Chapter Twenty-Two

Sources of Finance

22.0 Introduction

Every business organization requires finance for various reasons.

Firstly, an outlay of money is needed to start up a business. Secondly, after the take-off of business, maintenance of an adequate working capital becomes a necessity. Furthermore, since the intention of every investor is to grow and expand his business, another set of capital outlay would be required. However, the quantum of finance required at any level may vary according to the nature of the business.

It therefore becomes necessary that investors should be familiar with different sources of finance as it may not always be easy for them to provide their financial needs without recourse to external assistance. Broadly speaking, sources of finance are divided into short, medium and long term sources. These are discussed in detail below.

22.1 Short Term Sources

These are sources of finance that are repayable within one year. The funds are usually employed to meet routine financial needs of organizations such as payment of salaries, wages, electricity bills, rents, etc. The quantum of money involved in short term finances are generally small. The bigger an organization is, the more access it would have. This type of fund can be obtained from many sources. However, not all sources are available to all organizations.

It is ideal to finance short term projects with short term funds. The practice promotes maintenance of a healthy working capital.

Common sources of short term funds are:

1. Commercial Paper.
2. Bank Overdraft (Bank Credit)
3. Trade Credit
4. Acceptance Credit
5. Accruals
6. Bills of Exchange
7. Debt Factoring
8. Invoice Discounting
9. Franchising

Commercial Paper

This is a promissory note issued by large firms in order to raise short term funds from the money market. It is often issued by an issuing house, which could be a merchant bank, on behalf of the company. The issuing house also intermediates in finding willing investors and is paid a commission for the service. Commercial papers carry coupon rates while their maturity dates range between 30 and 270 days. Securities and Exchange Commission Decree of 1988 requires any commercial paper whose maturity date exceeds 270 days to be registered with the Securities and Exchange Commission.

Bank Overdraft (Bank Credit)

Commercial banks sometimes extend credits to their customers by allowing them to draw money in excess (to a certain limit) of the balances in their accounts to meet certain needs. However, credit worthiness of customers is ascertained before such overdrafts are granted or collaterals may be demanded. Banks charge interest on overdraft either at prime rate (a little above the bank's base rate) or premium rate (above the prime rate).

Trade Credit

This type of credit allows firms to defer payment for their purchases to a later date. By so doing, the firm uses the fund for other purposes pending the agreed date for payment. Regular customers of firms often avail themselves of this form of fund.

Acceptance Credit (Bankers Acceptance)

This is a form of bill of exchange that is guaranteed by a bank. This implies that a bank accepts to liquidate the debt on maturity should a default occur. The involvement of a bank undoubtedly conveys additional security on the debt instrument in the money market.

Accruals

Due expenditures may sometimes be deferred to a future date while the money meant for that purpose is gainfully employed in other activities. Expenditures often involved in accruals include salaries, rents, wages, electricity bills, etc. The deferment of the expenditure allows the firm further use of the money.

Bill of Exchange

Bill of exchange is defined as unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to bearer.

This arrangement permits the buyer to delay payment, though with the consent of the seller, for a period of time. The period [illegible] covers 30, 60, 90 or 180 days. Through this, the buyer uses the money meant for the payment for other purposes during the period.

Debt Factorimg

This entails the payment of a debt enblock by a factor at the due date instead of a piece meal arrangement. It enables the company access its debts once and therefore provides a reasonable source of finance.

Debt factoring eliminates possibilities of bad debts. The factor (person who pays the debt on behalf of the debtor) is paid a service charge based on turnover. For example, if a buyer is expected to pay his debts over three months in 50%, 30% and 20% installments, a factor may liquidate the entire debt at the first due date.

Invoice Discounting

This is similar to debt factoring except that the factor pays immediately an agreed percentage of the total debt sold to him on behalf of the debtor. The company thereafter collects the debt from its debtor on due dates for the factor. The company also pays interest to the factor.

Franchising

Franchising is an arrangement where a franchisee (someone who wants to use another person's trade name) is allowed by a franchisor (the owner of the trade name) to operate a business under the franchisor's trade name. The franchisor bears substantial part of the cost such as legal costs, marketing costs, establishment costs, architect's cost, etc. The franchisee is often required to make an initial franchise payment for set up costs; thereafter he pays an agreed percentage of his operating profit to the franchisor periodically. By this arrangement, the franchisee is allowed access to a relatively large business outlet on payment of a little initial set up costs.

22.2 Medium Term Sources

Medium term funds are those repayable within a period of 1-5 years. Major sources of these funds include:

i. Project Financing
ii. Venture Capital
iii. Bank Term Loan
iv. Hire Purchase

v. Equipment Leasing
vi. Mortgaging
vii. Sale and Lease-back.

