thereby showing the urgent need of competitive and fair equity market to boost up the economy. Besides, the study also intended to identify the pattern of financing in public limited companies of Nepal. The specific objectives of the study are:

- To trace out historical evaluation and to evaluate role of Nepalese equity market in business financing.
- To analyze the prospects of Nepalese business finance and equity market in Nepal.
- To identify the existing challenges of Nepalese business financing and equity market in Nepal.
- To suggest and recommend on the basis of major findings.

#### **1.5 Significance of the Study**

The pattern of financing of public limited companies and the development of equity market is of paramount importance because this factor has significant bearing on the pace of financial as well as economic development of a country. Most of the Nepalese public limited enterprises (especially manufacturing, trade and hotel sector) are not performing satisfactorily. The investors on the other hand are unaware about the benefit of their investment, they just invest in securities assuming buy and hold strategy. There is a need of market access for both, companies and general investors, so that financial as well as economic development of the country will be enhanced and the economic fruits of prosperity could be realized. But it requires effective policy framework. However, no systematic study concerning these aspects has been conducted so far, this study is the first of its kind in Nepal. So as to fulfill the research gap, this study will attempt to focus on problems and progress in the equity market

and its role in business financing. Moreover, the study is significant on the following ground:

- The study would depict the picture of Nepalese equity market on an unbiased way by providing basic data and information of the concerned sector.
- The study through the recommendation on the analysis of the data and information will help to develop and strengthen the prudential policy measures to improve and enhance the overall growth of Nepalese equity market.
- It would be more helpful in taking the reform measures for the improvement of the performance of both, stock market and the companies concerned. Meanwhile, the study would be useful for the regulatory authorities, policy makers, financial managers of business bodies, professional analysts and the general public as well.
- Besides, the study would open up new areas for further research.

## **1.6 Limitations of the Study**

Lack of experiences time, financial resources, and up to date information are the main limitation of the study. This is researcher's first research study. The study is prepared within a few months with limited budget. The study covers only the past and present state of equity market in Nepal hence may not make any prediction about the future. The study will consider the period of 7 years from 2002 to 2008 only, the analysis of the secondary data and only focused the equity market.

## **1.7 Organization of the Study**

As discussed in the previous section, this study intends to examine and evaluate the growth, problems, and prospects of equity markets in Nepal. This study is organized into five chapters. The thesis is divided into following chapters:

Chapter I : Introduction

The first chapter includes background, problems of the study, objectives of the study, significance of the study, and limitation of the study.

Chapter II : Review of Literature

The second chapter deals with review of literature of the study field. Therefore, this chapter includes the review of major

books, journals, research work, and thesis etc. along with conceptual framework.

Chapter III : Research Methodology

The third chapter represents the methodology adopted for the research design, sources and technique of data collection, population and sample.

Chapter IV : Data Presentation and Analysis

This chapter deals with presentation and analysis of secondary and primary data. Major findings from both types of data have been also presented in the last portion of this chapter.

Chapter V : Summary, Conclusion and Recommendation

Summary of the study, conclusion and recommendations are included in the fifth chapter.

## **CHAPTER –II**

### **REVIEW OF LITERATURE**

This chapter provides some glimpses on the literature that is available in the topic. This chapter deals with the review relating to business financing and equity market in more detail and descriptive manner. For this objective various books journal, articles from news -paper and magazines and other related studies have been available. In the context of Nepal, least research studies have been available regarding business financing and equity market in Nepal. This is a kind of research which covers the various information and documents about related subject.

The first section of this chapter is devoted to describe theoretically the behaviors of the business finance and equity market in Nepal. The introduction chapter has described about the general background, statement of the problems, objectives importance and limitations of the study. This chapter deals with the review relating to business financing and equity market in Nepal.

#### **2.1 Conceptual Review**

The Corporation is the most important form (in terms of size) of business organization. A corporation is a legal entity (person) with a life independent of its owners. The owners of the corporation enjoy limited liability for the debts and other legal obligation. The combination of limited liability and unlimited life makes it possible to separate the marginal function from the owner ship risk bearing function in the corporation (Kawn1995:33). Ownership (represented by shares of stock) in a business firm can be reading transferred, and the life of corporation therefore is not limited. The business form of organization has much variation around the world. The exact laws and regulations differ from country to country, of course but the essential features of public ownership and limited liability remain. These firms are often called joint stock companies, public limited companies or limited liability companies depending on the specific nature of the firm and the country of origin. There relative case of transferring ownership and the limited liability for business are the reasons why the business firm is superior when it comes to raising cash (Ross, Wethersfield and Jordan, 2002:9).

The more developed the business sector of an economy the more is its economic progress. The state of the business sector in an economy is the barometer of its economic development. The joint stock companies have played a major role and will also continue to play a key role in steering a countries economy however developed or developing the country may be (Moha Patra, 1999:36).

Finance is the most important critical factor, so it is called lifeblood, and also the most scare one in the process of economic development. Development being a function of capital, the higher the tempo of development, the greater is the requirement of capital. The need for capital is continuous and also boundless. The business sector of an economy is the major contributor to the process of economic development. As the business sector grows over time, due to expansion, diversification, modernization accompanied by some amount of inflation, the demand for funds also increases. Moreover, at every stage of economic development, an increasing demand for funds leads to the creation of different types of financial assets. Consequently, new financial intermediaries and new sources of finance emerge. (Moha Patra, 1999:64).

Finance can be defined as the art and science of managing money. Virtually all individuals and organizations earn or raise money and spend or invest money. Finance is concerned with the process institutions markets and instruments involved in the transfer of money among and between individuals, businesses, corporations and governments. (Gitman, 1998: 92)

The terms finance can be defined as the management of the flows of money through an organization. Whether, it is a corporation, school, bank or government agency. Finance concerns itself with the actual flows of money as well as any claims against money (Hampton, 1999: 88).

### **2.1.1 Clients of Financial System**

We start our analysis with a broad view of the major clients that place demand on the financial system. By considering the needs of these clients, we can gain consider able in sight into why organization and institutions have evolved as they have. We can classify the clientele of the investment environment into three groups: the household sector, the business sector and the government sector. This scheme is not perfect; it



excludes some organizations such as not-for-profit agencies and has difficulty with some hybrids such as unincorporated or family run businesses. (Bodie, Kane, Marcus-2000: 11).

### **2.1.2 Financing Decision**

Financing decision is one of the most important decisions taken by the business firm because the financing mix greatly influences the value of the firm. However earnings of a firm are also determined by the investment decisions, financing decisions also play a crucial role in success of a business.

Financing decision is the one of the most important function to be performed by the financial managers. Broadly, they must decide when, where and how to acquire funds to meet the firm's investment needs. The central issue before them is to determine the proportion of equity is known as the firm's capital structure. The finance manager must strive to obtain the best financing mix or optimum capital structure for their firm. The firm's capital structure is optimum when the market value of shares is maximized. The use of debt affects the return and risk of shareholders, it may increase the return on equity funds but it always increases risk. A proper balance will have to be struck between return and risk. When the shareholders return is maximized with minimum risk, the market value per share will be optimum. Once the financial manager is able to determine the best combination of debt and equity, he must raise the appropriate amount through best available sources. (Pandey, 1991:6).

Financing decisions are usually thought to reveal information about a firm's future cash flows that market participants do not have, Financing decision involves the most important and complex areas of financial management. The financing decision is an intricate and highly complex process and it requires choice of sources of finance to be made with great care. This is more so with regard to fixed assets financing as against current assets financing due to involvement of considerable amount of long term resources that are non-reversible once invested in fixed assets (Moha Patra, 1999:12).

In financing decision the financial managers has to decide about the optimal financing mix or make up of capitalization, in other words, the concern of financing decision with financing mix or composition of capital/capital structure or leverage. Mainly the

composition of capital consists of debt (fixed interest sources of financing) and equity capital (variable-divided securities sources of funds) A proper choice of these securities is related with the financing decision of firm.

Financing and investment decision are related with each other. Financing decision (to some extent) depends upon investment decision investment decision takes place in real markets, while financing decision takes place mostly capital markets.

The long-term financing decision of a firm is much more crucial than the short term financing decision. This is especially true as far as the choice between debt and equity as a source of finance is concerned (Srivastava, 1995:2).

While deciding about the debt and equity mix, the financial manager should follow such pattern which may be helpful in maximizing earnings per share and also the market value of shares. This involves examination in depth of some of the following important issues (Srivastava, 1995:37).

- (a) From what sources are funds available?
- (b) To what extents are funds available?
- (c) What is the cost of funds presently used?
- (d) What is the expected cost of future financing?
- (e) Given sources of funds are there costs what sources should be aped and to what extent?
- (f) What instrument should be employed to raise funds and at what time?
- (g) Should firm approach financial institutions for recurring funds? If yes, on what terms and condition?
- (h) Will the firm make under writing arrangements? If yes, on what terms?

Accepted answers to above questions are hard to derive without some knowledge of money and capital markets financial institutions, risk and uncertainty investors' psychology and economies (Srivastava, 1995: 38)

### **2.1.2.1 Business Financing**

Business finance is the combination of two words, business and finance. To know the meaning of business finance, we have to know the meaning of two words separately.

### **What is finance?**

Finance can be defined as the art and science of managing money. Virtually all individuals and organization earn or raise money and spend or invest money. Finance is concerned with the process institutions markets and instruments involved in the transfer of money among and between individuals, business and governments (Gitman, 1998: 92)

Therefore business finance deals with the financial problems of business enterprises. These problems include the financial aspects of the promotion of new enterprises and their administration during early development, the according problems collection with the distinction between capital and income, the administrative questions created by growth and expansion, and finally the financial adjustments required for the bolstering up or rehabilitation of a corporation has come into financial difficulties "(Manandhar Bajracharya, Bhattarai, 2004:1).

Business firms, needs, to raise funds to operate expand, and modernize and /or even to start their business. A need firm funds to invest in its fixed assets and current assets. The funds invested in fixed assets are called as fixed capital and those invested in current assets are known as working capital. The nature of the funds invested in fixed assets and the permanent part of working capital is long term and of those invested in the variable part of working capital is short term. A firm thus, needs both long term and short term funds to meet its total capital requirement. Long -term funds are required not only to set up new enterprises and to keep it going, but also for its expansion diversification and modernization programmers. (Moha Patra, 1999:2).

The financial manager in a view to maximize the wealth of the firm faces the real challenges in obtaining the required funds from the right sources and seeing their right use. The fixed assets financing pattern may differ firm one industry to another. The variations in the nature of industries not only cause difference in the requirement of gross fixed assets but also in the use of various sources of long - term finance among the industries. (Moha Patra, 1992:1).

### **2.1.2.2 Internal Vs External Financing**

Internal financing refers to the financing by the business in the form of depreciation and other reserves and income left over after meeting all expenses and is not distributed among owners of the enterprise. In other words internal sources are the funds that are generated from within the company by the retention of profits. The economic justification lies in its contribution to the company in the form of retained profits for its further expansion and future survival. The generation of internal sources thus clearly shows the healthy condition of a good business enterprise.

The process of creating savings in the form of reserves and surplus for its utilization in the business is technically termed as plugging back of profits (Srivastava, 1995:8). Plugging back of profits is an ideal method of financing and is an adjunct of sound financial management; it raises no problems or complications as does borrowing either from banks or from the public. Moreover whenever there is scarcity of funds in the capital market, the only source available for a business enterprise would be the internal finance (Moha patra, 1998:88).

Financing from internal sources (i.e. retained earning) may often be less costly than the external financing. The policy of plugging back of profits is an important means of capital formation that is necessary for the economic development of a country practically the under developed ones. However the internal financing is possible only for on going concerns; a new enterprise has to depend exclusively on external sources only. Moreover, excessive plugging back is likely to create greater impression among the investors that like company must be suffering from an inability to approach the organized market for financing to meet the cost external financing (Moha Patra 1999:90).

At times internally generated funds will be sufficient to finance all of the firm's positive net present value investment opportunities. When this happens, the firm must either abandon some profitable projects or else turn to external sources of long-term financing in what is known collectively as the capital market—the market where investors exchange current dollars (or other currency) for assets that represent claims to more or less certain amounts of money in the future. Most firms choose the latter course (Shapiro 1990: 363).

Thus, along with the internal sources of finance firms also mobilize resources from external sources. The main sources of external financing may be divided into two broad categories, (i) the ownership capital usually called as 'capital stock' consisting of ordinary and preference shares and (ii) the creditors capital popularly known as 'debt' comprising of bonds and debentures. The relative roles of external and internal funds in financing investment of business enterprise differ from country to country depending upon the capital markets, ability to generate internal surpluses investors' preferences availability of institutional finance, government policies and the financing assets (Moha Patra, 1999:91).

The demand for external financing is greatest just after economic activity peaks and starts turning down. The decline in sales reduces profits available for retained earnings, whereas capital spending and investment in inventory continue apace. Firms use external funds to finance the growing gap between investment and internal funds until they manage to adjust their spending to the upcoming recession (Shapiro, 1990:365).

A business to firm needs finance for varying terms to run it smoothly. On the basis of time duration the financial requirement of business firms can be classified into the following groups:

- i) Short-term finance
- iii) Long -term finance

### **2.1.2.3 Short-term Vs Long-term Financing**

Firms financing need may be broadly categorized into short-term and long-term. As per the nature of assets to be acquired, a firm may adopt either short-term financing, or long-term financing or both.

For most companies short-term financing is the principal means by which assets are funded. There are numerous types ranging from spontaneous credit in the form of accounts payables and accruals to negotiated interest bearing debt. The portion of short-term versus long term financing is a function of a company's funds requirements seasonal versus more permanent as well as the aggressiveness of management in matching its finance with its funds requirements (Vanhorne, 1990:395).

A financial manager has to assemble funds from numerous sources to meet financial requirements of the firm. As discussed earlier, a firm needs long-term funds to acquire fixed assets and to carry a portion of current assets as permanent investment in fixed assets to ensure uninterrupted and smooth flow of business activity. It requires short-term funds to cover day-to-day business needs. Frequently a firm may need medium capital for a period of 3-5 years for financing aggressive advertising campaign and for complete overhauling of its machine and equipments. Among these different kinds of capital requirements, capital needs for acquiring fixed assets are of considerable significance because tidy amount of funds has to be arranged for a very long period of time. (Joshi 1997:334).

Short-term financing is less expensive than long-term financing, but at the same time, short-term financing involves greater risk than long-term financing.

Various individual sources of finance are available to a firm to meet its financial requirements. Selection of the right source or sources from which the firm should source its funds requirement depends primarily upon whether the firm needs fixed capital or working capital.

The composition of long-term funds in the total financial structure of a firm is popularly known as capital structure, a decision most complex to be taken.

There are numerous sources of finance available to fulfill the capital need of the firm; the financial manager should be able to maintain the proper combination of short-term and long-term funds as per the requirement for the firm. Thus, the description of principal sources of long-term finance has been made in the next section financing instruments.

#### **2.1.2.4 Business Financing (Long-term) Sources**

When a company is formed it first issues equity shares to the promoters (founders) and also in most cases raises loans from banks, financial institutions, and other sources. As the need for financing increases, the company may issues shares and debentures privately to promoters, relatives, friends, business partners, employees,

financial institutions banks, mutual funds, and venture. Such investors are specific and small in number (Chandra, 2002:382).

As the company grows further, it may have to raise capital from the public. The first issue of equity shares to the public by the company is called initial public offering (IPO). Subsequent offerings are called seasoned offerings.

Financing instruments in the capital market: equity share, preference share and long-term debt are the basic sources of long-term financing. Other different kinds of long-term financing such as convertibles, warrants, leases, are the non-basic forms of long-term finance (Jeffery F. Jafe 1993:393).

Following section briefly describes the basic sources of financing instruments in the capital market.

**i) Equity shares (common/ordinary shares)**

Common stock is a security issued by a company to raise equity capital. It represents ownership of the company. Common stockholders of a company are its real owners. Their liability, however, is limited to the amount of their investment; common stock certificates are legal documents that evidence ownership of the holders in a company. But common stockholders have residual claim on income and asset common stock dividend is paid after payment of interest to the creditors, tax to the government, preferred dividend to the preferred stockholders. Similarly, in the event of liquidation, common stock holders have a residual claim on the assets of the company after the claim of all creditors and preferred stock-holders are settled in full.

Common stock does not have a maturity date. Shareholders, however, can sell their stocks in the secondary market. Hence, the company which needs fund for indefinite period issues shares of common stock. The business charter (memorandum of association) of a company specifies the number of authorized shares of common stock. The firm cannot sell more shares than the charter authorizes without obtaining approval from its owners through a shareholder vote or without amending its charter. As it is difficult to amend the charter to authorized the issue of additional shares, firm generally issues shares less than the authorized shares. These not issued shares allow

flexibility in granting stock option and splitting the stock. When shares of common stock are sold, they become issued shares. All or some portion of these share are purchased and actually held by the investors, which are called outstanding shares. If firm repurchases any of its outstanding shares, these shares are recorded as treasury stock and shown as a deduction from share holds equity in the firm's balance sheet.

### **i.i) Features of Common Stock**

#### **a) Par Value**

Par value is stated price in common stock certificates. the business charter specifies the par value of a share of common stock in Nepal, company Act, 2053 B.S (1997 A.D) has specified that par value of a share must be set at Rs. 100. A company should not issue common stock at a price less than par value, because any discount from par value is considered to be a contingent liability of the owner to the creditors of the company. In the event of liquidation, the shareholders would be legally liable to the creditors for any discount from par value. But in Nepal, company can't share at discount. In USR, common stock may be selling with or without a par value.

#### **b) Maturity**

Common stock has no maturity dates. It exists as long as a firm does. Therefore capital raised from common share is also called fixed or permanent capital.

