# CHAPTER – I

## INTRODUCTION

### 1.1 General Background of the study

Due to globalization of economy and market, present world economy has been more competitive and complicated. Every short 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, 2000).

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 (Vanhorne, 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). 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. 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.

As 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 2002:35).

Thus, with the globalization and increasing access to information, a corporate business firm can not relay on its own resources and those of the banks. Increasingly it has to relay 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 corporate stocks (such as T-notes and bonds, corporate 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 (GON, 1997-2001:167).

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 corporate 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 boarders do not present a great barrier and there is now a huge international OTC debt market .

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 etc. 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:2000:2).

In the changed circumstance of present day world, the role-played by the equity market in financing the corporate 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).

Although some analysis view stock markets in developing counties 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 Shamser 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).

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 on 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 publicity 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 corporate 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 protesting 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 corporate 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 (Bhattarai 1994:13).

Thus, Nepal Stock Exchange is working as a trading (operational) institution; which operates under Securities Exchange act, 1983, where as 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 corporate 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 peace with the growth of the private sector, NEPSE presently has 27 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 125 listed companies in 2005. The paid up value of listed companies increased from Rs. 9685.04 million in FY 2001/02 to Rs. 16771.85 million in FY 2004/05, market capitalization reached from Rs. 34703.87 million in FY 2001/02 to Rs. 61365.85 million from FY 2004/05 the percentage contribution of market capitalization on GDP is estimated to be 12.17.

NEPSE index in FY 2001/02 was 227.54 which reached to 286.67 in FY 2004/05 which is 64.63 points higher than that of the last FY's index (SBN 2005:29-31). The stock exchange set up in 1994 with only 8 listed companies. But its reached 127 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 corporate sector in the national economy is still very low due to the negligible size of corporate 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

In undeveloped like Nepal the development and growth of stock markets have been widespread in recent times. Despite the size and illiquid nature of stock market it continued existence and development could have important implications for economics activity. For instance pardy (1992) has noted that even in less developed countries capital markets are able to mobilize domestic savings and able to allocate funds more efficiently. Thus stock markets can play a role in including economic growth in less developed country by channeling investment where it needed from public. Mobilization of such resources to various sectors certainly helps in economic development and growth. Stock market development has assumed a developmental role in global economics and finance because of their impact they have exerted in corporate finance and economic activity. The role of financial system is considered to be the key of economic growth (Neupane, et.al.2006)

Stock market development has an important role to play in economic development which have been tried to show in this thesis. Stock market development is an important wheel for economic growth as there is a long run relationship between corporate finance and equity market. This study will attempt to dig out the empirical evidence in the context of underdeveloped nations regarding the role of stock market development on economic growth and conducted the empirical analysis of stock by market investigating the link between corporate Finance and equity Market in Nepal.

## 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 corporate 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 corporate firms, however the optimal level of performance has not achieved, whether it is due to the inability of the corporate firms to select the better way of financing its expenditures or the lack of efficient capital market, it still remains to be studied.

Nepalese corporate 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 (Nathan, 2002:1-12).

Why Nepalese corporate 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 corporate 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 125, which is less than 1 percent of al companies and 10% of public limited companies. In Nepal corporate 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 corporate 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 corporate 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 corporate equities rather than depositing on the bank.

However, because of various problems of stock market and the corporate 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 corporate 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 corporate 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 corporate sector, regarding corporate 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:

1. To trace out historical development and to evaluate role of Nepalese equity market in corporate financing.
2. .To analyzes the prospects of Nepalese corporate finance and equity market in Nepal.
3. To analysis the prevailing structure of corporate finance and equity market in Nepal.
4. To evaluate the relationship between the type of company and the issuance of equity.
5. To provide the some suggestions for the future improvements of corporate Finance and Equity Market in Nepal.

## 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 corporate 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 corporate bodies, professional analysts and the general public as well.
- Besides, the study would open up new areas for further research.

## 1.6 Limitation 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 2003 to 2009 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 of Data**

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

### 2.1 Introduction

This chapter provides same glimpses on the literature that is available in the topic. This chapter deals with the review relating to corporate 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 corporate 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 corporate 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 corporate financing and equity market in Nepal.

### 2.1.1 Meaning and Concept of Corporate Finance

**Corporate finance** is an area of finance dealing with financial decisions business enterprises make and the tools and analysis used to make these decisions. The primary goal of corporate finance is to maximize corporate value [1] while managing the firm's financial risks. Although it is in principle different from managerial finance which studies the financial decisions of all firms, rather than corporations alone, the main concepts in the study of corporate finance are applicable to the financial problems of all kinds of firms.

The discipline can be divided into long-term and short-term decisions and techniques. Capital investment decisions are long-term choices about which projects receive investment, whether to finance that investment with equity or debt, and when or whether to pay dividends to shareholders. On the other hand, the short term decisions can be grouped under the heading "Working capital management". This subject deals with the short-term balance of current assets and current liabilities; the focus here is on

managing cash, inventories, and short-term borrowing and lending (such as the terms on credit extended to customers). The terms corporate finance and **corporate financier** are also associated with investment banking. The typical role of an investment bank is to evaluate the company's financial needs and raise the appropriate type of capital that best fits those needs. Corporate Finance makes:

| | |
|---|---|
| 1. Capital Investment Decisions- | The investment Decision |
| | Project Valuation |
| | Valuing Flexibility |
| | Quantifying flexibility |
| 2. The financing Decision | |
| 3. The Dividend Decision | |
| 4. Working Capital Management- | Decision Criteria |
| | Management of Working Capital |
| 5. Financial Risk Management | |
| 6. Relationship with other areas in Finance- | Investment Banking |
| | Personal and Public Finance |

## 2.1.2 Equity Market

The market in which shares are issued and traded, either through exchanges or over-the-counter markets, also known as the stock market, it is one of the most vital areas of a market economy because it gives companies access to capital and investors a slice of ownership in a company with the potential to realize gains based on its future performance.

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

corporate firm can be reading transferred, and the life of corporation therefore is not limited. The corporate 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 corporate firm is superior when it comes to raising cash (Ross, Wethersfield and Jordan, 2002:9-10).

The more developed the corporate sector of an economy the more is its economic progress. The state of the corporate 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 (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 corporate sector of an economy is the major contributor to the process of economic development. As the corporate 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 (Patra, 1999:64) .

### 2.1.3 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 corporate 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 (Bodies, Kane, Marcus-6th Ed, 2000 11-12).

### 2.1.4 Financing Decision

Financing decision is one of the most important decisions taken by the corporate 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).

Financial managers are concerned with financing decisions. Financial manager must decide when, where and how to acquire funds to meet the firm's investment needs. They must be able to find the best financing mix or optimum capital structure, which maximizes the market value of share (Thapa, 2005:14).

Financing decisions are usually though to revel 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 (Patra, 1999:1-12).

Company invests in long-term assets (mainly property, plant and equipment) and net-working capital. There are various sources where they get cash to pay for these investments. By far, the great part of money is generated internally (by existing profitable firms) which comes from funds that company has set aside as depreciation and from earning that are not paid as dividends.

To make up the deficit (excess of financing need over the finds internally generated) companies must either sill new equity or borrow. So, companies face two basic financing decisions: How much profit should be plowed back into the business rather than paid out as dividends? And what portion of the deficit should be financed by borrowing rather than by an issue of equity? The financing policy of a firm (such as debt equity, dividend policy etc.) provides answer to such questions (Stewart 2000:383-84).

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 capitally 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, 1995a: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, 1995a: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 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, 1995a: 38).

#### 2.1.4.1 Corporate Finance

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

1) **What is corporation**?

Corporation is a form of business organization. Among three alternative forms (sole proprietorship, partnership and corporation) of business organization corporatism is a kind. Not all business organizations are corporations. Small venture can be owned and managed by single individual these are called sole proprietorships. In other cases several people may joint to own and manage a partnership. Almost all large and medium- sized businesses are organized as corporations. For example: Nepal Bank Ltd, Sagarmatha Insurance co. Ltd, Lumbini Finance and leasing co. Ltd etc.

**The following are the basic characteristics of corporation:**

* Shares of stock represent ownership in a corporation

*Ownership can easily be transferred to new owner

*The corporation has unlimited life

*Shareholders have limited liability

The most important characteristic of corporation is management of corporation is; always separate from its owner (Manandhar, Bajracharya, and Bhattarai, 2004:1).

2) **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.

Therefore corporate finance deals with the financial problems of corporate 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 and Bhattarai, 2004:1-2).

Corporate financing is related with the funding for business firm. (Oxford University, 1997:81). Corporate 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 (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 (Patra: 1-2).A business enterprise satisfies its initial funds requirements by taking resources to different external source of financing but resorts to internal financing for meeting its subsequent financial needs for expansion, modernization, rationalization and replacement programs.

### 2.1.4.2 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 in technically termed as plaguing back of profits (Srivastava, 1995a:8). Plaguing 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 (patra, 1998:88).

Financing from internal sources (i.e. retained earning) may often be less costly than the external financing. The policy of plaguing 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 two depends exclusively on external sources only. Moreover, excessive plugging back is likely to 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( Patra 1999:90).

At time internally generated funds will be sufficient to finance all of the firm's positive net present value investment opportunities. When this happen, 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 marked-the market where investors exchange current dollars (or other currency) for assets that represents 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 creditor ship 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 (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 corporate to firm needs finance for varying terms to run it smoothly. On the basis of time duration the financial requirement of corporate firms can be classified into the following groups:

i) Short-term finance

ii) Medium - term finance

iii) Long -term finance

## i) Short -term Finance: -

Short -term financing is that type of financing which matures within one year or less. Short term financing is used to support a large portion of the firm's current assets such as cash, marketable securities inventories etc. Financial managers should be more careful in taking decision about short- term financing. They are particularly concerned with sourced of short - term financing cost of alternative for a given set of conditions (Thapa 2061:2.1).

