

Class: MSc

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Chapter: Unit 1 Chapter 5

Chapter Name: Sources of Finance - 2

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1 Introduction



Long-term financing means financing by loan or borrowing for more than one year by issuing equity shares, a form of debt financing, long-term loans, leases, or bonds. It is usually done for big projects, financing, and company expansion.



2 Loan Capital



Loan capital is funding that must be repaid. This form of funding is comprised of loans, bonds, and preferred stock that must be paid back to investors. Unlike common stock, loan capital requires some type of periodic interest payment back to investors for use of the funds.

Features of loan capital:

1. It is conventional to refer to loan capital in units of £100 nominal.
2. It is usual to express the interest payments as a proportion of the par value.
3. It is normal to issue loan capital at a price close to, or just below, par.
4. Almost all loan capital is redeemed at par.
5. Holders of loan capital are creditors of the company and, unlike shareholders, they do not have voting rights.



https://www.business-standard.com/article/markets/5-companies-garner-rs-882-cr-via-non-convertible-debentures-in-april-july-120083100586_1.html

2.1 Variations in Loan Capital

1. Variable Rate Loans

A variable rate loan is a type of loan where the interest changes according to changes in market interest rates. Unlike a fixed-rate loan, where borrowers pay a constant interest rate, a variable rate loan comprises varying monthly payments that change according to the market interest rate changes.

2. Index-Linked Bond

An index-linked bond is a bond in which payment of interest income on the principal is related to a specific price index, usually the Consumer Price Index (CPI).

3. Stepped Bonds

A step-up bond is a bond that pays a lower initial interest rate but includes a feature that allows for rate increases at periodic intervals.

2.2 Rights of bondholders

- The rights of holders of loan capital will be set out in a loan agreement drawn up when the loan is issued.
- In most cases, a trustee is appointed to act on behalf of the loan stockholders. The trustee is normally a corporate body such as a bank or insurance company.
- The legal documentation setting out the obligations of the issuing company to the loan stockholders is known as the Trust Deed.

2.3 Types of loan capital

1. Debentures
2. Unsecured loan stocks
3. Subordinated debt
4. Eurobond loan capital
5. Floating-rate notes
6. Inflation linked bonds

2.3.1 Debentures



Debentures are loans which are secured on some or all of the assets of the company.

This means that, if the company fails to make one of the coupon payments or the capital repayment, various actions are available to the stockholders. They may:

1. appoint a receiver to intercept income from the secured asset(s)
2. take possession of the secured asset to sell it in order to meet their debt.

Features of debentures:

1. Debentures and loan stocks are used to raise large amounts of funds
2. The interest payments are tax deductible (as an expense of the company) – but the debenture holders are creditors of the company and have no right to interfere in its running.

2.3.1 Debentures

There are two types of debenture:

Mortgage debenture
(fixed charge)

• A fixed charge means that there are specific secured assets mentioned in the legal documentation for the mortgage debenture

Floating charge
debenture

• The company can change the secured assets in the normal course of business. For example, it can sell the assets, so long as they are replaced by equally satisfactory assets.

When a company fails to make an interest or capital payment, the debenture holders can apply to the courts to convert the floating charge to a fixed charge.

2.3.1 Debentures

1. Risk:

The main risk that fixed-rate debentures are exposed to is the opportunity cost that a better rate of return may be available elsewhere if interest rates were to increase. The credit risk is the risk that the investor's interest and/or capital are not repaid by the borrower.

2. Return:

Debentures carry the risk that coupon payments or capital repayment may not be made, but the stockholders have security in respect of the secured assets.

The value of all payments – capital and interest – may be eroded by inflation. Debenture stocks may also not be readily marketable. The total return on debentures will reflect all these risks.

3. Marketability:

Marketability of debentures is better than equity but worst than government bonds.

2.3.2 Unsecured loan stocks



With unsecured loan stock there is no specific security for the loan. If the company defaults, the loan stockholders' only remedy is to sue the company.

2.3.2 Unsecured loan stocks

1. Risk:

Since there is no security on loan it is risky.

2. Return:

Gross redemption yields are higher than on debentures to compensate for poorer marketability and greater risk.

3. Marketability:

It is worst than government bonds.

2.3.3 Subordinated debt



In the event of default, the holder of subordinated debt ranks below the firm's general creditors (but ahead of preference shareholders and the ordinary shareholders). The subordinated lender holds a junior debt and is paid after all senior debt holders are satisfied.

