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Alternative Sources of Finance, Private and Social Cost Benefit – RBI Grade B 2018
## Past Year Exam Analysis

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1 Alternative Sources of Finance

Normally we borrow from the bank for any need to sustain or grow the business but sometimes it might not be possible for an individual or a company to borrow from the banks. In such a case alternative sources of finance come into picture.

The following are the alternate source of financing which will discuss in this section.

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1.1 Leasing (Asset based Lenders)

1. It is a rental agreement that extends for a year or more and involve fixed monthly payments.

2. It is an agreement between two parties – the user (lessee) and the owner (lessor). The lessor grants the lessee right to use the property of the lessor for a defined period. The lessee just has the rights to use but does not have the ownership rights.

3. In return Lessee agrees to pay series of fixed payments to the lessor. Lessor is also called Asset based lender in this case.
Elements of Leasing

Leasing is one of the important and popular parts of asset based finance. It consists of the following essential elements

1. **Parties:** These are essentially two parties to a contract of lease financing, namely the owner and user of the assets.
2. **Leaser:** Leaser is the owner of the assets that are being leased. Leasers may be individual partnership, joint stock companies, corporation or financial institutions.
3. **Lesse:** Lesse is the receiver of the service of the assets under a lease contract. Lesse may be firms or companies.
4. **Lease broker:** Lease broker is an agent in between the leaser (owner) and lessee. He acts as an intermediary in arranging the lease deals. Merchant banking divisions of foreign banks, subsidiaries Indian banking and private foreign banks are acting as lease brokers.
5. **Lease assets:** The lease assets may be plant, machinery, equipment’s, land, automobile, factory, building etc.

Types of Leasing

Leasing, as a financing concept, is an arrangement between two parties for a specified period. Leasing may be classified into different types according to the nature of the agreement. The following are the major types of leasing as follows:

(A) Lease based on the term of lease
   1) Finance Lease
   2) Operating Lease

(B) Lease based on the method of lease
   1) Sale and lease back
   2) Direct lease

(C) Lease based in the parties involved
   1) Single investor lease
   2) Leveraged lease

(D) Lease based in the area
   1) Domestic lease
   2) International lease
1. **Operational Lease**: Operating lease is one of the short-term and cancelable leases. It is also called as service lease. The asset is returned to the lessor after the lease period comes to an end. It means a lease for a time shorter than the economic life of the assets; generally, the payments over the term of the lease are less than the lessor’s initial cost of the leased asset. For example: Hiring a car for a particular travel. It includes all expenses such as driver salary, maintenance, fuels, repairs etc.

2. **Financial lease**: It is also called as full payout lease. It is long term lease period. For example, lease for 100 years. During the lease period the ownership remains with the lessor but the ownership is transferred to the lessee after the lease period. The lessee has to pay very less price than the market value of the property after 100 years. For example: Hiring a factory, or building for a long period

3. **Direct lease**: When the lease belongs to the owner of the assets and users of the assets with direct relationship it is called as direct lease. Direct lease may be Dipartite lease (two parties in the lease) or tripartite lease. (Three parties in the lease)

4. **Sale and lease back**: It is a lease under which the owner sells an asset for cash to a prospective lessee and then leases back the same asset, making fixed periodic payments for its use. It may be in the form of operating leasing or financial leasing. It is one of the convenient methods of leasing which facilitates the financial liquidity of the company.

5. **Single investor lease**: When the lease belongs to only two parties namely lessee and it is called as single investor lease. It consists of only one investor (owner). Normally all types of leasing such as operating, financially, sale and lease back and direct lease are coming under this category

6. **Leveraged lease**: This type of lease is used to acquire the high level capital cost of assets and equipment’s. Under this lease, there are three parties involved; the lessee, the lender and the lessee. Under the leverage lease, the lessee acts as equity participant supplying a fraction of the total cost of the assets while the lender supplies the major part.

