Chapter 1

Long term finance

Chapter learning objectives:

Lead	**Component**	**Indicative syllabus content**
A1: Compare and contrast types and sources of long term funds	Compare and contrast: a. Long-term debt b. Equity finance c. Markets for long-term funds	• Characteristics of different types of shares and long-term debts • Ordinary and preference shares • Bonds and other types of long-term debt • Operations of stock and bond markets • Issuance of shares and bonds • Role of advisors

1. Introduction

Sources of long term finance

If company has large amount of cash, it may be able to afford undertaking new investment projects without help from external sources of finance.

However, if external funds are required, the company get the finance from the following sources:

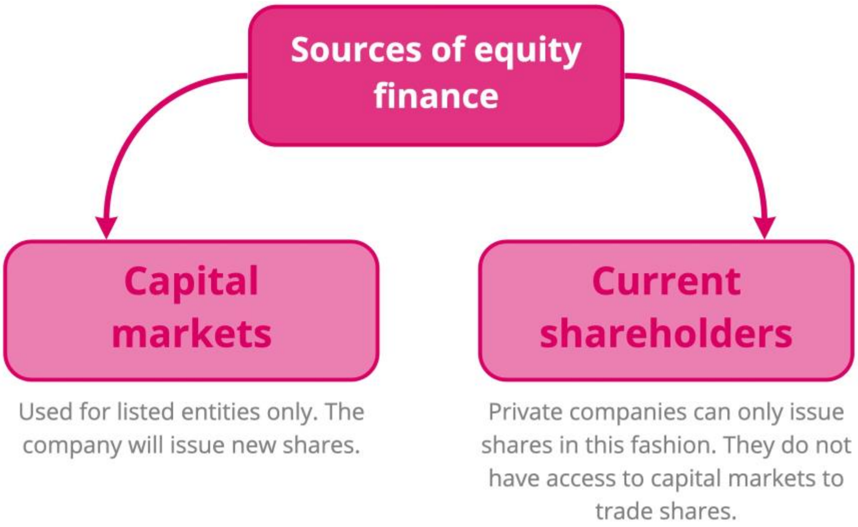
- The capital market - issue shares (equity finance).
- Bank borrowings - take out a loan (debt finance).
- Government and similar sources.

2. Equity finance

Equity is another name for shares or ownership rights in business.

Important terminology

Share	a fixed identifiable unit of capital in an entity which normally has a fixed nominal value
Ordinary shares	Ordinary shares pay dividends at the discretion of the entity's directors. The ordinary shareholders of a company are the owners of the company and they have the right to attend meetings and vote on any important matters.
Preference shares	Preference shares are shares that pay a fixed dividend, which is paid in preference to (before) ordinary share dividends, hence the name.



Capital markets

Capital markets (or stock markets) must fulfil both primary and secondary functions.

- **Primary function:**
  - To enable companies to raise new finance. Stock market gives the opportunity to communicate with a large pool of potential investors.
- **Secondary function:**
  - To enable investors to sell their investments to other investors.

Private vs public companies

A private limited company's disclosure requirements are lighter, but for this reason its shares may not be offered to the general public.

A stock exchange listing

When an entity obtains a listing (or quotation) for its shares on a stock exchange this is referred to as a flotation or an Initial Public Offering (IPO).

Advantages of listing	Disadvantages of listing
• Raises capital for future investments • Raises company's profile. • Makes employees' schemes more accessible. • Creates a mechanism for buying and selling shares in the future at will. • The market will provide a more accurate valuation of the entity than had been previously possible.	• Onerous reporting requirements. • Stringent stock exchange rules for obtaining a quotation. • Costly for a small entity in terms of floatation and underwriting costs. • Making enough shares available to allow a market results in losing at least some of the owners' control.

Test Your Understanding 1 : Listing

Which TWO of the following are the advantages of listing?

A. Flexible reporting requirements

B. Easy stock exchange rules for obtaining a quotation

C. Raises company's profile

D. Raises funds for future investments

UK capital markets

There are two important capital markets in UK:

- **The full Stock Exchange**

  Entry costs are high and scrutiny is very high for companies listed, but the shares are extremely marketable.