2.3.4 Eurobond loan capital



A Eurobond is a debt instrument that's denominated in a currency other than the home currency of the country or market in which it is issued.

Features:

1. Eurobond issues can be made in almost any currency including the euro.
2. Companies throughout the world raise money by issuing Eurobonds.
3. Most Eurobonds are redeemed at par on a set date with fixed coupon payments during the term of the Eurobond. However, coupon payments on Eurobonds are usually made annually rather than six-monthly.
4. Almost all Eurobonds are unsecured.
5. Eurobonds are 'bearer form' documents which means that, to claim interest payments, holders must cut out coupons from the certificates and send them to the company (or its paying agent).
6. Most trading in them occurs through the banks rather than through a stock exchange.
7. Eurobonds are also used to raise large sums – the minimum acceptable issue is \$75m or more.

2.3.4 Eurobond loan capital

1. Risk:

Eurobond is compatible with the risk profile of customers who are willing to take “Very High Risk”. It has higher probability of capital loss compared to Low and Medium Risk level products.

2. Return:

Gross redemption yields depend upon the issuer (and hence risk) and issue size (and hence marketability). Inflation will affect the real return achieved.

3. Marketability:

It is more marketable than debentures but not as much as government bonds.

2.3.4 Example

Bharti Airtel, the world's fourth largest mobile phone company, raised €750 million (around \$1 billion) from European investors in the first Euro corporate bond deal out of India.

Merchant bankers privy to the deal said that the market lapped up the bonds, which have been issued for a five-year period at an effective interest rate of 4.05%.

Bharti Airtel had mandated six banks – Deutsche Bank, JPMorgan, Barclays, UBS Investment Bank, Standard Chartered and BNP Paribas – for its third issue through its wholly owned Bharti Airtel International (Netherlands) BV.

Read more at:

https://economictimes.indiatimes.com/markets/bonds/bharti-airtel-raises-750-million-via-euro-bonds/articleshow/26814020.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

2.3.5 Floating-rate notes



Floating Rate Notes (FRNs) are fixed income securities that pay a coupon determined by a reference rate which resets periodically. As the reference rate resets, the payment received is not fixed and fluctuates overtime.

Features:

1. Floating-rate notes (FRNs) are medium-term debt securities issued in the Euro market whose interest payments 'float' with short-term interest rates, possibly with a stipulated minimum rate.
2. The issuer does not need to estimate the likely levels of future inflation and interest rates when issuing the notes, and the lender does not require an inflation risk premium.

3 Equity



Equity is the amount of capital invested or owned by the owner of a company. The worthiness of equity is based on the present share price or a value regulated by the valuation professionals or investors.

Features:

1. The shareholders are the owners of the business. Shareholders will have voting rights at meetings in proportion to the number of shares held.
2. They will receive 'dividend' payments made from a company's profits. Dividends are not a legal obligation of the company and are only paid at the discretion of the directors.
3. Dividends can be paid net of tax, with an attaching tax credit for the recipient.
4. They hold the equity interest or residual claim since they receive whatever assets or earnings are left over in the business after all its debts are paid.
5. Ordinary shares are almost always irredeemable.



<https://qz.com/india/2088059/why-the-nykaa-ipo-did-better-than-the-paytm-ipo/>

3 Equity

Occasionally some companies issue variations of the basic ordinary share described above. For example:

1. 'deferred' shares
2. redeemable ordinary shares
3. non-voting shares
4. shares with multiple voting rights,
5. 'golden' shares in newly privatised industries.

3 Equity

1. Risk:

The biggest risk in equity investment is the probability of loss of capital and non-guaranteed return.

2. Return:

Ordinary shares offer investors high potential returns for high risk, particularly the risk of capital losses. The dividends should increase with inflation and real growth in a company's earnings.

3. Marketability:

Marketability of ordinary shares varies according to the size of the company but is usually much better than for the loan capital of the same company.

There are three main reasons for this:

- (i) For many companies, the bulk of their capital is in the form of ordinary shares. So issues of ordinary shares tend to be large.
- (ii) Most companies only have one type of ordinary share whereas their loan capital is likely to be fragmented into several different issues.
- (iii) Investors tend to buy and sell ordinary shares more frequently than they trade in loan capital because the residual nature of ordinary shares makes them more sensitive to changes in investors' views about a company.

