MUTUAL FUNDS

Mutual funds represent one of the most important institutional forces in the market. They are institutional investors. They play a major role in today's financial market. The first mutual fund was established in Boston in 1924 (USA).

Meaning of Mutual Funds:

Small investors generally do not have adequate time, knowledge, experience and resources for directly entering the capital market. Hence they depend on an intermediary. This financial intermediary is called mutual fund.

Mutual funds are corporations that accept money from savers and then use these funds to buy stocks, long term funds or short term debt instruments issued by firms or governments. These are financial intermediaries that collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. They invest the funds collected from investors in a wide variety of securities i.e. through diversification. In this way it reduces risk.

Mutual fund works on the principle of "small drops of water make a big ocean". It is a form of collective investment. To get the surplus funds from investors, it adopts a simple technique. Each fund is divided into a small share called 'units' of equal value. Each investor is allocated units in promotion to the size of his investment.

Mutual fund is a trust that pools the savings of investors. The money collected is then invested in financial market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. Thus mutual fund invests in a variety of securities (called diversification). This reduces risk. Diversification reduces the risk because all stock and/ or debt instruments may not move in the same direction.

According to the Mutual Fund Fact Book (published by the Investment Company Institute of USA), "a mutual fund is a financial service organization that receives money from shareholders, invests it, earns return on it, attempts to make it grow and agrees to pay the shareholder cash demand for the current value of his investment".

SEBI (mutual funds) Regulations, 1993 defines a mutual fund as 'a fund established in the form of a trust by a sponsor, to raise monies by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations.

In short, a mutual fund collects the savings from small investors, invests them in government and other corporate securities and earns income through interest and dividends, besides capital gains.

Features of Mutual Funds:

Mutual fund possesses the following features:

1. Mutual fund mobilizes funds from small as well as large investors by selling units.

2. Mutual fund provides an ideal opportunity to small investors an ideal avenue for investment.

3. Mutual fund enables the investors to enjoy the benefit of professional and expert management of their funds.

4. Mutual fund invests the savings collected in a wide portfolio of securities in order to maximize return and minimize risk for the benefit of investors.

5. Mutual fund provides switching facilities to investors who can switch from one scheme to another.

6. Various schemes offered by mutual funds provide tax benefits to the investors.

7. In India mutual funds are regulated by agencies like SEBI.

8. The cost of purchase and sale of mutual fund units is low.

9. Mutual funds contribute to the economic development of a country.

Classification of Mutual Funds:

Mutual funds (or mutual fund schemes) can be classified into many types.

The following chart shows the classification of mutual funds:

1. On the basis of operation
    a. Open ended
    b. Close ended
2. On the basis of return
    a. Income fund
    b. Growth fund
    c. Conservative fund
3. On the basis of investment
    a. Equity fund
    b. Bond fund
    c. Balanced fund
    d. Money market mutual fund
    e. Taxation fund
    f. Leverage fund
    g. Index bond fund

A. On the basis of Operation:

1**. Close ended funds:** Under this type of fund, the size of the fund and its duration are fixed in advance. Once the subscription reaches the predetermined level, the entry of investors will be closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the unit holders in proportion to their holding.

Features of Close ended Funds

(a) The period and the target amount of the fund is fixed beforehand.

(b) Once the period is over and/ or the target is reached, the subscription will be closed (i.e. investors cannot purchase any more units).

(c) The main objective is capital appreciation.

(d) At the time of redemption, the entire investment is liquidated and the proceeds are liquidated and the proceeds are distributed among the unit holders.

(e) Units are listed and traded in stock exchanges.

(f) Generally the prices of units are quoted at a discount of upto 40% below their net asset value.

2. Open-ended funds: This is the just reverse of close-ended funds. Under this scheme the size of the fund and / or the period of the fund is not fixed in advance. The investors are free to buy and sell any number of units at any point of time.

Features of Open-ended Funds

(a) The investors are free to buy and sell units. There is no time limit.

(b) These are not trade in stock exchanges.