7. **Domestic lease**: In the lease transaction, if both the parties belong to the domicile of the same country it is called as domestic leasing
8. **International lease:** If the lease transaction and the leasing parties belong to the domicile of different countries, it is called as international leasing

1.2 Franchising

1. Under this model the Company which does not have capital to expand, give the franchise rights to an individual or a company. The company giving rights is called **franchisor** and company being given franchise is called **franchisee**

2. The franchisor gives the franchisee right to run a local business under the brand name of the franchisor. Franchisee benefits from already established brand name whereas franchisor benefits in terms of business expansion without much investment

3. Franchisor changes the franchisee initial lump sum money and later gets a share in the profit

4. Franchisor provides franchisee support in terms of guidance, training of employees, marketing etc.

5. Example would be Mc Donald which is going on a franchise model in India. All the petrol pumps from Indian Oil, Bharat Petroleum are also based on this model

**Types of Franchising**

There are 3 main type of franchising
1) **Product Franchise**: A product franchise is a franchising agreement where manufacturers allow retailers to distribute products and use names and trademarks. A product distribution franchise model is very much like a supplier-dealer relationship. Typically, the franchisee merely sells the franchisor’s products. However, this type of franchise will also include some form of integration of the business activities.

Example - Coca Cola, Maruti Suzuki

2) **Business format franchise**: It is a franchising arrangement where the franchisor provides the franchisee with an established business, including name and trademark, for the franchisee to run independently. The franchisee not only distributes the franchisor’s products and services under the franchisor’s trade mark, but also implements the franchisor’s format and procedure of conducting the business.

Example - KFC, Dominos.

3) **Management Franchise**: is type of franchise in which The franchisee provides the management expertise, format and/or procedure for conducting the business. Some examples of Management Franchise are Hilton, Hyatt

**Concept Check**

Ram and Sham have entered into a leasing agreement. Ram has sold the property to Sham for a sum of 30,0000 and then got the lease of the same property from Sham at a very nominal rate. What kind of lease agreement it is?

A. Domestic Lease  
B. Direct Lease  
C. Sale and lease Back  
D. Long term lease

Answer is C. Since Ram sold the assets and took back the lease it is an example of Sale and lease back
1.3 Factoring

1. **Factoring** is a financial transaction and a type of debtor finance in which a business *sells* its accounts receivable (i.e., invoices) to a third party *(called a factor)* at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs. Factoring is commonly referred to as accounts receivable factoring, invoice factoring, and sometimes accounts receivable financing.

2. **For example**, if Car seller sells a car to the customer then you generate an invoice. The payment for that car might come after 6 months (this type of payment which comes in future for already sold thing is called receivables) but car seller can use the invoice to take the money upfront from the party who is lending the money. The lender will make sure than when the invoice amount comes the due amount is given to the lender.

3. There are three parties directly involved: the **factor** who purchases the receivable, the one who sells the receivable, and the debtor who has a financial liability that requires him or her to make a payment to the owner of the invoice. The receivable, usually associated with an invoice for work performed or goods sold, is essentially a financial asset that gives the owner of the receivable the legal right to collect money from the debtor whose financial liability directly corresponds to the receivable asset. The seller *sells* the receivables at a discount to the third party, the specialized financial organization (aka the factor) to obtain cash. This process is sometimes used in manufacturing industries when the immediate need for raw material outstrips their available cash and ability to purchase "on account".

4. The **sale of the receivable transfers ownership of the receivable to the factor**, indicating the factor obtains all of the rights associated with the receivables. Accordingly, the...
receivable becomes the factor's asset, and the factor obtains the right to receive the payments made by the debtor for the invoice amount.

5. Usually, the account debtor is notified of the sale of the receivable, and the factor bills the debtor and makes all collections; however, non-notification factoring, where the client (seller) collects the accounts sold to the factor, as agent of the factor, also occurs. The arrangement is usually confidential in that the debtor is not notified of the assignment of the receivable and the seller of the receivable collects the debt on behalf of the factor.