The need of fund for not more than one year comprises of short - term finance. This kind if finance is originally scheduled for repayment with in one year. The main

sources of short term finance are accruals, trade credit, bank credit, short- term loan from financial institution commercial papers factoring receivable, public deposits etc. It is well known that the short term finance is needed to meet short term requirements particularly the working capital need. The role of this kind of finance cannot be underestimated in view of the fact that may corporate firms face difficulties due to the lack of working capital (Joshi, 1997:127).

### ii) Medium -term Finance:

The need of funds for more than one year but not exceeding five years comprises of medium -term finance. This kind of finance is originally scheduled for repayment in more than one year but less than five year.

The main sources of medium term finance are term loans condition sales contracts redeemable preference shares or debentures and lease financing. The commercial banks, development banks and other financial institutions such as insurance companies, provident fund and finance companies are the suppliers of such finance. Besides, public deposits are also regarded as a popular source of medium- term finance (Joshi, 1997:127).

### iii) Long -term Finance:

The line of demarcation between medium term and long- term finance is vague and invisible. Generally, the need of funds for over five comprises of long-term finance. The long term finance is needed by the corporate firms to replace existing capital assets expands the existing capacity modernize the industry etc. This kind of finance is in fact, the capital bearing the ultimate risk of the business.

The main sources of such finance are the sale of equity shares, common stocks preference shares, retained earnings, long-term loans, debentures, leading, financing through warrants and convertibles etc. Usually in the initial periods, equity share is the first source of funds to a new firm. However, over the periods, the retained earnings also becomes the source of long-term financing since equity capital alone can't meet the long-term loans are made available by the banks (commercial banks, development banks) and other financial institutions (Joshi, 1997:129).

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long-term loans are made available by the banks (commercial banks, development banks) and other financial institutions (Joshi, 1997:129).

### 2.1.4.3 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 perment as 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. Long-term funds involve two major decisions to betaken. There are the different size and the composition of long-term funds.

The size of long-term funds required by a firm depends mainly on the size and nature of its business. Bigger business requires more of every kind of funds including long-term in comparison to the smaller ones. The nature of business i.e. whether the business is industrial, commercial or service type, is yet another factor determining the requirements of long-term funds ( Patra, 1990:79-80).

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.

## 2.1.4.4 Corporate 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 (Jafe, 1993:393).

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

## 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 corporate 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 UN 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.

## Features of Common Stock:

## Par Value:

Par value is stated price in common stock certificates. the corporate 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.

## 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.

## 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.

## Claim on asset

Just as common stock has a residual claim on income, it also has residual claim on assets in case of liquidation. When a firm becomes bankrupts its assets are sold, and at first, the proceeds are distributed to employees, to the government, to secured creditors, to preferred stockholders and finally to common stockholders. This residual claim on income and asset increases the risk to the common stockholders.

## 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.

## 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.

## 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 les than par value. (Baral, Dahal, Gautam, Paudel and Rana 2062:188-190).

## 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 unsecured corporate debt, whereas a bond is secured by a mortgage on the corporate property. However, in common usage the word 'bond' is used indiscriminately and often refers to both secured and unsecured debt (Jaffe, 1993:401). We shall in our discussion, use bond and debenture as interchangeable words.

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-tern promissory note and lenders have great stake, a long-tern 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, 1984a:650).

Debenture is one of the frequently used methods by which a business can procure long-term fiends for its initial financial needs or for its subsequent requirements of growth and modernization (Srivastava, 1984a:649). In practice, the use of debentures

depends both on the nature of the fan'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).

## Certain distinguishing features of debentures are as follows:

### i)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, 1995:651-52).

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).

### ii) 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.

### iii) 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).

### IV) 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 fiends 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.

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.

## 2.1.4.5 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 l ong-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 deducibility 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 fine'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 (Patra, 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. Finns 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, 1996a: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 that 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 corporate finance literature (Maksimovic, 1996a:342).

A relatively underdeveloped stock market begins to develop in a given country; fines 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 corporate 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 letter 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 is 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 ( Ferris, 2000:78-79).

Analysis of actual financing decision show that fines tend to issue equity instead of debt, when market value is high, relative to book value and past market values, and tend to repurchase equity when market value is low. Moreover, firms tend to issue equity at times when investors are rather too enthusiastic about earnings prospects (Wurgler, 2002:7).

Most cases financing a Finn 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).

## 2.2 Potentiality of equity of 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, 1984a:624-25). 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 stun: 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 finds. 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 keen 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, 1984a: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 cheater 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, 1984a:626).

Alongside this, a company seeking additional capital through equity shares will be deprived of the valuable benefits of trading on equity 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. Equity stock capital, of course, provides strong basis of taking advantage of a cheaper source for further financing. However, if the management elects to limit (which is hardly noticed in the real world) further financing through equity shares, the company will be deprived of the benefit of leverage. In that case, earnings per share would tend to decline causing setback to share values in the stock market and ultimately impairing the financial health of the enterprise.

The above discussion posits 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 arid who 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, 1984a: 641).

Use of preferred stock provides leverage benefits to the company in so far as it earns more that 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.Preferred stock provides flexibility in the financing arrangement of the company. By inserting call or redemption feature in preferred stock, the management can keep the door of the company open for alternative sources of funds for further financing.

Furthermore, 'the management is free to pursue dividend policy to suit the needs of the company and if necessary, may decide to retain all its earnings for reinvestment in the enterprise. This in turn, strengthens the financial health of the enterprise in the long run (Srivastava, 1984a:641).

Preferred stock also helps the management to keep controlling power of the current stockholders intact. Sometimes, market factors favor the issuance of this kind of security. At a time when the economy is enveloped in uncertainty- and the stock market is caught in a whirlwind of slump and management finds that investors have a strong desire to hold investments promising higher yield as compared with fixed interest debt and greater certainty of return and added protection in relation to equity stock, preference share is the most suitable form of security to attract capital. Such a tendency gets reinforced when equity share prices plumb (Srivastava, 1984a:642).

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.There is also some fear of sharing control with holders of the preferred stock, particularly in the event of irregularity of dividend payment. This reinforces the indifferent attitude of current residual owners for preferred stock.

While choosing securities for raising long-term capital, the finance manager must familiarize himself with investors' felling 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.

## 2.3 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 most 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 fells 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 fine (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 severs 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-tern, 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 welldeveloped 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).

With the passage of time, a well-developed liquid equity market will become increasingly beneficial for the financing of technical innovation and new- economic activities. While use of debt finance tends to distort asset holdings towards fixed capital, equity finance facilitates the development of innovative activities (such as R&D) that do not necessarily yield collateral: a well developed equity market supports a venture capital industry by allowing venture capital industry to exit through an IPO. At the same

time market finance in general becomes valuable with economic development, which causes information to be held more widely in the economy (Takagi, 2002:92).

Studies have shown that, at low levels of development commercial banks are the dominant financial institutions.. 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, 1991:5-6).

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 (Stan, 1996:241).

## 2.4 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.

### 2.4.1 An Overview

The world has seen faster human and economic development during the past half century than during any previous comparable periods in history. Almost everywhere literacy rates are up, infant mortality is dog, and the people are living longer lives. But

some very real challenges remain. The world economy has grown by 4.0 percent in 2003 from 3.0 percent of 2002. This increase is attributable to the adoption of expanding financial and monitory policies by United States of America and South East Asian countries. Due to the increasing global industrial product, increasing confidence of the consumer, remarkable improvement in the world trade, dynamism in the financial markets and encouraging growth in the economy of United States of America and emerging economies of Asia.

The estimated growth rate was 5.1% in 2004. Similarly, on the basis of continuation of supporting environment of the financial markets which is increasing trend in the employment. Probability of continuation of economic growth rate would be 4.6 Percent in 2005. The rate of the developed countries increased in 2004 in companion to that of 2003 and reached 3.4 percent. However, this rate is estimated to decline in 2005. Likewise, the rate of the developing countries has also increased in 2004 and reached to 7.2 compared to that of 6.4 in 2003 (SBN 2004/2005).

### 2.4.2 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. Treasures are not confined to domestic markets as their source of finding and are now quick to exploit any attractive opportunity that occurs anywhere in the world (Shapiro, 1990:369).

### 2.4.3 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, 1997a: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 corporate 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).

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,2002:68-69).

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 fines 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).

The growth of equity markets in developing countries has won the enthusiastic support of policy makers and expanded financing options available to firms. But it raises a number of questions. How do firms decide whether to finance investment by debt or equity? How does stock market development affect the financing choices of firms' (Kunt and Maksimovic. 1996b:47).

It is true that the market for equities is sizable in emerging East Asia and may even exceed the balance of bank loans in sere of them. Equity markets can grow even when an existing market infrastructure does not support the development of markets for corporate 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-tern corporate financing (Kunt and Maksimovic. 1996b:69).

Corporate 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 of 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, 1998:1-2).

In the past several years, the opportunities for equity investment in developing economies have increased remarkably. The expansion of local equity markets and the developments of instruments for issuing equity directly on international markets have given firms in these economies increased access to the world supply of capital. Indeed,

developing economies as a group increased their borrowing through new equity issues from virtually zero in 1987 to S 5 billion in 1991 (Wemer, 1999:109).

Over the past 10 years (1999-2009), total capitalization of stock market worldwide has grown from $4.7 trillion to S 15 trillion; developing countries share of this total has jumped from less than 4 % to 15 %. These increases have been accompanied by the liberalization of stock markets, especially in developing world (Kunt and Maksimovic, 1996b:47).