(c) Units can be sold at any time.

(d) The main motive income generation (dividend etc.)

(e) The prices are linked to the net asset value because units are not listed on the stock exchange.

Difference between Open-ended and Close-ended Schemes

1. The close-ended schemes are open to the public for a limited period, but the open-ended schemes are always open to be subscribed all the time.

2. Close-ended schemes will have a definite period of life. But he open-ended schemes are transacted in the company.

3. Close-ended schemes are transacted at stock exchanges, where as open-ended schemes are transacted (bought and sold) in the company.

4. Close-ended schemes are terminated at the end of the specified period. Open-ended schemes can be terminated only if the total number of units outstanding after repurchase fall below 50% of the original number of units.

B. On the basis of return/ income

1. Income fund: This scheme aims at generating regular and periodical income to the members. Such funds are offered in two forms. The first scheme earns a target constant income at relatively low risk. The second scheme offers the maximum possible income.

Features of Income Funds

(a) The investors get a regular income at periodic intervals.

(b) The main objective is to declare dividend and not capital appreciation.

(c) The pattern of investment is oriented towards high and fixed income yielding securities like bonds, debentures etc.

(d) It is best suited to the old and retired people.

(e) It focuses on short run gains only.

2. Growth fund: Growth fund offers the advantage of capital appreciation. It means growth fund concentrates mainly on long run gains. It does not offers regular income. In short, growth funds aim at capital appreciation in the long run. Hence they have been described as "Nest Eggs" investments or long haul investments.

Features of Growth Funds

(a) It meets the investors' need for capital appreciation.

(b) Funds are invested in equities with high growth potentials in order to get capital appreciation.

(c) It tries to get capital appreciation by taking much risk.

(d) It may declare dividend. But the main objective is capital appreciation.

(e) This is best suited to salaried and business people.

3. Conservative fund: This aims at providing a reasonable rate of return, protecting the value of the investment and getting capital appreciation. Hence the investment is made in growth oriented securities that are capable of appreciating in the long run.

C. On the basis of Investment

1. Equity fund: it mainly consists of equity based investments. It carried a high degree of risk. Such funds do well in periods of favourable capital market trends.

2. Bond fund: It mainly consists of fixed income securities like bonds, debentures etc. It concentrates mostly on income rather than capital gains. It carries lower risk. It offers secure and steady income. But there is no chance of capital appreciation.

3. Balanced fund: It has a mix of debt and equity in the portfolio of investments. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

4. Money market mutual funds: These funds are basically open ended mutual funds. They have all the features of open ended mutual funds. But the investment is made is highly liquid and safe securities like commercial paper, certificates of deposits, treasury bills etc. These are money market instruments.

5. Taxation fund: This is basically a growth oriented fund. It offers tax rebates to the investors. It is suitable to salaried people.

6. Leverage fund: In this case the funds are invested from the amounts mobilized from small investors as well as money borrowed from capital market. Thus it gives the benefit of leverage to the mutual fund investors. The main aim is to increase the size of the value of portfolio. This occurs when the gains from the borrowed funds are more than the cost of the borrowed funds. The gains are distributed to unit holders.

7. Index bonds fund: These are linked to a specific index of share prices. This means that the funds mobilized under such schemes are invested principally in the securities of companies whose securities are included in the index concerned and in the same proportion. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.

Objectives of Mutual Funds:

1. To mobilise savings of people.

2. To offer a convenient way for the small investors to enter the capital and the money market.

3. To tap domestic savings and channelize them for profitable investment.

4. To enable the investors to share the prosperity of the capital market.

5. To act as agents for growth and stability of the capital market.

6. To attract investments from the risk aversers.

7. To facilitate the orderly development of the capital market.

Importance of Mutual Funds:

Mutual funds are growing all over the world.

They are growing because of their importance to investors and their contributions in the economy of a country. The following are the advantages of mutual funds:

1. Mobilise small savings: Mutual funds mobilize small savings from the investors by offering various schemes. These schemes meet the varied requirements of the people. The savings of the people are channelized for the development of the economy. In the absence of mutual funds, these savings would have remained idle.

