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Strategic Finance & Management Accounting

Long – Term Financing Sources 02

Sources of Long Term Financing

- **Loans,**
- **Bonds,**
- **Debentures,**
- **Leasing**

DEBT FINANCING

- **IPOs,**
- **Private Placements,**
- **Right Issues,**
- **Share Repurchase,**
- **Employee Share Ownership Schemes**

EQUITY FINANCING



Bank loans

Term loans

Banks often provide term loans as medium- or long-term financing for customers. The customer borrows a fixed amount and pays it back with interest over a period or at the end of it. You will hopefully remember that this contrasts with an overdraft facility, when a customer, through its current account, can borrow money on a short-term basis up to a certain amount. Overdrafts are repayable on demand.

The **advantages** of a term loan are as follows.

- (a) They are **easy and quick** to negotiate and arrange
- (b) **Flexible repayment schedules** may be offered by banks
- (c) They are particularly useful for **small entities** who can have problems raising capital

Mezzanine finance

This is unsecured loans that rank after secured debt but ahead of equity in a liquidation. It is commonly used for **management buy-outs**, where there is a need to **bridge the gap** between the amount of loans that banks are prepared to make and the amount of equity funding available.

It is **higher risk** lending than bank loans so tends to attract a **higher rate of interest**.

Creditworthiness

From the lender's viewpoint, the interest rate charged on loan finance will normally reflect the **risk** associated with the loan, and an assessment of a company's creditworthiness will be made.

Risk issue	Factors that will cause the interest rate to be higher
Purpose	If the lender assesses that the project is risky or is concerned about the abilities of the management team
Amount	If the amount of the loan is high relative to the financial resources of the borrower
Repayment	If repayment of capital is at the end of the loan, rather than in instalments
Time period	If the loan is for a long time period
Security	If there are no assets available against which the loan can be secured