#### **c) Claim on income**

Common stockholders have residual claim on income. Common stockholders are paid after satisfying claims of creditors, bondholders and preferred stockholders. Residual income can be distributed to common shareholders directly in the form of dividends or retained and reinvested by the firm. However, a firm's ability to pay dividends is affected by various factors such as legal provision, contractual restrictions etc.

#### **d) Voting rights**

Generally, each share of common stock entitles the holder to one vote in the election of directors and in other major decisions. Common shareholders can attend at the annual general meeting and cast vote in person or by means of a proxy. A proxy is a legal document giving one person the authority to represent on behalf of other.



### **e) Preemptive rights**

Common stockholders also have preemptive right. The preemptive right gives the existing shareholders right to purchase any new shares issued by the company at subscribed price on pro-rate basis. Preemptive rights allow common stockholders to maintain their proportionate ownership and control in the company.

### **f) Limited liability**

Although the common shareholders are the actual owner of the company and have residual claim on all assets, their, their liability in case of the liquidation / bankruptcy is limited to the amount of their investment. But shareholders liability will equal to par value if paid up capital is less than par value. (Baral, Dahal, Gautam, Paudel, Rana, 2062:188).

### **ii) Debentures**

Debenture as a debt security is given different names in different countries. In the United Kingdom and India the term 'debenture' is common, but in the United States the popular term is 'bond' (Chauhan, 1967:85). In Nepal the term is generally referred to as debenture.

Typical debt securities are called 'notes', 'debentures' or 'bond'. A debenture is an acknowledgement of a debt given under the seal of a company and containing a contract for the repayment of the principal sum at a specified date and for the payment of interest (usually half yearly) at a fixed rate percent (Chauhan, 1967:58). Since debenture is a long-term promissory note and lenders have great stake, a long-term agreement is entered into between the company and creditors and a deed is executed to set terms of borrowings. Such a deed is known as 'indenture' or 'trust deed' which contains among other things, protective provisions that usually include limits on indebtedness, restriction on dividends, provision of sinking funds for redemption of debt, convertibility provisions of the bond etc. It is through this indenture that the long-term relationship between the company and debenture holders is established (Srivastava, 1984:650).

Debenture is one of the frequently used methods by which a business can procure long-term funds for its initial financial needs or for its subsequent requirements of

growth and modernization (Srivastava, 1984:649). In practice, the use of debentures depends both on the nature of the firm's assets and on its general credit strength. An extremely strong company such as IBM will tend to use debentures; it simply does not need to put up property as security for its debt (Brigham, 1996:700).

**ii.i) certain distinguishing features of debentures are as follows:**

**a) Maturity**

Unlike stock, which has no maturity date, debenture matures. The principal amount of bond must be repaid at a definite time. Such bonds which have a fixed maturity date and are payable in cash are called 'Redeemable Bonds'. Others, which have no maturity date, are 'Irredeemable or perpetual bonds. Bonds can be retired by way of redemption, refunding or by conversion (Srivastava, 1995:651). Although bonds traditionally have been issued with maturities, between 20 to 30 years, in recent years, shorter maturities, such as 7 to 10 years, have been used to an increasing extent (Brigham, 1996: 699).

**b) Claims on Income**

Bondholders have priority of claim to income over stockholders. They have legal recourse for enforcing their rights. There are certain types of bonds on which interest payment is made only out of profits, such bonds are called 'income bonds ' however they are superior to preferred and equity stock.

**c) Claims on Assets**

Bondholders also have priority over stockholders in respect of their claims on assets. As against this superior position, the creditors are entitled to get only the principal amount they had lent out plus unpaid interest (Brigham, 1996:656).

**d) The Controlling Power**

Debenture holders do not have controlling power because they have no right to vote for the election of directors. They may, however, indirectly influence managerial decision through protective covenants in indenture. For instance, to protect interest, bond indenture may provide for maintenance of minimum liquidity ratio and for building up stipulated amount of reserves before making dividend payments to stockholders (Brigham, 1996:658).

Debt is considered a cheaper source of financing not only because debt is less expensive in terms of interest cost and issuance cost than any other forms of security but essentially due to availability of tax benefits. The interest payment on debt is deductible as tax expense. Debt provides protection against unexpectedly high inflation because its real cost varies inversely with the rate of inflation. Besides, it is easier to raise sufficient funds by means of debenture issue, as it is possible to tap the resources of the people of conservative nature who desire to get fixed income without much risk. As a general rule, only those companies whose earnings are reasonably stable and high enough to cover fixed interest charges on debentures can afford the luxury of financial leverage (debt equity mix).

However, debentures impose a great burden on the finances of the company since interest must be paid whether there is profit or not. Greater use of debt financing increases the firm's financial risk, possibly leading to bankruptcy and eventual liquidation. In general, the increase in financial leverage raises the firm's cost of equity capital. These restrictions may reduce the firm's ability to engage in value maximizing behavior. Further, debt proves fatal when the expectations and plans on which the debt was issued changes. Since debt makes good time better and bad time worse, due consideration should be given on the nature, situation of the business and overall structure of the economy while making decision on the use of debt as source of finance.

#### **2.1.2.5 Equity Financing vs. Debt Financing**

To support its investments a firm must find the means to finance them. Equity and debt represent the two broad sources of finance for a business firm. Equity consists of equity capital, retained earnings and preference capital. Debt consists of term loans, debentures and short-term borrowing (Chandra, 2002:366).

For the optimum utilization of different sources of funds, a financial manager should maintain the best mix of funds; however, maintaining the best composition of long-term funds (also referred to as capital structure decision) is the most complex decision to be taken.

An important question facing companies in need of new finance is whether to raise debt or equity. In spite of continuing theoretical debate on capital structure, there is

relatively little empirical evidence on how companies actually select between financing instruments at a given point in time (Marsh, 1982:121). The role of debt and equity changes over time and with the level of development. As an economy develops, the aggregate ratio of debt to equity will generally fall, yet, debt and equity remain complementary sources for the financing of capital investments (Smith, 1996:371).

The combination of debt and equity has many implications to an enterprise. Firstly, the use of debt capital turns out to decrease the overall cost of capital and increase the wealth of the shareholders due to tax deductibility of the interest paid on the debt. This is what generally called as 'trading on equity'. Secondly, debt is relatively cheaper than equity in terms of issuance cost as well as interest costs. Thirdly, the use of debt financing does not result in dilution of control over the enterprise of the existing shareholders. Though using debt is advantageous, use of more debt in the total structure is risky. Moreover, the uses of debt will not automatically improve the overall return to the firm, but it may lower it if the firm's rate of return is less than its cost of debt. A great deal of controversy has thus developed over whether the capital structure of a firm as determined by its financing decision affects its cost of capital (MahaPatra, 1999:80).

Considering the choice between equity and debt, if there are no tax implications or other market imperfections, the form of the obligation is of little importance: it doesn't matter whether the financing takes the form of equity or debt or some combination of two, because capital is capital and owners are owners. However, the deductibility of dividends on equity causes firms to favor debt, at least up to some point. Increasing the amount of debt increases the probability of bankruptcy, and therefore increases both the cost of debt and the cost of equity. Firms that do not want to incur rising costs of debt and equity, and other costs of bankruptcy, will therefore limit their borrowing to an optimal level which includes enough debt to take advantage of the tax shields but not so much debt that cost of capital are driven too high.

Because debt financing creates incentives to act opportunistically, a highly levered firm may not be able to obtain credit or to explore fully opportunities for mutually beneficial contracting with customers' rivals or suppliers. In these cases, issuance of

equity would mitigate the incentive problems created by debt financing (Maksimovic, 1996:344).

Greater use of debt financing increases the firm's financial risk, possibly leading to bankruptcy and eventual liquidation. Moreover, the real cost of debt will be greater than expected if the rate of inflation turns out to unexpectedly low (Shapiro, 1990:377).

It is true that higher debt ratios means that more companies will fall into financial distress if a serious recession hits the economy. But all companies live with this risk, to some degree and it does not follow that less risk is better. Finding the optimal debt equity ratio is like finding the optimal speed limit, we can agree that accident at 30 miles per hour are generally less dangerous than accidents at 60 miles per hour, but we do not therefore set the speed limit on all roads at 30. Speed has benefit as well as risks, so does debt (Mayers, 2002:389).

In principal, companies needing new finance should issue equity if they are above their target debt level and debt if they are below. Theory predicts that the overall target will be a function of bankruptcy risk and tax and that the composition of debt will depend on the company's size\_ asset composition, and on uncertainty about future inflation rates. In particular, equity issues seem to be favoured after period of strong share price and overall market performance (Marsh, 2002:121).

Various factors affect the mix of financing. The extent to which the variation in the aggregate debt-equity ratio within the countries can be explained by (i) The level of development of the country's financial markets (ii) Macro economic factors (iii) The differences between to tax treatment of debt and equity securities and (iv) The firm's specific factors that have been identified in the business finance literature (Maksimovic, 1996:342).

A relatively underdeveloped stock market begins to develop in a given country; firms in that country initially increase their debt-equity ratios. Not only do they issue new equity but they also borrow more. So at early stages of market development, improvement in information quality, monitoring and business control may be large

enough to induce creditors to lend more. For these firms debt equity finance are complementary, however, as stock markets continue to develop, the ratio changes. In countries with relatively developed stock markets, as the latter continue to develop; firms begin to issue equity for debt (Maksimovic, 1996:48).

Current empirical research has shown that when managers believe their firm's equity is undervalued, they do not issue new equity. This decision not to issue maintains the value of existing shareholder's wealth. Conversely, managers issue equity when their firm's security is overpriced, resulting in a wealth transfer from new to current shareholders. A rational market, anticipating managers' opportunistic behavior discounts the price of issuing firm's equity (P. Ferris, 2000:78).

Most cases financing through equity has many advantages over debt financing. The equity markets have expanded rapidly during the eighties. Rising financing through equity has emerged as the cheapest way of financing in the 1990s. Moreover, the risk attached to the equity capital of companies operating in the emerging markets is relatively lower as compared to the debt. With the passage of time, an equity market will become particularly beneficial as a means of financing new and complex activities, as equity Finance does not require fixed assets and can better reward risk taking activities (Jain 1995:25).

### **2.1.3 Potentiality of Equity Capital as a Source of Finance**

#### **i) Potentiality of common stock**

Equity stock is the most potent source of financing that provides substantially large amount of funds without involving the company and the management in any fixed obligations. The management is left free to utilize the funds so raised without being bothered to repay them to their owners till the business of the enterprise continues (Srivastava, 1984:624). Moreover, the company need not mortgage any portion of its assets to secure equity share capital.

Equity stock facilitates the company to reap the benefits of leverage by taking recourse to debt, which is the cheapest of all sources of Financing. Creditors are desirous of investing in debentures of a company with a considerable amount of equity share capital because it provides a cushion to them to absorb any loss.

Accordingly, a company with a tidy amount of equity share capital experiences no problem in raising long-term loan capital at convenient terms and conditions, in turn: it strengthens the credit capacity of the company.

Furthermore, equity share capital provides a considerable amount of maneuverability in the financial structure of the company. A company with equity share capital is under no commitments to its suppliers of capital and can adjust its sources of funds in response to major changes in need of funds. It also enhances the bargaining power of the company when dealing with a prospective supplier of funds, which is not possible in case a company is too heavy with debt. That is why the management of newly set up enterprises always prefers to seek equity capital in order to keep the top open on senior securities in the event that a change in plans or other unforeseen contingencies makes more senior securities (preference shares and debentures) financing desirable in the future (Srivastava, 1984:625). The management in a company with an all equity stock structure has complete discretion in distributing as much of the earnings in dividends as it wishes. Since the company is under no legal obligation to pay dividends to the shareholders, the management can retain its earnings entirely for their investment in the business of the enterprise. Thus, a new and growing company seeking large funds for its expansion programs secures ample resources at cheaper cost and without any inconvenience and obligations. In view of the above factors, equity shares have proved to be the most prominent source of financing. It also appeals to a large number of investors who are venturesome and are willing to assume risks for a larger income. By purchasing equity shares, they become owners of the benefits of prosperity and progress of the company. This is why a company does not experience great difficulty in garnering funds through equity stock issues (Srivastava, 1984:626). However, there is a danger of losing control to outsiders if the company elects to raise additional funds in substantially large amount through equity issues. Controlling position of the current stockholders is jeopardized; new entrants become owners of the company and reap the benefits of the company's prosperity and progress. Current stockholders are therefore averse to additional financing by means of equity stock (Srivastava, 1984:626).

The above discussion reveals that equity shares are the most convenient and popular source of financing. For new and nascent enterprises recourse to equity share

financing is most desirable. However, for further financing purposes, the management should, as far as possible avoid using equity shares.

## **ii) Potentiality of preferred stock**

This topic examines the role of preference shares as a source of equity capital for the firm. By means of preferred stock the management can acquire capital from those who are cautious and average to taking risks and that have strong preferences for low but certain return on their investment. The management can utilize this money until the dissolution of the enterprise. The company is under no legal compulsion to repay the money unless provided in the agreement. What is further significant is that it brings in permanent capital without involving the company in fixed obligation and without creating any charge against its assets. Even if the company has sufficient earnings to pay dividends and the management decides to reinvest whole amount of earnings, the preferred stockholders cannot legally enforce dividend declaration. Thus, a new and growing concern requiring larger funds for growth purposes may find it more convenient to raise funds through the preferred stocks (Srivastava, 1984: 641).

Use of preferred stock provides leverage benefits to the company in so far as it earns more than what it costs. If the investment financed by preferred share capital can be expected to earn more than the stipulated dividend rate, the company will gain from this type of security as compared with the issuance of additional equity stock. The leverage benefits will result in a rise in earnings per share of equity stock and consequently a rise in share values. Indeed the leverage benefits in this case will not be as high as in respect of debt, but the company has the advantage of avoiding risks of bankruptcy in case of default in payment of fixed charges and problems associated with the maturing of bonds as are otherwise involved in debt. Thus, while debt is a riskier form of leverage, the preferred stock promises relatively lower leverage with greater safety. It would be more useful for a company with relatively unstable and uncertain earnings to employ preferred stock.

However, a company seeking preferred stock capital must pay higher return as compared to bonds to compensate for greater amount of safety in the latter. Non-deductibility of preferred stock dividend for taxation purpose makes cost differential



between preferred stock and bond much greater. Even if dividend rate on preference share is equal to bond interest rate, effective cost of former will be higher by 60 percent (if the company is in the tax bracket of 60 percent) relative to debt. This tax factor has therefore, limited the potentiality of the preferred stock as a source of finance.

While choosing securities for raising long-term capital, the finance manager must familiarize himself with investors' feeling about different kinds of securities. So as to decide whether to issue preferred stock, the financial manager should take into account the pros and cons of the stock and financial condition of the enterprise, if the firm does not have sufficient fixed assets to offer as security for acquiring funds, preferred stock financing would be of considerable use. The use of this stock will be strongly favored if the use of debt entails the risk of insolvency in the enterprise and issuance of common stock poses a threat of parting control with new equity stockholders.

#### **2.1.4 Equity Market: Nature and its Role**

Equity market has the key role in the overall development of the economy. At first, efficient equity markets make the best allocation of capital i.e. they channel savings to best uses. Improved capital allocation increases overall economic efficiency. Moreover, equity markets play an important role in encouraging savings and investments, which are essential in economic development. In addition, by allocating and diversifying across variety of assets, equity markets reduce the risk that investor must bear. Since the public limited companies/corporations place ultimate decision-making power in the hands of shareholders, managers of public corporations with traded equity claims are not free to make decisions in a vacuum but must consider shareholders and social responsibilities.

Equity markets facilitate the flow of funds from individual or institutional investors to corporation. Thus they enable corporations to finance their investments in new or expanded business ventures. They also facilitate the flow of funds between investors. Stock market facilitates the equity investment into firms and the transfer of equity investment between investors (Madura, 2001:231).

In addition to their primary role of supplying capital to the economy equity markets have an important informational role. Equity markets aggregate information about the prospects of the firms whose shares are traded. This aggregated information becomes publicly observable by the firm's creditors and investors. Equity markets thereby facilitate the monitoring of the firm by making it more profitable for investors to contribute capital to the firm (Levine, 1996:229).

Stock market may affect economic activity through the creation of liquidity. Liquid equity markets make investment less risky and more attractive because they allow savers to acquire asset equity and to sell it quickly and cheaply if they need access to their savings or want to alter these portfolios. At the same time, companies enjoy permanent access to capital raised through equity issues. By facilitating long-term, more profitable investment liquid markets improve the allocation of capital and enhance prospects for long-term economic growth. Further, by making investment less risky and more profitable, stock market liquidity can also lead to more savings and investments (Levine, 1996:229).

There is a synergy between equity market development and bond market development. For a bond market to develop there must be a well developed equity market capable of processing complex information. In contrast, an equity market can develop without a well-developed bond market, particularly in a growing economy where downside risks are low. Given the principle of limited liability, equity holders may even be willing to invest in shares in order to benefit from upside gains. An efficient priced equity market however will not develop without a well-developed bond market, which provides the correctly priced term structure of risk-adjusted discount rates (Takagi, 2002:84).

Studies have shown that, at low levels of development commercial banks are the dominant financial institutions. As economies grow, however specialized financial intermediaries and equity markets develop and prosper. Study shows that the low-income economies had virtually no stock market activity or non-bank institutions in the 1970's. By 1990, however, both, non-banks and stock markets began to develop. The financial systems in middle and high-income economies have evolved according

to a similar pattern. The middle and high-income economies are simply ahead of the low-income group (Kurt and Levine, 1996:225).

Equity markets create value when a corporation issues shares of stock; promising rights of control and allocation of expected earnings that are traded for cash in the present. Value is created in markets for guarantees when one party pays another for a promise to assume a financial obligation realized to the occurrence of a future event. Thus, value arises when a firm's contract or promise is made or traded. The value of contract equals its price (Pischke, 1991:5).