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, 1995:8-14).

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 S171 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, 1995:8-140).

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.

### 2.4.4 Book Review

In their book, under the topics 'Why don't fines issue more equity. Ross, Wethersfield and Jaffe (Jefferv, 1993:386-87). Stated that external equity, as a percentage of total corporate 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 corporate 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 extra ordinary 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, corporate 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 few companies 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 high cost of capital is one important obstacle to private sector capital information and economic development in Nepal, and that high cost is associated with lack of competition in the financial sector and the poor performance of the government - owned banks. The (real) bank deposit rate is negative to neutral. NSCs offer higher rater than bank deposits and are tax -free.

The lending rates of government financial institutions are lower than those of other institutions, and this distortion affects the capital market. The high rate on risk-free and tax -free government securities establishes a high bench- mark rate for corporate fixed-income undermine the healthy development of the corporate debt market. (Kviback, 2005, Nepal Survey).

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.

An efficient market is one where a security's current price gives the best estimate of its ten watches. In an efficient market, there are higher free launches 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).

### 2.4.5 Review of Rules and Regulations

### Legal Arrangements of Corporate 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 corporate securities market in Nepal, legal reforms and policy stance are required to make the market allocation ally and operationally efficient. 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 corporate 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, corporate 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 HMG/N (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.

### 2.4.6 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 subsided, 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

## 2.4.7 Impact of Rule and Regulation

Regulation of stock Prof. Dr. M. K. Shrestha (20 13:20) 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 allocate-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 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 tr4ading 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 corporate governance practices and absence of institutional investors in capital market. Even then, programme 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 promoter's 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.

## 2.5 Review of Related Studies

### 2.5.1 Review of Journals, Articles and Newspapers

Dr. Manohar Krishna Shrestha (1985) in his analysis of capital structure in selected public enterprises pines 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 (2002). 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 tern 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, Bekaertan 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 word 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 and Harvey 1997:5.

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, 1997:92).

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 1st 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 forurn 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 2002:4) 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, 12th 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 terns of debt financing in the market. Nepalese companies may capitalize the benefits of preference shares in the days to come.

### 2.5.2 Review of Thesis

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 corporate 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 fiends 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 raise 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 199194 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 corporate) arranging different types of instruments for the creation of new savings vehicles which lead individuals to invest more in corporate 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, 2002:1-32). 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 corporate bodies. Investors are willing to invest in the common stocks of public limited companies but the corporate 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-tern 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.

Mr. Shrestha. Rai and Khadka (2002) further pointed out that whenever the corporate bodies offered stocks in the primary market there is an over whelming response from the retail investors. 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 corporate bodies and the corporate 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 corporate 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 Corporate Finance Decision"**, Mr. Kunt and Maksimovlc (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 fun's managers and its customers and suppliers as well as between different classes of investors in the firm.

For example, fines 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 fine 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 fine 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 corporate control may be large enough to induce creditors to lend more. For these fines, 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; fines 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.

In the study of corporate Finance, Mr.Dinesh Prasad (2006) has shown some econometric limitations, the results show some interesting generalizations in Nepalese context. The GDP growth rate is negatively related to total debt ratio and shortterm debt ratio. It is positively related to long-term debt ratio. It implies that higher economic growth tends to cause to use more long-term debt and less short-term debt. Since the contribution of short-term debt on total leverage is significantly high, the evidence is obvious. This evidence implies that the Nepalese companies prefer long-term debt securities and rely less on short-term borrowing when the economic growth is higher. The inflation rate is negatively related to total debt ratio and short-term debt ratio, whereas, it is positively related to long-term debt ratio.

It implies that increasing inflation supports to increase longterm debt and decrease short-term debt. To some extent, in short-run, the higher inflation decreases the interest rate, which could foster long-term borrowing. Finally, both debt ratios vary positively with market capitalization. It implies that as capital markets become more developed, they become a viable option for corporate financing. However, the institutional data and econometric analysis offers tantalizing glimpses of what macroeconomic factors really mean, rigorous study in this regard is inevitable.

On the study of Modern finance and behavioral finance Mr. Narayan Krishna Joshi (2008) have identified several types of anomalies in the stock market, e.g., calendar effect (seasonalities), weather effect, lunar cycle effect.1 Calendar effect states that return on common stock is not the same for all the months of the year or the days of the week. They mainly includes: January effect (stock returns, are on average higher in January than in other), Monday effect (Monday returns are on average lower than returns on other days). Weather effect argues that economically neutral weather variables such as rain, temperature, humidity and cloud cover influences the stock market returns through their effect on moods and feelings of individuals. On the other hand lunar cycle effect means that stock returns in the 15 days around New Moon dates are higher than the returns in the 15 days around full moon dates.2 These are only few

but main important anomalies explaining seasonal pattern in stock returns. In this article, I will basically focus on monthly seasonality, that argues that return on common stock is not the same for all the months of the year, and show how to take advantage of it by timing buying and selling decisions according to monthly trends.

Modern finance and behavioral finance have identified several types of anomalies in the stock market, e.g., calendar effect (seasonalities), weather effect; lunar cycle effect.[1] Calendar effect states that return on common stock is not the same for all the months of the year or the days of the week. They mainly includes: January effect (stock returns, are on average higher in January than in other), Monday effect (Monday returns are on average lower than returns on other days). Weather effect argues that economically neutral weather variables such as rain, temperature, humidity and cloud cover influences the stock market returns through their effect on moods and feelings of individuals. On the other hand lunar cycle effect means that stock returns in the 15 days around New Moon dates are higher than the returns in the 15 days around full moon dates.[2] these are only few but main important anomalies explaining seasonal pattern in stock returns. In this article, I will basically focus on monthly seasonality, that argues that return on common stock is not the same for all the months of the year, and show how to take advantage of it by timing buying and selling decisions according to monthly trends.

Empirical studies conducted in the developed stock market (for instance, US, Japan) have uncovered the statistically significant positive returns to common stocks in January while significant negative returns to common stocks occur in December. Hence the name January effect for monthly seasonality. The existence of these evidences violate the efficient market hypothesis which was developed by Professor Eugene Fama of University of Chicago Graduate School of Business as an academic concept of study through his published Ph.D. thesis in the early 1960s at the same school.

According to the hypothesis "A capital market is efficient if all the information set is fully reflected in securities price such that it is impossible to make economic profit by trading on the basis of information set . By economic profit, we mean the risk adjusted returns net of all costs. To put in layman words, the hypothesis means that it is impossible to "beat the market" because stock market efficiency causes existing share

prices to always incorporate and reflect all relevant information. However the hypothesis has been subjected to debate and opponents have proposed Behavioral Finance as an alternative to efficient market hypothesis.

On the thesis of Co-operative movement of Mr. Shanta Raj Sharma Neupane( The modern co-operative concept or principles in the formal sense may not be very old but the concept of co-operatives is definitely the ancient one. The informal co-operation can perhaps be cited from the primitive age of mankind. Two men or women working together to hunt down an animal in the forest for their food must have been the first example of co-operative effort or a work of cooperation. The word co-operative' is derived from the Latin word 'Cooperari' that means working together with others. In simple words, cooperation is a 'give and take' process to each other, working together for similar and a common cause. According to ICA Congress.

"A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise. Co-operatives are based on the values of self-help, selfresponsibility,democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others"[1]. Presently, there are seven principles of cooperation, which were adopted in 1995, at Manchester World Congress of ICA are Voluntary and Open Membership; Democratic Member Control. Member Economic Participation, Autonomy and Independence, Education, Training and Information, Cooperation among Co-operatives, Concern for Community.

Co-operative enterprises can be divided roughly into consumers and producers co-operatives, which are based on human activities. Based on their purposes, co-operatives are either multipurpose or single purpose society. However, Co-operatives are largely of different types based on their business activities and of homogeneity of the people. They can be described as financial services cooperatives (savings and credit, banking and insurance/mutual), milk producers/dairies, livestock, agricultural, food and food processing, horticultural, plantation, forest users, tea and coffee, sugar, rubber and coconut, fisheries, workers, services, youth, renewable energy, tribal and backward community, women, health, housing, tourism, transport,

wholesale/retail trade, industrial, and press and news papers etc. The international network organization of cooperatives called International Cooperative Alliance was established in London, in 1895 to represent the World Cooperative Movement. At present, there are 800 millions of co-operative members' worldwide fewer than two million co-operative enterprises covering almost every country[2].

The **objectives** of this research are to study the status and the role of co-operative movement in Nepal. We also studied the best practice cases of co-operatives and microfinance institutions in Sri-Lanka (SANASA), India (AMUL), and Bangladesh (Grameen Bank) to learn the lessons. We intended to find out obstacles related to it and recommend the strategies for co-operative development and appropriate model for Nepal to modernize co-operative movement. Both primary and secondary data were collected through different sources. We visited AMUL in Gujarat, SANASA co-operatives in Sri Lanka and Grameen Bank of Bangladesh to collect data on best practice cases. Opinions of all those respondents were noted and included in the study. The tentative period of secondary data in the study was from 1980 to 2000 but in some cases, it has covered complete period from 1956/57 to 2001/02. Period of primary data was of 2001/02 to 2002103.The data were collected from both primary and secondary sources. Focus was made to mainly four districts namely Rupandehi, Chitawan, Kathmandu, and Baglung.