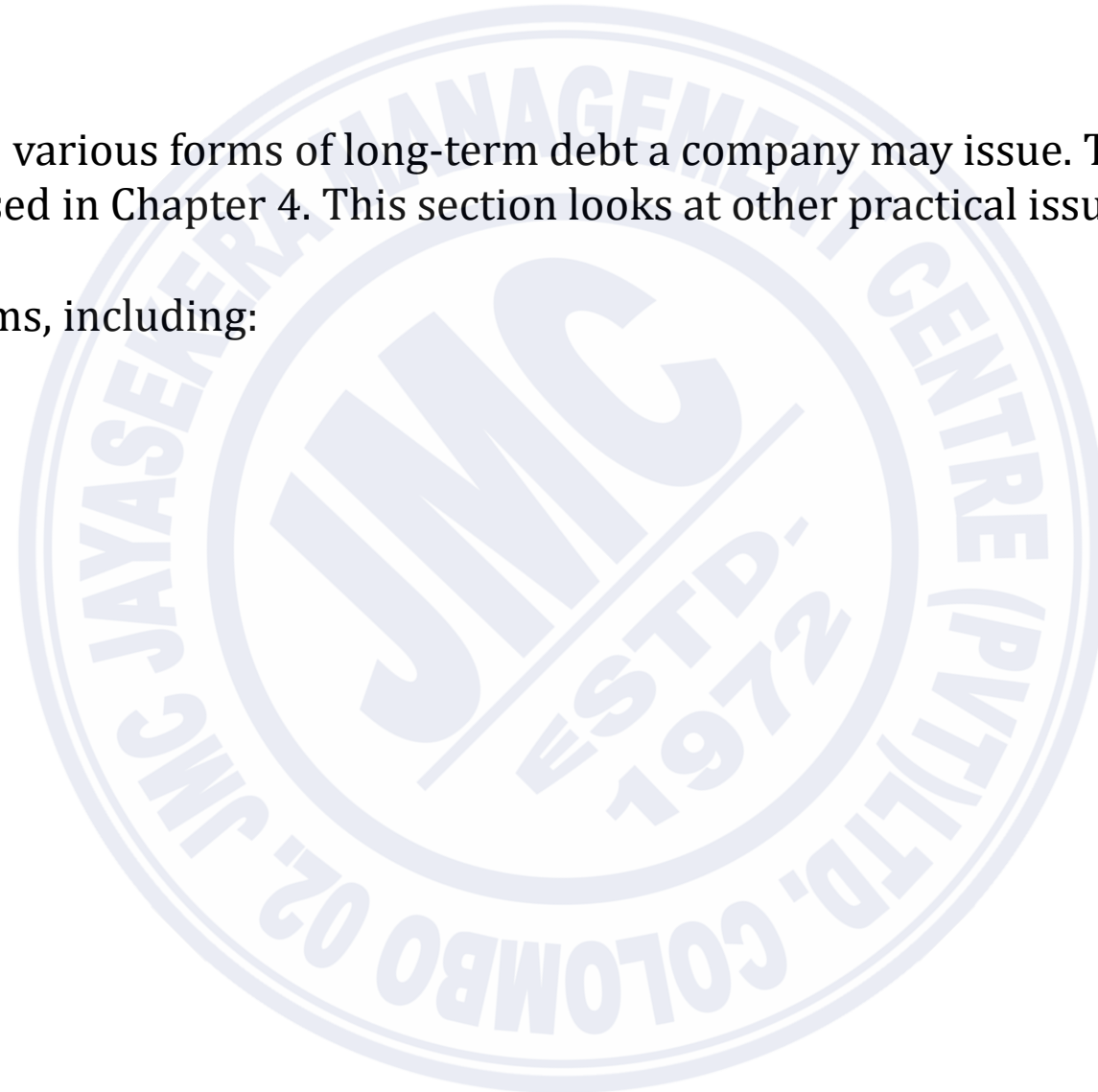
Long-term debt

Bonds

The term **bonds** describes various forms of long-term debt a company may issue. The parameters of bonds and their valuation was discussed in Chapter 4. This section looks at other practical issues relating to their issue.

Bonds come in various forms, including:

- ☐ Redeemable
- ☐ Irredeemable
- ☐ Floating rate
- ☐ Zero coupon
- ☐ Convertible



Debentures

A **debenture** is a written acknowledgement of a debt by a company, usually given under its seal and normally containing provisions as to payment of interest and the terms of repayment of principal. A bond may be secured on some or all of the assets of the company or its subsidiaries.

Debentures are defined as the written acknowledgement of a debt incurred by a company, normally containing provisions about the payment of interest and the eventual repayment of capital. The terms of the bond are set out in a **trust deed**

Security

Bonds will often be secured. **Security** may take the form of either a **fixed charge** or a **floating charge**.

(a) **Fixed charge**

Security would be related to a **specific asset** or group of assets, typically land and buildings. The company would be unable to dispose of the asset without providing a substitute asset for security, or without the lender's consent.

(b) **Floating charge**

With a floating charge on **certain assets** of the company (for example inventory or receivables), the lender's security in the event of a default of payment is whatever assets of the appropriate class the company then owns (provided that another lender does not have a prior charge on the assets).

The company would be able, however, to dispose of its assets as it chose until a default took place. In the event of default, the lender would probably appoint a receiver to run the company rather than lay claim to a particular asset.

Securitisation

refers to the bundling together of financial assets into another financial instrument, often to increase liquidity. For example, banks securitise mortgages (receivables for the bank) and sell them on to increase their liquidity – mortgages pay a return over a long period, whereas selling the securitized mortgages provides close to instant liquidity.

Commercial paper

refers to short term 'IOUs' issued by large, well-established businesses, often to finance working capital needs in the short term. They do not reward the lender with a rate of interest, but are issued at a discount to face value.

For example, a Rs. 100 commercial note may be issued for Rs. 95, and repaid at face value in 6 weeks' time. They are usually unsecured, hence only practical for large, well-known businesses that investors have a high level of confidence in.

Convertible securities

Convertible bonds

Convertible debt is a liability that gives the holder the right to convert into another instrument, normally ordinary shares, at a pre-determined price/rate and time.

The conversion value and the conversion premium

The current market value of ordinary shares into which a unit of bonds may be converted is known as the conversion value. The **conversion value** will be below the value of the bonds at the date of issue, but will be expected to increase as the date for conversion approaches, on the assumption that a company's shares ought to increase in market value over time.