Poorly developed equity markets inhibit the transfer of capital ownership. Moreover, the costs of transacting in equity markets affect not just the level of investment, but the kinds of investments that are undertaken (M. Stan, 1996:241).

### **2.1.5 International Context**

The focus of the study is however with the Nepalese/national context, the researcher felt that it would be fruitful to present some information on the international context. In the era of globalization, the study of regional and/ or global context (Here, on financing and capital market) would help to draw some new knowledge and experience for a developing country like Nepal. However it is very difficult to have required and reliable data, an effort has been made to present the related information as far as possible.

### **2.1.6 Globalization of Financial Markets**

Advances in communications and technology, together with financial deregulation abroad-the lifting of regulatory structures that distinction between domestic and foreign financial markets. As the necessary electronic technology has been developed and the costs of transaction have plummeted, the world has become one vast interconnected market. Markets for certain stocks, (Such as U.S. Government securities) foreign exchange trading, inter-bank borrowing and lending etc. operate continuously around the clock and around the world and in enormous size. Globalization has brought inhibit competition and protect domestic markets have blurred the about an un-presented degree of competition among key financial centers

and financial institutions that has further reduced the costs of issuing new securities (Shapiro, 1990:369).

The combination of freer markets with widely available information has laid the foundation for global growth. In 1988 some \$ 370 billion was raised in international capital markets, \$ 60 billion higher than the previous peak, in 1986. Treasuries are not confined to domestic markets as their source of funding and are now quick to exploit any attractive opportunity that occurs anywhere in the world (Shapiro, 1990:369).

### **2.1.7 Equity Markets in Asia and Developing Countries**

Developing countries are more integrated into international financial and capital market, as seen in the growth of private capital flows 3.7% of developing countries' fixed investment in 1990 to 1.1 % in 1995, or more than double the rate before the debt crisis. Financial integration has been driven partly by investors' needs to diversify portfolios but mainly by the higher creditworthiness of domestic financial and capital markets and improved macroeconomic fundamentals (World Bank, 1997:19).

There is simply not enough equity capital in Asia to fuel the economic miracle to which it aspires. To keep the dream alive, Asian business firms have to seek new equity from the international markets mainly through the use of depository receipt. The markets for new issues from Asia have changed fairly dramatically in recent years. Before the Asian economic crisis, an equity issue of one billion dollar was huge. Today, it is almost common place (Asia Money, 2002:1). When the banking sector came into difficulty, this necessitated the development of domestic capital markets in post crisis Asia.

Since the late 1980s, progress had already been made in much of emerging Asia to develop capital market institutions, so that the financial structure of the crisis-affected countries could not have been characterized as bank-based in the same sense that they were in the early 1980s. Within the framework of rapid economic growth, interest rate liberalization, and other financial deregulation, considerable improvements were made in the infrastructure of capital markets, and the size of the equity and bond markets did expand considerably in the late 1980s and early 1990s (Takagi,2002:669).

Despite the recent growth of capital markets, however, the Asian financial systems may still rightly be characterized as largely bank-based even for the more advanced emerging market economies. Perhaps with the exception of Hong Kong, China, and Malaysia, the number of listed firms as well as the participation of individual investors in the equity market is limited. Much of the growth of the equity markets from the late 1980s to the early 1990s was driven by expectations of capital gains associated with booming economies; irrespective of the quality of market institutions or price formation (Takagi, 2002:68).

It is true that the market for equities is sizable in emerging East Asia and may even exceed the balance of bank loans in some of them. Equity markets can grow even when an existing market infrastructure does not support the development of markets for business bonds. The bond markets remain even more limited. In virtually all-Asian countries where bond markets exist, they are dominated by government securities. The bond market in Asia is virtually nonexistent; it has remained the least developed segment of financial system, especially as a vehicle of long-term business financing (Kunt and Maksimovic. 1996:69).

Business ownership in many Asian countries is highly concentrated. Ownership concentration could be a means for investors to be better able to monitor and control management. In many advanced economies, significant shareholders are usually institutional investors such as banks, mutual funds, insurance companies and pension funds. These institutional investors themselves have relatively dispersed ownership and are transparent, and hence are found to be generally effective in monitoring management. In southeast and East Asian countries, on the other hand, significant shareholders are often families or family groups. In the Republic of Korea for example, family dominated conglomerates were found to have an average debt/equity ratio of 4:1 and in some cases 10:1 at the time the crisis started. They were overextended, over diversified and vulnerable to shocks. Family dominance may make it easy to exploit other business relationships with companies under their control (ADB, 1998:1).

Efforts to improve the functioning of financial markets of developing countries, that is, to allocate capital more efficiently, have often focused on core financial themes

such as interest liberalization, smaller government role in credit allocation and improvement in the role of banks as financial intermediaries. Recently, capital markets in general and stock markets in particular have received increased attention from policy makers (Claessens, 1995:8).

Developing countries' access to capital markets deteriorated substantially in 2001. Total capital markets commitments (bank loans, bond issues and portfolio equity) declined to an estimated \$171 billion, about one-quarter less than the level in 2000 (World Bank, 1999:32).

Equity portfolio flows can benefit developing countries by diversifying the sources of external finance; increasing the risk-bearing by investors, reducing the cost of capital, improving incentives for managing the investment process, assisting the development of domestic capital markets and enhancing the mobilization of domestic resources. To further reap these benefits, developing countries should (continue) lower barriers to foreign equity flows. The most important barriers appear to be instability, underdeveloped stock markets, and lack of openness. (Claessens, 1995:8).

As anywhere in the developing world, the relative underdevelopment of capital markets in developing Asia can be attributed to inadequate market and legal infrastructure, which in the presence of informational problems raises the cost of external finance.

In addition to proper fiscal and monetary policies, other policy measures: a solid regulatory and accounting framework, investors' protection and less restriction on foreign ownership can help remove the existing barriers.

### **2.1.8 Legal Arrangements of Business Securities Market in Nepal**

Dr. M. K. Shrestha, R.B. Poudel and D.V. Bhandari (2003) in his book Fundamental of Investment has focus on the legal arrangements of business securities market in Nepal, legal reforms and policy stance are required to make the market efficient in allocation and operation. Securities Marketing Center 1976 was an outcome of this realization. Though established in 1976, the then Securities Marketing Center

confined its activities in the purchase and sale of government securities and management of a few public issues of business securities till 1984.

The realization that the organization like securities exchange center should act as facilitator rather than market operator necessitated massive reforms in securities act 1983. Accordingly, securities act (first amendment) 1992 was enacted in 1992, which came into force since 1993. This amendment converted securities exchange center into Nepal Stock Exchange Limited, which now acts as an organized exchange and a separate regulator - security exchange board - has been constituted to regulate and to promote the securities market in Nepal. The second amendment was made in 1997 with the objective of upgrading the securities upgrading system. This amendment further empowered securities board of Nepal as an apex regulator of the capital market.

Securities board is empowered to issue guidelines and directives to stock exchanges, business bodies issuing securities to general public and securities business persons. Accordingly, the board has issued guidelines for regulation and issue approval of securities, 1995 to regularize the issue of securities by companies. The guidelines and directives have prescribed the minimum conditions/qualifications of the company/management for issuing securities.

Further changes are taking place in improving the acts by laws and guidelines to regulate securities market. SEBO forwarded initial draft of new securities act, 1999 to Nepal Government (Now Nepal Government). Disclosure formats were developed in 2000 and implemented in stock exchange and to stock brokers in 2001. Bonus share issue guidelines 2001 were made effective for operation in 2002.

#### **2.1.8.1 Regulatory Framework**

Dr. M. K. Shrestha, R.B. Paudel and D.B. Bhandari (2003) in his book Fundamental of Investment has focused on the regulatory framework, regulations not only provide benefit but also impose costs on financial institutions and market. It is argued that a freely competitive financial structure prevails where institutions are wealth maximizing competitors that are neither subsidized, penalized nor regulated by the government and where entry into and exit from the market is not constrained. Therefore, the imposition of regulation usually entails a movement away from free

competition and towards greater costs or sub optimal portfolios. Therefore, benefits and costs of regulations must be properly analyzed before introducing them.

In Nepal, financial market is governed by number of regulations, among them the following acts are important.

Companies Act, 1997

Nepal Rastra Bank Act, 2002

Commercial Banks Act, 1974

Development Banks Act, 1997

Co-operatives Act, 1993

Provident Fund Act, 1962

Finance Company Act, 1986

Insurance Act, 1992

Securities Exchange Act, 1983

Securities Exchange regulation Act, 1993

Investment Fund Act, 1996

Financial Intermediary Act, 1998

#### **2.1.8.2 Impact of Rule and Regulation**

Prof. Dr. M. K. Shrestha in his article impact on Capital market in Nepal, capital market is the general barometer that measures the proper collection and canalization of savings for investments in productive and income generating assets. The allocative-efficiency in the use of funds is the basis for measuring the performance of capital market. But what matters crucial is the effective regulation of securities market. However experience in the number of advanced and developing countries shows that regulation of securities market became a felt necessity as a result of the manipulative practices and dishonest security dealings.

SEBO/N is trying to insist through regulation to help investors behave rationally at least among those who actively participate in capital market. Efforts are going to make the information freely and widely available to market participants at the right time with out delays and enable investors to be both price makers and price takers as well as avoid emotions on the part of investors to response to the new information that may come in the market.



Regulation of stock market by historical experience became a felt necessity in number of countries having securities market to overcome the problem of market disorders and misuse of inside information, avoid unfair trading practices, eliminate price manipulation and discourage fraudulent trading activities. By what degree and to what extent these can be controlled these are lapses going unchecked due to weak enforcement and non compliance of specified legal provisions. Issues have been raised on code of conduct of the brokers, issue manager, market players and intermediaries that have taken responsible takes with due care and intelligence to protect the interest of investors.

The world Bank under its country assistance strategy, 1992-2001 has clearly spelled out that stock market growth is constrained by weak and unstable government in addition to low returns inefficient public limited enterprises, weak economic management and violent Maoist insurgency. In the ninth plan, issues have been addressed regarding weak enforcement of regulation leading to low level of investor confidence, inadequate disclosure and poor business governance practices and absence of institutional investors in capital market. Even then, programmed has been laid down to develop institutional and suitable legal framework for regulation. This is in line with the support of Asian Development bank with the help of expert Group found in 1998 by improving securities transaction act and marketing timely arrangement on code of conduct other accountability liability of promoters' securities persons and other professionals dealing in the stock market. The pros and cons of regulation have changed with act and developing various guidelines to monitors and supervises capital market in the country. At the same time, efforts are going to develop regulation system of international standards provided government provides adequate enforcement power to SEBO/N.

## **2.2 Review of Related Studies**

This section reviews some related books, articles and journals, rule and regulation and related thesis.

### **2.2.1 Review from Book Study**

In their book, under the topics 'Why don't firms issue more equity. Ross, Wethersfield and Jaffe (Jefferv, 1993:386). Stated that external equity, as a percentage of total

business sources of financing have historically been very low or negative. Many firms do not like to use external equity. They presented the findings of Donaldson's study, (Donaldson, 1984) as per Donaldson; many business financial managers are reluctant to use external equity as a regular source of financing. Many corporations that made use of the public equity markets did so as a kind of contingency reserve for extraordinary circumstances and outside the normal financing framework. Donaldson presented the argument of the people and stated their opinion as; such fact is due to the inefficiency of the market.

Ross, Wethersfield and Jaffe Further wrote that, business managers give a number of reasons to justify why they do not issue new equity, in this regard they pointed that, one of the reasons is that many company executives believe that their stock is priced below true or intrinsic value. This reason is inconsistent with the efficient market hypothesis because stock should be correctly priced under the hypothesis.

The state development of equity market indicates low well-versed issues, investors and intermediaries are in dealing with securities with primary and secondary market levels. Nepal's overall market is still in its infancy however, the Nepal Stock Exchange (NEPSE) is a late development, founded only at present 125 companies are listed. Very little company listed on the exchange make a book profit on which a dividend can be paid. Most trading takes place operating in Nepal (Such as Coca Cola and UNI-lever) those companies in need of considerable improvement. Manual procedures are used for dealing trading, lack of credibility, weak accountability, lack of knowledge about capital markets, low investor confidence and high interest rate the main constraints to further development.

The Nepalese capital market has been passing through the transaction phase over the past few decades after since independence. There are the past few decades after since independence. There are various inconsistencies and hindrances existed on the way of functioning of market. Not only that institutional bottleneck are hampering the growth of capital but at times, the existing imperfect national characteristics phenomenon deeply noted in socioeconomic system has undermined the proper trading in securities market. The arbitrarily quoting of stock price without fundamental and technical

justification made securities market not to look after the protection of investors. (Pro. Dr. Shrestha, M.K, "Capital Market In Nepal: Changing Dimension and Strategies")  
An efficient market is one where a security's current price gives the best estimate of its true value. In an efficient market, there are higher free lunches non-expensive dinner. It is not possible to systematically gain or lose profits from trading on the available public information (Weston and Copland: 1995:731).

### **2.2.2 Review of Journals, Articles and Newspapers**

Dr. Manohar Krishna Shrestha (1985) in his analysis of capital structure in selected public enterprises finds that in almost all public enterprises, capital structure contributed to remain a very indeterminate problem in view of the lack of guided criteria determining it. He had chosen to public enterprises for undertaking study and concluded that the selected public enterprises have a very confusing capital structure since the corporations are not guided by objectives based financial plans and policies.

A thesis entitled "**Short-term Financing Management of selected Nepalese manufacturing companies**" submitted by Santosh Karkee (2007). According to him, the public sector and manufacturing companies in developing countries have required capital for investment, which reflect the importance of short-term financing. Neither higher usage nor lower usage of short term financing should be done and only seasonal requirement should be financed through it. Most of the Nepalese manufacturing companies suffer huge losses due to their inappropriate financial mix. Since, higher use of short-term debt is risky for the company he had recommended to adopt mix approach.

This paper examines the sources of return variation in emerging stock branches. From the prospective of collecting independent samples, emerging market countries are particularly interesting because of their relative isolating form the capital markets of other countries. Compared to developed market, the correlation between most emerging markets and other stock markets has historically been low (Harvey 1990:) and until recently many emerging countries restricted investment by foreign investors. Interestingly, Bekaert and Harvey (1995) find that despite the recent trend toward abolition of restrictions and the substantial inflows of foreign capital, some emerging equity markets have actually become more segmented from world capital markets. A

large portion of the equity capital of emerging economies is held by local investors who are likely to evaluate their portfolios in light of local economic and market condition (Beckaertan Harvey 1997)

Brenan and Henry have conducted a study about international portfolio invest flows in journal of finance. In the study they construct a portfolio between foreign as well as domestic market and find act that domestic investors are able to get quick information that foreign investors and take enough benefits by it. According to them, "The article develops model of international equity portfolio investment flow based on difference in international endowments between foreign and domestic investors. It is shown that when domestic investors posses communicable information advantage over foreign investors periods when the return on foreign assets is high and to see when the return is low". (Brenan and Henry, 1997:1092)

In Nepalese context, there is little study available about stock market behaviors in small capital markets. Out of them, this study mainly concerns with the stock market behaviors in a small capital market" by Dr. Radheshyam Pradahan in 1993 and "The dividend policy and value of firm in small stock market" conducted by Dr. Karnal Das Manandhar in 1998.

In the post report "Trading on Whim Bearish Stock Rally Continues" (Kathmandu Post 14th January 2003:7) it is said that if the main happenings in the nine -year history of the country's only secondary market, Nepal stock Exchange (NEPSE) has to be put in a nut shell, then a summary can only be as follows, "Two bullish and bearish rallies each, having taken place alternatively".

In the course of nine years of NEPSE, which ended at that day, (Jan-14, 2003) the report said that, "The market saw two cycles of bullish-bearish rallies. In other words, while the market boomed in the first two years of the NEPSE operation, it then slumped and then made a sustained recovery for the next few years. The post report by recording the NEPSE index of different time period describes the situation of Nepalese capital market. The report further pointed that, the index, which began at the base mark of 100 points on Jan. 12.1994, despite the initial setback rallied high to touch 261 points within a year. It then made a quick fall to a low of 156 points within

three years and then rose to an all time high of over 540 points in 2000. Just like the 1<sup>st</sup> bull, the 2nd market bull, which occurred as a result of NRB directives to raise the capital base of banks too was short lived. And as of late, the market continues to show a bearish trend, with the index presently rallying in and around the 200 point mark.

As per the report the fluctuations in the index as mentioned above clearly portray the dreary (gloomy) state in which the stock market has been or rather is performing.

In this regard, the report says that, the last nine years of stock operation has unfortunately been largely on a whim, and without any serious analysis. The report clarifies that, being the stock market dependent on banking sector, the index movement is still determined by what happens in the banking sector whether it floats shares, gives away dividends or makes any important announcements. Moreover, the report depicts the saying of expert, as "the excessive dependence of the stock market on banks for good performance is the darker side".

Further, as per the report even the General Manager of the NEPSE (N1r. Mukunda Dhungel) conceded that the stock market has not exactly grown in a manner that it should have been "had the stock performance grown with a growth in the real sector, and then certainly the market would have been much better". However, he added that the NEPSE has provided a forum for investors to play. If there had been no stock exchange there would have never been over 400 thousand investors, or public offerings, as the report quoted the GM's statement.

The post, at the end, however showed that, despite the short history and a relatively gaunt performance, the stock market operation in a span of nine years has certainly taught investors good lessons in the sense that the relatively ignorant Nepalese investors are now wary of the stock market operations.

In his article 'Dubious Financial Market' (Katlunandu Post, 21" December 2008:4) Mr. Chandra Thapa has indicated the gloomy situation of the Nepalese financial market; he has warned, saying, "Until we do something concrete to soar investors' confidence, the gloomy picture will murkier".