6. If the factoring transfers the receivable "without recourse", the factor (purchaser of the receivable) must bear the loss if the account debtor does not pay the invoice amount. If the factoring transfers the receivable "with recourse", the factor has the right to collect the unpaid invoice amount from the transferor (seller).

7. There is also a risk that the debtor who has to pay to the factor might return some units of the product originally bought from the seller of the receivables. Such a risk is called risk of merchandise return. Such merchandise returns are responsibility of the seller and the factor will typically hold back paying the seller for a portion of the receivable being sold (the "factor's holdback receivable") in order to cover the merchandise returns.

8. There are four principal parts to the factoring transaction, all of which are recorded separately by an accountant who is responsible for recording the factoring transaction:
   I. "Fee" paid to the factor,
   II. The Interest Expense paid to the factor for the advance of money,
   III. The "bad debt expense" associated with portion of the receivables that the seller expects will remain unpaid and uncollectable,
   IV. The "factor's holdback receivable" amount to cover merchandise returns, and any additional "loss" or "gain" the seller must attribute to the sale of the receivables.
   V. Sometimes the factor's charges paid by the seller (the factor's "client") covers a discount fee, additional credit risk the factor must assume, and other services provided. The factor's overall profit is the difference between the price it paid for the invoice and the money received from the debtor, less the amount lost due to non-payment.

9. The Kalyanasundaram Study Group set up by the Reserve Bank of India in January 1988 to examine the feasibility and mechanics of starting factoring organizations in the country paved the way for provision of domestic factoring services in India. The Banking Regulation Act, 1949 was amended to include factoring as a form of business in which the banks might engage.
10. The government of India enacted the **Factoring Regulations Act, 2011** to bring in the much needed legal framework for the factoring business. The Act also specifies that any entity conducting the factoring business would need to be registered with the RBI as NBFCs.

11. Factoring has still not realized its potential due to lack of awareness among people.

12. Factoring is not the same as *invoice discounting*. Factoring is the *sale* of receivables, whereas invoice discounting is a *borrowing* that involves the use of the accounts receivable assets as collateral for the loan.

### 1.4 Forfeiting

1. Forfeiting is similar to factoring which allows exporters to obtain cash by selling their receivables from the foreign country at some discount. For example, if exporter of cycles would get Rs 2 lakh after 6 months from a firm in Germany then the exporter can get some money right now at some discount from a lender in India. The lender in this case may give money after applying 10% discount i.e. Rs 1, 60,000. Lender in India will get all amount of 2 lakhs after 6 months from the firm in Germany.

2. The Indian company lending money in this example would be called forfeiter. Normally it’s a specialized firm or a bank who acts as a forfeiter.

3. Forfeiters only work with exporters unlike in factoring where transaction can take place with any entity.

#### 1.4.1 Characteristics of Forfeiting

The characteristics of a forfaiting transaction are:

- The payment is normally receivable in any major convertible currency.
- A letter of credit or a guarantee is made by a bank, usually in the importer's country.
- The contract can be for either goods or services.

At its simplest, the receivables should be evidenced by a promissory note, a bill of exchange, a deferred-payment letter of credit, or a letter of forfaiting.

The International Trade & Forfaiting Association (**ITFA**) was founded in 1999 as a worldwide trade association for the forfaiting industry with a cash contribution of the **VEFI** (VEFI, founded in 1978 is the oldest forfaiting association in the world). Its purpose is to develop business relationships and assist other forfaiting-related organizations.
**Concept Check**

Mr. Sharma has sold a set of receivables to the Bank who is acting as a factor in this case. But unfortunately the qualities of goods sold by Mr. Sharma was very bad and the company who bought goods returned back almost 1/3rd of the units initially bought. But Bank was not impacted by this as thanks to the bank manager they had taken this scenario into account. What part of factoring transaction is that which saved the loss to the bank?

