Funding Strategy

Methods of Funding
Introduction

Strategy refers selecting the best out of all the viable options. Hence, funding strategy is determining the best (most suited) funding mechanism which results enhance the value of the business.

Strategies involved with fund management shall cover both short term and long term financing models/mechanisms. In this chapter, we consider the long term funding strategies of an organization.

Sources of Long Term Finance

In a highly competitive business world, company finds itself that cash generated internally from its main operations is insufficient to re-invest in long term projects/investments. Hence, most of the companies seek long term finance from various external sources. Long term finance does refer the funding sources of which maturity period is more than one year. Equity and Debt are the two major sources of long term finance.
Sources of Long Term Finance (Contd.)

Most of these long term finances are required to invest in long term projects including procurement of NCA. It is quite a norm in strategic finance that company should finance its long term assets (assets which generates return in long run/IFRS) with long term finance and vice versa. This concept is called: Hedging.

**Hedging**: period of return on investment should all the time match with the repayment period of finance/funds used in such investment.

- **Perfect hedging**: financing NCA & permanent CA with LT sources as opposed temporary CA with ST sources.
- **Conservative hedging**: financing NCA / permanent CA and some temporary CA with LT sources as opposed some temporary CA with ST sources.
- **Aggressive hedging**: financing NCA / some permanent CA with LT sources as opposed all temporary CA and some permanent CA with ST sources.
Sources of Long Term Finance (Contd.)

As a result of the dramatic structural changes taking place in the capital markets, some of the popular/common long term funding sources available to the organization are as follows.

- Equity capital
- Internal reserves
- Preference share capital
- Debt capital
- Venture capital
Sources of Long Term Finance (Contd.)

Equity Capital
Equity capital represents the capital introduce/contribute by the ordinary shareholders of the company. As a result, they claim the ownership of the company. Since ordinary shares usually does not carries maturity date/period, it will be treated as permanent financing model. But, remember the liability of the S/H will be limited to capital contributed. (other than guaranteed)

Recall the memories of calculating value of equity using book value and market value.

Raising equity capital is obviously easier for the QPC than private companies. Private companies can proceed with private placements/offers. With the intention of financing long term projects and/or float the company on the stock market and/or finance takeover opportunity, the company decides to raise equity capital in many ways.
Sources of Long Term Finance (Contd.)

Raising of funds/finance by means of Equity Capital

- **Placement**: sale of shares directly to one or few known institutional investors through stock exchange with the support of stock brokers. No costs as in IPOs and no need to disclose information to public at large.
- **Stock Exchange Listing**: the process in which company seeks its shares/securities to list in stock exchange. This also called as IPO and quotation. This being treated as first time the company issues shares to the public. Considerable amount of costs will be incurred in this process.
- **Public Offer**: the process in which company offers (invites) its shares to the public at large. This either can do by fixed price offer for sale or offer for sale by tender.
- **Rights Issue**: the process of issuance of shares to the existing shareholders only. The rights issue price (TERP)should be less than MV to attract shareholders. This method will not be costly and preserve the existing control structure.
- **Share Options**: the process of giving certain employees the right to subscribe for new shares in the company at a future date at a price determined now. This also called as ESOP. Simple and effective mechanism since it can also be treated as incentive scheme for employees.
Sources of Long Term Finance (Contd.)

Adjustment to the capital structure without affecting equity capital

- **Bonus Issue:** this also called as script issue and capitalization of reserves. This shall be a kind of book entry in which reserves (revenue) will be capitalized. Both the company and shareholders are benefited.
- **Share Split:** the process in which company split its ordinary share value by predetermined number. This results share price being decreasing and marketability increasing.
- **Share Consolidation:** the opposite of share split in which company consolidate (pooling) its ordinary share value by predetermined number.
- **Scrip Dividends:** the process in which company offers payment of dividend to its shareholders by means of shares instead of cash. This almost same as bonus issue in which reserves converts into shares.
- **Share Repurchases:** the process of repurchasing shares back by the company. This also called as share buy back. There are restrictions in the companies act on this. Company being benefited even it incur cost of repurchasing.
Sources of Long Term Finance (Contd.)

