COPY Nov. 1973 12

8 1973

Reprinted from The Chartered Accountant, November 1973

Conversion of Loans into Equity

(An Economic Analysis)

By Guruprasad Murthy

Conversion of Loans into Equity*

(An Economic Analysis)

By Guruprasad Murthy

Introduction

EVERY BUSINESS has as its first dimension an economic dimension. Economic performance is dependent upon the performance of the organisation i.e. total management performance which in turn is the product of the operating management performance vis-a-vis financial management performance. The effectiveness and adequacy with which business operates will be greatly influenced and even exclusively determined by the freedom that entrepreneurs enjoy to affect the parameters that govern operating & financial management performance. The input (cost) output (revenues) and the commitments (capital) should be subject to management control in order to accomplish the intended purpose of economic performance. However, in recent times the Government is playing an important and active role in the process of economic development of our country. The government's economic policy is directed at attaining high rates of economic growth consistent with necessary economic stability, desired economic justice and due economic freedom. One of the important facets of economic development is capital formation. And the corporate sector plays an important part in the same. Once again the success of the corporate sector is limited to the freedom given to the entrepreneurs in the desired task. The government, through a plethora of controls is placing several constraints directly or indirectly, on the corporate sector.

An important constraint placed by the Government is the directives, issued to the concerns assisted by financial institutions, based on the recommendations of the Industrial Licensing Policy Inquiry Committee (ILPIC), which has two facets

(a) Insertion of a convertibility clause in respect of loans granted by financial institutions to assisted concerns

(b) Nomination of directors by financial institutions on the boards of assisted concerns.

Objectives

It is the purpose of this paper to address itself to the following with the aid of the case study (vide historical and projected data in exhibits at the end)

A. Government's directives to financial institutions regarding convertibility clause in respect of loans granted to assisted concerns.

B. Impact of conversion of the loans into equity, over the economic life of the proposed project, on the economic health of the business.

C. The justifiability of the convertibility clause.

D. The terms of conversion — i.e. at what price?

A. ILPIC DIRECTIVES

The following points may be noted regarding the ILPIC directives :

(a) Financial Institutions mean and include the ICICI, IFCI, IDBI, UTI and LIC.

(b) The loans eligible for conversion are :

(i) rupee loans; (ii) loans granted out of the U.K. line of credit; (iii) rupee debentures directly subscribed to; (iv) debentures taken up as a result of underwriting.

(c) Convertibility clause shall not be necessary if the aggregate assistance (as defined below) is less than Rs. 25 lacs. Convertibility clause may be inserted if the aggregate assistance is greater than Rs. 25 lacs and less than Rs. 50 lacs, but it can be waived with prior consultation with the IDBI. Convertibility clause is compulsory if the aggregate assistance exceeds Rs. 50 lakhs. However, even in this case if a waiver is to be exercised it can be done with the consultation of the Ministry of Finance (Department of Banking) through the IDBI.

(d) Aggregate assistance is defined as the sum of the proposed rupee assistance in all forms to the total outstanding rupee assistance in all forms from financial institutions. Rupee assistance is defined as

(i) rupee loans; (ii) debentures directly subscribed or taken up as a result of underwriting; (iii) share capital directly subscribed or taken up as a result of underwriting; (iv) loans granted out of U.K. line of credit but excluding the lines of credit from IBRD & KFW.

B. ECONOMIC IMPACT OF CONVERSION

The analysis of the economic impact

* The author acknowledges with sincere thanks the assistance offered by his students, Mr. S. K. Palekar, in preparing the Computer Programme for generating the data shown in Exhibits in this paper and Mr. J. S. Basrur for his views.