A. Fee  
B. Bad debt expense  
C. Factor's holdback receivable  
D. Discount fee

Answer is C: The "factor's holdback receivable" amount to cover merchandise returns, and any additional "loss" or "gain" the seller must attribute to the sale of the receivables.

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1.5  Peer to Peer Platforms

1. Traditionally, for every business the primary source to raise loans to scale up or as working capital came from banks. However, banks often want collaterals and small businesses and ones engaged in the service sector find it extremely difficult. Also, compared to bigger
and established companies, banks often charge a higher rate of interest for smaller companies as they view such loans risky.

2. Online P2P sites seek to connect interested lenders with borrowers, thereby eliminating intermediaries and costs. Borrowers now have an attractive option to raise money to fund their business needs, mostly without the need for collaterals and at much lower rates compared to banks, while investors that are sitting on idle cash have the option to get returns that are very lucrative.

3. In Short, Peer-to-peer lending, sometimes abbreviated P2P lending, is the practice of lending money to individuals or businesses through online services that match lenders with borrowers. Since peer-to-peer lending companies offering these services generally operate online, they can run with lower overhead and provide the service more cheaply than traditional financial institutions.

4. As a result, lenders can earn higher returns compared to savings and investment products offered by banks, while borrowers can borrow money at lower interest rates even after the P2P lending company has taken a fee for providing the matchmaking platform and credit checking the borrower. But there is a risk of borrower defaulting on the loans taken out from peer-lending websites.

5. Also known as crowdlending, many peer-to-peer loans are unsecured personal loans, though some of the largest amounts are lent to businesses. Secured loans are sometimes offered by using luxury assets such as jewelry, watches, vintage cars, fine art, buildings, aircraft and other business assets as collateral. They are made to an individual, company or charity. Other forms of peer-to-peer lending include student loans, commercial and real estate loans, payday loans, as well as secured business loans, leasing, and factoring.

6. Globally platforms like Fundingcircle.com and in India platforms like Faircent.com provide businesses an alternative source to raise working capital. In a validation of the model Google has earlier this year tie-up with Lending Club in the US to provide small loans to its technology partners.

7. The Platform provides a credit rating to the individual who wants to borrow money. The lenders can provide the money based on the credit rating. Several lenders can give their rate of interest and buyer can avail the cheapest option available.

8. The platforms provide services such as details of credit history of a borrower or collecting interest payments from the borrower. For this the platforms charges a fee from both the lender and borrower.
9. The lender's investment in the loan is **not normally protected by any government guarantee**. On some services, lenders mitigate the risk of bad debt by choosing which borrowers to lend to, and mitigate total risk by diversifying their investments among **different borrowers**. Other models involve the P2P lending company maintaining a separate, ring-fenced fund also known as provision fund. The Provision fund is used to pay lenders back in the event the borrower defaults.

### 1.5.1 Services Provided by P2P Platforms

1. Online investment platform to enable borrowers to attract lenders and investors to identify and purchase loans that meet their investment criteria
2. Development of credit models for loan approvals and pricing
3. Verifying borrower identity, bank account, employment and income
4. Performing borrower credit checks and filtering out the unqualified borrowers
5. Processing payments from borrowers and forwarding those payments to the lenders who invested in the loan
6. Servicing loans, providing customer service to borrowers and attempting to collect payments from borrowers who are delinquent or in default
7. Legal compliance and reporting
8. Finding new lenders and borrowers (marketing)

### 1.5.2 RBI’s Regulation of Peer to Peer Platforms

There has been a lot of debate whether this sector should be regularized by RBI or not since it is just in nascent stage. RBI has **proposed** following regulations for these platforms though **these are yet to be formally put in practice by RBI**