- **The Alternative Investment Market**

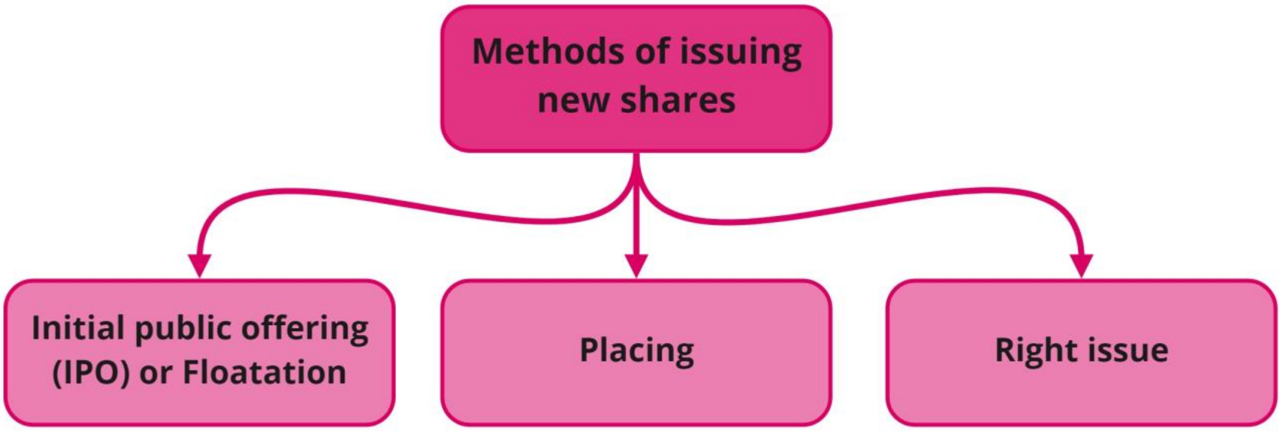
  Market for smaller companies with lower associated costs and less stringent entry criteria.

Prices of shares on the stock exchange are determined by the forces of supply and demand in the market.

The role of advisors in a share issue

Stockbrokers	provide advice on the various methods of obtaining a listing.
Institutional investors	have little direct involvement other than as investors, agreeing to buy a certain number of shares.
Registrars to na issue	will provide administrative functions such as collecting and processing applications from potential investors, monitoring payments due and made to and from investors and providing advice and information regarding share issues to stock exchanges, investors and issuing entities.
Public and Investor relations	will work with the entity to ensure communications regarding the share issue are transparent, informative and are understandable to those investing.
Reporting accountants	will provide advice regarding the impact on the financial statements of any potential shares issues.
Underwriters	are financial institutions that help corporations raising finance by taking on the risk associated with a new issues and attempting to promote the new share issue to 3rd party investors.

3. Methods of issuing new shares



Initial public offering (IPO)

IPOs occur when a company seeks to be listed on a stock market for the first time. These offers may be of completely new shares or they may derive from the transfer to the public of some or all of the shares already held privately.

Shares are offered for sale to investors, through an issuing house. The offer could be made as follows:

- At a fixed price set by the company
- In a tender offer.

Tender offer

For a tender offer, investors are invited to tender for new shares at their own suggested price. All shares being offered are sold at the best price that would generate the required finance.

Placing

Shares are placed directly with certain investors (normally institutions) on a prearranged basis.

4. Right Issues

A right issue is where new shares are offered for sale to existing shareholders, in proportion to the size of their shareholding.

The right issue gives the opportunity to purchase additional shares, which are normally offered at a price lower than the current share price quoted.

Pre-emption

The right to buy new shares ahead of outside investors is known as the 'pre-emption rights' of shareholders. The purpose of pre-emption rights is to ensure that shareholders have an opportunity to prevent their stake being diluted by new issues.

Market price after issue

- After the announcement of a rights issue there is a tendency for share prices to fall.
- The temporary fall is due to uncertainty about:
  - consequences of the issue
  - future profits
  - future dividends.
- After the actual issue the market price will normally fall again because:
  - there are more shares in issue (adverse affect on earnings per share), and
  - new shares were issued at market price discount.

'Cum rights'

All existing shareholders have the right to subscribe for new shares.

'Ex rights'

On the first day of dealings in the newly issued shares, the rights no longer exist and the old shares are now traded 'ex rights' (without rights attached).

Theoretical prices/values

$$= \frac{(\text{N} \times \text{cum rights price}) + \text{Issue price}}{\text{N}+1}$$

Where N – number of shares required to be held in order to receive one rights issued share.

Test Your Understanding 2 : Ex rights

Cheddar plc has 5m $1 ordinary shares in issue, with a current market value of $5 per share. It offers a 1 for 4 rights issue at $4 per share.

Calculate theoretical ex-right price (TERP).

Note:

The calculation of TERP would not be a requirement to an exam question within syllabus area F2.A1. It is included here for illustration purposes only.

From the viewpoint of the shareholders:

- they have the option of buying shares at preferential price
- they have the option of withdrawing cash by selling their rights
- they are able to maintain their existing relative voting position (by exercising the rights).

From the viewpoint of the company:

- it is simple and cheap to implement
- it is usually successful ('fully subscribed')
- it often provides favourable publicity.

5. Debt finance

This is the loan of funds to a business without conferring ownership rights. The key features of debt financing arising from this 'arm's length relationship' are:

- Interest is paid out of pre-tax profits as an expense of the business.
- It carries a risk of default if interest and principal payments are not met.

