PROJECT APPRAISAL AND INVESTMENT ANALYSIS

CONCEPT OF CAPITALIZATION

TYPES OF SECURITIES

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CAPITALIZATION

The objective of every business is to maximize the value of the business. In this respect the finance manager, as well as individual investors, want to know the value created by the business.

The value of business relates to the capitalization of the business.

The need for capitalization arises in all the phases of a firm's business cycle.

Virtually capitalization is one of the most important areas of financial management.

CONCEPT OF CAPITALIZATION

Capitalization refers to the valuation of the total business. It is the sum total of owned capital and borrowed capital. Thus it is nothing but the valuation of long-term funds invested in the business. It refers to the way in which its long-term obligations are distributed between different classes of both owners and creditors.

CONCEPT OF CAPITALIZATION

In a broader sense it means the total fund invested in the business and includes owner's funds, borrowed funds, long term loans, any other surplus earning, etc. Symbolically

Capitalization = Share Capital + Debenture + Long term borrowing + Reserve + Surplus earnings

THEORIES OF CAPITALIZATION

We have seen that capitalization refers to the determination of the value through which a firm is to be capitalized.

In the context of capitalization there are two popular theories:

- Cost Theory
- Earning Theory

THEORIES OF CAPITALIZATION

Cost Theory

This theory is focused on the cost of acquiring assets. The total value of capitalization under the Cost Theory is the sum of cost of acquiring both fixed and current assets. Under this theory the costs incurred for issue of shares and other securities are also included in capitalization.

This theory is best used by a new firm as it helps to find the total amount of capital needed for establishing the business

THEORIES OF CAPITALIZATION

Cost Theory Limitations

- It highlights only the cost aspect but not the capacity of the assets;
- It remains silent about time when the asset becomes obsolete; and
- For a firm having fluctuating earnings, the theory loses its importance.

THEORIES OF CAPITALIZATION

Earning Theory:

Under this theory the earning capacity of the business is considered as the basis of capitalization. According to this theory the capitalized value of earning of the firm is the amount of capitalization. Industry's representative rate of return is taken as the rate of capitalization.

THEORIES OF CAPITALIZATION

Earning Theory:

The value of capitalization is calculated thus

Capitalization = Average Annual Future Earnings / Capitalization Rate x 100

THEORIES OF CAPITALIZATION

Earning Theory Limitations:

- Estimation of future earning for a new company is very difficult;
- Rate taken for capitalization may not be proper representative of the firm; and
- Mistake committed at the time of estimating the earnings will directly influence the amount of capitalization

SECURITIES

Security relates to a financial instrument or financial asset that can be traded in the open market, e.g., a stock, bond, options contract, or shares of a mutual fund, etc. All the examples mentioned belong to a particular class or type of security.

Security is a financial instrument that can be traded between parties in the open market.

The three types of security are debt, equity, and derivative securities.

Holders of equity securities (e.g., shares) can benefit from capital gains by selling stocks

TYPES OF SECURITIES

Debt Securities

Debt securities, or fixed-income securities, represent money that is borrowed and must be repaid with terms outlining the amount of the borrowed funds, interest rate, and maturity date. In other words, debt securities are debt instruments, such as bonds (e.g., a government or municipal bond) or a certificate of deposit (CD) that can be traded between parties.

TYPES OF SECURITIES- DEBT

Debt securities, such as bonds and certificates of deposit, as a rule, require the holder to make the regular interest payments, as well as repayment of the principal amount alongside any other stipulated contractual rights. Such securities are usually issued for a fixed term, and, in the end, the issuer redeems them.

TYPES OF SECURITIES

Equity Securities

Equity securities represent ownership interest held by shareholders in a company. In other words, it is an investment in an organization’s equity stock to become a shareholder of the organization.

The difference between holders of equity securities and holders of debt securities is that the former is not entitled to a regular payment, but they can profit from capital gains by selling the stocks..

TYPES OF SECURITIES- EQUITY

Another difference is that equity securities provide ownership rights to the holder so that he becomes one of the owners of the company, owning a stake proportionate to the number of acquired shares.

In the event a business faces bankruptcy, the equity holders can only share the residual interest that remains after all obligations have been paid out to debt security holders.

Companies regularly distribute dividends to shareholders sharing the earned profits coming from the core business operations, whereas it is not the case for the debt holders.

TYPES OF SECURITIES

Derivative Securities

Derivative securities are financial instruments whose value depends on basic variables. The variables can be assets, such as stocks, bonds, currencies, interest rates, market indices, and goods. The main purpose of using derivatives is to consider and minimize risk. It is achieved by insuring against price movements, creating favorable conditions for speculations and getting access to hard-to-reach assets or markets.

TYPES OF SECURITIES-DERIVATIVE

Formerly, derivatives were used to ensure balanced exchange rates for goods traded internationally. International traders needed an accounting system to lock their different national currencies at a specific exchange rate.

SECURITIES- SECURITIES MARKET

There are two types of Security Market Primary and Secondary Market.

In the *primary market,* where new issues of securities are offered to the public.

In secondary market, the securities are simply assets held by one investor selling them to an other investor, with money going one investor to other

HOW SECURITIES ARE TRADED

Types of Markets

- **Direct Search Markets**
  - Buyers and sellers locate one another on their own
- **Brokered Markets**
  - 3rd party assistance in location buyer or seller
- **Dealer Markets**
  - 3rd party acts as intermediate buyer/seller
- **Auction Markets**
  - Brokers & dealers trade in one location, trading is more or less continuous

TYPES OF ORDERS

MARKET ORDER

BUY OR SELL AT *CURRENT* PRICE

LIMIT ORDER

BUY OR SELL AT A *SPECIFIC* PRICE

STOP ORDER

BUY OR SELL AT *CURRENT* PRICE AFTER A *SPECIFIC* PRICE IS REACHED

BUYING ON MARGIN

- Purchasing stocks on margin means the investors borrows part of the purchase price of the stock from a broker.
- Initial margin is the amount that must be deposited in the margin account to initiate or continue trading of securities.

BUYING ON MARGIN

- Maintenance margin is the amount below which the margin account balance should not decrease.
- Investor will receive a margin call if amount falls below the maintenance margin.