2. Diversified investment: Small investors cannot afford to purchase the shares of the highly established companies because of high market price. The mutual funds provide this opportunity to small investors. Even a very small investor can afford to invest in mutual funds. The investors can enjoy the wide portfolio of the investments held by the fund. It diversified its risks by investing in a variety of securities (equity shares, bonds etc.) The small and medium investors cannot do this.

3. Provide better returns: Mutual funds can pool funds from a large number of investors. In this way huge funds can be mobilized. Because of the huge funds, the mutual funds are in a position to buy securities at cheaper rates and sell securities at higher prices. This is not possible for individual investors. In short, mutual funds are able to give good and regular returns to their investors.

4. Better liquidity: At any time the units can be sold and converted into cash. Whenever investors require cash, they can avail loans facilities from the sponsoring banks against the unit certificates.

5. Low transaction costs: The cost of purchase and sale of mutual fund units is relatively less. The brokerage fee or trading commission etc. are lower. This is due to the large volume of money being handled by mutual funds in the capital market.

6. Reduce risk: There is only a minimum risk attached to the principal amount and return for the investments made in mutual funds. This is due to expert supervision, diversification and liquidity of units.

7. Professional management: Mutual funds are managed by professionals. They are well trained. They have adequate experience in the field of investment. Thus investors get quality services from the mutual funds. An individual investor would never get such a service from the securities market.

8. Offer tax benefits: Mutual funds offer tax benefits to investors. For instance, under section 80 L of the Income Tax Act, a sum of Rs. 10,000 received as dividend from a mutual fund (in case of UTI, it is Rs. 13,000) is deductible from the gross total income.

9. Support capital market: The savings of the people are directed towards investments in capital markets through mutual funds. They also provide a valuable liquidity to the capital market. In this way, the mutual funds make the capital market active and stable.

10. Promote industrial development: The economic development of any nation depends upon its industrial advancement and agricultural development. Industrial units raise funds from capital markets through the issue of shares and debentures. Mutual funds supply large funds to capital markets. Besides, they create demand for capital market instruments (share, debentures etc.). Thus mutual funds provide finance to industries and thereby contributing towards the economic development of a country.

11. Keep the money market active: An individual investor cannot have any access to money market instruments. Mutual funds invest money on the money market instruments. In this way, they keep the money market active.

Organization structure of Mutual Fund Company:

Besides investors the following three parties are involved in Mutual Funds Set up.

1. Trustees
2. Asset Management Company
3. SEBI the regulator.

1. **Trustees**: All mutual funds are set up in the form of a trust, which has sponsor, trustees, asset Management Company (AMC) and custodian. The trust is established by a sponsor or sponsors like a promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of management and supervision over AMC and they monitor the performance and compliance of SEBI regulations. As per SEBI regulations at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.
2. **The Asset Management Company (AMC):** The Asset Management Company is formed by the Mutual Fund Organization (MFO) which invests the money for buying of shares, deposits, bonds, Government securities etc. The AMC makes profit or loss by regular trading of assets held by it. An AMC should have a minimum of net worth of Rs.10 Crores. The AMC invest their funds in small cap, mid cap and large cap companies. The companies are classified as small cap (up to 150Crores), mid cap (between 150 crores to 1500 Crores) , large cap (above 1500 crores) on the Market capitalization of Companies.
3. **SEBI as regulator**: The Mutual funds are subject to SEBI regulations and they are monitored and inspected by SEBI. *The set of* regulations for the mutual funds was notified by SEBI in 1993. Subsequently, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in

1996 and have been amended thereafter from time to time. SEBI has been issuing guidelines to the mutual funds from time to time to protect the interests of investors.

The functions of Mutual Fund Organizations (MFO) can be described as

(a) Collection of funds from public

(b) Investment of funds collected from public in capital market

(c) Proper management of investment portfolio as a trustee to the investor's money.