However, questionnaires were distributed to the co-operatives in 20 districts in Nepal covering hills and Terai region. Research also largely relies on the secondary sources of data/ information including published literature, such as articles, co-operatives acts and rules, co-operative data books and annual statistical reports published by department of co-operatives and ministry of agriculture and cooperatives of Nepal. The researcher visited the selected Co-operatives in four different districts of Nepal, AMUL in Gujarat, SANASA co-operatives in Sri Lanka and Grameen Bank of Bangladesh, met and discussed with co-operative staff, members, and primary, secondary, and national level board members/leaders and collected concerned data, and opinions of all those respondents were noted and included in the study. Primary questionnaires were processed and analyzed through SPSS and Onfront software packages. Different statistical techniques from simple descriptive tools to econometric

models e.g. Ratio Analysis, Chart-Graph-Bar diagrams, and Data Envelopment Analysis model were applied to analyze, interpret, and find out the results.

Some of the important variables analyzed in the study are ratio of active members and their participation in business and decision-making, economic efficiency / self—help and autonomy of the co-operative enterprises, efficiency, and activeness of the board ofdirectors and accounts committees. Education and trainings to members and staffs, performance of staff and members; Reasons and situation of success and failures; support of government and other agencies for co-operative cause; contribution of co-operative sector to the economy; legal reforms and tax issues in cooperatives, in addition, structural reforms in co-operative movement.

In **review of literatures**, an attempt has been made to review several research articles and books related to different issues of co-operatives in different countries, particularly in India. From the available literature, different types of thoughts and analysis on cooperative enterprises were found the analytical ideas on failures and success, participation of members in business as well as effective management system are some, which are useful for the research. There are several factors, which are untouched by others. However, on exploring the literature on this subject - Cooperatives in Nepal, we did not find any comprehensive study covering the co-operative sector broadly. From the present research, we are trying to cover up those areas of co-operative development also, which were not covered in the earlier studies. People's organizations are defined as membership based organizations.

The purpose of the peoples' organization is to serve the needs of its members. The best example of people's organization is a co-operative; the others are farmers' association, mothers group, labour unions and users/consumers organization. Almost all people based organizations are self-service oriented and not like intermediate organizations who provide services to the people at large rather than its members or shareholders, such as private agencies, government departments, NGOs, and religious organizations. Therefore, co-operatives are regarded as the major people's organization because their purpose of establishment is to serve to the members, by the members and for the members.

In his observations, co-operative enterprises in Nepal could play considerable role in the Nepalese economy though they have very poor contribution in the economy at present. There could be better prospects of success for the co-operatives if management and business operation capacities are improved, efficient, participatory, and transparent. Co-operatives could not succeed without having efficient participatory management and effective marketing of members' products and services.

Active and responsible participation of the members in cooperative business will increase I enhance the economic efficiency to ensure the success of the co-operative enterprises. Without active participation of its members, the co-operatives cannot increase the economic efficiency and get succeed. Successful co-operative enterprises can generate higher prospects of employment, economic surplus that leads to poverty alleviation and the members' family well-being and easy accessibility of goods and services preserving quality and fair price. Until now, co-operative enterprises in Nepal have not much role in employment generation and poverty alleviation vis a vis socio economic upliftment that could be visible at national level. Nevertheless, co-operative enterprises are considered more members based I people oriented as compared to private enterprises. Nevertheless, Nepalese co-operatives today seem less member participative and have low level of members' friendliness

## 2.6 Research Gap

This study, Development of Financial institutions in Nepal, is concerned with the (recent) development of the structure of Nepalese financial institutions - formal and informal. It will generate academic as well as policy implications, and will be the first of its kind in the country. This (empirical) study will integrate quantitative and qualitative approaches in the generation of information on financial institution of Nepal- the structure and performance of financial institutions, and experiences as well as perceptions of key stakeholders - policymakers and implementers/Managers regarding the financial institutional development.

Thus the financial information will be collected, collated, and triangulated to obtain pertinent issues and implications for future course of academic research and policymaking as well as implementation. This exercise will incorporate pertinent experiences and lesions learnt from other countries, especially from the South Asian

ones. It is expected to contribute to the development of a sound financial development in Nepal.

Finance constitutes a blood line of every investment activity. A responsive and efficient financial sector is needed for effectiveness of such activities. Given the weaknesses of the banks, Nepal initiated financial sector reform program. The improvements that it has brought about and the lessons learned would be pivotal in further extending the benefits drawn so far. It is in this regard a study is proposed to examine the reform against the emerging questions that are critical in extending the benefits.

# 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 corporate 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 of the Study

The number of public limited companies listed in the NEPSE Ltd. by the end of F/Y 2004/2010 in 89 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, Trading and others. The study has been carried out by selecting the 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 companies or | Name of the Companies | No.of sample companies (n) | Sample companies | Percent % |
|---|---|---|---|---|---|
| Banks | 29 | SBBL,KIST,GBL,ABBL,NABIL,EBL,SBI,NCCB,NIB,NBBL,BOAN,NMB,KBL,NSLMB,SBL,LBL,CZBIL,MBL,SRBL,SWBBL,SBBLJ,LUBLMGBL,HBL,SCB,BOK,NICB,NBB,SMBF | 10 | BOK, HBL, NBB, NDB, DCB, NUB, KB, NICB, EBL, LB | 47.62 |
| Finance company | 18 | RUBSL,NSM,PFL,JFL,UFLK,PRFL,GFCL,CMBSL,ICFC,PFLBS,NEFL,KFL,SFFIL,CFL,AFL,LBFIL,PFC,LFLC,WMBF,SBSL,LFC,STFL,NNFC,IMEFL,KAFIL,SIFC,PFCL. | 11 | NEFL, CFL, KFL, GFCL, NMFC, SIFC, UFLK, MNFC, PFC, BFC, PFCL | 34.62 |
| Insurance | 6 | SICL,LGIL,CIT,SIL,HGIC,LICN, | 3 | HGIC, NECOIC, SICL | 25.71 |
| Hotel | 1 | TRH | 1 | TRH | 25 |
| Mfg.and processing co.& Company Ltd | 5 | NTC,NABB,,BPCL,BBC,SFC | 2 | BBC,SFC | 50 |
| Total | 59 | | 27 | | |

## 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 (as for as possible) have also been used. The sources of primary data include; structured questionnaire, interviews with officials and other exports. 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 kinks 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 as possible as other sources of info information also used to collect the data.

## 3.4 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

## 3.5 Necessary Tools and Techniques

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.

### 3.5.1 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.

#### 3.5.1.1 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.

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

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, although it was called. Paid up capital can be equal or lesser than the called up capital but it can not be more than the called up capital.

### 3.5.2 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 analyzed with the help of statistical tools as noted below:

#### 3.5.2.1Trend 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.

### 3.5.2.2 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 $H_o$. 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 $H_i$. For the purpose of our study, following hypothesis has been set for testing:

### Hypothesis 1

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

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

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

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

### Hypothesis 2

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

(There is no significant difference between the type of company and the issuance of equity)

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

(There is significant difference between the type of company and the issuance of equity)

[Where, B = Bank, F = Finance, I = Insurance; MP = Manufacturing and Processing, H=Hotels, T=Trading, 0 = others] These hypotheses have been tested by using one-way ANOVA, which is described below:

### 3.5.3 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:

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

$$F = \frac{MSB}{k\,Z1}, MSW = \frac{SSW}{N\,Zk}, SSB = ni$$

TSS = SSB + SSW or, TSS =

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 stun 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.

### 3.5.3.1 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:

$$LSD = ta / 2 (N - a) \sqrt{MSE \ \frac{1}{n_1} \Gamma \frac{1}{n_j}}$$

Where,

N = Total number of observation

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

MSE = Mean sum of square

n,=nj=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 x and is computed as:

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

In case of frequency distribution

$$X = \frac{fx}{f}$$

Where,

x = Weighted average or arithmetic mean

X = Value of the variables

N =  f = Total frequency

### 3.5.3.2 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  and is computed as:

=

Where,

X = Value of the variables

x = Mean/average value

n = No. of observation

### 3.5.3.3 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:

$$\text{CV} = \frac{\acute{o}}{\bar{X}} \text{ i.e. } \frac{\text{Standard Deviation}}{\text{Mean}}$$

Mean, standard deviation and coefficient of variation have been sued 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 SEBON, 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 Corporate Financing in Nepal

The question of corporate 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-teem financing (especially corporate 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 corporate sector or industries from the external sources in modem time is the capital market through which corporations or companies assembles the required fiends 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 corporate sector. In a country like Nepal it is important for the corporate 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 corporate 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 corporate 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 fluids from the capital market.

However, the corporate 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 in Nepal

### 4.2.1 Primary Market

In the first nine months of FY 2007/08, 30 companies issued securities and mobilized Capital equivalent to Rs.7.315 billion. Of the 30 companies, 4 companies issued Ordinary shares, 24 issued right shares and two issued debentures. This amount is more 46.7 percent higher than the amount mobilized through the issuance of securities in the same period last year. In the first nine months of FY 2007/08, 26 companies had mobilized Rs.4.986 billion by issuing securities.