4 Preference shares



Preference shareholders have a preferential right to either dividends, or return of capital, or both, compared to ordinary shareholders.

Features:

1. Preference shares pay a fixed dividend, and so can be regarded as a form of fixed-interest stock.
2. They do not usually carry voting rights.
3. Dividends do not have to be paid. However, if dividends are not paid on preference shares, no ordinary share dividends can be paid.



https://www.business-standard.com/article/news-cm/indrayani-biotech-allots-9-25-lakh-compulsorily-conver-tible-preference-shares-122051200845_1.html

4 Preference shares

Variations :

- be non-cumulative
- be redeemable
- be participating
- be convertible
- be stepped
- pay variable dividends.

4 Preference shares

Types of preference shares:

1. Cumulative

Cumulative preferred stock is a type of preferred stock with a provision that stipulates that if any dividend payments have been missed in the past, the dividends owed must be paid out to cumulative preferred shareholders first.

2. Irredeemable

Irredeemable preference shares are those preference shares that would NOT be redeemed by a company.

4 Preference shares

1. Risk:

Preference shares provide a fixed income from the dividends which is not guaranteed to ordinary shareholders. Hence, the risk is reduced significantly.

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2. Return:

For all investors, the expected return on preference shares is likely to be less than on ordinary shares because the risk of holding preference shares is less.

3. Marketability:

Marketability of preference shares is similar to loan capital marketability.

5 Convertibles



Convertible forms of company securities are, almost invariably, unsecured loan stocks or preference shares that convert into ordinary shares of the issuing company.

- **Convertible preference shares** are preference shares which give the right to convert into ordinary shares at a later date. The investor does not pay anything to convert other than surrendering the convertible preference shares. For convertible preference shares, the stated rate will be in a similar format to dividends.
- **Convertible unsecured loan stocks** are unsecured loan stocks which give the right to convert into ordinary shares of the company at a later date. The convertible loan stock will have a stated annual interest payment (paid in twice-yearly instalments).

5 Convertibles

- There will be a specified number of ordinary shares for each convertible. The date of conversion might be a single date or, at the option of the holder, one of a series of specified dates.
- At any time, the cost of obtaining one ordinary share by purchasing the required number of convertible securities and converting can be compared with the market price of the share. The difference is known as the **conversion premium**.
- The characteristics of a convertible loan stock in the period prior to conversion are a cross between those of fixed-interest stock and ordinary shares. As the likely date of conversion (or not) gets nearer, it becomes clearer whether the convertible will stay as loan stock or become ordinary shares. As this happens, its behaviour becomes closer to that of the security into which it will convert. This is also the case for convertible preference shares.

5 Convertibles

1. Risk:

There will generally be less volatility in the price of the convertible than in the share price of the underlying equity.

2. Return:

Convertibles generally provide higher income than ordinary shares and a lower income than conventional loan stock or preference shares.

3. Marketability:

Not common in India.

5.1 Warrants



Warrants are call options written by a company on its own stock.

Features:

1. When they are exercised, the company issues more of its own shares and sells them to the option holder for the strike price.
2. The exercise of a warrant leads to an increase in the number of shares that are outstanding. This, in turn, leads to some dilution in the value of the equity.
3. Warrants are often added to the issue of a fixed-interest bond to make it more attractive to investors □ a significant proportion of private placement bonds, are sold with warrants.
4. Warrants are also often given to investment banks as compensation for underwriting services or used to compensate creditors in the case of bankruptcy.
5. The warrant holders are not entitled to vote or receive dividends. But the exercise price of the warrant is automatically adjusted for any share dividends or share splits.

5.2 Options issued by companies

- Warrants issued to senior managers as part of their remuneration package, with strike prices that are intended to represent a performance target for the executive.
- The effect of issuing such instruments is to dilute the value of the equity already in issue.
- Increasingly, firms with significant amounts of warrants (or convertibles) outstanding are required to report earnings on a 'fully diluted' basis. This recognises the potential increase in the number of shares.

6 Winding up a company



ABC Company plc manufactures widgolets for widgets but faces financial strain due to a recession. It has ordinary and preference shares, along with different types of loans: fixed-charge debentures (secured on the factory), floating-charge debentures, and unsecured loan stock. The company struggles to pay interest on unsecured loans while managing a stretched overdraft, trade credit, and hire purchase agreements for machinery. This forces the company to shut down its operations.

Write down the order in which the company will make its payments to the credit holders.