The investment made by the public/investors in the AMC under a scheme is divided into number of units. The investor will be allotted number units in the scheme proportionate to total investment in the scheme. The investor is thus called unit holders. The Mutual Fund Organizations (MFO)s with huge resource of investments of public and a team of experts in their employees roll, analyses investment opportunities in various securities, bonds and financial investments. Based on the appraisal made by the specialists, investment decisions in the capital market to buy/sell the securities will be taken. The profit earned in the form of capital appreciation is distributed among the investors in the scheme after appropriating the administrative and other overhead expenses.

Mutual fund investment Vs. Stock market investment:

Stock market investing means investing directly in the stocks of the company. Here, you are purchasing the companies listed on the stock exchange with an expectation to earn profits when the price of that stock goes up.

On the other hand, a mutual fund is a collective investment that pools together the money of a large number of investors to purchase a number of securities like stocks, FDs, bonds, etc.

1. Cost of investing:

While investing in mutual funds, you have to pay different charges like expense ratio, load fee (entry load, exit load), etc. For the top mutual funds, the expense ratio can be as high as 2.5-3%.

On the other hand, if you invest in the stock market, you have to open your brokerage account (which includes opening account charges), and you have to pay some annual maintenance charges too. Further, there also different costs while transacting in stocks like brokerage, STT, stamp duty, etc.

2. Volatility in investment:

Direct investing in stocks has more volatility when compared to mutual fund investing. This is because when you invest in shares- you generally purchase 10-15 stocks.

On the other hand, the mutual fund consists of a diversified portfolio with investment in different securities like stocks, bonds, fixed deposits, etc. Even the equity-based mutual funds invest in at least 50-100 stocks. Due to the broad diversification, the volatility in the mutual funds is a lot less compared to that of shares.

3. Return potential:

Stock market investing has a very high return potential. Most of the successful investors in the world and India have built their wealth by investing directly in the stock market.

However, the complete fact is that the majority of people lose money in the stock market. Although the return potential is high while investing in stocks, however, the risk is also higher.

On the other hand, most of the good ranked mutual funds have given decent consistent returns to their shareholders. Although the returns are not as high as what many successful investors can make from stocks, however, this return is enough to build a massive wealth for an average person for a secured future.

4. Tax saving:

If you invest in ELSS (equity linked saving scheme) under mutual funds, you can enjoy a tax deduction up to Rs 1.5 lakhs in a year under the section 80c of the income tax act.

Another benefit of investing in the mutual fund is that you do not have to pay tax if the fund sells any stock from its portfolio as long as you are holding the fund.

On the other hand, when you sell stock while investing directly in the stock market, you have to pay a tax, no matter what's the scenario. There are no tax benefits while investing in the stock market. You have to pay a tax of 15% on short-term capital gains and a tax of 10% (above a profit of Rs 1 lakh) on the long-term capital gains.

5. **Monitoring:**

Investing in the stock market requires frequent monitoring. This is because stock market investing is a personal thing. Here, no one is going to do this for you and hence you have to monitor your stocks yourself. Moreover, due to the high volatility of the share market, the frequency of the monitoring should be higher. At least every quarter or half yearly.

On the other hand, for the mutual fund -there are fund managers who take care of the investments and make the buy/sell decision on your behalf. That's why, when you invest in mutual fund, you do not need to monitor your fund much frequently. Anyways, you should watch your funds at least every year so that you can confirm that your fund's performance is in line with your goals.

6. SIP Investment:

Mutual funds investment provides you with an option of a systematic investment plan.

A Systematic Investment Plan refers to periodic investment. For example, the investor can invest a fixed amount, say Rs 1,000 or 5,000, every month (or every quarter or six months) to purchase some units of the fund. SIP helps in investing automation and it brings discipline to the investment strategy.

On the other hand, there's no option of SIP available in stock market investing.

7. Asset class restriction:

While investing in the stock market, the only asset where you can spend is stocks of the company.

On the other hand, the mutual fund gives you an opportunity to invest in a diversified portfolio. Here, you can invest in a variety of asset classes. For example- debt mutual funds, equity-based mutual funds, gold funds, hybrid funds, etc.