**Table No: 3.2**

**Position Market Capitalization**

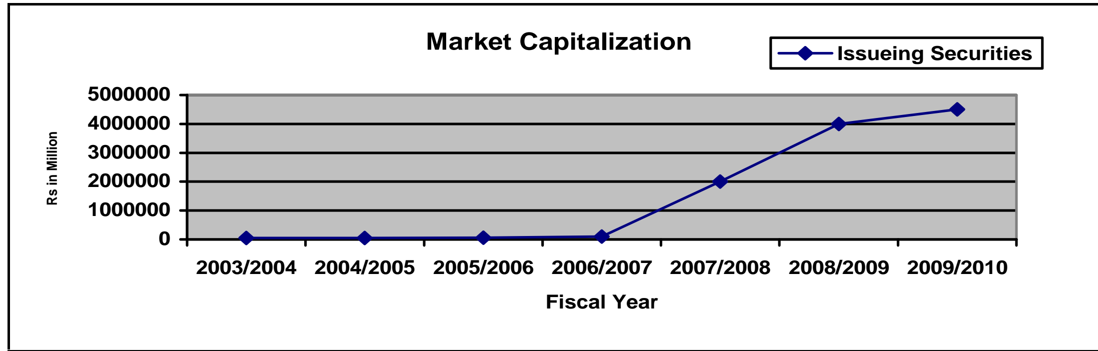
| Fiscal Year | Issuing Securities | Increase Percentage |
|---|---|---|
| 2003/2004 | 50000 | 4 |
| 2004/2005 | 52000 | 5.76 |
| 2005/2006 | 55000 | 81.8 |
| 2006/2007 | 100000 | 1900 |
| 2007/2008 | 2000000 | 100 |
| 2008/2009 | 4000000 | 12.5 |
| 2009/2010 | 4500000 | - |

**Source: Securities board of Nepal**

**The above data can be presents in following figure:**

Figure No: 3.2

## Market Capitalization




From the above table 4.1 and figure 4.1 we can see the Market capitalization of Issuing Securities from 2003 to 2010.The Issuing Securities from 2007 to 2010 has been increased in the Ratio of 2003 to 2007. It means we can analysis that the increase rate of 2007 to 2010 is good.

### Table No: 3.3

## Primary Market Trend

**(In Million Rs)**

| Description | 2003/2004 | 2004/2005 | 2005/2006 | 2006/2007 | 2007/2008 | 2008/2009 | First Nine Months | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | 2008/2009 | 2009/2010 |
| Capital Mobilization | 69.66 | 109.04 | 167.23 | 244.33 | 229.55 | 996.82 | 498.65 | 731.55 |
| Ordinary Shares | 39.43 | 65.75 | 37.75 | 57.98 | 38.02 | 92.48 | 40.24 | 99.30 |
| Right Shares | 16.22 | 7.0 | 94.93 | 101.35 | 126.53 | 609.34 | 308.41 | 557.25 |
| Preference Shares | - | - | - | - | 40 | - | - | |
| Debentures | - | 30.00 | 30.00 | 85.00 | 25 | 295 | 150 | 75 |
| Mutual Funds | 10.00 | - | - | - | - | - | - | - |
| Citizens Unitary Plan | 4.01 | 6.29 | 4.55 | - | - | - | - | - |
| No of capital Mobilizing Companies | 18 | 14 | 14 | 29 | 34 | 64 | 26 | 30 |

**Source: Securities Board of Nepal**

## Table No: 3.4

## Primary Issue

| Fiscal Year | Primary Issue | Increase/Decrease (%) |
|---|---|---|
| 2003/2004 | 1000 | 50 |
| 2004/2005 | 1500 | 33.33 |
| 2005/2006 | 2000 | 75 |
| 2006/2007 | 3500 | 14.28 |
| 2007/2008 | 4000 | 162.5 |
| 2008/2009 | 10500 | - |
| 2009/2020 | | |

**Sources: Securities Board of Nepal**

**The above date can be presents in following figure:**

## Figure No: 3.4

## Primary Issue

In the picture, during the period of 2002/2003 to 2008/2009 the primary issue has been made by 3500 and it has goes to 10500 in the year of 2007/2008 but it has been decreased in 2008/2009 in the ratio of 2007/2008.

## 4.2.2 Secondary Market

In the first nine months of FY 2007/08, 15 more companies got listed in Nepal Stock exchange Limited (NEPSE). With this, the total number of companies listed with NEPSE has reached 157. The number of listed companies was 142 at the end of FY

2007/08. Market capitalization increased by 74.7 percent totaling Rs. 421.159billion by mid-April of FY2008/09 from Rs.241.128billion a year ago. The total value of capitalized NEPSE turnover touched a record high to Rs. 612.0 billion on 31 August 2008, which was Rs. 366.30billion at the end of FY2007/08.

Altogether, 22.16 million units of shares were traded in the first nine months of FY 2008/09 as compared to 18.735 million units traded in the same period last year with an increase of 13.8 percent. Total value of such transactions was Rs.16.983billion as compared to Rs. 14.925 billion in the same period of the previous fiscal year The paid-up value of listed shares steeply rose by 122.38 percent reaching Rs. 54.681billion in the first nine months of the current fiscal year as Compared to Rs. 24.589billion in the corresponding period a year ago. The number of share transactions conducted in first nine months of FY2008/09 grew by 58.3 percent totaling 151,942 shares from 95,970 shares transacted in the same period of FY2007/08.

## Table No: 3.5

## Secondary Market Trend

**(In Million Rs.)**

| Description | 2003/2004 | 2004/2005 | 2005/2006 | 2006/2007 | 2007/2008 | 2008/2009 | First Nine Months | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | 2008/2009 | 2009/2010 |
| Share Transaction Value | 575.8 | 2144.3 | 4507.7 | 3451.4 | 8360.1 | 22820.8 | 2007/08 | 2008/09 |
| No of Shares Transaction(000) | 2428 | 6468 | 18434 | 12222 | 18147 | 28599.77 | 14925.4 | 16982.8 |
| Transactions (No) | 69.163 | 85533 | 106246 | 97374 | 120510 | 150800 | 18735.88 | 22106.57 |
| Market Capitalization Value | 35240.4 | 41424.8 | 61365.9 | 96813.7 | 186301.3 | 367247.5 | 95970 | 151942 |
| Percent of Transaction in Market Capitalization Value | 1.63 | 5.18 | 7.34 | 3.56 | 4.48 | 6.23 | 241127.8 | 421159.1 |
| Market Capitalization as % of GDP | 7.16 | 7.72 | 10.41 | 14.98 | 25.90 | 40.66 | 6.22 | 4.03 |

| Paid up Capital value of Listed Shares | 12560.0 | 13404.9 | 16771.9 | 20008.6 | 21798.8 | 29462.0 | - | - |
|---|---|---|---|---|---|---|---|---|
| No of Listed Companies | 108 | 114 | 125 | 135 | 135 | 142 | 24589.0 | 54681.0 |
| No of Companies under Transaction | 8818 | 992 | 1102 | 1110 | 136 | 1136 | 146 | 157 |
| Nepse Indes in point | 204.86 | 222.04 | 286.67 | 386.86 | 683.95 | 963.36 | | |

**Source: Securities Board of Nepal, Nepal Stock Exchange, and Central Bureau of Statistics.**

## Table No: 3.6

## Paid -Up Value and Turnover

| Fiscal Year | Paid up Capital | Turnover | Percentage |
|---|---|---|---|
| 2002/2003 | 200 | 12000 | 4.17 |
| 2003/2004 | 2000 | 12500 | 28 |
| 2004/2005 | 5000 | 16000 | 37.5 |
| 2005/2006 | 2500 | 22000 | 22.73 |
| 2006/2007 | 10000 | 27000 | 11.11 |
| 2007/2008 | 20000 | 30000 | 100 |
| 2008/2009 | 15000 | 60000 | - |

## Figure No: 3.6

## Paid –up Value and Turnover

During the first nine months of FY2008/09, NEPSE Index stood at 661.27 points with a decline of 85.42 percent from 746.69 points in the same period of the previous fiscal year.

## Table No: 3.7

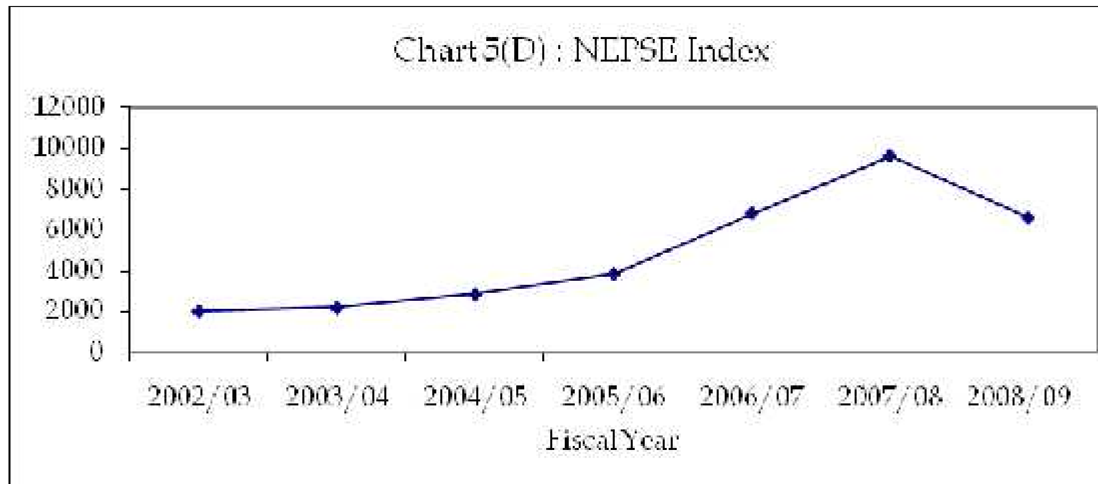
## NEPSE Index

| Fiscal Year | Nepse Index | Percentage |
|---|---|---|
| 2002/2003 | 2000 | 10 |
| 2003/2004 | 2200 | 59 |
| 2004/2005 | 3500 | 14.28 |
| 2005/2006 | 4000 | 100 |
| 2006/2007 | 8000 | 25 |
| 2007/2008 | 10000 | -20 |
| 2008/2009 | 8000 | - |

**Sources: Securities Board of Nepal**

## Figure No: 3.7

NEPSE Index




**Securities Board of Nepal (SEBON)**

The Securities Board of Nepal has brought out the Shares Registration and Issuance Rules, 2008 (commenced from 12 November 2008) with incorporation of additional provisions for registration and issuance of shares; and Share Issuance Guidelines, 2009 (commenced from 22 March 2009). The Securities Board of Nepal

initiated for establishment of Securities Data Management System, at the end of the previous fiscal year, with the grants assistance from the International Development Association (IDA).Establishment of the system aimed at: (a) creation of securities related Central Data Bank by setting up internal and external direct information relationship; (b) efficient management of data system and information related to securities; (c) Mechanization of all internal operations of the Central Data Bank; (d) enhancement of the Share Market Monitoring capacity of the Board; and (e) prepare the Board for providing share market related information to national and international investors.