He has further' claimed that misguided attempts in the secondary security market have been made to sweeten the offer for inviting naive and ignorant investors to pay exorbitant and above the intrinsic value (i.e. real market price), keeping this fact as a reason the article says that our security market is one of the most inefficient ones, in the entire world, where lack of transparency is the key and the dominating factor of our dubious financial market.

Article further pointed that, much of the immature and/or hungry investors hardly go through the prospects or dare to make any inquiry regarding the company's financial projection. People demand IPOs just for speculative dreams of selling them in the secondary market at much elevated worth rather than making rational decisions by projecting the future demand of dividends and capital gains. Moreover, the article said that such rush from the part of investors (without having any analysis) is due to the fact that Nepal has a very fragile and immature security market with a very few options for investments. Mr. Thapa has raised many questions regarding the miss pricing of securities. Finally the article attempted to put suggestions (such as the modernization of stock exchange operation, investors awareness program, etc.) to improve the stock market.

In the article "**Preference Shares: Less Preferred but Useful**", Mr. L.D. Mahat (Kathmandu Post, 12<sup>th</sup> February 2005:4) has discussed about the financing options available for the company. Mr. Mahat writes that effective cost of funds may be one of the crucial factors for the company to select a debt or equity option of financing. Debt funds provides tax shield to the company and it is the cheaper source to the companies falling under high tax bracket. But if the company doesn't have taxable income or income of the company is exempted from tax, issue of preference shares may be attractive over raising debt finance. A company can raise funds from preference shares without a fear of equity dilution. On the other hand, preference shares are considered as a part of equity at the time of computing debt equity ratio. An increased equity component in the capital structure of the company may help in bargaining for better rate of interest as well as better terms of debt financing in the market. Nepalese companies may capitalize the benefits of preference shares in the days to come.

### **2.2.3 Previous Research Review**

On the research study, "Dynamics of stock market in Nepal" (Bhatta, 1997:1-58) made by Mr. Bharat Prasad Bhatta, covering the period of 1985/86 to 1995/96, Mr. Bhatta has indicated that the liquidity of Nepalese stock market is very poor and trading of only about fifty percent of the listed stock takes place in the stock exchange when the market is boom. His study found that the supply of funds was nearly three times the demand for funds in the stock market during the study period as the investors are interested to invest in the shares of business sector through the stock market. Findings of the study showed that the banking sector has attracted the maximum number of investors as observed in the over-subscription of the public issue about 12 times followed by 3 times subscription in the finance and insurance, 2.47 times in the trading and 0.87 times in the manufacturing sector. The study further showed that the extremely small size of the stock market has the implication of low liquidity of shares. Taking 10 listed public limited companies in his sample; Mr. Bhatta observed that the possibility of raising funds from the public is very high in the Nepalese stock market. Unfortunately, the demand for funds from the public by the entrepreneurs is very low due to underdevelopment of entrepreneurship in the Nepalese economy. The study has given emphasis on the proper implementation of policies rather than their formation, but the study remains silent regarding what exact policies should be formed by the government. The study points out that the regulatory authorities of the stock market should create an environment to rise the trading of shares in the stock exchange: however, it has not addressed how to create such an environment or what should be done to create the good environment. Mr. Bhatta in his study has concluded that the stock market has a good prospect for the resource mobilization to finance the productive enterprise in the Nepalese economy. Another study, "Current Status and Problems of Stock Market in Nepal" (Pant, 2000:1-89) was performed by Mrs. Rekha Pant. The period of study was 1991/94 to 1998/99 with the main objective of analyzing the trend of Nepalese stock market including its problems and prospects. On her study Mrs. Pant has indicated the urgent need to develop money and bond market (both government and business) arranging different types of instruments for the creation of new savings vehicles which lead individuals to invest more in business debt and equity, relative to bank deposit and government securities. The study has addressed the major problems in the stock market such as; unfavorable macroeconomic condition, political instability, low investors' confidence, weak tax

system, slow privatization process, inadequate institutional investor base, weak legal affairs for stock market regulation and enforcement investment of savings in bank deposit and government securities, lack of improved prospectus to investors and restriction on foreign portfolio investment.

Since the study is theoretical, the valid of facts is bound to be low. The study has mentioned that companies are listed for legal or tax reason rather than to obtain on going equity financing but at the same time it remains silent about how to inspire and/or motivate the company's listing for equity financing. Mrs. Pant through the study has made recommendation for the privatization of NEPSE, de-listing of inactive securities, exposition of SEBO/N and NEPSE to the latest concept and techniques, provision of appropriate policies by the government. She raised various key problems but the study does not seem sufficient to adequately address the exact method of solving those problems. On the study of "Stock market in Nepal (Primary market)" Mr. Shrestha, Rai and Khadka (Khadka, 2008:1-32). Indicated the need of the well-developed primary stock market in Nepal. They discussed about the problems and prospects of primary stock market. Mainly, the study has pointed out that the principal hindrance in the capital market is the gap between the investors and business bodies. Investors are willing to invest in the common stocks of public limited companies but the business bodies are not coming ahead to collect fund from the primary market through public issues. Rather they are opting for loan from banking and financial institutions for their long-term capital requirement. They have suggested few measures to overcome such hindrance but at the same time, the study remains silent about the method of applying such measures. It also is not clear about what should be done particularly in order to improve the market.

Mr. Shrestha. Rai and Khadka (2008) further pointed out that whenever the business bodies offered stocks in the primary market there is an over whelming response from the retail investors. Almost every public issue has been oversubscribed. This can be attributed to the insufficient knowledge of retail investors about the securities market rather than the development of market in the true sense. They further indicted that the declining interest rate of deposits in the commercial banks due to the slowdown in the economic activities is the other reason for oversubscribing the initial issues. The study reflected that there are not enough issues to meet the demand of most of the retail



investors. At the same time, the performance of companies going public for raising capital are also not able to meet the expectation of the investors in the sense that they are unable to provide a minimum acceptable rate of return to the investors, except in the case of companies in the banking and finance sector. In their study they have pointed out other problems such as inadequate knowledge of investors about the stock market, lack of investors' confidence, shortcomings on existing laws and regulations, lack of co-ordination between the SEBO/N and NRB, restriction for foreign investors, high cost of public issues, lack of transparency etc.

Moreover, they claimed that there exists ample opportunities for the investors to invest in the stock of business bodies and the business bodies have the opportunities of collecting required capital through the issue of stock through primary market. They realized that reform could bring institutional investors into the market, encourage creation of new saving vehicles, leads to the individuals to invest more in business equity relative to bank deposits and government securities and raise the overall savings ratio. Much of the problems in the primary stock market are reflected in their study, however, the study being in a descriptive form without having the detailed analysis of the data is not sufficient enough to direct the market towards right direction.

For the review purpose, the researcher has referred another study, which was conducted by Mr. Kunt and Maksimovic (1996). In their study of "**Stock Market Development and Business Finance Decision**", Mr. Kunt and Maksimovic (Maksimovic, 1996b:47-49) indicated that in the absence of well functioning stock market, firms are unable to optimally structure their financing packages. They further pointed that: usually there are conflicts of interest between a firm's managers and its customers and suppliers as well as between different classes of investors in the firm. For example, firms with high levels of debt may have increased their profitability of bankruptcy sufficiently that they may enter into overly risky projects, thus, harming their creditors. Because debt financing creates incentives to take greater risks, a highly leveraged firm may not be able to obtain additional credit. In these cases, if there were a well functioning stock market, issuance of equity would mitigate the incentive problems, allowing the firm to borrow more.

The finding of their study suggested that as a relatively underdeveloped stock market begins to develop in a given country, firms in that country initially increase their debt equity ratios. Not only do they issue new equity but they also borrow more. So, at early stages of market development, improvements in information quality, monitoring and business control may be large enough to induce creditors to lend more. For these firms, debt and equity finance are complementary. However, as stock markets continue to develop, the ratio changes. In countries with relatively developed stock markets as the latter continue to develop; firms begin to substitute equity for debt. The study showed that capital structure might be different across country because of differences in economic development; supporting institutions, tax treatment of debt versus equity, and level of development of financial institution. The study however, remains silent about what exactly is the financing mix in a country with particular level of overall development.

## **CHAPTER -III**

### **RESEARCH METHODOLOGY**

In order to achieve the objectives of the study mentioned in chapter one, an appropriate methodology becomes more relevant, which has been given due importance throughout this study. Different sections included in this chapter are research design, population and sample, nature and sources of data, coverage of the study, presentation and analysis of data and methods and tools for analyzing collected data.

#### **3.1 Research Design**

The research design is the overall plan of actions to be carried out in connection with research project. In another words, research design is the plan, structure and strategy of investigation conceived so as to control variance (Kerlinger, 1986, p.275). As the principal objective of this study is to analyze the relationship between the development of equity market and the pattern of business financing in Nepal, this study follows the descriptive as well as analytical approach so that logical conclusion could be drawn. Most importantly, the study is designed as ex-post facto research as the study is based on historical data. However, descriptive approach has also been adapted for the analysis of primary data obtained from questionnaire.

#### **3.2 Population and Samples**

The number of public limited companies listed in the NEPSE Ltd. by the end of F/Y 2007/2008 in 145, which is regarded as the size of total population. They are categorized into seven sectors by NEPSE, these include, Banks, Finance companies, Insurance companies, Hotel, Mfg and Processing, Trading and others. The study has been carried out by selecting the minimum two representative companies from each sector. A stratified sampling technique have been allowed, seven different sectors as mentioned above have been taken as the number of strata. Factors like paid up value market capitalization, mix of capital and availability of required data are also the main factor for selection.

The numbers of total population and the sample companies have been shown in the following table.

**Table 3.1**  
**Total Population and the Number of Sample Companies**

Sector	No. of total or population (N)	No. of sample companies (n)	Sample companies
Commercial Banks	17	2	BOK, HBL
Finance company	55	2	NFSC, NFC
Insurance	16	2	HGIC, NECOIC,
Hotel	4	2	YYH, SH
Mfg. and processing company	21	2	BNL ((Balaju), NLO
Trading company	6	2	, BBC, STC
Other	6	2	NH, NPEDCL
Total	145	14	

### 3.3 Nature and Source of Data

Data are considered as an integral part of research. Required data for this study would so collected mostly from secondary sources, however primary data have also been used. The sources of primary data include; structured questionnaire, interviews with officials and other experts. The sources of secondary data include published materials from various organizations, such as annual reports of public limited companies guidance and directives of SEBO/N and NEPSE, trading report of NEPSE, publication of; NRB, Department of statistics National planning commission, World Bank, Asian Development Bank and other related institution. Resources as media can be interpreted as having a content of data and a process of methodology, collecting data is the connecting links to the world of reality for the researcher; (Pant 2002 P. 138). And other data and information have been connected from various books, Journals, periodicals, previous research reports, newspaper/ magazines etc. besides the most relevant information has been collected from websites Internet. And other sources of information also used to collect the data.

### 3.4 Coverage of the Study

The result of the study also depends upon the sample size and coverage of the study. We have considered the scope of our study only to listed companies. A reasonable number of samples (about 10% i.e. 14 out of 145 listed public limited companies) have been selected for the purpose of study to keep the study within manageable

limits. Regarding the temporal coverage, this study covers the period of 7 years (2001/2002 to 2007/2008). However for the purpose of descriptive analysis the study covers the period of above 10 years i.e. very beginning from the establishment of NEPSE and SEBO/N. Within the coverage, the study would represent the whole Nepalese equity market. Situation and conditions equity market in Nepalese context.

### **3.5 Presentation and Analysis of Data**

The data collected from various sources have been presented in the form of table, chart and bar graph as per the need of the study. Details of individual's company's data and other useful information have been presented in the appendix at the end of the study.

### **3.6 Tools for Analysis**

Statistical and financing tools are the key for the analysis of numerical data in most of the research. In this study, two types of analytical tools have been uses financial tools and statistical tools.

#### **3.6.1 Financial Tools**

It can be used in the financial analysis of the data analysis of financing mix requires the ratio of different types of capital mix in the total financing, so debt/ equity ratio and equity to total assets ratio as the financial tool have been used in the study.

#### **Debt Equity Ratio**

The relationship between borrowed funds and owner's capital (as a popular measure of long term financial solvency of a firm) is shown by debt- equity ratio. Alternatively this ratio indicates the relative proposition of debt and equity in financing the assets of a firm. A high debt- equity ratio would make it difficult for a fine to face the adverse possibilities of 9 business depression without fear of insolvency. There are many outsiders' claims and owner's capital can be shown in different ways. For the purpose of our study the total debt to the shareholders' equity (only paid-up capital) has been considered thus.

$$D/E \text{ ratio} = \frac{\text{Total debt}}{\text{Equity}}$$

Where. Total debt = Average of sample companies' long-term plus short-term debt.

Equity = Average of sample companies' paid-up capital.

**Paid-up capital:** It is the part of called up capital, which is actually paid up by the shareholders. In other words, paid up capital is called up less calls in arrears or the amount not paid by the shareholders. However, Paid up capital should be equal or lesser than the called up capital but it can not be more than the called up capital.

### **3.6.2 Statistical Tools**

Statistical tools help to measure the relationship between the variables. Mainly, the relationship between the type of company and the issuance of equity, increase in equity capital over the period (trend analysis) has been performed/analyzed with the help of statistical tools as noted below:

#### **Trend Analysis**

Trend also called secular or long-term trend is the basic tendency (of series) to grow or decline over a period of time (Gupta, 1992, p.633). Trend analysis is used to detect the pattern of change in statistical information over regular intervals of time. Moreover, the trend reflects the dynamic pace of movements of a phenomenon over a period of time. Mathematically, a time series is defined by the functional relationship.  
 $Y=f(t)$

Where, Y is the value of the phenomenon (or variable) under consideration at time T. The trend analysis describes the historical pattern of given phenomenon. For the purpose of our study trend analysis has been used to know the changes in the issue of equity capital over a given period.

#### **Hypothesis Testing**

Testing of hypothesis begin with an assumption, called a hypothesis that we make about a population parameter. For the purpose of testing whether the assumption or hypothesis is valid or not, a sample is selected from the population, sample statistic is obtained to observe the difference between sample mean and population hypothesized value, and the test is done whether the difference is significant or insignificant. Each hypothesis is set as null and alternative hypothesis.

## Null Hypothesis

The hypothesis of no difference, which is under statistical test, is known as null hypothesis. It is usually denoted by  $H_0$ . In the words of R.A. Fisher "Null hypothesis is the hypothesis which is tested for possible rejection under the assumption that it is true"

## Alternative Hypothesis

Any hypothesis that is complementary to the null hypothesis is called alternative hypothesis. It is usually denoted by  $H_1$ . For the purpose of our study, following hypothesis has been set for testing:

### Hypothesis 1

Null hypothesis ( $H_0$ ):  $\mu_B = \mu_F = \mu_I = \mu_{MP} = \mu_H = \mu_T = \mu_O$

(There is no significant difference in D/E ratio in each sector)

Alternative hypothesis ( $H_1$ ):  $\mu_B \neq \mu_F \neq \mu_I \neq \mu_{MP} \neq \mu_H \neq \mu_T \neq \mu_O$

(There is significant difference in D/E ratio in each sector)

These hypotheses have been tested by using one-way ANOVA, which is described below:

### Analysis of Variance (ANOVA)

ANOVA enables us to test the significance of the differences between more than two sample means. ANOVA technique is helpful to make inferences about whether the samples drawn are from population having the same mean. F-statistics is used in ANOVA and is computed as:

$$F = \frac{MSB}{MSW} \text{ i.e. } \frac{\text{Variance between Sample}}{\text{Variance within samples}}$$

$$F = \frac{MSB}{k - 1}, MSW = \frac{SSW}{N - k}, SSB = ni$$

$$TSS = SSB + SSW$$

Where,

MSB= Mean sum of square between samples

MSW= Mean sum of square within samples

SSB= Sum of square between samples

SSW= Sum of square within samples

TSS= Total sum of square

k = No. of independent variables

N = Total no. of observations

n = Size of the samples

X = Mean value of the variables

$X = \mu_B = \mu_F = \mu_I = \mu_{MP} = \mu_H = \mu_T = \mu_O$

c.f. = Correction factor =  $\frac{T^2}{N}$  , T = Grand total

Test result: If F-calculated is less or equal to F-tabulated (i.e.  $F_{cal} < F_{tab}$ ) accept the null hypothesis (I) and vice-versa.

### **Least Square Significance Difference (LSD) Test**

For testing the significance of difference of D/E ratio between the individual sector (Bank, Finance, Manufacturing etc.), LSD test have been applied, under this technique the difference of average value (in our case, the D/E ratio between any two sector) is compared with LSD and the decision is made whether the difference is significant or not. If the value of LSD is smaller than the value of  $Y_i - Y_j$  the ratios are significantly different and vice versa.. LSD is computed as:

$$LSD = t_{\alpha/2} (N - a) \sqrt{MSE \left( \frac{1}{n_1} + \frac{1}{n_j} \right)}$$

Where, N = Total number of observation

a = No. of treatment (No. of sector)

MSE = Mean sum of square

$n_1, n_j = n$  = No. of observation in each sector

### **Mean**

Simple or arithmetic mean of a given set of observations is their sum divided by the number of observations. Simple or arithmetic mean usually denoted by  $\bar{x}$  and is computed as:

$$\bar{x} = \frac{\sum x}{n}$$

In case of frequency distribution,  $\bar{X} = \frac{\sum fx}{\sum f}$



Where,

$\bar{x}$  = Weighted average or arithmetic mean

$X$  = Value of the variables

$N = \sum f$  = Total frequency

### **Standard Deviation**

Standard deviation is measure of dispersion of possible outcomes around the expected value of random variable. It is a weighted average deviation from the expected value and it gives an idea of how far above or below the expected value the actual value is likely to be. It is denoted by  $\sigma$  and is computed as:

Where,

$X$  = Value of the variables

$\bar{x}$  = Mean/average value

$n$  = No. of observation

**Coefficient of Variation (CV)** Coefficient of variation is the relative measure of dispersion. It is also known as coefficient of standard deviation (if the dispersion is based on standard deviation). CV is suitable for comparing the variability, homogeneity or uniformity of two or more distributions.