8. The time required for investing:

The total time needed for directly investing in stock is a lot more compared to that of a mutual fund. This is because a fund manager manages a mutual fund.

However, for direct investment in the stock market, you have to do your research. Here, you have to find the best possible stock for investing yourself, and that requires a lot of study, time and efforts.

9. Ease of investment:

For investing in the stock market, you have to open your brokerage account with the help of a stockbroker. Here, you need to start your Demat and trading account which can take as long as a week to open.

On the other hand, you can start by investing in a mutual fund within 10 minutes. You do not require any brokerage account to start investing in mutual funds. There are a number of free platforms (like Groww or FundsIndia) available on the Internet where you can register within a few minutes and start investing in mutual funds.

10. Time Horizon of investment:

Generally, the investment time horizon in mutual funds for long-term like 5 to 7 years. Here, you are not trading funds, but investing for the long-run to make money by capital appreciation or regular income through dividend funds.

On the contrary, if you invest in stocks- it can be a long-term or short term. You can even keep the stock for a week and get good returns.

11. Control on investment:

If you are investing directly in the stock market, you will have a lot of power and control. Here, you can make critical decisions like- when to buy, when to sell, what to buy, what to sell, etc.

On the other hand, while investing in the mutual fund, you do not have much control over your investments. It’s your fund manager who makes the decisions like which securities to buy, when to buy, when to sell etc. The highest control that you have is to find and invest in a good mutual fund. However, once you have spent your money, everything will be taken care of by the fund manager.

Further, mutual fund performance depends on the efficiency of the fund manager. If the fund manager is efficient, you can get high returns. Otherwise, if the fund manager is not that good, you might get fewer returns. In addition, there is always a possibility that the fund manager may quit or join some other fund house.

Venture capital

Meaning of Venture Capital:

The term venture capital comprises of two words, namely, ‘venture’ and ‘capital’. The term ‘venture’ literally means a ‘course’ or ‘proceeding’, the outcome of which is uncertain (i.e., involving risk). The term capital refers to the resources to start the enterprise. Thus venture capital refers to capital investment in a new and risky business enterprise. Money is invested in such enterprises because these have high growth potential.

A young hi-tech company that is in the early stage of financing and is not yet ready to make a public issue may seek venture capital. Such a high risk capital is provided by venture capital funds in the form of long term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Venture capital is the money and resources made available to start up firms and small business with exceptional growth potential (e.g., IT, infrastructure, real estate etc.). It is fundamentally a long term risk capital in the form of equity finance for the small new ventures which involve risk.

But at the same time, it a the strong potential for the growth. It thrives on the concept of high riskhigh return. It is a means of equity financing for rapidly growing private companies.

Venture capital can be visualized as ‘your ideas and our money’ concept of developing business. It is ‘patient’ capital that seeks a return through long term capital gain rather than immediate and regular interest payments as in the case of debt financing.

When venture capitalists invest in a business, they typically require a seat on the company’s board of directors. But professional venture capitalists act as mentors and provide support and advice on a number of issues relating to management, sales, technology etc. They assist the company to develop its full potential. They help the enterprise in the early stage until it reaches the stage of profitability. When the business starts making considerable profits and the market value of the shares go up to considerable extent, venture capitalists sell their equity holdings at a high value and thereby make capital gains.

In short, venture capital means the financial investment in a highly risk project with the objective of earning a high rate of return.

Characteristics of Venture Capital:

The important characteristics of venture capital finance are outlined as bellow:

1. It is basically equity finance.

2. It is a long term investment in growth-oriented small or medium firms.

3. Investment is made only in high risk projects with the objective of earning a high rate of return.

4. In addition to providing capital, venture capital funds take an active interest in the management of the assisted firm. It is rightly said that, “venture capital combines the qualities of banker, stock market investor and entrepreneur in one”.

5. The venture capital funds have a continuous involvement in business after making the investment.

6. Once the venture has reached the full potential, the venture capitalist sells his holdings at a high premium. Thus his main objective of investment is not to earn profit but capital gain.