Rights of Equity Shareholder

- **Right to Control**: original shareholders or their nominees (proxy) enjoy rights to vote at AGM. As a result, they will be appointed the board of directors/external auditors as their wish.
- **Right to Income**: bottom line of the company for the particular year ended belongs to ordinary shareholders. After serving third party funding costs, ordinary shareholder can enjoy PAT after (even) eliminating preference dividends. Either shareholder get this physically by means of dividend or accumulate as reserves in the company.
- **Pre-emptive Right**: as law determined, existing ordinary shareholders receives the first opportunity to purchase (pro-rata basis) additional issuance of share capital by the company. This helps to maintain their proportional ownership of the company.
- **Right in liquidation**: even though all the parties including preference shareholders have priority on claim in liquidation, ordinary shareholders still have a right to claim on residual over the assets.
Sources of Long Term Finance (Contd.)

Advantages of Equity Capital

- No maturity date. Hence no requirement of redeemed.
- No compulsory requirement to pay dividends.
- Ability to obtain debt finance since strong capital structure.
- Some tax exemptions to investors encourage more to invest.

Disadvantages of Equity Capital

- Cost of equity funding usually high since shareholders expects high return over high risks.
- No benefits over income tax in payment of dividends.
- Overall costs involved in raising funds at the beginning is high.
- Dilute the ownership when shareholders are selling their shares.
Sources of Long Term Finance (Contd.)

Internal Reserves

- **Retained Earnings**: this usually belongs to the ordinary shareholders and as such it called as internal sources of finance. When closely analyze/observe, you will recognize/realize that retained earnings is the most prominent sources of finance.

  Traditional calculation of growth by using return on equity into retention ratio \( g = rb \) emphasise the importance of retaining some part of profits for the continues growth of the business.

- **Depreciation Charges**: this merely represents a periodic write off of a capital cost incurred in the business. Since it is treated as non-cash expenditure but keep as reserve built internally, it will be an internal sources of finance.
Sources of Long Term Finance (Contd.)

Preference Share Capital

Preference share capital represents hybrid form of finance since it entails characteristics of both equity and debt capital.

Equity:
- Preference dividends pay only out of distributable profits
- Most of the times, preference dividend is not compulsory to pay
- Preference dividend is not a tax-deductible

Debt:
- Rate of Preference dividends is usually fixed
- Preference shareholder has priority of claim over ordinary S/H
- Preference shareholders do not enjoy the right to vote
Sources of Long Term Finance (Contd.)

Preference Share Capital (Contd.)

Many companies issued preference share capital with different verities in order to fulfil different needs.

- **Cumulative and non-cumulative**: preference shares with the ability to claim any unpaid dividends by the company due to making losses is cumulative. If such right not entail, it shall be non-cumulative.

- **Participating and Non-Participating**: the ability of the preference shares to entitle for profits other than dividends is participating and any other shall be non participating.

- **Redeemable and Irredeemable**: when the preference shares has definitive repayment/settlement period, it should be treated as redeemable. If not, it shall be irredeemable.
Sources of Long Term Finance (Contd.)

Preference Share Capital (Contd.)

Advantages of preference share capital
- There is no legal obligation to pay dividends as in debt.
- Preference share capital is treated as part of net worth of the company. (it is not being treated in current practice)
- Since it doesn’t carry voting rights, no dilution of ownership.
- No need of pledging company’s assets as in debt.

Disadvantage of preference share capital
- Expensive sources of finance when compared with debt since dividend is not tax-deductible.
- Even though, no legal obligation to pay dividend; failure to do so will badly affect to the corporate image of the company.
- There is a tendency of having voting power too. (convertible preference shares)
- Preference share holders get priority over claim.
Debt Capital

Most common funding mechanism which basically obtain through borrowings and has a special feature of fixed interest commitment (sometimes, variable).

- Interest should pay regardless whether the company makes profit or not.
- Interest takes first priority over preference/ordinary dividends.
- In the event of liquidation, debt must be settled first.

In general, company obtains debt capital in following sources;

- Financial institutions
- Capital market: issuance of debt securities
Regardless the types of debt instruments the company selected, the fixed interest commitment will be a common feature. However, based on the nature of the obligations involved, debt capital (raising) instruments could be categorized as follows:

- Bonds
- Debentures
- Term Loans
- Leasing
- Hire Purchase
- Convertibles and Warrants

In addition, subprime loan (subordinated/mezzanine) and securitization will also be part of debt capital to certain extent.
Sources of Long Term Finance (Contd.)