CV is expressed as percentage and is computed as:

$$CV = \frac{\sigma}{\bar{x}} \text{ i.e. } \frac{\text{Standard Deviation}}{\text{Mean}}$$

Mean, standard deviation and coefficient of variation have been used to analyze the responses of questionnaires. Besides, percentage analysis also has been carried out for comparing two or more data and for analyzing the responses of few questionnaires in our study.

## **CHAPTER - IV**

### **PRESENTATION AND ANALYSIS OF DATA**

This is the key chapter as it helps achieve the objectives of the study as mentioned in the first chapter. It makes systematic presentation and analysis of data. Analysis is based on the data obtained from primary and secondary sources. Primary source includes mainly the responses to questionnaires and personal interviews with exports officials, stock brokers and other resourceful persons; similarly the secondary source includes available annual reports of sample companies, publications of SEBO/N, NEPSE, NRB, ADB, WB and etc. Appropriate statistical tools have been used in order to derive actual results from the analysis of data.

#### **4.1 Business Financing in Nepal**

The question of business sector development and large-scale industrialization of a country is closely related to the provision of adequate long-term finance. Whenever Nepal has attempted to improve the economic development, the question of finance has come to the forefront. And whenever the long-term financing (especially business financing) has been considered. The growth and the functioning of stock market have been questioned due to the inherent weakness of the stock market.

As noted earlier that one of the mechanisms of financing the business sector or industries from the external sources in modern time is the capital market through which corporations or companies assemble the required funds by issuing various forms of securities from the surplus spending units directly and or financial intermediaries. Thus, an orderly growth of capital market is essential to ensure better financing and a higher rate of investment in the business sector.

In a country like Nepal it is important for the business sector to obtain a higher share of finance from the capital market. The stage of industrial development is still in its infancy, so the companies (mostly industrial) are not becoming able to push up necessary resources internally; in other words, most of the companies in Nepal have undertaken external funds (either from banks, financial institutions or from capital market) for financing their capital need. Because that the capital market development

is relatively new and is in the developing stage, the financing of the Nepalese business sector is heavily dependent on the banking system.

However, the Biratnagar Jute Mills Ltd. initiated public flotation of securities in 1937, previously, before 1976 there was no system of raising funds from the public by the flotation of securities, especially the stocks in the market, since the capital market was absent. In the absence of the development of business security market, the only securities floated in the market were the government securities and through which the government used to assemble the funds directly from the surplus spending units. Over the period, particularly after 1980s public limited companies were developed and with the development of stock market institutions, companies gradually started to assemble funds from the capital market.

However, the business culture in Nepal has been developed, most of the companies are reluctant to disclose their financial activities and want to keep important data as confidential, they do not like to be accountable to the stakeholders and they are lacking the knowledge regarding the benefit of widening the ownership. Among others, these are the reasons why most companies (public limited and others) have not been listed in the stock exchanges. On the other hand, listed companies are not well aware about better financing mix. Debt equity ratio does not seem satisfactory among most of the companies. Companies have not been attracted by the equity market, however, over the period, equity market has been gradually developed and new companies have started to enter into the market for fulfilling their financing need and for increasing the value of the firm.

Studies have found (for e.g. the study made by the World Bank) that nearly 40 % of Nepalese firms reported that finance is the major obstacle for their operations. Among other problems like depressed economic activity and low aggregate demand for products, poor access to finance is also the most cited problem of the business community. Moreover, Nepalese companies are facing difficulties in obtaining financing because of high collateral requirements by the banks, the need to provide personal guarantees, the inability of the banking system to use profitability of the firm as a basis for providing financing, high interest rate on loans and most importantly the state of underdeveloped equity market. Thus, there is no doubt that equity market

development is of great importance to ensure better financing choices for the companies and to reach the growth potential of the companies and the market itself.

## 4.2 Capital Market Instruments in Nepal

Capital Market Instruments consists of government bonds, business bonds and equity securities. Nepal banking sector is highly involved in primary market. Asia's emerging markets, there is dominance of banking in primary market for government debt instruments and secondary market for government debt instruments is normally inactive, financing instruments namely common shares, right shares, performance shares and debentures are brought in to practice by Nepalese firms.

**Table 4.1**  
**Public Issues of Various Financing Instruments**

(Rs. in Million)

Equity share						Preference share		Debenture		Mutual/Unit Fund		Total	
Common		Right		Total		No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.
No.	Amt.	No.	Amt.	No.	Amt.								
126	4200.02	58	4384.22	184	8584.24	5	636.5	9	2153	2	516.32	200	11889.74
63%	35.33%	29%	36.87%	92%	72.1%	2.5%	5.3%	4.5%	18%	1%	4.43%	100%	100%

Source: SEBO/N, Annual Report 2007/08.

As of F/Y 2007/08 there were 126 common stock, 58 right shares, 5 preferred stock, 9 debentures, and 2 mutual funds listed on the NEPSE.

In above table 4.1 out of total public issues of various financing instruments (200), number common stock is 126, right share 58, preference share 5, debenture 9 and mutual fund 2. The percentage of common stock, right share preference share, debenture and mutual fund is 63%, 29%, 2.5%, 4.5% and 1% respectively. And their monetary value, in million, of common stock, right share, preference share debenture and mutual fund is Rs. 4200.02, Rs. 4384.22, Rs. 636.5, Rs. 2153, and Rs. 516.32 respectively. It shows that a percentage of common stock is higher due to issue high number of common stocks and the percentage of mutual fund is low due to issue low number of mutual fund.

### **Common Stock**

In Nepal, common stock has been a most preferred and popular instruments for the business firms. There were 184 common stocks out of 200 (including rights) it represents 92% of the total issues. In terms of capital raised equity share alone represent about 79.3% of the total capital raised from the primary market. It is higher than annual report of F/Y 2007/08. So, we can say the equity market is growing in Nepalese financial market. However, companies are found to be using more of bank loan rather than the issue of equity in the market.

### **Preference Share**

Preferred stock as a financing instrument has not been widely practiced in Nepal. In terms of number of issues and amount raised it is the least preferred instrument. However, preference share has emerged as one of the most important instrument in the market.

In the initial period (i.e.1993/93) there were only 2 public issues of preferred stocks. Total five preferred stocks have been issued until now. Preferred stock holders get fixed dividends only when the company makes profit, so the investors in Nepal are not comfortable with this type of stock option. With the development of equity market, the issue of preferred stock is likely to be popular in the future.

### **Debenture**

During the last 14 years (1994-2008), there were only 9 issues of debentures, which represent about 18% of total amount raise (Rs. 2153 million) from the public offering. Secondary market for business bonds in Nepal is virtually non-existent; however, recently the development of business debt market requires well-developed equity market in the country. Data showed that companies have not widely selected debenture as a source of finance. Investors who are not wanting to risk they invest in debenture.

### **Mutual/Unit Fund**

In Nepal, NCM first mutual fund, an open-ended fund with a par value of Rs. 10 per unit was brought into practice by NIDC capital market Ltd. in the year 1993. Its objectives were to provide expert investment services. Later on the fund was

converted into close-ended fund and listed in the NEPSE in the year 2000, during that period the Net asset value (NAV) of fund was Rs 22.15. Unit scheme is an opened scheme and provides regular income in the form of divided to the unit holders. Now, F/Y 2007/08 its amount reached 516 million, it is the 4.43% in the financing instruments. The total amount of Rs. 350 million and 166 million for Mutual fund and Unit Scheme respectively was approved by SEBO/N.

Thus, when were analyze the public issues, the Nepalese business bodies have raised funds through various financing instruments such as common stock, preferred stock, debentures, mutual fund and unit scheme. Among these instruments, common stock has been the most popular; it dominates the volume of fund-raised and the number of issued made. The funds raised through other instruments have been found to be negligible. Instruments with warrants and convertible features have not been practiced in Nepal. It seems appropriate to bring a number of such instruments in practiced and widen the investments options for the development of equity market in the country.

### **4.3 Equity Market Development Indicators**

Equity market development is closely linked with the development of the real sector. It needs no emphasis that the overall economic progress is possible through the development of business sector which makes it necessary to have an efficient equity market through which needed funds for the corporation could be raised. Since equity issue increase with the increase in saving and investment, the equity market development is analyzed in both macro economic and exchanges marker environment perspective.

Equity market development is of recent phenomenon in Nepal, if the history is compared with that of other developed countries. Due to various prevailing market is narrow and is dominated by a few sectored transactions. As seen in the table below, the amount of capital raised has not been increased significantly. During the time of establishment of Nepal stock exchange in 1994, listed companies raised Rs. 0.34 billion from the market. Until 2000, companies raised less than half billion each year. It is only in 2007/08 that the total capital raised from the market exceeds Rs. 1.22 billion of funds.

Equity market development is closely linked with the development of the real sector. It needs no emphasis that the overall economic progress is possible through the development of business sector which makes it necessary to have an efficient equity market through which needed funds from the corporation could be raised. Since equity issued increases with the increase in saving and investment, the equity markets development is analyzed in both macro economic and exchanges market environment perspective.

Nepalese equity market lacks liquidity, which is evident from the figure in the table below. One of the important indicators of market liquidity, percentage of turn over securities is traded in the market. The market capitalization shows that the equity market is little fluctuated in size between the periods of 2004/5 to2007/08.

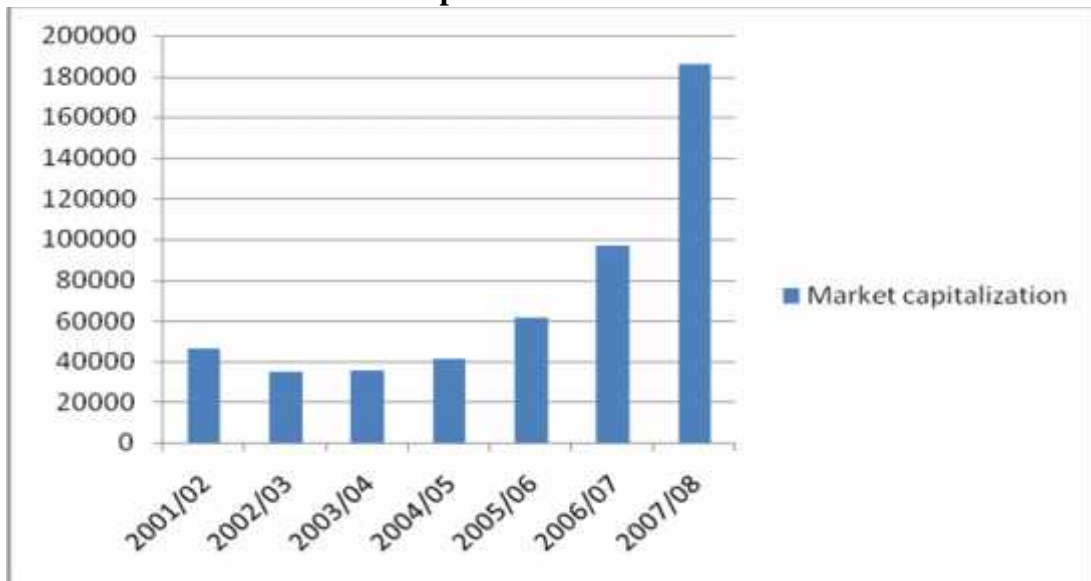
**Table 4.2**  
**Equity Market Development Indicators**

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Capital raised	484.29	1266.63	853.83	1547.20	1315.80	1096.1	1210.35
No. of Issued made	8	15	17	16	14	29	34
No. listed company	115	96	108	114	125	135	145
No. of company trade	67	69	81	92	102	110	116
Paid-up value of listed companies	8165.20	9685.04	12560.07	13404.90	16771.84	19958.4	21798.8
Market capitalization	46349.4	34703.87	35240.40	41424.77	61365.89	96763.7	186301.3
Annual turnover (Securities transactions)	2344.16	1540.63	575.80	2144.27	4507.68	3451.4	8360.1
Percentage of turnover on market capitalization	5.06	4.44	1.63	5.18	7.35	3.57	4.48
Percentage of market capitalization on GDP	11.81	8.45	8.09	8.77	12.17	16.03	27.78
Market Day	231	246	238	243	236	228	232
No. of share traded (in thousand)	4989	6005	2428	6468	18433.55	12221.93	18147.25
No. of listed securities	124971	134150	159958	161141	194637	226540	243504
NEPSE Index (Point)	348.43	227.54	204.86	222.04	286.67	387.07	683.95

Source: NEPSE, SEBO/N Annual Reports, Economics Survey 2007/08

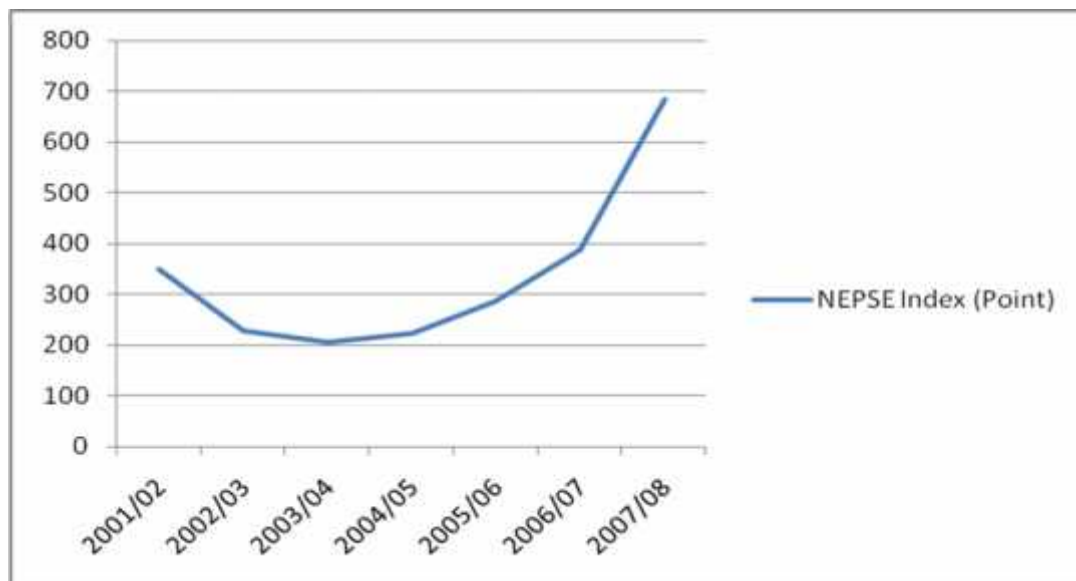
Another measure of capital market development is the ratio of market capitalization to GDP. This ratio ranged from 11.81% in 2002 to 27.78 in 2008. This figure is well below that of developing countries. Market capitalization of GDP is low because of small size of the market.

**Figure 4.1**  
**Market Capitalization over the Period**



Share price indicates evidence that market had gone down continuously since 1995 until 1999 (not shown in table and graph). However, it grow from 2000 to 2002; in the year 2003 it decreased by 120.89 points (i.e. 348.43 in 2002 to 227.54 in 2003). Thereafter it grew respectively 2004, 2005 and 2006 but difference is growth is higher in 2005 and 2006. Similarly the growth rate rose dramatically in the year 2007 and 2008. Market capitalization was 120150.7 in 2007 and 186301.3 in 2008. The NEPSE index reveals fluctuating figure, it ranged from 384.43 in 2002 to 683.95 in 2008.

**Figure 4.2**  
**NEPSE INDEX**





Overall figure showed that Nepalese equity market is not dynamic enough to maintain and/or develop the proper size of the market. Numerous structural and is going to be stronger slowly.

#### 4.4 Growth of the Economy and Equity Market

The size of equity market is small as evident from the table below. The total equity capital was about 2% of the nominal GDP in 2002. Over the period, the equity capital has grown, and in the year 2008, the share of equity capital on GDP exceeds 4%. However, equity issue as a percentage of GDP is very low; it is growing steadily over the period. Table below reflects that the paid-up capital or equity capital, which was only 2% in 2002, became more than double in 2008 arriving at 4.6% of GDP.

**Table 4.3**  
**Key Indicators of Equity Markets Development**

(Rs in Million)

Indicators Period	Real GDP at current price	Economic growth rate	Nominal GDP at current price	Growth rate on nominal GDP	Paid up Capital (Equity capital)	% of paid up capital on nominal GDP
2001/02	279749	4.7	393566	7.5	8165.20	2.1
2002/03	280085	0.12	404482	2.8	9685.2	2.39
2003/04	291148	3.95	419731	3.77	12560.07	2.99
2004/05	304774	4.68	438245	4.41	13404.9	3.05
2005/06	314283	3.12	450735	2.88	16771.84	3.7
2006/07	323083	2.80	464888	3.14	19958.4	4.29
2007/08	331160	2.50	475534	2.29	21798.8	4.6

Source: SEBO/N, Annual Report 2007/08. Economic survey 2007/08 Nepal Government MOF and Compilation

Data revealed that the equity market has been performing strongly over the last 7 years then in earlier periods. Particularly after 2001, equity market data has shown satisfactory growth in relation to the growth of the economy, for example, from the year 2006 there is diminishing economic growth rate but the percentage of paid up capital on GDP has increase in each year, however, the percentage increase is very low.

Various factors are attributed for the improvement in the equity market such as increasing effort of the concerned authorities for the market development ,broader household participation in the equity market and good prospects of business earnings (especially financial sectors). Previously it was thought that if the secondary market is

made efficient, it will hamper the transaction of government bonds, but later on this thinking has been changed, consequently the government (however is no active enough) started making effort for the development of equity marker. Recently, the government has planned to float the shares of large PEs (Such as Nepal Telecom, Agriculture Development Bank etc.) to the public in its privatization process; such activities would further widen the size of the market. There are still numerous constraints and problems existed in the Nepalese equity market; if such problems are addressed effectively the equity market will definitely move towards right direction.