FORMULA TO LEARN

$\text{Conversion value} = \text{Conversion ratio} \times \text{Market price per ordinary share}$

$\text{Conversion premium} = \text{Current market value} - \text{Current conversion value}$

QUESTION

Convertible debt

The 10% convertible bonds of PW Co are quoted at Rs. 142 per Rs. 100 nominal. The earliest date for conversion is in four years' time, at the rate of 30 ordinary shares per Rs. 100 nominal. The share price is currently Rs. 4.15. Annual interest on the bonds has just been paid.

Required

- (a) **Calculate** the current conversion value.
- (b) **Calculate** the conversion premium and comment on its meaning.

ANSWER

- (a) Conversion ratio is Rs. 100 bond = 30 ordinary shares

$$\text{Conversion value} = 30 \times \text{Rs. } 4.15 = \text{Rs. } 124.50$$

- (b) Conversion premium = Rs. $(142 - 124.50) = \text{Rs. } 17.50$

$$\text{Or } \frac{17.50}{124.50} \times 100\% = 14\%$$

The share price would have to rise by 14% before the conversion rights became attractive.

The issue price and the market price of convertible bonds

A company will aim to issue bonds with the **greatest possible conversion premium** as this will mean that, for the amount of capital raised, it will, on conversion, have to issue the lowest number of new ordinary shares. The premium that will be accepted by potential investors will depend on the company's growth potential and the prospects for a sizeable increase in the share price.

Convertible bonds issued at par normally have a lower coupon rate of interest than straight debt. This lower yield is the price the investor has to pay for the conversion rights. It is, of course, also one of the reasons why the issue of convertible bonds is attractive to a company, particularly one with tight cash flows around the time of issue, but an easier situation when the notes are due to be converted.

When convertible bonds are traded on a stock market, their **minimum market price** or **floor value** will be the price of straight bonds with the same coupon rate of interest. If the market value falls to this minimum, it follows that the market attaches no value to the conversion rights.

The actual market price of convertible bonds will depend on:

- ❑ The **price of straight debt**
- ❑ The **current conversion value**
- ❑ The **length of time** before conversion may take place
- ❑ The **market's expectation** as to future equity returns and the risk associated with these returns

Example: Convertible bonds

CD has issued 50,000 units of convertible bonds, each with a nominal value of Rs. 100 and a coupon rate of interest of 10% payable yearly. Each Rs. 100 of convertible bonds may be converted into 40 ordinary shares of CD in three years' time. Any bonds not converted will be redeemed at 110 (that is, at Rs. 110 per Rs. 100 nominal value of bond).

Estimate the likely current market price for Rs. 100 of the bonds, if investors in the bonds now require a pre-tax return of only 8%, and the expected value of CD ordinary shares on the conversion day is:

- (a) Rs. 2.50 per share
- (b) Rs. 3.00 per share

Compute value of a bond under above each options....

Advantages of convertibles

- (a) Convertibles serve as a **sweetener** for debt by allowing the investor to participate in increases in price of share capital.
- (b) The issuer can pay **lower interest** than on straight debt. This may be significant if funds are tight during the early years of issue of the bonds. They are usually issued by **high-growth companies** who do not want the burden of high interest payments.
- (c) The attractions of the conversion rights, the possibility of a significant capital gain and the hedge against risk (the right to have the debt repaid if conversion is not worthwhile), should mean the lender is willing to accept fewer other conditions.
- (d) Convertibles may provide a means of issuing equity ultimately at a higher price than current market price.
- (e) There may be provisions in the issue terms allowing the issuer to force conversion if the market price of the bonds is greater than the conversion price.
- (f) If the company issued straight bonds initially and then issued equity to redeem the bonds, two lots of issue costs would be paid, whereas with convertible debt, issue costs would only be paid once.
- (g) The debt ratio is reduced if conversion takes place.

Disadvantages of convertibles

- (a) If the company had waited for funds, and the **market price increases significantly** above the conversion price, it would be better off issuing shares at a higher price, rather than having to issue shares at the lower conversion terms.
- (b) The company has to **repay the debt** if the share price does not increase.
- (c) Some borrowers may be reluctant to invest because of the **lower yield** on convertible shares compared with securities not having conversion rights.