The Project, during this period of nine months of the current fiscal year, has accomplished about 80 percent achievement including training the Board personnel on data management, procurement of hardware and software, preparation of various modules on information flow and the Central Data Bank. Once the project is completed, companies listed as well as making fresh issues can submit required statements online to the SEBON as per the Securities Act and Regulations. During the review period the Board, upon revelation of a Broker found to have owned the businesses of more than one businesses and hiding the fact, fined the broker with Rs. 100,000 under the sub clause (4), Clause 101 of the Securities Act, 2063 (2007).

In addition, a Law Enforcement Committee is formed on 8 April 2009 for effective execution of provisions of Securities Act and Regulations. A Committee was formed under the coordination of the Chairperson of the SEBON as per the Secretary level decision of the Government of Nepal on 13 January 2009 for the establishment of a Central Savings repository System. The Committee completed its task and submitted its Report on 15 March 2009.

Accordingly, a Committee established with the Chairperson as a Coordinator, as per the Secretary level decision of the Government, is carrying out the task towards establishing the System. The SEBON has issued Merchant Banking License to 15 companies as per the Share Traders (Merchant Banker) Rules, 2064 (2008) during first nine months of the current fiscal year. This number stood at nine in the same period of the previous fiscal year. Merchant Banking business is expected to be more competitive with the entry of additional Merchant Bankers. The SEBON, during the review period,

permitted issuance of primary shares to 30 companies subsequent to registration of Shares worth 7 billion 315 million 477 thousand one hundred Rupees. In addition, the Board registered the Stock Dividend worth 2 billion 629 million 405 thousand six hundred Rupees of 40 companies and accordingly permitted issuance of Bonus Shares.

### 4.2.3 Nepal Stock Exchange Limited

The NEPSE, in the first nine months of FY 2008/09, collected Rs. 678.079 million as capital gain taxes from share transactions and deposited in revenue accounts. The capital gain tax in the review period of FY 2008/09 is higher by 2.6 percent more than Rs.661.2 million collected as the capital gain tax in the same period last year. As per the provision of the Securities Listing Regulations 2006, a total number of 78 listed companies have been classified as category A institutions in FY 2008/09. The number of companies listed in category A. During the review period is more by 7. In FY2007/08, the number of companies listed in category A among the total registered companies was 71.

### 4.2.4 The Share Traders

At the end of first nine months of FY2008/09, the number of share brokers stood at 23, merchant bankers 15, seven issue managers for the government treasury bonds, and three market makers. The number of such traders in the same period of the previous fiscal year was, 23 share brokers, 9 merchant bankers, 7 issue managers for government treasury bonds, and three market makers.

### 4.2.5 Mutual Fund

The trading of NCM Mutual Fund worth Rs.100 million created on the Trusteeship of NIDC, and managed by NIDC Capital Market is carrying out the trading of Units issued under the Fund since brought into operation by listing it in Nepal Stock Exchange Market Limited in August 2003. Total value of the NCM Mutual fund by the end of first nine months of FY2008/09 was Rs.476.630 million with the Net Assets Value of the per Unit of Rs. 39.

### 4.2.6 Citizens Investment Trust (CIT)

The Citizens Investment Trust, in addition to funds collected through the Citizen Unit Scheme, collects funds from other plans it is operating including the Increment Approved Retirement Fund, Gratuity Fund Scheme, Investor Accounts Scheme, Insurance Fund Scheme, Defined Contribution Pension Plan etc. CIT, in the first nine months of the current fiscal year, added Rs. 5.03 billion the total fund accumulation amounting to 14.20 billion. Of the amount collected in the review period, 59.22 percent was in Employees Savings Increment Approved Retirement Fund, 4.68 percent in Citizen Unit Scheme, 10.65 percent in Investor Account Scheme, 15.53 percent in Gratuity Fund Scheme, 9..68 percent in Insurance Fund Scheme, and 0.25 percent in the Defined Contribution Pension Plan. The total fund collected during the first nine months of FY2007/08 stood at Rs. 9.168 billion.

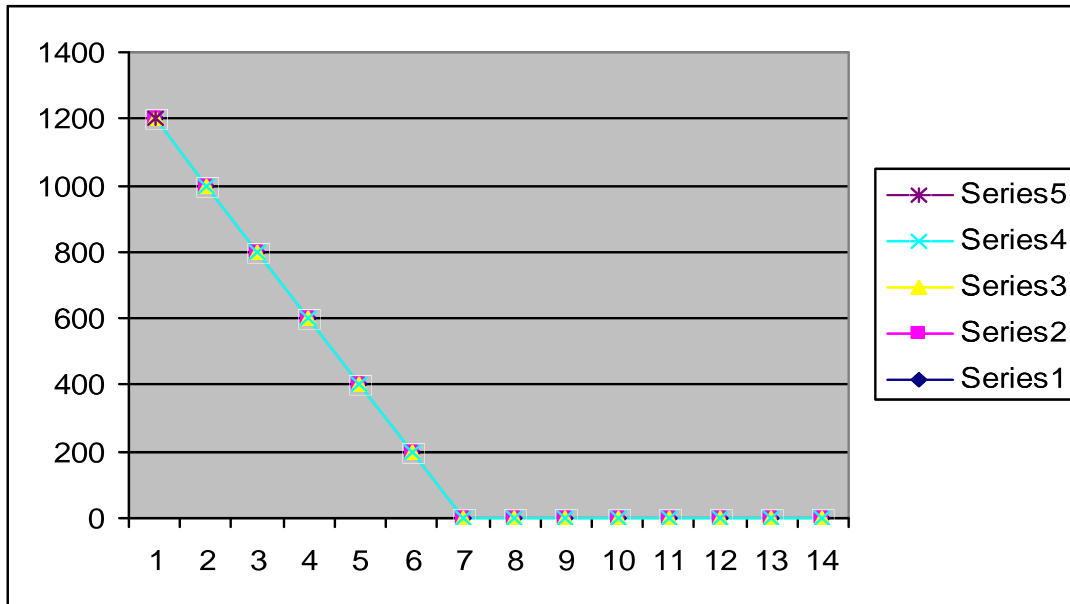
The CIT in 2008/09, as compared to first nine months of the previous fiscal year, has invested additional amount of Rs. 4.985 billion making its total loan portfolio management reach to Rs.14.011 billion. Of the total investment, portfolios comprise of 11.63 percent in the Government Treasury Bonds and other fixed interest bearing instruments; 10.45 in periodic loans; 1.89 percent in share investment of companies; 9.45 percent in preference shares and debentures of companies; 11.0 percent on participants lending and home loans; and the remaining 55.57 in the fixed deposit accounts. In the review period, total sale of the Unit Scheme introduced by the CIT has reached Rs.664.0 million with 13,415 participants in the scheme. The scheme has distributed the dividend of 6.25 percent per unit to participants during this period. The net amount of the fund by mid-April of 2008 stood at Rs. 698.2 million.

## 4.3 Indices

Due to a whopping increment in the share prices of banks, financial institutions, hydropower companies and development banks, the NEPSE index increased notably over the year. The restoration of peace, an improvement in listed companies' financial performance and, most importantly, the central bank's direction, dated 26 March 2007, to double paid-up capital for banks and financial institutions contributed to a remarkable increment in share prices and subsequently the stock market indices.

## Figure 3.8

**(NEPSE during FY 2007/08)**




**1- Jul/Aug, 2-Aug/Sep, 3,Sep/Oct, 4-Oct/Nov, 5-Nov/Dec, 6-Dec/Jan, 7-Feb/Mar, 8-Jan/Feb, 9-Mar/April, 10-Apr/May, 11-May/Jun, 12-Jun/July**

The above data and chart shows there is increasing in equity shares but very slowly growing up right share and another. In comparison of previous percentage, highly increase in equity share than other. The stock market opened with the NEPSE index of 683.95 points at the beginning of the FY 2007/08 and ended with 963.36 points during the year. The year on year NEPSE index increased by 40.9 percent. It reached the high of of 1064.09 on 17 December 2007 and the low of 677.98 on 18 July 2008. Of the NEPSE Index, banking sub-index went up by 181.39 points to 985.65 (which is also the highest point) during the year. The banking sub-index measures the transactions of companies listed under commercial bank group. It touched the lowest point of 759.67 on 31 July August 2007. The twelve-month standard deviation stood at 110.8 in mid-July 2008 compared to 87.4 a year ago, reflecting an increased volatility in the stock market.