#### 4.5 Public Issue of Securities (Issue Approval and Actual Issue)

Prior to the public issue of securities, companies must get approved from securities board.

**Table 4.4**  
**Public Issue Approval**

	Amount	Percent
Equity Share	4292.72	34.34
Rights Share	4936.22	39.3
Preference Share	636.5	5.16
Debenture	2153	17.1
Mutual/Unit funds	516.32	4.1
Total	12543.60	100

(Rs. in Million)

Source: Annual Report 2007/08, SEBO/N

**Figure 4.3**  
**Percentage of Public Issue Approval**

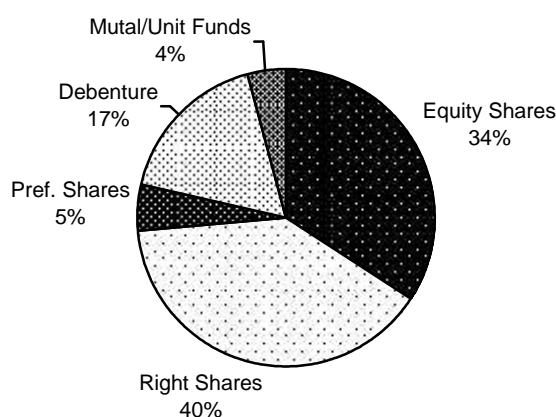


Table and chart above shows that about 35% of the total amount approved is for equity share, next to the equity share is rights share, it represents 40.% of the total

flotation approved ,debenture occupies about 17%, where as preference share and mutual fund have very small figure which represent only about 5.16% and 4.1% respectively. The number of issue approved also shows almost similar position of different instruments in the Nepalese Capital Market.

Data available regarding the actual public issue of financial instrument showed that there is little variance in the issue approved by the SEBO/N and the actual made by the company.

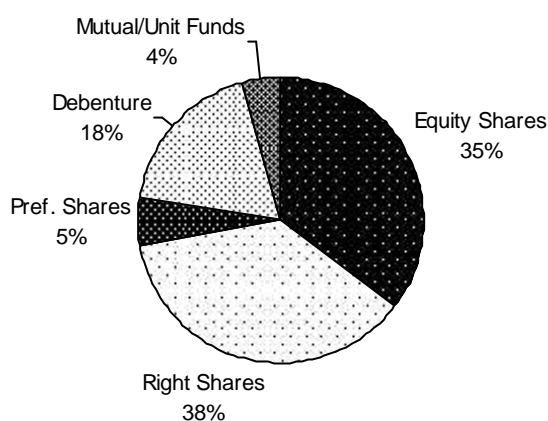
**Table 4.5**  
**Public Issue Made**

(Rs. in Million)

Particular	Amount (Rs.)	Percent
Equity Share	4200.02	35
Rights Share	4384.22	38
Preference Share	636.5	5
Debenture	2153	18
Mutual/Unit Funds	516.32	4
Total	11889.74	100

Source: Annual Report 2007/08, SEBO/N

**Figure 4.4**  
**Percentage of Public Issue of Various Instruments**



Some company postponed the issue for the long period and few companies even after having issue approval, never made the issue. Above table along with chart shows the data on public issue.

About 38% of the total amount of public issues is from right shares, representing the highest amount of new capital rose from the public followed by equity shares (35%), debentures (18%), preference shares (5%), and mutual/unit fund (4%).

**Table 4.6**  
**Number of Issue Approved and Number of Issue Made**

(F/Y 1994/95 to 2007/08)

Sector	Bank	Finance	Insurance	Mfg. & Processing	Trading	Hotels	Others	Total
Issues approved	42	60	17	22	6	4	6	157
Issue made	37	55	16	21	6	4	6	145

Source: Annual Report 2007/08, SEBO.N, Trading Report 2007/08

**Figure 4.5**  
**Number of Issue Approved and Number of Issue Made**

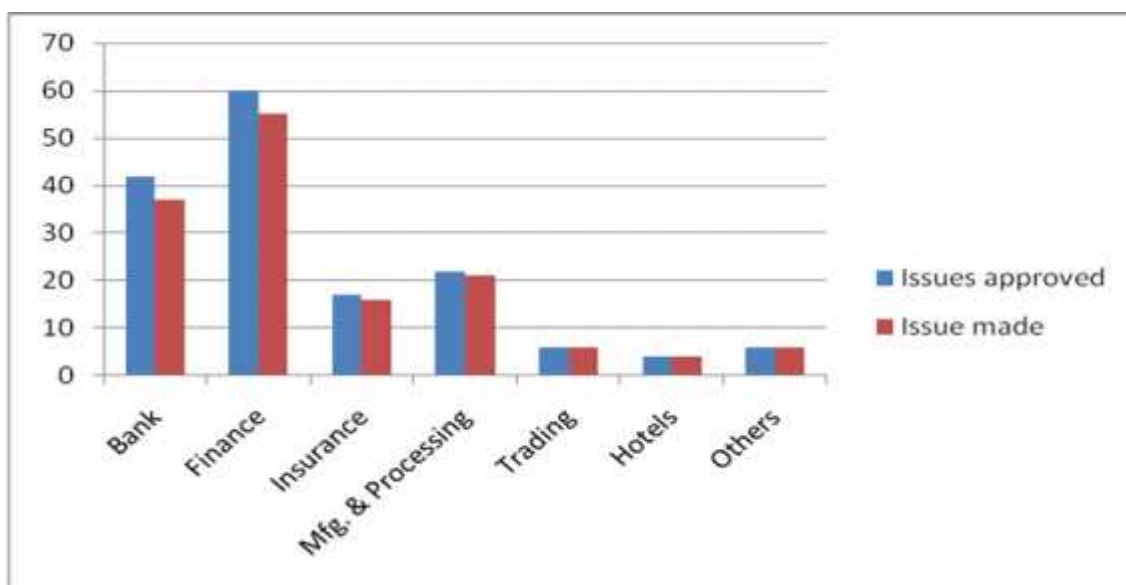


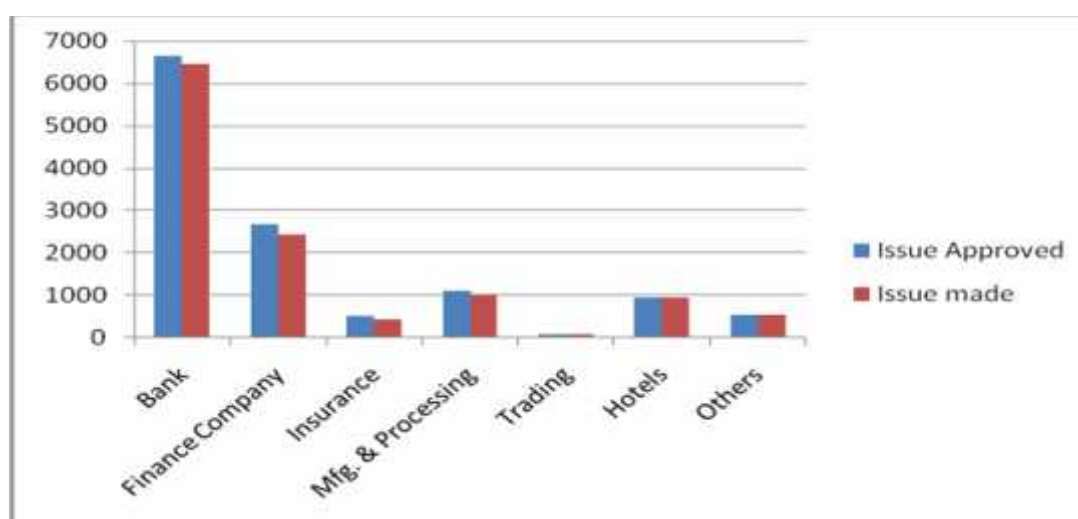
Table and figure below reveals that there is little variance between the issue approved by the SEBO/N and actual issue by the companies among different sectors, this is due to the reason that some companies postponed the issue for the later period and few didn't go to public even after having approval from SEBO/N. Trading, Hotels and other sector have raised fall amount of issue approved and the actual issue made to the public. But another sector is difference between issue approved and issue made. There is issue made was finance company (55), Bank (37), manufacturing and processing (21), Insurance (16), Trading (6), other (6) and Hotels (4) respectively

**Table 4.7**  
**Amount of issue Approved and Amount of Issue Made**  
 F/Y 1994/95 to 2007/08 (Rs. in Million)

Sector	Bank	Finance Company	Insurance	Mfg. & Processing	Trading	Hotels	Others	Total
Issue Approved	6658.95	2685.3	526.7	1120.32	70.15	939.3	542.2	12543.6
%	53.62	20.77	4.18	8.9	0.55	7.6	4.18	100
Issue made	6460	2443.3	424.5	1010.63	70.15	939.3	542.2	11889.74
%	54.33	20.55	3.57	8.50	0.59	7.9	4.56	100

Source: Annual Report 2007/08 SEBO/N. Trading Report 2007/08

**Figure 4.6**  
**Amount of Issue Approved and Amount of Issue Made**



An enquiry with SEBO/N staff in this regard made it known that there is no provision of charging any penalty or no legal punishment to the company which doesn't go to public even after having permission/approval of public issue.

Maximum amount for financing capital need has been raised by Banks (Rs. 6460Million) followed by, finance companies (Rs. 2443.3 Million), manufacturing and processing (1010.63) hotels (Rs.939.37 Million), insurance (Rs. 424.5million), others (Rs. 524.50 million) and Trading (70.19 Million).

Above table and diagram showed that issued approved and issue made is highly fluctuated in banking sector than other. There is same (approved and issue) amount trading, hotels and other sectors.

#### 4.6 Testing of Hypothesis

Test of hypothesis is based on F-Statistics. Hypothesis test about whether there is significant difference in D/E ratio in each sector

**Table 4.8**  
**Sector wise D/E Ratio over the Period**

Period Sector	2002	2003	2004	2005	2006	2007	2008	Average
Bank	33.51	42.85	41.98	33.59	44.22	42.29	37.51	39.42
Finance	13.14	13.96	13.86	11.84	14.12	13.88	11.52	13.19
Insurance	1.09	1.54	1.93	1.54	1.94	1.29	1.57	1.56
Mfg.& Processing	2.80	2.59	2.68	2.68	3.12	2.94	2.98	2.83
Hotels	3.13	3.57	3.56	3.23	3.57	3.28	3.54	3.41
Trading	18.12	20.67	21.09	21.60	22.20	19.81	21.10	20.66
Others	6.22	5.10	5.97	NA	6.45	5.94	6.32	6

Source: Field Survey and Compilation

#### Testing of hypothesis:

$$H_0: \mu_B = \mu_F = \mu_I = \mu_{MP} = \mu_H = \mu_T = \mu_O$$

There is no significant difference in D/E ratio in each sector.

$$H_1 = \mu_B \neq \mu_F \neq \mu_I \neq \mu_{MP} \neq \mu_H \neq \mu_T \neq \mu_O$$

There is significant difference in D/E ratio in each sector.

**Table 4.9**  
**One-way ANOVA Table**

Source of Variation	d.f.	Sum of Squares	Mean Sum of Squares	F-ratio
Between Seven years period	7-1=6	7866.15	$\frac{7866.15}{2}$ = 3933.08	$F = \frac{3933.08}{74.66}$ X52.68
With in Seven years period	47-6=41	149.32	$\frac{149.32}{2}$	
Total	48-1=47	-	X74.66	

Table value of F at 5% level of significance with  $k = 6$  and  $n = 41$  is 2.32 since  $F_{cal} > F_{tab}$  i.e. (52.68 Vs 2.32),  $H_0$  is rejected. Hence, there is significant difference in D/E ratio in each sector.

#### 4.7 Testing of LSD (Least Square Significant Difference)

In order to test the significance for the difference of D/E ratio of individual financial sectors under consideration, least square significance difference (LSD) is carried out.

$$LSD = t \frac{r}{2} (N - Z - a) \sqrt{MSE \frac{1}{n_i} + \frac{1}{n_j}}$$

**Table 4.10**  
**Significance of Difference in D/E Ratio Between Sectors**

Difference Between	$\bar{Y}_i - \bar{Y}_j$	LSD for $\bar{Y}_i - \bar{Y}_j$	Significance of difference
$\bar{Y}_1 - \bar{Y}_2$	39.42-13.19	26.23>12.43	$\mu_1$ and $\mu_2$ are significantly different
$\bar{Y}_2 - \bar{Y}_3$	13.19-1.56	37.86>12.43	$\mu_1$ and $\mu_3$ are significantly different
$\bar{Y}_1 - \bar{Y}_4$	39.42-2.83	36.59>12.43	$\mu_1$ and $\mu_4$ are significantly different
$\bar{Y}_1 - \bar{Y}_5$	39.42-3.41	36.01>12.43	$\mu_1$ and $\mu_5$ are significantly different
$\bar{Y}_1 - \bar{Y}_6$	39.42-20.66	18.76>12.43	$\mu_1$ and $\mu_6$ are significantly different
$\bar{Y}_1 - \bar{Y}_7$	39.42-6	33.42>12.43	$\mu_1$ and $\mu_7$ are significantly different

$\bar{Y}_1 Z \bar{Y}_3$	39.42-1.56	11.63<12.43	There is no significant different between $\mu_2$ and $\mu_3$
$\bar{Y}_2 Z \bar{Y}_4$	13.19-2.83	10.36<12.43	There is no significant different between $\mu_2$ and $\mu_4$
$\bar{Y}_2 Z \bar{Y}_5$	13.19-3.41	9.78<12.43	There is no significant different between $\mu_2$ and $\mu_5$
$\bar{Y}_2 Z \bar{Y}_6$	13.19-20.66	(7.47)<12.43	There is no significant different between $\mu_2$ and $\mu_6$
$\bar{Y}_2 Z \bar{Y}_7$	13.19-6	7.39<12.43	There is no significant different between $\mu_2$ and $\mu_7$
$\bar{Y}_3 Z \bar{Y}_4$	1.56-2.83	(1.27)<12.43	There is no significant different between $\mu_3$ and $\mu_4$
$\bar{Y}_3 Z \bar{Y}_5$	1.56-3.41	(1.85)<12.43	There is no significant different between $\mu_3$ and $\mu_5$
$\bar{Y}_3 Z \bar{Y}_6$	1.56-20.66	(19.1)<12.43	There is no significant different between $\mu_3$ and $\mu_6$
$\bar{Y}_3 Z \bar{Y}_7$	1.56-6	(4.44)<12.43	There is no significant different between $\mu_3$ and $\mu_7$
$\bar{Y}_4 Z \bar{Y}_5$	2.83-3.41	(0.58)<12.43	There is no significant different between $\mu_4$ and $\mu_5$



$\bar{Y}_4 Z \bar{Y}_6$	2.83-20.66	(17.83)<12.43	There is no significant different between $\mu_4$ and $\mu_6$
$\bar{Y}_4 Z \bar{Y}_7$	2.83-6	(3.17)<12.43	There is no significant different between $\mu_4$ and $\mu_7$
$\bar{Y}_5 Z \bar{Y}_6$	3.41-20.66	(17.25) < 12.43	There is no significant different between $\mu_5$ and $\mu_7$
$\bar{Y}_5 Z \bar{Y}_7$	3.41-6	(2.59)<12.43	There is no significant different between $\mu_5$ and $\mu_7$
$\bar{Y}_6 Z \bar{Y}_7$	20.66-6	14.66>12.43	$\mu_6$ and $\mu_7$ are significantly different

As from above table the D/E ratio between banking ( $\mu_1$ ) and all other sectors ( $\mu_2, \mu_3, \mu_4, \mu_5, \mu_6, \mu_7$ ) is significantly different i.e. banking sector has high D/E ratio (39.42). Table indicates that there is no significant difference of debt and equity between finance companies and other all companies except that of banking companies. Except with that of finance companies. The D/E ratio of trading companies is also significantly difference with all companies from different sectors.

#### 4.8 Trend Analysis

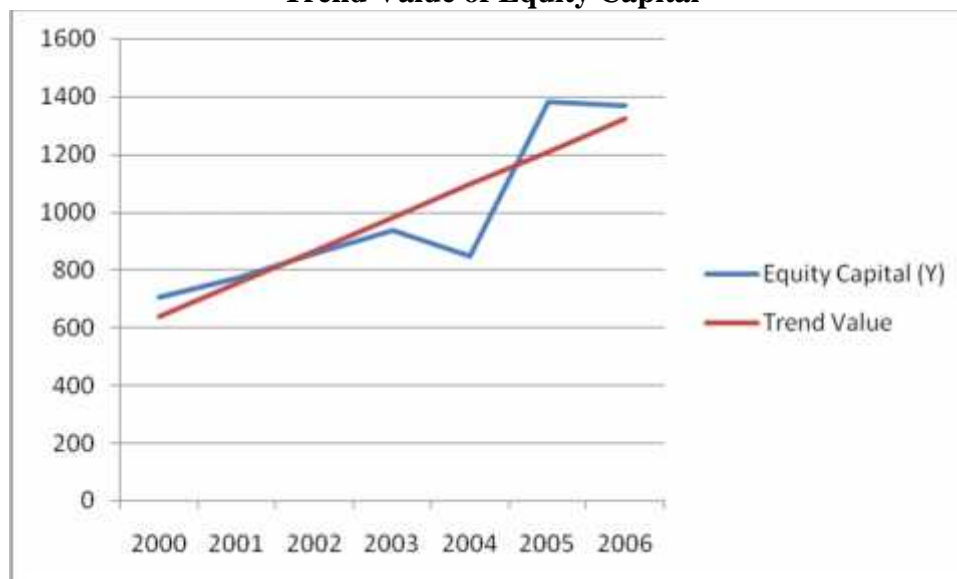
Trend analysis has been carried out to knowing the trend in the issue at equity capital.