International debt finance

Large companies with excellent credit ratings use the **euromarkets** to borrow in any foreign currency using unregulated markets organised by merchant banks. This market is much bigger than the market for domestic bonds.

International borrowing

Borrowing markets are becoming increasingly internationalised, particularly for larger companies. Companies are able to borrow long-term funds on the **eurocurrency (money) markets** and on the markets for **eurobonds**. These markets are collectively called '**euromarkets**'. Large companies can also borrow on the **syndicated loan market** where a syndicate of banks provides medium- to long-term currency loans. The word 'euro' does not refer to the euro currency, it means any currency other than the domestic currency (see below).

If a company is receiving income in a foreign currency or has a long-term investment overseas, it can try to **limit the risk** of adverse exchange rate movements by **matching**. It can take out a long-term loan and use the foreign currency receipts to repay the loan.

Eurocurrency markets

Eurocurrency is currency which is held by individuals and institutions outside the country of issue of that currency.

Eurodollars are US dollars deposited with, or borrowed from, a bank outside the US.

A SL company might borrow money from a bank or from the investing public, in SL rupees. However, it might also borrow in a foreign currency, especially if it trades abroad, or if it already has assets or liabilities abroad denominated in a foreign currency. When a company borrows in a foreign currency, the loan is known as a **eurocurrency loan**. (As with euro-equity, it is not only the euro that is involved, and so the 'euro-' prefix is a misnomer.) Banks involved in the eurocurrency market are **not subject to central bank reserve requirements** or regulations in respect of their involvement.

The eurocurrency markets involve the **depositing of funds** with a **bank outside the country** of the currency in which the funds are denominated and **re-lending these funds for a fairly short term**, typically three months, normally at a floating rate of interest.

Eurocredits are medium- to long-term international bank loans which may be arranged by individual banks or by **syndicates of banks**. Syndication of loans increases the amounts available to hundreds of millions, while reducing the exposure of individual banks.

Eurobonds

A **eurobond** is a bond sold outside the jurisdiction of the country in whose currency the bond is denominated.

How are eurobonds issued?

Step 1 A lead manager is appointed from a major merchant bank; the lead manager liaises with the credit rating agencies and organises a **credit rating** of the eurobond.

Step 2 The lead manager organises an **underwriting syndicate** (of other merchant banks) who agree the terms of the bond (eg interest rate, maturity date) and buy the bond.

Step 3 The underwriting syndicate then organise the sale of the bond; this normally involves **placing** the bond with **institutional investors**.

Advantages of Eurobonds

- (a) Eurobonds are '**bearer instruments**', which means that the owner does not have to declare their identity.
- (b) Interest is paid gross and this has meant that eurobonds have been used by investors to avoid tax.
- (c) Eurobonds create a liability in a foreign currency to **match** against a foreign currency asset.
- (d) They are often **cheaper** than a foreign currency bank loan because they can be sold on by the investor, who will therefore accept a lower yield in return for this greater liquidity.
- (e) They are also extremely **flexible**. Most eurobonds are fixed rate but they can be floating rate or linked to the financial success of the company.
- (f) They are typically issued by companies with excellent credit ratings and are normally **unsecured**, which makes it easier for companies to raise debt finance in the future.
- (g) Eurobond issues are not normally advertised because they are **placed** with institutional investors and this reduces issue costs.

Disadvantages of Eurobonds

Like any form of debt finance, there will be **issue costs** to consider (approximately 2% of funds raised in the case of eurobonds) and there may also be problems if gearing levels are too high.

A borrower contemplating a eurobond issue must consider the **foreign exchange risk** of a long-term foreign currency loan. If the money is to be used to purchase assets which will earn revenue in a currency different to that of the bond issue, the borrower will run the risk of exchange losses if the currency of the loan strengthens against the currency of the revenues out of which the bond (and interest) must be repaid.

Note. Since eurobonds are a major source of finance, they may feature in exam questions. For example, you may be required to compare euro bank loans and a euro-denominated eurobond, or to discuss the advantages and disadvantages of different methods of funding, including a euro-denominated eurobond.