## Table No 3.9

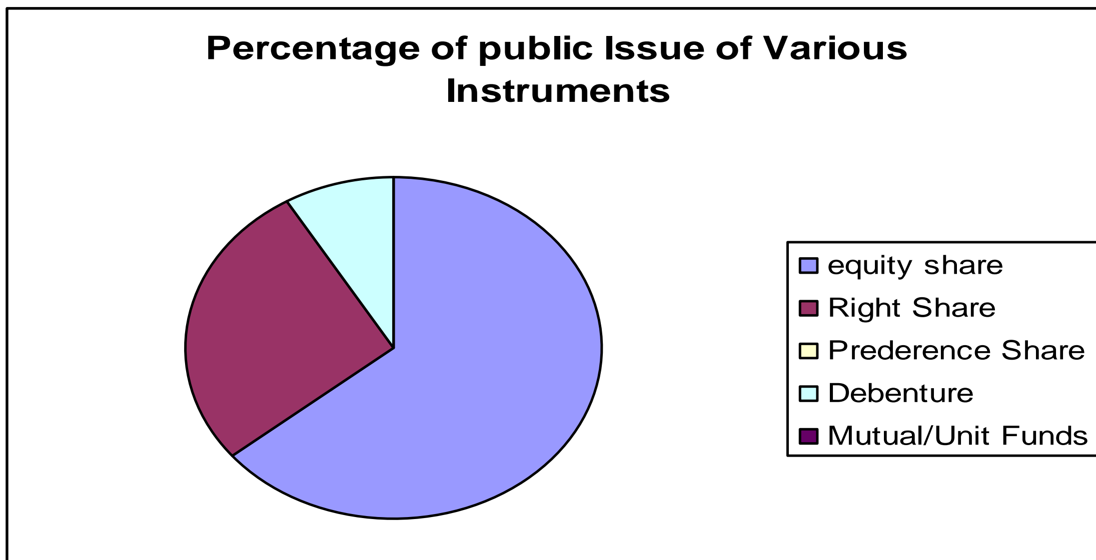
## Public Issue made (Rs. in Million)

| Particular | Amount (Rs.) | Percent |
|---|---|---|
| Equity Share | 92.48 | 59.89 |
| Rights Share | 609.34 | 25.21 |
| Preference Share | - | - |
| Debenture | 295 | 8.04 |
| Mutual/Unit Funds | - | - |
| Total | 731.32 | 93.14 |

**Sources: Securities Board of Nepal**

**The above table can be presents in following figure.**

## Figure 3.9




About 60% of the total amount of public issues is from equity share, representing. The highest amount of new capitalized from the public followed by right shares (25.21%), debentures (8.04%).

## Table 3.10

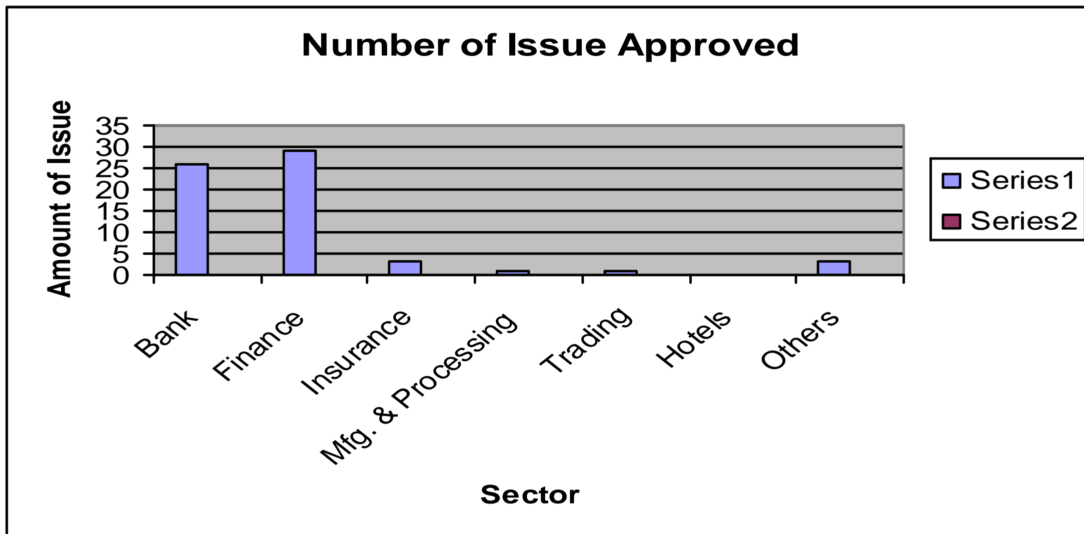
## Number of Issue Approved F/Y 2008/09

| Sector | Bank | Finance | Insurance | Mfg. & Processing | Trading | Hotels | Others | Total |
|---|---|---|---|---|---|---|---|---|
| Issues approved | 26 | 29 | 3 | Hydropower | 1 | - | 3 | 63 |

**(Source: Annual Report 2008/09, SEBO.N)**

## Figure No 3.10

## Number of Issue Approved




The above 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 approval from SEBO/N. Trading, Hotels and other sector have raised fall amount of issue approved to the public. But another sector is difference between issue approved and issue made.There is issue approved was finance company (29), manufacturing and processing (1), Bank (26), Insurance (3), Trading (1) and other (3) respectively.

## 4.4 Test Hypothesis

Both the test of hypothesis is based on F-Statistics. First hypothesis test about whether there is any relationship between the type of company and issuance of equity, where or second hypothesis test about whether there is significant difference D/E ratio in each sector.

### Testing of Hypothesis 1:

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

There is no significant difference between the type of company and the issuance at equity.

$H_1$ : $\mu_B \quad \mu_F \quad \mu_I \quad \mu_{MP} \quad \mu_H \quad \mu_T \quad \mu_O$

There is significant difference between the type of company and the issuance at equity.

## Table No 3.11

## One-way ANOVA Table

| Source of Variation | d.f. | Sum of Squares | Mean Sum of Squares | F-ratio |
|---|---|---|---|---|
| Between Seven different sector | 7-1=6 | 967611.05 | $\frac{967611.05}{2}$ = 483805.53 | F = $\frac{483805.53}{307375.71}$ X1.57 |
| With in Seven different Sector | 48-6=42 | 614751.42 | $\frac{614751.42}{2}$ X307375.71 | |
| Total | 49-1=48 | 1605309.62 | | |

**Source: Computation in Appendix - (iii)**

Table value of F at 5%, level of significance with = 6 and = 42 is 2.32 Since $F_{cal} < F_{tab}$ i.e. (1.57 Vs 2.32) $H_o$ is accepted, this reveals that there is no significant different between the type of company and issuance of equity.

# Table 3.12

## Sector wise D/E ratio over the period

| Period / Sector | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 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 2:**

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

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

$H_1 = \mu_B \quad \mu_F \quad \mu_i \quad \mu_{MP} \quad \mu_H \quad \mu_T \quad \mu_O$

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

## Table 3.13

## 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 | $\frac{149.32}{2}$ X74.66 | |
| Total | 48-1=47 | - | | |

**(See: Computation in Appendix – iv)**

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

## 4.5 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 = $t\frac{r}{2}(N\,Za)\sqrt{MSE\ \frac{1}{n_i}\Gamma\frac{1}{n_j}}$

# Table 3.14

# Significance of Difference in D/E ratio between Sectors

| Difference Between | $\overline{Y}_i Z \overline{Y}_j$ | LSD for $\overline{Y}_i Z \overline{Y}_j$ | Significance of difference |
|---|---|---|---|
| $\overline{Y}_1 Z \overline{Y}_2$ | 39.42-13.19 | 26.23>12.43 | $\mu_1$ *and* $\mu_2$ *are* significantly different |
| $\overline{Y}_2 Z \overline{Y}_3$ | 13.19-1.56 | 37.86>12.43 | $\mu_1$ *and* $\mu_3$ *are* significantly different |
| $\overline{Y}_1 Z \overline{Y}_4$ | 39.42-2.83 | 36.59>12.43 | $\mu_1$ *and* $\mu_4$ *are* significantly different |
| $\overline{Y}_1 Z \overline{Y}_5$ | 39.42-3.41 | 36.01>12.43 | $\mu_1$ *and* $\mu_5$ *are* significantly different |
| $\overline{Y}_1 Z \overline{Y}_6$ | 39.42-20.66 | 18.76>12.43 | $\mu_1$ *and* $\mu_6$ *are* significantly different |
| $\overline{Y}_1 Z \overline{Y}_7$ | 39.42-6 | 33.42>12.43 | $\mu_1$*and* $_7$ *are* significantly different |
| $\overline{Y}_1 Z \overline{Y}_3$ | 39.42-1.56 | 11.63<12.43 | There is no significant different between $\mu_2$ *and* $\mu_3$ |
| $\overline{Y}_2 Z \overline{Y}_4$ | 13.19-2.83 | 10.36<12.43 | There is no significant different between $\mu_2$ *and* $\mu_4$ |
| $\overline{Y}_2 Z \overline{Y}_5$ | 13.19-3.41 | 9.78<12.43 | There is no significant different between $\mu_2$ *and* $\mu_5$ |
| $\overline{Y}_2 Z \overline{Y}_6$ | 13.19-20.66 | (7.47)<12.43 | There is no significant different between $\mu_2$ *and* $\mu_6$ |
| $\overline{Y}_2 Z \overline{Y}_7$ | 13.19-6 | 7.39<12.43 | There is no significant different between $\mu_2$ *and* $\mu_7$ |
| $\overline{Y}_3 Z \overline{Y}_4$ | 1.56-2.83 | (1.27)<12.43 | There is no significant different between $\mu_3$ *and* $\mu_4$ |
| $\overline{Y}_3 Z \overline{Y}_5$ | 1.56-3.41 | (1.85)<12.43 | There is no significant different between $\mu_3$ *and* $\mu_5$ |
| $\overline{Y}_3 Z \overline{Y}_6$ | 1.56-20.66 | (19.1)<12.43 | There is no significant different between $\mu_3$ *and* $\mu_6$ |
| $\overline{Y}_3 Z \overline{Y}_7$ | 1.56-6 | (4.44)<12.43 | There is no significant different between $\mu_3$ *and* $\mu_7$ |
| $\overline{Y}_4 Z \overline{Y}_5$ | 2.83-3.41 | (0.58)<12.43 | There is no significant different between $\mu_4$ *and* $\mu_5$ |
| $\overline{Y}_4 Z \overline{Y}_6$ -Y6 | 2.83-20.66 | (17.83)<12.43 | There is no significant different between $\mu_4$ *and* $\mu_6$ |
| $\overline{Y}_4 Z \overline{Y}_7$ | 2.83-6 | (3.17)<12.43 | There is no significant different between $\mu_4$ *and* $\mu_7$ |
| $\overline{Y}_5 Z \overline{Y}_6$ | 3.41-20.66 | (17.25) < 12.43 | There is no significant different between $\mu_5$ *and* $\mu_7$ |
| $\overline{Y}_5 Z \overline{Y}_7$ | 3.41-6 | (2.59)<12.43 | There is no significant different between $\mu_5$ *and* $\mu_7$ |
| $\overline{Y}_6 Z \overline{Y}_7$ | 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. baking 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. The D/E ratio of trading companies is also significantly difference with all companies from different sectors.