1. P2P companies must act only as intermediaries and their role must be limited to bringing the borrower and lender together. This basically means that P2P lenders **cannot take on the functions of a bank and seek and keep deposits**
2. Funds must move directly from the lender’s account to the borrower’s account to prevent risk of money laundering
3. P2P platforms **can’t assure returns to lenders**
4. The companies must have a **minimum capital of Rs.2 crore**
5. The platforms may have to adhere to a leverage ratio so that they do not expand indiscriminately
6. Since lenders may not be sophisticated, there may be limits on maximum contribution by a lender to a borrower/segment of activity

7. Promoters, directors and chief executive officers of P2P platforms will have to meet so-called “fit and proper” criteria. Fit and proper criteria is defined in detail in the ‘Corporate Governance Unit’

8. Some proportion of the board members of such platforms may need to have a background in finance.

9. Platforms will need to submit regular reports on their financial position, loans arranged each quarter, complaints and so on to RBI

10. Since RBI can only regulate companies and co-operative societies (and not individuals, proprietorships, partnerships or limited liability partnerships), all P2P platforms may have to be structured as companies

11. The platforms will have to guarantee confidentiality of customer data

12. Loan-recovery practices of the P2P platforms will need to adhere to existing guidelines on recovery practices

1.6 Crowd Funding

1. There are various crowd funding sites. These sites allow businesses to pool small investments from a number of investors instead of having to look for a single investment.

2. Since investments are made from large number of people and hence the name crowd funding
3. Normally the investors ask for a share in the company in lieu of return for the money. But many a times if investment is made for social benefit then investors might not ask anything in return. For example, many people funded political party AAP for eradicating corruption without asking anything in return.

4. Some examples of equity crowdfunding platforms are Syndicate Room, Crowd cube, Kickstarter and Seders.

5. Investor protection is a major area of concern as the investor putting money may be misled by the borrowers and may misuse the money.

6. SEBI is undertaking active discussions with stakeholders to come up with a suitable policy.

There are 2 Major types of crowdfunding

1) **Rewards crowdfunding**: entrepreneurs presell a product or service to launch a business concept without incurring debt or sacrificing equity/shares. This kind of funding is used when the project is a long gestation period research project. Usually, the prototype is launched and people are asked to contribute towards development of the product to pre-book the product at a lower price. It is a risky proposition as many a times, these prototypes are never converted into a real product and the entire money put by the customer goes into waste. This method is also used for production of movies, art and other high risk products.

2) **Equity crowdfunding**: Equity crowdfunding is the online offering of private company securities to a group of people for investment and therefore it is a part of the capital markets. Because equity crowdfunding involves investment into a commercial enterprise, it is often subject to securities and financial regulation. Equity crowdfunding is also referred to as crowd-investing, investment crowdfunding, or crowd equity. Equity crowdfunding is a mechanism that enables broad groups of investors to fund startup companies and small businesses in return for equity. Investors give money to a business and receive ownership of a small piece of that business. If the business succeeds, then its value goes up, as well as the value of a share in that business—the converse is also true. Coverage of equity crowdfunding indicates that its potential is greatest with startup businesses that are seeking smaller investments to achieve establishment, while follow-on funding (required for subsequent growth) may come from other sources.

3) **Debt Based Crowdfunding**: The concept discussed in Peer to Peer lending is called Debt based Crowdfunding.
4) **Litigation Funding**: This is done basically to fund a litigation for a common cause. For example, a builder sold 100 flats to 100 parties but did not deliver. In such a case those 100 people can contribute money to fight the litigation against the builder.

5) **Charity donation-based crowdfunding** is the collective effort of individuals to help charitable causes. In charity crowdfunding, funds are raised for pro-social or pro-environmental purposes.

**Concept Check**

Which of the following is true about P2P lending?

A. P2P lending is regulated by RBI
B. P2P lending can lead to scams if left Unregulated
C. Both A and B
D. None of the above

Answer is B: P2P lending is still not regulated by RBI. It is proposed to be regulated by RBI. So answer A is not correct. Statement B is correct.