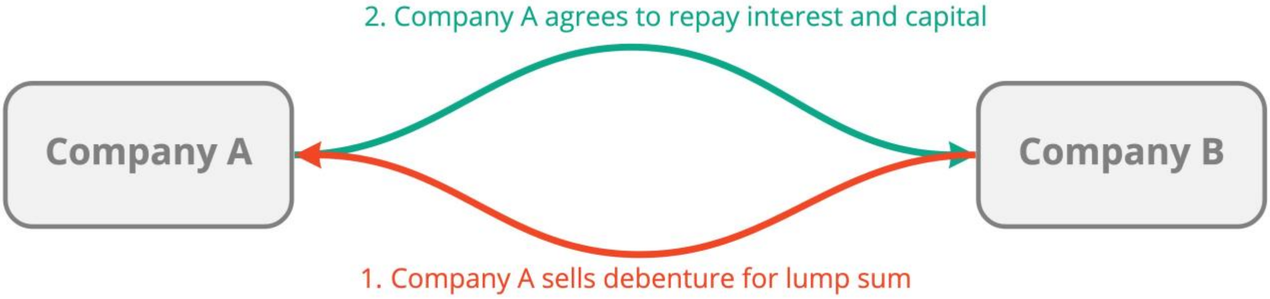


Illustration debt finance

Company A issues 6% $100 debentures at a market value of $93. The debenture is redeemable after 5 years at a premium of 10%.

Par value	**$100**	**Headline value of a debenture**
Coupon rate	6% × $100 = $6 interest repayment each year (in cash)	Minimum interest repayment per annum based on par values
Market value	$93	Cash received from issuing loan
Redemption date	5 years	Date of repayment of capital element of loan
Premium	$10 10% premium on par value of $100 = repayment of $110 (premium of $10)	Extra amount repayable at redemption date based on par values

Security - charges

1) **Fixed charge** → The debt is secured against a specific asset, normally land or buildings.
2) **Floating charge** → The debt is secured against underlaying assets that are subject to changes in quantity or value.

Test Your Understanding 3 : Security charges

Which ONE of the following types of charge can cover any other assets that are not already subject to fixed charge?

A. Floating charge
B. Fixed charge
C. Both of them
D. None of them

Covenants

Specific rules laid down as a condition of taking on debt financing. May include:

- Dividend restrictions
- Financial ratios
- Financial reports
- Issue of further debt

Capital markets

Bonds

A bond is a debt security, in which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay interest (the coupon) and/or to repay the principal at a later date. i.e. a bond is a formal contract to repay borrowed money with interest at fixed intervals.

Issuers

The issuers sell bonds in the capital markets to fund the operations of their organisations. This area of the market is mostly made up of governments, banks and corporations.

Underwriters

The underwriting segment of the bond market is traditionally made up of investment banks and other financial institutions that help the issuer to sell the bonds in the market.

Purchasers

The final players in the bond market are those who buy the bonds. Buyers basically include every group mentioned as well as any other type of investor, including the individual.

Test Your Understanding 4 : Bond market

Which segment of bond market is traditionally made up of investment banks and other financial institutions that help the issuer to sell the bonds in the market?

A. Purchasers

B. Underwriters

C. Issuers

D. None of them

Features of debt	Features of equity
• High default risk – interest and capital • Minimum servicing of finance per year required – interest • Cheap form of finance • Can be easily accessible	• No default risk for ordinary shares. • Dividends are discretionary • Can be expensive in periods of strong performance • Uptake depends on market conditions and shareholder appetite. Share issues can fail to raise the desired amounts.

6. Other sources of finance

Retained earnings/existing cash balances

An entity can use its current cash balances to finance new investments.

Sale and leaseback

Selling good quality fixed assets such as high street buildings and leasing them back over many years (25+). Funds are released without any loss of use of assets.

Grants

Money that's given to a business for a specific purpose. Whereas a lender wants you to demonstrate your ability to repay the loan, an agency that offers grants wants to see that your business aligns with its mission or a specific initiative.

Debt with warrants attached

A warrant is an option to buy shares at a specified point in the future for a specified (exercise) price. Warrants are often issued with a bond as a sweetener to encourage investors to purchase the bonds.

Convertible debt

Type of bond that the holder can convert into a specified number of shares of common stock in the issuing company or cash of equal value. It is a hybrid security with debt- and equity -like features.

Venture capital

This is finance provided to young, unquoted profit-making entities to help them to expand. It is usually provided in the form of equity finance, but may be a mix of equity and debt.

Business angels

Wealthy individuals who invest personal capital in start-up companies. They invest in return for an equity stake. In other words, when they invest they obtain a percentage ownership of the start-up business.

Test Your Understanding 5 : Other sources of finance

Which TWO of the following are similar to each other?

A. Venture capital and business angels

B. Venture capital and grants

C. Business angels and grant

D. Retained earnings and grant

7. Solutions to Test Your Understanding

Test Your Understanding 1 : Listing

Correct options: C & D

Options C and D are the advantages of listing.

Test Your Understanding 2 : Ex rights

The cum rights price = $5

Issue price = $4

N = 4

Therefore, TERP = [(4 × $5) + $4]/5 = **$4.80**

Test Your Understanding 3 : Security charges

Correct option: A

Floating charge can cover any other assets that are not already subject to fixed charge.

Test Your Understanding 4 : Bond market

Correct option: B

The underwriter segment of bond market is traditionally made up of investment banks and other financial institutions that help the issuer to sell the bonds in the market.

Test Your Understanding 5 : Other sources of finance

Correct option: A

Business angels are similar to venture capitalists.

8. Chapter summary