## 4.6 Trend Analysis

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

**Table 3.15**

**Trend Analysis of Equity Capital**

| Year(T) | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|
| Equity Capital (Y) | 706.20 | 771.18 | 858.15 | 937.90 | 849.47 | 1381.53 | 1368.52 | 1360.21 | 1372.42 | 1395.55 |
| Trend Value | 639.1 | 753.33 | 867.6 | 981.85 | 1098.1 | 1210.35 | 1324.6 | 1321.5 | 1351.1 | 1382.1 |

**Source: Securities Board of Nepal.**

**Figure 3.15**

**Trend value of Equity Capital Over the Period (Rs. in Million)**

**Figure 4.14**

Above trend line shows that the issue of equity capital is increasing trend in year 2004 to 2008 and decreasing in the year of 1999 then the year of 1999 to 2002. With the compare in the year of 2004 and 2003 equity capitals is increasing trend and with compare the year of 2005 and 2004 equity capital is decrease.

## 4.7 Equity Capital over the Period in 2006 to 2010 (Rs. in million)

| Year | Equity Capital (Y) |
|---|---|
| 2006 | 1096.1 |
| 2007 | 1210.35 |
| 2008 | 1324.6 |
| 2009 | 1438.85 |
| 2010 | 1553.1 |

**(Source: Appendix IX)**

The above table shows that the equity capital is in increasing trend year by year in 2006, 2007,2008,2009,2010. The forecasted equity capital is Rs.1096.1 Rs.1210.35 Rs.1324.6 Rs.1438.85 Rs.1553.1 respectively. It wills average issues of equity capital increase about by Rs.114.25 (million) in each year

### 4.7.1. Descriptive Analysis

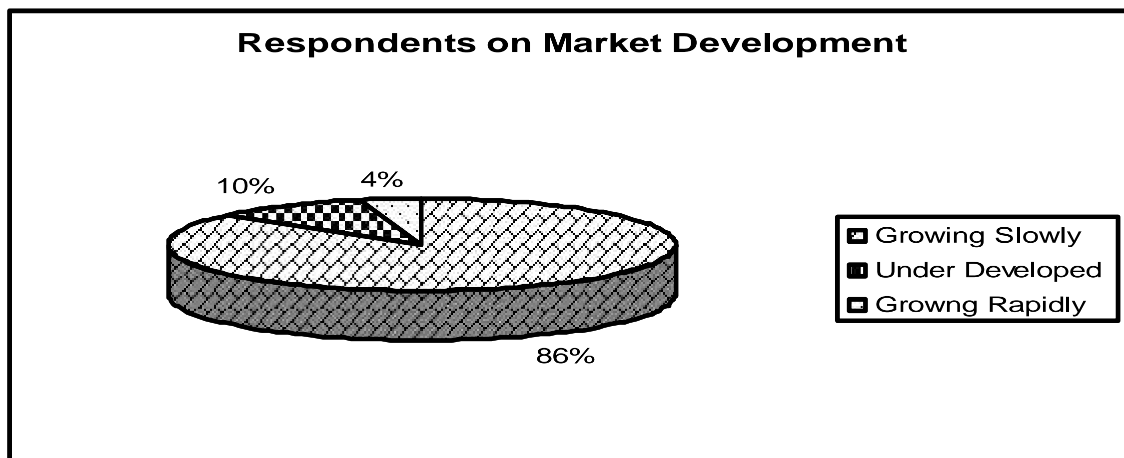
Nepalese equity market is very small in comparison to that of other developing countries. However, the market has grown slowly over the period; it has not kept pace in its steady growth. The capital market is incomparable with that of the cross-broader countries like India, even the single company like 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 3.16**




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 corporate 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 corporate sector pointed that; 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 finds, 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 corporate 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 corporate 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.

## 4.8Problems 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 corporate 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 of Equity Market in Nepal

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 corporate 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 corporate 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 corporate sector and the investors to actively involve into the stock market.

### 3) Inadequate Institutional Investors 'Base

A sound development of equity market and corporate sector requires strong institutional investors' base, which potentially offers a rage 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 (FEls) 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 corporate firms. Improper tax policy as created disincentive for the investment in the equity and debt. In most of the emerging markets capital gains on securities investments arc 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.

## 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.

## 11) Slow Privatization Process

Privatization has been accepted as an important component of the liberal economic policy. A healthy development of the corporate 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 corporate 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 corporate 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 corporate 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 corporate sector because of which investors have to deposit their savings into banks and other financial institutions rather than on corporate 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 (corporate 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, mere are good prospects of equity market development in Nepal in the days to come.

## 4.9 Major Findings of the Study

From the analysis of statistical data and oilier information, the findings of the Study is as pointed below:

- 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 2001/02) however, the pace of growth is very slow and now it reached 3.08% in 2008/2009.
- There is significant difference between the type of company and issuance of equity. Banking is the principal sector issuing equity capital; trading companies have least issue of equity.
- An analysis of 49 companies showed that equity capital of companies has been grown each year by more than Rs. 100 million.
- 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).
- 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.

- There are 131 equity offerings (including rights i.e. equity, common shares 98 and rights shares 33 out of 139 issues approved), issue of preference shares and debentures is negligible (4 issues of preference shares and 4 issues of debt and 3 mutual funds).
- 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.
- Investors have no sufficient alternatives (because of limited number of financial instruments) to form best portfolio of their investment.
- 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.
- 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.
- Corporate 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.
- 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.
- 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, corporate governance in Nepal is extremely poor.

- Most of the corporate 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.
- Market regulations, monitoring and supervision systems in Nepal still not strong enough to regulate the market.
- The restriction of foreign portfolio investment has limited the flow of capital for the growth of the corporate sector and for enhancing the efficiency of equity market.
- There is lack of incentives for the investors and corporate firms to involve towards capital market.
- 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.
- 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 AND 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 corporate 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 relay on its own resources and those of the banks, increasingly it has to relay 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 corporate sector. Thus, this study "Corporate Financing and Equity Market in Nepal" mainly aims to examine and analyze the prevailing structure of corporate financing and equity market in Nepal.

The specific objectives of the study are:

- To evaluate the relationship between the type of company and the issuance of equity.

- To trace out historical evaluation and to evaluate role of Nepalese equity market in corporate financing.
- To analyze the prospects of Nepalese corporate finance and equity market in Nepal.
- To identify the existing problems and challenges of Nepalese corporate financing and efficient equity market in Nepal.
- To analysis the prevailing structure of corporate 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 corporate 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 Mih1 and Nepal Bank Ltd. were floated to the general public. At mat 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 corporate 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 corporate 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 16771.84) in FY 2008/09, similarly market capitalization reached from Rs. 13872 million to Rs. 61365.89 million in the same period. The NEPSE index was 226.03 in FY 1993/94; it was 360.70 in FY 1999/00 and came down to 286.67 in FY 2008/09 indicating inconsistent figures?

At present there are 125 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 125 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 corporate sector in the national economy is still very low due to the negligible size of corporate 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 two hypotheses to make the study more systematic and realistic. For analyzing the real situation, samples of 49 companies (out of 125 listed were selected for the purpose of study, But, it reached 127 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 131 equity offerings (including rights) out of 139 issues approved issue of preference shares and debentures is negligible (only 4 issues of preference shares and 4 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 corporate governance), lack of strong enough legal and regulatory framework, 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 corporate 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 corporate 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 corporate sector. Equity market in Nepal is steadily growing but has many structural weaknesses, so it requires accelerated growth of savings, investment and corporate 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 corporate 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 mere 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 Recommendation

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 mat 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 monitory 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 Corporate Sector Development

Nepalese listed companies are found to be not fully accountable with equity Investors they are not actively involved in the market corporate 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, corporate 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 corporate firms are not able enough in maintaining proper financing mix, agencies such as 'Institute for Corporate Finance', 'Corporate Finance Department' etc. as financing facilitator could be established.

## C. Others

- Emphasis should be given on ensuring good corporate governance. For the good corporate 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 corporate 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.

## 5.4 Future Avenues

This study is not the first but tried to enhance previous data of study of corporate finance and equity market in Nepal and this is a small effort with regard to the perfection of Nepalese equity market. Many things remained to be explored and there are numerous avenues for future research in the area of "corporate financing and equity market". One area that may be taken up by future researcher is to make the study on "equity market, its impact on corporate financing decision and economic growth". Moreover, one can make a study on "Nepalese equity market, its growth and challenges", similarly, the comparative study on equity market development and corporate financing practice in Nepalese context and other developing nations i.e. the comparative study at national and regional or global level could be carried out. Next area of study might be a detail study on corporate financing practice of individual companies and its impact on profitability.