1.7 **Angel Investors**

1. They are group of individuals or an individual itself who invest their own money
2. Angel Investors invest in the early (concept) Stages of the company and in return take a share in the company
3. They invest typically less money than the Venture Capitalists
4. They are not involved much in the functioning of the company though they may advice and ask for reports and status

1.8 **Venture Capitalists (VCs)**

1. They are professional managing money of corporates, pension funds and individuals which is invested into the companies requiring funding and are high potential
2. They are not much into funding at early stages of the business though if the concept is really good they might invest in early stage also
3. They invest huge amounts of money, much larger than Angel Investors
4. When they invest, they also designate people on the board of the company and people who have the industry knowledge to work on a daily basis in the operations of the company
5. They are fully involved in the functioning of the company
1.8.1 Difference between VC and Angel Investor

<table>
<thead>
<tr>
<th>Angel Investor</th>
<th>VC</th>
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<tbody>
<tr>
<td>Amount Invested is less</td>
<td>Amount Invested is high</td>
</tr>
<tr>
<td>Invest in Start Ups</td>
<td>Invest in little established business</td>
</tr>
<tr>
<td>Not Involved Much in day to day functioning</td>
<td>Involved fully in the board and daily operations of the company</td>
</tr>
<tr>
<td>Decide quickly on the investment decision</td>
<td>Takes huge amount of time to take decision on investing</td>
</tr>
</tbody>
</table>

1.9 Public Equity

1. In this process the equity (Share in business) is offered to general public through Initial Public Offering (IPO)
2. Individual People or Corporates like pension funds, mutual funds may buy those shares
3. It’s only possible for companies with established business model looking for capital for further growth

1.10 Comparison between Sources of alternate Funding

<table>
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<tr>
<th>Funding Type</th>
<th>Benefit</th>
<th>Drawback</th>
<th>Suitable for</th>
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<tbody>
<tr>
<td>Leasing</td>
<td>Property Is not sold but still finance is arranged</td>
<td>Not any as such</td>
<td>Person needing finance and having idle lying property</td>
</tr>
<tr>
<td>Franchising</td>
<td>Growth without much investment</td>
<td>Franchisee eats into the profits</td>
<td>Established brands looking for growth in local area without investment</td>
</tr>
<tr>
<td>Factoring</td>
<td>Credit for payments due in future</td>
<td>Fees may be charged from lender</td>
<td>Companies having poor cash flows and problems with working capital</td>
</tr>
<tr>
<td>Forfeiting</td>
<td>Credit for payments due in future in foreign countries and thus eliminating the risk</td>
<td>Fees may be charged from lender which can be high</td>
<td>Companies having poor cash flows or wants to eliminate the risk of payment from foreign country</td>
</tr>
<tr>
<td>Peer to peer</td>
<td>Gets best interest rate after comparison</td>
<td>Risk for the investor that he does not know the risk involved in the business</td>
<td>Small business which are deemed to be risky</td>
</tr>
</tbody>
</table>
### Crowd Funding

<table>
<thead>
<tr>
<th>crowd funding</th>
<th>flexible funding timelines and not much pressure to perform</th>
<th>not much guidance from the funders</th>
<th>where angel investors and vc’s do not agree for funding or funding is required for social cause</th>
</tr>
</thead>
</table>

### Angel Investors

<table>
<thead>
<tr>
<th>Angel Investors</th>
<th>Some coaching and contacts</th>
<th>Some meddling by investors and regular results reporting</th>
<th>Early in the company concept stage</th>
</tr>
</thead>
</table>

### VC’s

<table>
<thead>
<tr>
<th>VC’s</th>
<th>Don't have to pay the money back. VCs can also bring advice and partners</th>
<th>VCs involvement in the company may challenge management</th>
<th>Early stage typically before you want to make big but have a proven model</th>
</tr>
</thead>
</table>

### Public Equity

<table>
<thead>
<tr>
<th>Public Equity</th>
<th>Access to Large amount of Capital</th>
<th>Lot of money and effort spent on accounting and reporting</th>
<th>Companies which are profitable and has sustained business model</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public Investors do not interfere in day to day activities</td>
<td>Effort spent on managing/informing the stock exchanges</td>
<td>Large Amount of Money</td>
</tr>
</tbody>
</table>

## 2 Private and Social Cost Benefit

Whenever we try to start a project or a company, we always do the analysis whether it is beneficial or not. This section would let us know what kind of costs and benefits we should analyze before starting the project.