**Table 4.11**  
**Trend Value of Equity Capital over the Period**

Year(T)	2000	2001	2002	2003	2004	2005	2006
Equity Capital (Y)	706.20	771.18	858.15	937.90	849.47	1381.53	1368.52
Trend Value	639.1	753.33	867.6	981.85	1098.1	1210.35	1324.6

Source; Appendix IV

**Figure 4.7**  
**Trend Value of Equity Capital**



Above trend line shows that the issue of equity capital is increasing trend in year 2000 to 2003 and decreasing in the year of 2004 then the year of 2000 to 2003. With the compare in the year of 2005 and 2004 equity capitals is increasing trend and with compare the year of 2006 and 2005 equity capital is decrease.

**Table 4.12**  
**Equity Capital over the Period in 2007 to 2011**

(Rs. in million)

Year	Equity Capital (Y)
2007	1096.1
2008	1210.35
2009	1324.6
2010	1438.85
2011	1553.1

Source: Appendix VII

The above table shows that the equity capital is in increasing trend year by year in 2007, 2008, 2009, 2010, and 2011. The forecasted equity capital is Rs.1096.1 Rs.1210.35 Rs.1324.6 Rs.1438.85 Rs.1553.1 respectively. It will average issues of equity capital increase about by Rs.114.25 (million) in each year

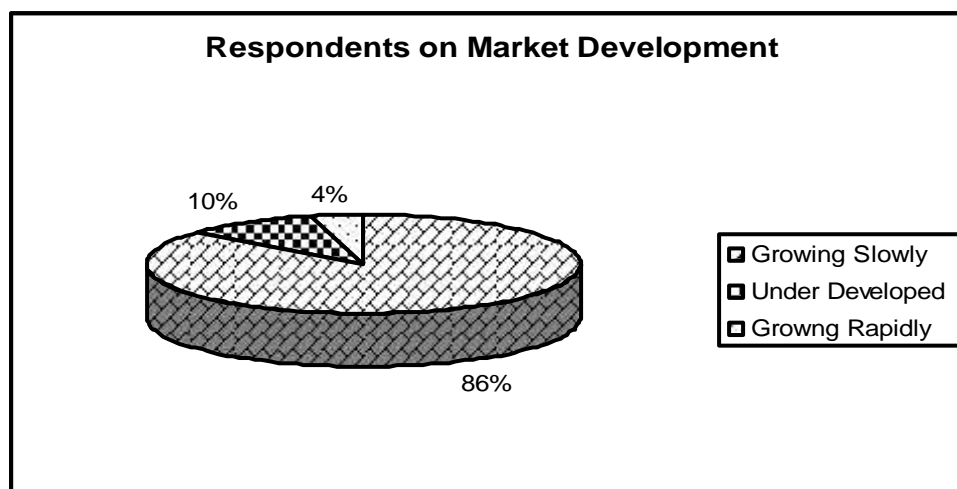
## 4.9 Analysis of Exiting Challenges & Prospects of Business Finance and Equity Market in Nepal

### a. Descriptive Analysis

Nepalese equity market is very small in comparison to that of other developing countries. However, the market has grown slowly over the period; it has not kept pace in its steady growth. The capital market is incomparable with that of the cross-broader countries like India, even the single company like Hindustan Lever Ltd. greatly exceeds the total size of Nepalese capital market in terms of market capitalization.

Regarding the overall aspects of Nepalese equity market varying responses were obtained. Most of the respondents (86%) said that Nepalese equity market is growing slowly because at least a system has been developed and people (however not adequately) are gradually becoming aware of market activities and they have growing interest to invest on the securities of the companies rather than the bank's deposit. Another 10% respondents believed that our capital market is under-developed and insufficient or the market infrastructure is very poor. Most of the companies' shares even listed have not been traded in the market, and the diversified capital market instruments have not been brought into practice. Pricing of shares is not fair; stocks price is affected on the basis of unrelated information like rumors. The market is heavily concentrated only to financial sector, there is no diversification towards the real sectors, and the regulations are still not strong enough to regulate the market. Very few respondents (4%) said that the market is growing rapidly; however, they did not provide evidences on it.

Figure 4.8



On a query regarding the factors affecting equity market development, most of the respondents (about 80%) pointed that main factors are low level of equity culture development, low level of business governance system and slow economic growth and other (20%) claimed that such factors are political instability, poor policy framework, lack of proper implementation of policies, lack of investors' awareness, inadequacy of market research, ineffective trading system and other structural problems. Analysis of the questionnaire shows that most of the respondents focused on almost similar problems i.e. consistency was found in their voice. In a question concerning about structural change (i.e. privatization of NEPSE) no consistent reply was obtained, however, half of the respondents agreed to fully privatized with majority private sector and minority government and some said that it shouldn't be privatized but current arrangement should be reviewed after 2-3 years.

About 100% of respondent in the business sector pointed that; they are facing financing problems in dealing with equity market. Principal cause of which is the lack of developed equity market, other causes are high cost of funds, lack of funds supply in the market due to low level of saving and procedural problems too. Few regulatory authorities pointed that there is lack of private sectors' interest to share ownership and profit with general public so that, whose firms have no easy access to equity market.

Finally, in response to the questions seeking the measures for improvement, varying responses were obtained, majority of the respondents (90%) suggested that there should be the system of good governance; such that accounting and auditing standards would be adequate and there would be no problem of disclosure and transparency of financial activities. Respondents also focused on implementation of the policies and the introduction of market oriented programs (such as incentives to business sector to be involved in the market activities, investors awareness programs etc.). Few respondents (about 2%) gave emphasis on coordination among related institutions, the provision of foreign portfolio investment and the political stability. Another 8% respondent emphasized on building credible regulatory and institutional structures, implementing effective monitoring and supervision policies, and the joint effort of market participants and academic institution to undertake more research and market analysis activities.

Thus, it is found that the equity market is not efficient enough for the sound development of the business sector. However, the market is growing slowly; there are still regulatory, structural and/or infrastructural problems, which have hindered the growth of the market. If proper measures as described above are undertaken, there is no doubt that the equity market will emerge as a developed one.

#### **4.10 Statistical Analysis of Result from Empirical Investigation**

Statistical tools have been applied to get the true result from the questionnaire. Only the questions provided with ranking options have been analyzed in this section:

##### **4.10.1 Analysis of the Problems that Nepalese Equity Market is currently Facing**

Option	W		CV %
a. Poor policy and lack of implementation	2.64	2.25	85
b. Lack of good governance	2.57	2.27	88
c. Procedural problems	3.00	1.75	58
d. Lack of savings	4.39	2.40	55
e. Lack of proper market research	6.30	2.21	35
f. Lack of investors' awareness	2.93	1.92	66
g. Ineffective trading system	2.68	1.65	62
h. Lack of proper co-ordination	5.73	2.29	40
i. Lack of liquidity in the market	4.95	1.70	34
j. Restriction on foreign portfolio investment	3.58	2.27	63

Source: Appendix I

In response to the question "what are the problems that Nepalese equity market is currently facing" varying responses were obtained. Among 10 options provided to the respondent, majority of the respondent ranked option b (2.57) (i.e. lack of good governance) as the most significant problem. Option a (ranked 2.64), option g (ranked 2.68), option c (ranked 3.0) i.e. poor policy framework and lack of effective implementation of policies, ineffective trading system, lack of investors awareness and procedural problems respectively are other important problems followed by lack of good governance. As per the ranking of various options, restriction on foreign portfolio investment, lack of savings and lack of liquidity in the market are moderately important problems where as, as per the ranking made by various respondent, lack of proper co-ordination among related institutions, lack of proper market research are

oilier problems (ranked lowest in their order) in the Nepalese equity market. Among the 10 options, option d (lack of savings) has higher standard deviation indicating greater variability in the ranking, where as option g (ineffective trading system) has lower standard deviation, which indicates that there is no great dispersion in the ranking of this option. Data on CV shows mat option a (lack of liquidity in the market) has lower CV (34%) where as option a (lack of policy framework and lack of implementation of policies has higher CV (85%) indicating inconsistency in me ranking of this option.

#### 4.10.2 Factors that to be Consider While Financing Capital Need

Option	W		CV %
a. Cost of Funds	2.27	1.46	64
b. Flexibility	3.17	1.73	55
c. Nature of funds need	3.18	1.90	60
d. Competitors	5.36	0.71	13
e. Nature of the organization	3.63	1.84	51
f. Legal provision	2.35	1.42	60

(Source: Appendix II)

In response to the question "what factors should be considered while financing a firm's capital need", varying responses were obtained. Among 6 options provided, option a (cost of funds) was considered most significant factor (ranked 2.27), second most important factor was option (legal provision, ranked 2.35). As per ranking other factors are flexibility (ranked 3.17), nature of funds need (ranked 3.18), nature of organization (ranked 3.63) and competitors (ranked 5.36) respectively. Higher standard deviation is for option c (1.90) and lower standard deviation is for option d (0.71). Data on CV shows that there is greater dispersion in the ranking of options a (64%) and option d has less dispersion (13%) in ranking.

#### 4.10.3 Responsible for the Effective Development of Equity Market

Option			CV %
a. Government	1.91	1.04	54
b. NEPSE	2.16	1.17	54
c. SEBO/N	2.30	1.29	56
d. NRB	4.16	1.96	47
e. CRO	3.75	1.87	50
f. General investors	2.72	1.55	57
g. Business sector	2.68	1.53	57

Source appendix-II

In response to the questions “which of the following are mostly responsible for the effective development of equity market” varying responses were obtained. The highest weighted average ranking is for NRB (4.16) and lowest weighted average ranking is for government (1.91), which showed that government is most important (i.e. mostly responsible) for the effective development of equity market. Data showed that SEBO/N (average rank 2.3), NEPSE (average rank 2.16) and general investors (2.72) respectively are other responsible factors for the effective development of the equity market. As per the response, company registrar office (CRO) and NRB respectively are the least important factor responsible for the development of the equity market. Data on standard deviation showed that there is lowest standard deviation in the ranking of government i.e. there is much unanimous in the response; highest standard deviation is for NRB i.e. highly varying responses were obtained in the ranking of NRB. However, data on CV showed that there is higher variation in the ranking of option f and g (i.e. general investors and business firms, 57%) and lower variation in the ranking of option d (i.e. NRB, 47%).

#### **4.11 Problems and Prospects of Equity Market in Nepal**

Mostly in developing countries there are good prospects of equity market and this is not the exception for Nepal. The history of Nepalese stock market is long -more than seventy years; however, the market was given a proper structure only in 1993. Particularly after tins period, the market got signals of development and the pace of development is becoming faster than the development of real sector but the market has not been able and effective enough for the growth of the business sector and for the overall economic development of the nation. Several factors can be attributed for the ineffectiveness/ weakness of the equity market.

##### **Major Problems**

There exist a number of problems in the Nepalese equity market, which have been detailed in the following section.

### **1) Political Instability**

The reinstatement of parliamentary democracy in 1990 brought increased momentum to the reform process, aimed at accelerating development and promoting a modern market oriented economy. Some progress has been made on privatization, financial sector reforms and trade liberalization, however because of the high degree of political instability (with more than a dozen governments between 1990 and 2005), the attention on financial sector and more importantly the overall business sector has remained low and insufficient. Formulation of proper policies and their implementation to develop a healthy equity market calls for the stable government (or political stability) in the country.

### **2) Weak and Fragmented Regulatory and Legal Framework**

However, there are a number of acts, rules and regulations relating to stock market operations in Nepal (like Securities Exchange Act 1983, Securities Exchange and Regulation 1993, Companies Act 1997, Securities Listing Bye-Laws 1996, New Issue Management Guidelines 1997, Securities Registration and Issue Approval Guidelines 2000, Bonus Share Issue Guideline 2001 etc.), but the various Acts governing the business sector are not necessarily consistent and are often conflicting among each other. Laws, rules and regulation allow for discretionary interpretation and lead to excessively high transaction costs and lower private sector competitiveness. Few Acts are not clear enough regarding the division of authorities between the regulatory institutions (e.g. Securities Exchange Act and Companies Act in providing authorities to CRO and SEBO/N). Moreover, existing laws and securities regulations do not clearly define the supervisory and enforcement function of NEPSE and SEBO/N, due to which there is no enforcement and proper regulation of the market, and also the safeguard essential for investors' protection is lacking. Thus, the securities regulatory system is vague and deficient which have resulted complications and disincentives for the business sector and the investors to actively involve into the stock market.

### **3) Inadequate Institutional Investors 'Base**

A sound development of equity market and business sector requires strong institutional investors' base, which potentially offers a large pool



of funds that could be invested in the productive sector. Various types of institutional investors that are prominent in both in developed and emerging market are: i) provident funds ii) collective investment funds iii) bank /trust institutions iv) insurance companies v) venture capital firms etc. In Nepal, institutional investors' base is very small and insufficient. Formulation of proper policies and their implementation to develop a healthy equity market calls for the stable government (or political stability) in the country.

#### **4) False Prospectus of the Companies**

In order to attract the investors, most of the companies sweeten their prospectus and add attractive features, but in reality information given are defective (mostly in non-financial companies) and vague. Thus there is general feeling among the investors that the information disclosed through the public announcement and prospectus do not truly reflect the true pictures of the future prospects of the company which have been found in reality also. Actually, such practice reduces the inventors' participation /attraction towards stock market.

#### **5) Low Investors' Confidence**

Investors are the key factors in the stock market development, hi Nepal, because of the volatility in the stock market, low return on investment, inadequate information to make investment decisions, lack of sufficient knowledge and understanding about the operation of stock market, investors' confidence towards stock market has been low. This has led to the reluctance of investors towards stock market.

#### **6) Restriction on Foreign Portfolio Investment**

Free flow of foreign investment is important in today's globalize economy. In Nepal government has made effort to attract foreign direct investment (FDI) in various sectors such as hydropower, telecommunications and manufacturing industries, however, there is restriction on foreign portfolio investment in the Nepalese stock market. In many developed and emerging securities market foreign institutional investors (FIEs) are an important source of professional portfolio management for stock market development. External capital flows in the form of international portfolio investment can contribute to stock market development. The restriction on

foreign portfolio investment also has been one of the problems for equity market growth in Nepal.

#### **7) No Transparency in Financial Activities and Securities Transactions**

Transparency is the degree to which real/exact information is made publicly available. This element has significant impact on investors' decision to purchase and sale the securities. Most of the companies' activities (both trading and non-trading) are not transparent enough, more relevant and important information are kept confidential. Such situation on transparency is against to investors' interest and has emerged as one of the major problems in Nepalese equity market.

#### **8) Poor Accounting and Auditing Standards**

Weak accounting and auditing standards are among the most important impediments to the development of equity market in Nepal. Financial statement of many companies' are not credible, some companies even listed have not produced accounts for several years (For example Nepal Bank Ltd.). Companies (especially non-financial) maintain accounting standard in their own style, in some cases company accounts are purposefully misleading, which have led to the complexities in the part of financial analysis from outsiders.

#### **9) Ineffective Tax System**

Taxation policy in Nepal is ineffective and it has contributed to high cost of capital for the business firms. Improper tax policy has created disincentive for the investment in the equity and debt. In most of the emerging markets capital gains on securities investments are tax free, but in Nepal, capital gain on securities transactions are taxed as ordinary income to corporations and individual investors. Investors have to pay significant amount of tax if there are good profits but there are no provisions to compensate investors if company makes huge loss. Moreover, there are no tax incentives to companies for taking burdens associated with offering of shares and information disclosure to the public. There is high level of taxation on transaction executed on the stock exchange. High transaction costs and excessive tax discourage investment in stock market and also reduce market liquidity.

## **10) Weak Institutional Capacity for Regulation and Supervision**

The regulatory institutions play key role in shaping the market, in Nepal effective supervisory and regulatory functions are largely missing. The main regulatory institutions (SEBO/N) and other institutions, NEPSE, CRO, and NRB lack a clear mandate and adequate enforcement powers and tools, and are constrained by a weak human resource base and lack adequate technological support, moreover, the effective coordination among these institutions is also lacking. Above all have led to ineffective supervision and regulation of the stock market.

### **1) Slow Privatization Process**

Privatization has been accepted as an important component of the liberal economic policy. A healthy development of the business sector is enhanced with the deregulation by the government. In order to widen the ownership base of the national economy, to ensure greater economic efficiency at enterprise level and to make the market fairly competitive, the state owned enterprises needs to be privatized. In Nepal, however, the government initiate privatization program in 1992, the pace of privatization has been much delayed. Several reasons including, frequent change in government, philosophical differences with regard to objectives and mode of privatization, lack of technical and other experts etc. has made the privatization too slow. Privatization and equity market development are closely related but this view has not been considered in a strategic way.

### **12) Lack of Savings**

Nepal is one of the poorest countries in the world (with per capita income of U.S. \$ 270 lower than the average for south Asia US \$ 336). Most of the people (80%) are dependent on subsistence farming, economic activities are extremely low, in such a situation people have no good savings, which is also considered as one of the problems with Nepalese equity market.

### **13) Poor Business Environment**

For the private sector investment the business environment in Nepal is not conducive. Poor government policy, weak market infrastructure, political turmoil, insecurity to large business sector (manufacturing and others), no wide area of investment (poor investment climate) lack of access to finance (particularly long-term finance) etc.

have made the environment not conducive for the development of business sector. Unless the business environment is significantly improved, it will be difficult for the Nepalese equity market to develop further from its current state.

### **Prospects**

Nepal as the capital deficient economy requires a huge amount of investment to employ towards productive sector for the economic development of the nation. Most of the large business firms (especially manufacturing trading and others) are in search of funds to fulfill their investment need. On the other hand Nepalese investors/savers have limited opportunities for making long-term investment in business sector because of which investors have to deposit their savings into banks and other financial institutions rather than on business equities. This is also evident by the fact that most of the IPOs are oversubscribed.

