



The
Smart Manager

APR-JUN 2004 VOL 3 ISSUE 2

thinking IPO?

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In the recent months, there has been a spate of public offers by the government and private sector. Here is an essential survivor guide.

valuation

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what is the cost of capital?

by Sandeep Parekh

Are we paying too much for too little?

Regulations reduce the cost of capital employed by firms as they increase marketplace confidence in the firm and in the market itself. In an ungoverned capital market, certain risks can be avoided by regulating the market and its players effectively.

Intuitively people think that regulation of the securities market is a given good and a laissez faire policy leaves the system open to unnecessary fraud and market risks. What is less apparent is that regulations invariably impose a cost on all regulated entities not merely on the fraudulent entities. Even though the companies pay for these costs, they are ultimately borne by the investors.

punish only the wicked

From an economic perspective there are two ways regulations are beneficial despite the costs involved. Firstly, the law of diminishing marginal utility applies to regulations. So long as the incremental benefits of regulations outweigh incremental costs to the market, increased regulations can be implemented. Thus up to a point, regulations enhance the confidence of the



public in the marketplace and directly reduce the cost of capital for companies raising capital. For instance a quarterly statement of accounts of listed companies may be accepted as a net benefit but a monthly or weekly statement of accounts may not pass the test.

Secondly, the basis of securities regulations is that the implementation of disclosure norms and anti-fraud rule imposes proportionately larger costs on the bad companies than it does on the good companies. This hypothesis must be tested. Let us take an example of two

identical companies, except that X has a director convicted of economic fraud in the past. Y's directors have an unblemished record. A rule mandating disclosure of past convictions would impose a cost on both companies. Both companies would need to verify the information that their boards do not have a convicted person then collate and publish the information in various disclosures. However company X with the convicted director would not only have to pay the cost of compliance but will also need to pay a far higher return on the cost of capital for it to raise capital since fewer people would be interested in investing in a company with such a person as a director. But the hypothesis is valid only if an efficient enforcement mechanism is in place and working. Without such a mechanism, companies would resort to lying. In the above example if company X thinks that the probability of an enforcement action and a subsequent conviction is less than 3%, then there may be an economic incentive to violate the law.

quantify everything

The first problem about weighing the costs and benefits of



sandeep parekh
thrill seeker

A LL.M. from Georgetown University, currently Parekh is a partner in P H Parekh and Co and advises on issues such as strategic corporate contractual subjects and insider trading. During his career Parekh worked with various financial institutions in India. He is a multilingualist, fluent in German, French, Hindi and Gujarati, and enjoys rock climbing, squash, trekking, rafting, sailing, golf and kayaking.

regulations is the difficulty of quantification. The Securities Exchange Commission (SEC) often does a quantification of the costs involved to society by the introduction of a new regulation. For example, before the introduction of filings under Regulation Fair Disclosure, the SEC carried out an analysis of how many listed companies would be affected. The cost to each firm was estimated by looking at the proposed form, number of filings a year, and estimating the number of hours needed in filing the documents. The attorney time, internal counsel time and other time required for complying, were multiplied by the average rate of fees for each. After taking the cost to all the firms and costs to the society including time of the regulator and stock exchanges, a probative cost to society of \$35mn to \$50mn was arrived at. The benefits were not quantifiable but were enumerated before coming to the conclusion that the benefits exceeded the costs.

freedom to choose

There are two philosophies with respect to disclosure by companies, leave the disclosure to market forces or mandate disclosure. In theory, voluntary disclosure can work. To continue with the earlier example, let us presume both companies operate in an environment of no regulations except a general rule

against fraud. Company Y will disclose that their directors have never been convicted of any offence. Were they not to disclose they would be lumped with companies with convicted directors and attract poor valuation. Thus good companies would fully disclose. If company X were to decide whether to disclose the existence of the convicted director, it will have two choices open to it. First is to remain silent. In the absence of a disclosure rule, the company is free to remain silent. Though if Company Y had disclosed that it does not have a convicted director, people will presume that Company X is silent because it has one or more directors convicted of an offence. To escape the penalty the market would impose on the valuation of X presuming that all the directors are convicted of some offense, X would disclose the conviction of one director.

Such an economic compulsion would compel companies with two directors convicted of offenses to disclose fully as well. The companies, which remain silent will be those where all the directors are convicted of offences. This argument would oppose a rule against mandatory disclosure. However, few regulators subscribe to this philosophy and prefer a list of disclosures, which ensure comparable disclosure norms of both listed and unlisted

companies. Most take mandatory disclosure as a given good in securities regulations. However, the requirement for increased mandatory disclosure may be highly overvalued as voluntary disclosure can often ensure full disclosure given an effective and enforced anti-fraud rule, which prevents companies from lying.

balance the scales

Regulations in the markets undoubtedly impose a cost on investors. But they also provide a benefit to investors. In the current business scenario, amidst large frauds in the corporate world, more regulations substitute for better enforcement. Such over regulation only increases costs to investors without affording them a safer investment. From the companies' perspective, more regulations mean more compliance time spent in ensuring that no technical violations are made, getting no benefits in terms of improved cost of capital or increased investor confidence and losing productive focus of the main business. To combat the situation, regulations need to be passed with a cost benefit analysis. The current fad of corporate governance is an example of enacting mandatory disclosure where voluntary disclosure with an effective and enforced anti-fraud rule would suffice. ■

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