There are three kinds of costs and Benefits that we should analyze:

1. Private Costs and Benefits
2. Social Costs and Benefits
3. External Costs and Benefits

**To understand this, we would take an example:** The wildlife forests, in the region of Uttaranchal, are being cleared by company XYZ at a relatively rapid rate. The company has hired workers to cut the trees. The trees are transported using trucks to the furniture market where they are used for making furniture. XYZ Company has built roads in wild life forests for faster transportation.
2.1 Private Costs and Benefits

**Private Costs**: Private costs are the costs borne by those who are directly involved in the decision to produce a product. In the case of a XYZ company, private costs will include, for example, the cost of transporting the wood and the cost of labor.

**Private Benefits**: Private benefits are the benefits received by those directly involved in the consumption and production of a product. The private benefit for XYZ Company would be revenue earned from selling the wood.

Company XYZ might only consider private costs and benefits and as long as the private benefits exceed the cost, the company will keep on cutting the trees.

2.2 External Costs and Benefits

When firms produce products and households consume them, they often affect other people. For example, someone smoking in a factory may harm the health of other workers and a clothing firm, that dumps waste into a river, may damage the fishing stocks of a fish farmer and harm the environment. These kinds of costs are often not considered while doing a feasibility analysis for the project.

**External Costs**: The negative effects on third parties, due to the consumption and production activities of others, are known as external costs. In case of company XYZ, external costs due to cutting of trees may include damage to wildlife habitats, loss of plant species that could be used to develop medicines, global warming and interference with the lifestyle of local tribes.

**External Benefits**: The positive effects on third parties, due to the consumption and production activities of others, are known as external benefits. In Case of company XYZ, external benefits may include reduced transport costs and reduced transport time for tourist firms in the area due to construction of roads by company XYZ.
2.3 Social Costs and Benefits

Social costs are the total costs of an economic activity to society. The social cost of cutting down trees in the wildlife forest, will consist of both external and private costs. When social costs exceed private costs, there are external costs involved.

Social benefits are the total benefits to the society, arising from an economic activity. They include both private and external benefits. Again, where social benefits are greater than private benefits, external benefits exist.

The level of output which will cause maximum benefit to the society and not only individual will occur when the social benefit of the last unit produced is equal to the social cost of that unit. If the social cost exceeds the social benefit, it implies that too many resources are being devoted to the production of the product.

In our example, company xyz might only be considering the private costs and benefits and is keen on cutting more trees as it gives more profit. But if company XYZ also includes the external costs and benefits then it may realize that social costs in this case are greater than the social benefits.

Concept Check

Trident Hotel is building a new hotel in Gurgaon. They have bought a very costly land and they are spending huge amount of money on building the hotel. The hotel will create a lot of job opportunities for the people nearby and would result in creating pukka houses for the people who have been displaced. Hotel will generate huge profits every year from this project because there is no hotel nearby and there is huge demand of hotels in this area. What kind of benefits are being discussed in the passage?

A. Public Benefits
B. Private Benefits
C. Social Benefits
D. All of the above

Answer is D. Public benefits means the benefits of Job and Pukka house to poor people. Private benefits mean benefits of profits to hotel. Both are clubbed together as Social benefits.

3 Summary Sheets
Click the next green button on the bottom of your screen to view the summary sheets containing summary on this topic.

1. The summary will be helpful to revise just before the exam
2. This helps you in assessing your understanding and is very useful in improving retention.