Types of Venture Capital:

Venture capital is typically available in four forms in India: equity, conditional loan, income note and conventional loan.

Equity: All VCFs in India provide equity but generally their contribution does not exceed 49 percent of the total equity capital. Thus, the effective control and majority ownership of the firm remain with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

Conditional loan: It is repayable in the form of a royalty after the venture is able to generate sales.

No interest is paid on such loans. In India, VCFs charge royalty ranging between 2 and 15 per cent; actual rate depends on the other factors of the venture, such as gestation period, cost-flow patterns and riskiness.

Income note: It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially low rates.

Conventional loan: Under this form of assistance, the enterprise is assisted by way of loans. On the loans, a lower fixed rate of interest is charged, till the unit becomes commercially operational. When the company starts earning profits, normal or higher rate of interest will be charged on the loan. The loan has to be repaid as per the terms of loan agreement.

Other financing methods: A few venture capitalists, particularly in the private sector, have started introducing innovative financial securities like participating debentures introduced by TCFC.

Stages of Venture Capital Financing:

Venture capital takes different forms at different stages of a project. The various stages in the venture capital financing are as follows:

1. **Early stage financing:** This stage has three levels of financing. These three levels are:

(a) Seed financing: This is the finance provided at the project development stage. A small amount of capital is provided to the entrepreneurs for concept testing or translating an idea into business.

(b) Start up finance/first stage financing: This is the stage of initiating commercial production and marketing. At this stage, the venture capitalist provides capital to manufacture a product.

(c) Second stage financing: This is the stage where product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture capital firms provide larger funds at this stage.

2. Later stage financing: This stage of financing is required for expansion of an enterprise that is already profitable but is in need of further financial support. This stage has the following levels:

(a) Third stage/development financing: This refers to the financing of an enterprise which has overcome the highly risky stage and has recorded profits but cannot go for public issue. Hence it requires financial support. Funds are required for further expansion.

(b) Turnarounds: This refers to finance to enable a company to resolve its financial difficulties.

Venture capital is provided to a company at a time of severe financial problem for the purpose of turning the company around.

(c) Fourth stage financing/bridge financing: This stage is the last stage of the venture capital financing process. The main goal of this stage is to achieve an exit vehicle for the investors and for the venture to go public. At this stage the venture achieves a certain amount of market share.

(d) Buy-outs: This refers to the purchase of a company or the controlling interest of a company's share. Buy-out financing involves investments that might assist management or an outside party to acquire control of a company. This results in the creation of a separate business by separating it from their existing owners.

Advantages of Venture Capital:

Venture capital has a number of advantages over other forms of finance. Some of them are:

1. It is long term equity finance. Hence, it provides a solid capital base for future growth.

2. The venture capitalist is a business partner. He shares the risks and returns.

3. The venture capitalist is able to provide strategic operational and financial advice to the company.

4. The venture capitalist has a network of contacts that can add value to the company. He can help the company in recruiting key personnel, providing contracts in international markets etc.

5. Venture capital fund helps in the industrialization of the country.

6. It helps in the technological development of the country.

7. It generates employment.

8. It helps in developing entrepreneurial skills.

9. It promotes entrepreneurship and entrepreneurism in the country.

Leasing

Meaning of leasing:

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

1. A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.

2. The document in which this contract is written.

3. A great way companies can conserve capital.

4. An easy way vendors can increase sales.

A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

The advantages of leasing include:

a. Leasing helps to possess and use a new piece of machinery or equipment without huge investment.

b. Leasing enables businesses to preserve precious cash reserves.

c. The smaller, regular payments required by a lease agreement enable businesses with limited capital to manage their cash flow more effectively and adapt quickly to changing economic conditions.

d. Leasing also allows businesses to upgrade assets more frequently ensuring they have the latest equipment without having to make further capital outlays.

e. It offers the flexibility of the repayment period being matched to the useful life of the equipment.

