Over the years the Colombo Stock Market has grown from strength to strength and in 2009 and 2010 it became the second best performing market in the world in terms of Index Performance reflecting an impressive growth of 125.3% and 96% respectively. Since the capital market provides an alternative source of funding and the benefits of the stock market should trickle down to all segments of society this article is the first of a series that is aimed at discussing investment opportunities in the capital market of Sri Lanka.

AN INTRODUCTION TO INVESTING IN THE CAPITAL MARKET OF SRI LANKA

What is a "Stock Market"?

A Stock Market is an organised place where stocks, bonds, or other securities are bought and sold.

The Colombo Stock Exchange (CSE) is the organization responsible for the operation of the stock market in Sri Lanka. The CSE is a company limited by guarantee, licensed by the Securities and Exchange Commission of Sri Lanka (SEC) to operate as a stock exchange in Sri Lanka. The CSE currently has a membership of 26 Stockbroker firms licensed by the SEC to trade in debt and equity. The Stockbroker firms act as intermediaries performing a number of services to investors and companies.

Securities and Exchange Commission of Sri Lanka

The SEC is the statutory body entrusted with the task of regulating the Securities Market in Sri Lanka. The SEC was established in pursuance of the Securities and Exchange Commission of Sri Lanka Act. No. 36 of 1987 as amended by Act No. 26 of 1991, Act No. 18 of 2003 and Act. No.47 of 2009.

For the purpose of carrying out its objects the SEC grants licences to the Stock Exchange, Stock Brokers, Stock Dealers and Managing Companies of Unit Trusts as well as register all Market Intermediaries i.e. investment managers, margin providers, underwriters, credit rating agencies and clearing houses.

The objects of the Commission are as follows:

- the creation and maintenance of a market in which securities can be issued and traded in an orderly and fair manner;
- the protection of the interest of investors
- the operation of a Compensation Fund to protect investors from financial loss arising as a result of any licensed stock broker or licensed stock dealer being found incapable of meeting his contractual obligations; and
- the regulation of the securities market and to ensure that professional standards are maintained in such market

The Commission of the SEC comprises of ten members out of whom seven are appointed by the Minister of Finance and the rest are ex-officio members. The appointed members include a Deputy Governor of the Central Bank of Sri Lanka nominated by the Governor and six other persons who appear to the Minister to have wide experience and shown capacity in legal, financial, business or administration matters, whilst the ex- officio members include the Deputy Secretary to the Treasury, the Registrar of Companies and the President of the Institute of Chartered Accountants of Sri Lanka.

What is a Share?

A share represents your ownership in a company. As a part owner you are investing in the future growth of the company. Here is an example of how buying shares work. If a company releases 100,000 Ordinary shares to the market and an investor purchases 1,000 shares, then we can say that the investor owns 1% of the said company. As an investor of a company, you have the right to receive the annual report of the company you have invested in, to participate at Annual General Meetings, as well as other benefits offered to shareholders such as dividends (if declared by the company) for profits the company has made.

There are currently 243 companies listed on the CSE, across 20 business sectors.

Why companies issue shares

The primary reason a company issues shares to the public is to raise large amounts of capital quickly. Let's imagine that you decide to start up your own Printing business. You will need to invest in equipment and property. All the money that you invest to start your business is called capital. Capital is the money that keeps businesses performing day-to-day tasks effortlessly and allows those companies to grow. Essentially, the capital of a business consists of all of its assets (or items to assist in the creation of wealth). What if it dawns on you that you don't have enough cash to buy all the needed assets?

Equity vs. Debt

If you are starting a business and are looking at your financing options, there are two types of financing available: equity financing and debt financing. If the owners of our Printing Press invested all their own savings to buy the materials necessary to start the business, they made an equity investment in the company. Equity is simply ownership of a corporation. Typically, ownership units in a corporation are referred to as stock. However, if our owners did not have necessary funds to start their own business they could finance their operation in one of two ways:

1. Issue stock (or certificates of partial ownership in his company) to people who may be interested in helping their venture out in return for a proportional share of the profits that the company might generate.

2. Debt financing means taking a loan, money that has to be paid back over a certain period of time usually with interest. Debt financing can either be short term (to be repaid in less than a year) or long term (to be repaid in more than a year). When obtaining a business loan, the only obligation of the business is to repay the loan according to the terms that were agreed upon and the lending party does not gain ownership in the business.

These sources of funding have limitations--corporate bonds, for example, must be repaid at interest and are restricted in how the proceeds can be used--or may not be able to provide adequate resources. Money raised by the issue of stocks is never repaid and is unrestricted. A privately held company might issue stocks to compensate employees or to enfranchise investors.

Some of the advantages and disadvantages of issuing shares.

Raise Cash

Equity financing is when the business owner gets cash in return for giving partial ownership in the company to the investors. The cash that is raised by issuing shares can be used to pay expenses and expand the company's operations. Raising cash is the primary incentive most

companies have for going public. The major advantage of equity financing is that the cash flow that would have been used to repay a loan, can be used to grow the business.

Attract Investors

If a company is privately held it may have trouble attracting investors. When a company issues shares to the public it is required to conform to certain regulations regarding shareholder rights and transparency of company financial information. These regulations help potential investors evaluate the company. As a result, some investors are more willing to make an investment in a company that is publicly traded.

Attract and Retain Employees

A company that issues shares can use shares of stock to pay bonuses and incentives to employees in the form of stock option plans. Stock option plans can attract talent to a company. They can also help a company retain employees due to the potential stock bonuses the employees can earn.

Buy Other Companies

After a company issues shares of stock they can use stock to buy other companies. This can help a company expand. Also, when a company buys another company with stock they do not have to pay cash for the purchase. This can help the company's overall cash flow.

Disadvantages of Issuing Stock:

1. The loss of interest of ownership of the business and also the possible loss of complete control that can accompany a sharing of business ownership with shareholders

2. Shareholders have a voice in policies that affect the company operations.

Advantages for Stockholders

As part owner of a corporation, you may be entitled to share in the profits of the company. There is also a chance that the company will grow and the price of the stock may rise. If the company achieves economic success, the stock value will go up and stockholders will benefit. For example, if you invested Rs 10,000 to buy 1000 shares of a company at Rs 10.00 each and the shares rose to RS 13.00 each you would gain Rs 3000.

How do you purchase shares?

A market can be split into two main sections: the Primary and Secondary market.
- the **primary market** is where new issues are first offered
- any subsequent trading goes on in the **secondary market**

The Primary Market:

The primary market is the market for new share or debenture issues and deals with the issuance of new securities. Companies can obtain funding through a new share issue, i.e. through an

Initial Public Offering (IPO). In the primary market, the security is purchased directly from the issuer (company). In a primary issue, the company offering the share/debenture publishes a Prospectus, which is an invitation to the general public to buy shares or debentures of that company and includes the details of the offer, the business activities of the company, its financial standing and future plans, its directors and management and for what purpose the company is raising this capital.

How to invest in the Primary Market

- Open an account with the Central Depository System (CDS) of the CSE through a stockbroker
- Obtain a prospectus free of charge from a stockbroker/ Managers to the issue/ Colombo Stock Exchange website / Bankers to the issue/ company offering the shares
- Read the Prospectus carefully and if necessary, consult an expert for advice
- Complete the application form for the purchase of shares or debentures provided along with the Prospectus
- Remember to indicate your CDS account number on the application form
- Send this form directly to the company concerned or to a stockbroker with payment for the amount due
- The allotted shares would be credited to the applicant's CDS account
- Where an application is accepted only in part, the refund payment will be made as specified by the applicant
- The share holder can sell the shares once the shares are listed