Above situation clearly reveals that there is a strong need to develop an efficient equity market for channeling the funds from surplus unit (savers) to the deficit unit (business sector).

Nepal's government in its policy to make liberalized economy has considered privatization as an important component of liberal economic policy, 18 enterprises have been already privatized and other few PEs are considered for privatization. Government is planning to sell the shares of large PEs (such as NEA, NIC, NAC etc.) to public. Such corporation could raise required finds from the equity market by issuing equities to the general public.

After proper reforms, more companies will enter the equity market; consequently individual investors would have opportunities to invest in the shares, of profitable companies. Moreover, with the establishment of more companies, the number of listed companies (in NEPSE) will also increase which will result in greater competition in obtaining funds from the public. In such situation investors could make good portfolio of their investment for increasing return and reducing risk. Thus, despite the various problems as mentioned earlier, there are good prospects of equity market development in Nepal in the days to come.

## 4.12 Major Findings

From the analysis of statistical data and other information, the findings of the study are as pointed below:

### 4.12.1 Findings from Secondary Data

- J The size of equity market in Nepal is relatively small. Over the period particularly after the year 1990 it has grown (the paid up capital as a percentage of nominal GDP in 1990 was 0.85 % which reached to 2.39 % in 2002/03) however, the pace of growth is very slow and now it reached 4.6% in 2007/08.
- J An analysis of 14 companies showed that equity capital of companies has been grown each year by more than Rs. 100 million.
- J D/E ratio in each sector (7 sectors specified by SEBO/N) is found to be significantly different. On an average D/E ratio is about 12:1 which showed that Nepalese companies are highly levered. Banking and trading sector have high D/E ratio (more than 37 and 19) where as insurance and manufacturing have relatively low D/E ratio (less than 5).
- J Nepalese equity market (primary as well as secondary) is dominated by financial sector companies; the participation of the real sector (manufacturing, hotels etc.) is quite low or negligible.
- J There are 184 equity offerings (including rights i.e. equity, common shares 126 and rights shares 58 out of 200 issues approved), issue of preference shares and debentures is negligible (5 issues of preference shares and 9 issues of debt and 2 mutual fund).
- J Nepalese capital market is narrow in terms of capital market instruments. Only common shares, rights shares and to a very little extent, preference shares, debentures and few mutual funds are brought into practice. Contingent securities like warrants and convertibles, options and other securities are not brought into practice.
- J Investors have no sufficient alternatives (because of limited number of financial instruments) to form best portfolio of their investment.
- J The capital market is underdeveloped both in terms of supply and demand. On the supply side there is low number of high-grade securities brought about by a small group of listed corporations. On the demand side, there is a narrow base of

investors actively involved in the stock market.

- J Only about 10 percent of total companies (public ltd.) are listed and there is no competition, which makes manipulation easier and prices more volatile, which in turn deters investors from participating in the market.

#### **4.12.2 Findings from Primary Data**

- J Business firms have preference to use debt (mostly bank debt) over equity financing; the probable cause is that interest expenses are tax deductible while dividends are not.
- J The regulatory institutions have published more information relating to the operation of the market, (guidelines, reports and other booklets) but not vigorously disseminated to the public.
- J Accounting standards of companies are poor and companies are not fulfilling disclosure norms and requirements. The quality of information provided to investors is low and inadequate. Thus, business governance in Nepal is extremely poor.
- J Most of the business firms are not aware about the financial mix. Long-term strategies regarding financing policies have not been adapted. Companies are raising funds whatever source they get. In other words no emphasis is given in making better financial mix.
- J Market regulations, monitoring and supervision systems in Nepal still not strong enough to regulate the market.
- J The restriction of foreign portfolio investment has limited the flow of capital for the growth of the business sector and for enhancing the efficiency of equity market.
- J There is lack of incentives for the investors and business firms to involve towards capital market.
- J Due to insufficient knowledge and lack of information, investors randomly invest in security, purchase and sale of security is made on the basis of intuition, imagination, market rumor, guesswork and conscious judgment rather than proper analysis of risk and return.
- J In fact, the professionalism is not adequate and there is the absence of fair competition among the various players in the equity market.

What is found in the course of research is that most of the persons, (who are involved or responsible or linked with capital market) focused in formulation of laws and policies, in other words almost all the concerned put greater concern on formulation but the implementation part which is greatly important was not emphasized, in short voice remained higher rather than action.

## **CHAPTER-V**

### **SUMMARY, CONCLUSION & RECOMMENDATIONS**

This is the last chapter of the study. The analysis and explanation in the previous chapters have been summarized and from the overall study a conclusion has been made. This chapter also consists of recommendations or suggestive measures for the improvement of equity market in Nepal. The last part of this chapter includes future avenues, which would help other researcher to make further study in the topic.

#### **5.1 Summary**

With the development/advancement in technology, the world has become a global village and with the globalization of business, the competition among firms has tremendously increased. To successfully compete, the business firms should expand and modernize their business, which needs huge amount of funds; it is the financial market, which can provide the easy access to finance. Thus, with the expansion of business along with increasing competition among forms, a firm cannot rely on its own resources and those of the banks, increasingly it has to rely on innovative financing scheme with ample use of the capital market. Resource mobilization is assumed to be vital in the present day economy, capital market, which is called lifeblood of the liberalized economy, is the mechanism through which the resources (savings) are mobilized and flowed from non-productive sector to productive sector. The importance of capital market is increasing day by day and the capital market development is of great importance in a country like Nepal. The pace of development of equity market in Nepal is extremely slow and it has not been efficient enough to contribute to the development of business sector. Thus, this study "Business Financing and Equity Market in Nepal" mainly aims to examine and analyze the prevailing structure of business financing and equity market in Nepal. The specific objectives of the study are:

- To trace out historical evaluation and to evaluate role of Nepalese equity market in business financing.
- To analyze the prospects of Nepalese business finance and equity market in Nepal.



- To identify the existing problems and challenges of Nepalese business financing and efficient equity market in Nepal.
- To analysis the prevailing structure of business finance and equity market in Nepal.

More importantly in developing country like Nepal there is greater importance of capital market and particularly the equity market, since it facilitates the development of business sector and the overall growth of the economy. The history of capital market in Nepal dates back to 1937 when the shares of Biratnagar Jute Mill and Nepal Bank Ltd. were floated to the general public. At that time the participation of ownership was restricted to Rana family, however the capital market at least got the signals of development. Introduction of the Company Act in 1951 and the first issue of government bond in 1964 were other significant developments relating to capital markets. Real market activities however did not commence until the establishment of SEC in 1976. Institutional development of securities market was started after the establishment of SEC under the company Act. Initially SEC limited its function for trading the government bonds and national savings certificates only (predominantly held by NRB), SEC started secondary market for the business securities in 1984 with 11 listed companies and their paid-up capital was Rs.273 million. With the objectives of ensuring regulated and orderly market for primary issue and secondary trading of securities and fostering the development of stock exchanges, SEBO/N was established on May 26, 1993 after the amendment in the Securities Exchange Act. 1983 became effective.

After 18 years of incorporation, N/G converted SEC into NEPSE Ltd. On May 16, 1993 with the objectives of imparting free marketability and liquidity to government bond and business securities by facilitating transaction in the trading floor through the market intermediaries. NEPSE started open out-cry system of trading on January 13, 1994. Thus, NEPSE is an autonomous institution acting as focal organization of the securities market.

After these institutions came into operation, market activity increased more rapidly as market promotion and easier access permitted a significantly greater number of players to enter the market. The paid-up value of listed companies increased from Rs.2182.20 million to 21798.8 in FY 2007/08, similarly market capitalization reached from Rs. 13872 million to Rs. 186301.3 million in the same period. The NEPSE index was 226.03 in FY 1994/95; it was 360.70 in FY 2000/01 and came down to 286.67 in FY 2005/06, and rose to 683.95 in FY 2007/08, indicating inconsistent figures.

At present there are 145 listed companies, 27 licensed brokers, 7 issue managers, 2 portfolio managers and no market makers (there were some market makers in the earlier period). Despite the fact that 145 companies are publicly listed, very few companies' shares are actively traded. On an average, about 30 companies' shares are traded on a daily basis.

Nepalese security market thus, witnessed interesting ups and downs from its establishment to date. Although the growth of stock market is high relative to the growth of the economy, the share of business sector in the national economy is still very low due to the negligible size of business sector; however there is a room for its substantial development.

Regarding the attainment of the objectives of this study as stated in previous paragraph, we formulated hypotheses to make the study more systematic and realistic. For analyzing the real situation, samples of 14 companies (out of 145 listed were selected for the purpose of study, But, it reached 144 listed company when research period). Both primary as well as secondary data were collected from various sources. Source of primary data includes personal interviews and questionnaire where as source of secondary data includes the annual reports and other publications of related organization. The collected data have been presented in tables, charts, bar graph etc. Analysis of data has been made by using financial and statistical tools. Mainly, the ratios, mean, standard deviation, coefficient of variation etc. have been used. For the purpose of testing hypothesis, F-test has been applied.

An analysis of debt and equity situation of sample companies revealed that companies have used more of debt capital than equity. Banking and trading sector have high D/E ratio where as insurance and manufacturing sectors have relatively low D/E ratio.

The issue of equity capital showed increasing trend by relatively small figure (about Rs.70 million each year). Study revealed that until now there are 184 equity offerings (including rights). Out of 200 issues approved issue of preference shares and debentures is negligible (only 5 issues of preference shares and 9 issues of debentures). Nepalese capital market is narrow in terms of capital market instruments. Only common shares, rights shares and to a very little extent preference shares, debentures and two mutual funds are brought into practice. Contingent securities (like warrants and convertibles) are not yet in practice. So the investors have no sufficient alternatives to form best portfolio of their investment. Other problematic factors are, poor accounting and auditing standard, weak disclosure norms (poor business governance); lack of strong enough legal and regulatory frameworks, restriction on foreign portfolio investment, lack of professionalism, absence of fair competition among various players in the equity market. Moreover, pricing of securities is highly volatile and it does not reflect the true position of the company. Getting perfect/exact or complete information on trading activities and company's operational activities or performance is extremely difficult. Investors are seeking right places for making their investment, however; there is low per capita income and low savings. These facts reflect that there are many challenges with which all the concerned has to effectively confront and make sustained efforts, which will help improve the market and increase the access to finance for the business firms.

There are a number of things to do for enhancing and/or improving the market, these include; i) making regulatory institutions more efficient by empowering, strengthening and by granting autonomy to fully supervise, regulate, promote and control the market ii) modernizing trading activities iii) enhancing and promoting good business governance iv) maintaining better co-ordination among various institutions v) educating investors and protecting or ensuring the interest/rights of investors vi) bringing new reform measures and making laws and acts more suitable and effective enough to promote, control and regulate the market in the changed circumstances vii) encouraging companies to enter the market by bringing various incentives packages ix) increasing the access to market information etc. The sustained

efforts to implement above points will definitely facilitate the improvement/development of equity market in Nepal.

In sum, the smooth functioning of equity market is essential for the long-term growth of the business sector. Equity market in Nepal is steadily growing but has many structural weaknesses, so it requires accelerated growth of savings, investment and business sector activities to bring more dynamism in the market and to make the market really viable for economic development.

## **5.2 Conclusion**

Equity market has the key role in the development of the economy. In the changed circumstances of the present day world, the role played by the equity market in financing the business firm is of paramount importance; moreover, the growth of equity markets expands the financing options available to firms. In addition to their primary role in supplying capital to the economy by channeling savings to productive use, equity markets have an important informational role. Also for the bond market to develop there must be well-developed equity market capable of promoting complex information.

In Nepal, however the efforts have been made for the proper development of equity market, still the country's equity market has been unable to provide market access to all the potential investors. There is simply not enough equity capital in Nepal (however is also the case in south Asia) to fuel economic miracle to which it aspires. Nepalese equity markets represent a very small figure even in south Asian market, and it is far behind from the global network of equity market. After the political change in 1990 and particularly after the establishment of NEPSE's trading floor and other regulatory institutions such as SEBO/N. more new companies have entered the market and public participation in stock market has increased. Thus, the market seems to heading towards right direction, however because of the various bottlenecks or inherent problems such as structural and institutional weakness, low income, low savings and low investment (weak investment environment) along with

other numerous problems, the potentials of equity market are largely untapped.

Thus, all concerned with the market; the investors, the issuers, the market players and more importantly the regulators- the Stock Exchange Authorities, the Securities Board, Nepal and above all the government of Nepal have an arduous task ahead of them. With sustained efforts on the part of all these, Nepalese equity markets can easily prove to be not only foundations for funds but also vehicles of distributing wealth among people in the country.

### **5.3 Recommendations**

On the basis of overall analysis and findings of the study we have made the following recommendation for the further improvement and/or development of equity market in Nepal.

#### **A. Regarding Institutional Effectiveness**

From the overall study one of the important factors hindering the growth of equity market consists of inefficiency in the institutional and regulatory structures. Following points have been considered as suitable measures for their efficiency and effectiveness:

- ) To ensure that the market operates in a fair and transparent manner, programs that support the substantial strengthening of the regulatory agencies should be initiated.
- ) However there should be the authorities like MOF to monitor the activities of SEBO/N and to assist in taking policy level decision with SEBO/N, SEBO/N should be granted with exclusive authority to make rules and regulations within the bounds of existing laws.
- ) Regulatory institutions such as SEBO/N and NEPSE should undertake occasional programs by participating listed companies, brokers, intermediaries and other stakeholders so that credibility among institutions will increase and companies will be more responsible towards their activities.
- ) To enhance the ability of the SEBO/N, it should be made more autonomous by giving direct and specific authority regarding provisions for market regulation and operations. Its power to impose monetary fines and types of sanctions

should be broadened. Moreover, Central Depository System (CDS) should be introduced for quick and easy transfer of shares.

- ) The process of modernization and computerization of the NEPSE's trading, clearing and settlement system should be initiated in order to make the market not only broad and liquid but also fair and efficient.
- ) To increase their effectiveness, human resources in the regulatory institutions should be given proper training and they should be given opportunities to involve in workshop and seminars at national and international level.

## **B. Regarding Business Sector Development**

Nepalese listed companies are found to be not fully accountable with equity investors and they are not actively involved in the market business sector.

- ) To get the needed equity funds at lower cost and to increase the credibility in the market (which will help increase the value of the firm), companies must be transparent enough and they must fulfill the disclosure requirements and should be more concerned in the accounting and auditing standards.
- ) Besides AGM, business firms should make proper environment; for the interaction of management and general investors.
- ) Management of the companies should always act in the best interest of the investors so that popularity could be gained.
- ) Government intervention (on large corporations such as RNAC, NTC, and NEC etc.) should be gradually removed and they should be facilitated to enter the market so that competitiveness in the market would increase and monopoly would be discouraged.
- ) Since business firms are not able enough in maintaining proper financing mix, agencies such as 'Institute for Business Finance', 'Business Finance Department' etc. as financing facilitator could be established.

## **C. Others**

- ) Emphasis should be given on ensuring good business governance. For the good business governance, a system of information dissemination, accounting

and auditing in line with international standard, accountability and transparency has to be established and practiced.

) Since D/E ratios of the firms are not satisfactory, the regulatory body could specify some measures to maintain proper financing mix, and more appropriate tax incentive should be brought into practice.

) To retain and enhance the investors' confidence over the stock market, laws and acts, which protect the interest of investors, should be formulated.

To encourage the establishment of more business firms and to increase their involvement in the stock market, special provisions should be made and companies should be provided with various incentives such as tax waivers, associated with the offering of shares and disclosure of information to public.

To increase the countrywide awareness and to expand the coverage of capital market, the topics of capital market should be introduced into the curriculum of higher education in economics, business and law with great emphasis.

In order to make the capital market more efficient, market participants and academic institutions should jointly promote and undertake more research and market analysis activities.

For achieving significant level of foreign investment, the present barriers to foreign portfolio investment should be removed i.e., market should be made open for global investors. Foreign portfolio investors and intermediaries should be allowed to enter the capital market. Government should make necessary efforts towards this direction. To widen the ownership in the companies, various regulatory measures have to be brought into practice; holding of controlling stake of a single person in various companies should be restricted.

A good co-ordination between various stockholders (Government, SEBO/N, CRO, NEPSE, NRB and the private sector) should be established to have a multiple effect on market development.

More diversified capital market instruments (such as options, warrants and convertibles) should be introduced in the capital market 1\$ order to appeal the investments from a large range of investors.

One suggestion on the part of investors is that each individual investor should have long-term perspective on their investment (for example, they should think that they are investing not for the next week month or year, they are investing for the education of their children, for the post retirement needs etc.).

- ) Most of the investors hold very little knowledge on the workings of the financial system, so the regulatory institutions should undertake a campaign to vigorously disseminate adequate information on the overall aspect of the stock market. In addition to this following could be done.
- ) Establishment of information channel in NEPSE to provide quick information to investors.
- ) Development of institutions providing consultancy services to investors for risk-return trade-off.
- ) Existing acts laws and regulations should be reviewed; moreover, an evaluation should be made regarding their effectiveness in market promotion. In other words the systematic reforms should be made to make the equity market safer, more transparent and more modern.
- ) Government should make effort to promote the market and should assist in formulating policies, which are more encouraging to create proper investment environment (For example taxation policy should be reviewed, privatization process should be made more transparent and more participation of general public in those PEs which are privatized).
- ) In order to encourage the public to save more, productive activities should be enhanced and good environment for investment should be created.
- ) For enhancing the institutional demand for equities, activities such as liberalizing entry/listing requirements, promoting/encouraging healthy competition, and broader private sector participation could be done.
- ) In order to provide real information to investors the practice of publishing defective or insufficient prospectus should be



discouraged. Finally, all should make effort to maintain political stability in the country.

It is believed that the successful implementation of the above lines points will facilitate further development of the equity market and consequently this will help meet the needs of the real sector.