f. It gives businesses certainty because asset finance agreements cannot be cancelled by the lenders and repayments are generally fixed.

g. However, they can also be structured to include additional benefits such as servicing of equipment or variable monthly payments depending on a business's needs.

h. It is easy to access because it is secured – largely or entirely – on the asset being financed, rather than on other personal or business assets.

i. The rental, which sometimes exceeds the purchase price of the asset, can be paid from revenue generated by its use, directly impacting the lessee's liquidity.

j. 'ease instalments are exclusively material costs.

k. Using the purchase option, the lessee can acquire the leased asset at a lower price, as they pay the residual or non-depreciated value of the asset.

l. For the national economy, this way of financing allows access to state-of-the-art technology otherwise unavailable, due to high prices, and often impossible to acquire by loan arrangements.

Limitation of leasing

a. It is not a suitable mode of project financing because rental is payable soon after entering into lease agreement while new project generate cash only after long gestation period.

b. Certain tax benefits/ incentives/subsidies etc. may not be available to leased equipments.

c. The value of real assets (land and building) may increase during lease period. In this case lessee may lose potential capital gain.

d. The cost of financing is generally higher than that of debt financing.

e. A manufacturer (lessee) who want to discontinue business need to pay huge penalty to lessor for pre-closing lease agreement

f. There is no exclusive law for regulating leasing transaction.

g. In undeveloped legal systems, lease arrangements can result in inequality between the parties due to the lessor's economic do'inance, which may lead to the lessee signing an unfavourable contract.

Types of Lease:

(a) Financial lease

(b) Operating lease.

(c) Sale and lease back

(d) Leveraged leasing and

(e) Direct leasing.

1) Financial lease

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs.

Only title deeds remain with the lessor. Financial lease is also known as 'capital lease'. In India, f'nancial leases are very popular with high-cost and high technology equipment.

2) Operational lease

An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

3) Sale and lease back

It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals.

However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement.

4) Leveraged leasing

Under leveraged leasing arrangement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

5) Direct leasing

Under direct leasing, a firm acquires the right to use an asset from the manufacture directly. The ownership of the asset leased out remains with the manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc.

Financial evaluation of leasing:

The ways are:

1. Lessee's Point of View

2. Lessor's Point of View

1. Lessee's Point of View:

The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

The following steps are involved in such an analysis:
(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

(v) Evaluation: As the present value of after-tax cash outflows under the leasing option is lesser than the present value of after-tax cash outflows of the buying option, it is advisable to take the asset on lease.
(vi) Decision if Investment Allowance is allowed: In case Investment Allowance is allowed on purchase of asset the total of present value of net cash outflows will decrease by the present value of tax savings on investment allowance.

2. Lessor's Point of View

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

(a) Present Value Method:
This method involves the following steps:
(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

(iii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

(b) Internal Rate of Return Method:
The internal rate of return can be defined as that rate of discount at which the present value of cash- inflows is equal to the present value of cash outflows.

It can be determined with the help of the following mathematical formula:
$C = A_1/(1+r) + A_2/(1+r)^2 + A_3/(1+r)^3 + \dots \dots \dots \dots + A_n/(1+r)^n$
where, C = Initial Outlay at time Zero.

$A_1, A_2, \dots \dots \dots A_n$ = Future net cash flows at different periods.
2,3 …….. , = Numbers of years

r = Rate of discount of internal rate of return

Hire purchase

Concept and Meaning of Hire Purchase:

Hire purchase is a type of instalment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last instalment is paid.

The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as “An agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

1) The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic instalments.

2) The property in the goods is to pass to such person on the payment of the last of such instalments, and

3) Such person has a right to terminate the agreement at any time before the property so passes".

Features of Hire Purchase:

1. **Immediate possession-**under HP, the buyer takes immediate possession of goods by paying only a portion of its price.

2. **Hire Charges**- under HP, each instalment is treated as hire charges.

3. **Property in goods** - ownership is–passed to the hirer only after paying last or specified number of instalments

4. **Down payment**- hirer has to pay 20 to 25% of asset price to the vendor as down payment.