Debt Capital (Contd.)

Advantages of debt capital
- Interest on debt capital is tax deductible
- There is no risk/threat of dilution of ownership
- Initial costs of raising funds is lower than other funding mechanism
- Since the rate of interest (commitment) fixed, it provides comfort to manage finance

Disadvantages of debt capital
- Debt increase the financial risk of the company which in turn results increase WACC and decrease value
- Inability to meet repayments can even causes bankruptcy
- Can limit company’s financial and operating flexibility
- Priority over settlement on residual of assets
Sources of Long Term Finance (Contd.)

Venture Capital
Venture capital usually refers participation by way of equity or co-financing through long term convertible debt in selected business/projects. VC is used to finance high risk business models/projects as compared with others (high business risk by nature).

Company seeks VC when it feels that obtaining finance is quite difficult by means of equity or debt due to high risk involvement (uncertainty) of the project/business model. VC takes control over management and involves with all planning due to high risk of the business which in turn carries high risk on money they have invested.

Some of the requirements for which VC might seek/require;
- Expansion or diversification
- Business start up
- Management buy-out
- Leveraged buy-out
Key Determinants: Selecting the Best Long Term Funding Mechanism

- Size and nature of the company’s business
- Gearing position (current)
- Asset base at current
- Overall financial risk
- Overall cost involvement
- Degree of impact to the profitability
- Degree of impact to the dilution of ownership
- Duration of repayment
- Availability of different sources of long term funding mechanisms
- Legal restrictions (BOI requirements)

In addition, 03 macro economic factors will also affect on the decision.
Cost of Funding

All the funding mechanisms discussed in above have their own costs since they are treated as scares (financial) resources. The overall cost of (company’s) capital represents the average costs of each funding sources. In other words, average of the return required/expected by the various investors.

It is a rate at which company must pay financing fee as well as a rate at minimum company must generates return from the project for which funds has utilized.

Cost of capital figure represents following key elements;
- **Risk free rate of return**: return which can be expected from the projects/sources with no default risk. Premium is only for inflation.
- **Premium for business risk**: return expects from the business model/project which entails risk of uncertainty.
- **Premium for financial risk**: return expects at a situation where debt is in excess of equity. (high gearing).
Cost of Funding (Contd.)

In general, cost of equity differs from cost of debt. In other words, return required by the debt holders and shareholders differ. Due to many reasons, return expected by the debt holders is quite low than the return expected by the shareholders. Hence, costs involved in raising debt capital is usually less than equity capital.

Detailed discussion of calculating cost of funding mechanisms including WACC: see capital structure.
Enterprise value and WACC

As we have already studied and understand in our first chapter, main objective of an organization is to maximize its shareholders’ wealth. Enterprise value refers market value of both equity and debt considered together.

Assuming constant pattern of performance over the years, enterprise value could mathematically derived based on EBITDA.

Enterprise value : \([\text{EBITDA}/\text{WACC}]\)

It is clearly evident that enterprise value will eventually enhance when minimizing the WACC while maintaining same pattern over business performance which represents through EBITDA.

Arguably, equity holders will be benefited from enhancement of EV. Hence, you can build the argument: shareholders’ wealth will be maximized when minimizing the WACC.
Business Risk/Financial Risk/Leverage

**Business Risk** : kinds of a natural risk arise based on the nature of the business model/project being undertake. Business models with high level of uncertainty over its operations and revenue streams treated as having business risk.

Many factors affect on (determining) the level of business risk and business risk leads to **operating leverage**. Operating leverage is the degree to which business model/project relies on fixed costs. Higher the fixed costs in overall costs structure; higher the operating leverage. (how well and/or to which extent you can control the business or not)

**Financial Risk** : additional risk arise due to inclusion of debt in overall capital structure. When debt includes in capital structure, equity holders cannot enjoy whole profit and as such additional risks create on them.

Financial risk leads to **financial leverage** of the company. Financial leverage is the degree to which EBIT will be carve out by the cost of debt capital (interest). (overall impact to the profitability)