5. **Repossession**- Hire vendor, if default in payment of instalment made by hirer, can reposes the goods and he can resell the goods.

6. **Return of goods**- hirer is free to return the goods without being required to pay further instalment falling due after the return.

7. **Depreciation**- depreciation and investment allowances can be claimed by the hirer even though he is not an exact owner.

Differences between Lease and Hire purchase:

1. Ownership- in lease, ownership rests with the lessor throughout and the hirer of the goods not becomes owner till the payment of specified instalments.

2. Method of financing- leasing is a method of financing business assets whereas HP is financing both business and non-business assets.

3. **Depreciation**- in leasing, depreciation and investment allowances cannot be claimed by the lessee, in HP, depreciation and IA can be claimed by the hirer.

4. **Tax benefits**- the entire lease rental is tax deductible expense. Only the interest component of the HP instalment is tax deductible.

5. **Salvage value**- the lessee, not being the owner of the asset, doesn't enjoy the salvage value of the asset. The hirer, in HP, being the owner of the asset, enjoys salvage value of the asset.

6. **Deposit**- lessee is not required to make any deposit whereas 20% deposit is required in HP.

7. **Nature of deal** - with lease w– rent and with HP we buy the goods.

8. **Extent of Finance**- in lease financing is 100 % financing since it is required down payment, whereas HP requires 20 to 25% down payment.

9. **Maintenance**- cost of maintenance hired assets is borne by hirer and the leased asset (other than financial lease) is borne by the lessor.

10. **Reporting-** HP assets is a balance sheet item in the books of hirer where as leased assets are shown as off- balance sheet item.

Financial Evaluation of hire purchase:

The framework of financial evaluation of a hire purchase deal vis-à-vis a finance lease from both the hirer's as well as the finance company's viewpoint.

1. **From the Point of View of the Hirer (Purchaser):**

The tax treatment given to hire purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire installment. Thus, hire purchase and lease financing represent alternative modes of acquisition of assets. The evaluation of hire purchase transaction from the hirer's angle, therefore, has to be done in relation to leasing alternative.

Decision criterion: The decision criterion from the point of view of hirer is the cost of hire purchase vis a vis the cost of leasing. If the cost of hire purchase is less than the cost of leasing, the hirer should prefer the hire purchase alternative and vice-versa.

Cost of hire purchase: The cost of hire purchase to the hirer consists of the following:

1. Down payment

2. + Service Charges

3. + Present value of hire purchase payments discounted by the cost of debt.

4. – Present value of depreciation tax shield discounted by cost of capital.

5. – Present value of net salvage value discounted by cost of capital.

Cost of leasing: The cost of leasing consists of the following elements:

1. Lease management fee

2. + PV of lease payments discounted by cost of debt

3. – PV of tax shield on lease payments and lease management fee discounted by cost of capital.

4. + PV of interest tax shield on hire purchase by cost of capital.

2. **From the View Point of Vendor / Financer:**

Hire purchase and leasing represent two alternative investment decisions of a finance company / financial intermediary / hire vendor. The decision criterion therefore is based on a comparison of the net present values of the two alternatives, namely, hire purchase and lease financing. The alternative with a higher NPV would be selected and the alternative having a lower NPV would be rejected.

NPV of Hire purchase Plan: The NPV of HPP consist of

1. PV of hire purchase instalments

2. + Documentation and service fee.

3. + PV of tax shield on initial direct cost

4. – Loan amount

5. – Initial cost.

6. – PV of interest tax on finance income (interest)

7. – PV of income tax on finance income meted for interest tax

8. – PV of income tax on documentation and service fee.

NPV of Leas Plan: The NPV of LP consists of the following elements:

1. PV of lease rentals.

2. + Leas management fee

3. + PV of tax shield on initial direct costs and depreciation.

4. + PV of Net salvage value.

5. – Initial investment

6. – Initial direct costs.

7. – PV of tax liability on lease rentals and lease management fee