Project Financing

Here, a company or an individual agrees to finance a project considered to be viable enough to offset the costs and make reasonable return on capital employed. The financier is not concerned with the credit worthiness of the borrower but the viability of the project. In other words, the project is seen as a self-liquidating facility where no extra security is required.

Venture Capital

This is capital invested on a new business enterprise with unascertained chances of success. As the name suggests, it is capital provided to enthusiastic entrepreneurs to try their luck on new businesses. Due to the high degree of risk associated with this class of capital, capitalists rarely provide the fund. Common source of venture capital include family members, friends, etc. The capital is often referred to as seed money and provided in stages depending on the nature of the enterprise.

Bank Term Loan

Apart from longer period required for repayment, higher interest rate, more collateral facilities and more rigorous assessment of applicants, bank term loan is similar to bank overdraft. Once the necessary conditions are met, banks show in-depth interest in granting the loan.

Hire Purchase

Bigg and Perrins (1971) define hire purchase as an arrangement where the owner of goods leases them to a person, called the hirer, on the terms that the hirer shall pay to the owner, a numbe installments, until a price has been paid, when the ownership of the goods will either pass automatically to the hirer, or he may exercise an option to purchase them by the payment of a stated sum. The hirer only assumes ownership of the goods after the payment of the last installment or exercise of the option to purchase the goods.

The Hire Purchase Act of 1965 states in part, that where one third of the hire purchase has been paid, the owner (the finance company), cannot repossess the goods without a court's order. Otherwise, following a default of payment for one installment, the owner can take possession of the goods from the hirer.

Hire Purchase is an easy way of obtaining finance especially for machinery and automobile equipment.

Equipment Leasing

This is a contractual arrangement between the owner of an asset (lessor) and another person desirous of using the asset (lessee) in which the lessee is allowed the use of an asset on payment of periodic installments. Unlike in hire purchase, the ownership of the asset remains with the lessor. Leasing is a good source of finance for heavy and expensive equipment.

Types of Lease

Lease is generally divided into:

- Finance Lease
- Operating Lease
- Exploitative Lease

Finance Lease: This is the type of lease that its duration is specified and the cost of maintenance of the equipment or asset rests on the lessee. At the expiration of the period of the lease, the contract may be renewed or discontinued.

Operating Lease: The period of the lease contract is not specified and the responsibility of maintenance of the asset is that of the lessor. However, any of the parties may terminate the contract by giving a notice of unwillingness to continue.

Exploitative Lease: Here, the lessee is allowed to exploit some mineral resources for which royalties are paid to the lessor. Some oil producing countries without developed technologies often engage in exploitative lease for their oil reserves.

Mortgaging

This is a means of borrowing money with the use of freehold property as collateral. Repayment of principal and the interest is usually spread over a long period of time. Insurance and investment companies use this method a lot. In the event of default, the company will resort to the freehold property to recover its money.

Sale and Lease-back

Sometimes, a company that has many heavy equipment may suddenly become illiquid to the extent of not being able to meet its short and medium term obligations. The company may sell one of its assets and thereafter repossess it through a lease arrangement. The method enables such a company to acquire cash from the sale of the asset as well as utilize the same asset, though on payment of agreed rentals.

22.3 Long Term Sources

Long term finances can be raised through these methods:

1. Equity capital
2. Preference shares
3. Debenture stock

Equity Capital

Many companies raise long term funds through issue of shares. Shares could be ordinary, preferred or deferred. Ordinary shareholders have voting rights that are attached to their investments but are not entitled to a fixed dividend rate.

Preferred ordinary shareholders are entitled to a fixed rate of dividend before the ordinary and deferred shareholders. Deferred ordinary shareholders are usually the last to be settled from the profits of the company; hence it is sometimes called founders' shares.

Equity capital can be raised through:
a) Private placement
b) Rights issue
c) Offer for Sale by Subscription.

Private Placement: Here, the shares of the company are offered to specific groups of investors. The group may include insurance companies and institutional investors. The shares are not open to the general public. In practice, the owners and employees of the company may undertake the responsibility of marketing the shares.

Rights Issue: This is a means of offering shares to all existing shareholders in proportion to their share holding in the company. It has the advantage of retaining the ownership structure of the company if all the shares are taken up. This method is sometimes called preemptive right issue, subscription right issue or subscription privilege issue.

Offer for Sale by Subscription: The company offers fresh issues to the public usually through an issuing house. Through this method, ownership structure of the company is diluted by new members.

PREFERENCE SHARES

Holders of preference shares are usually entitled to claims to income inferior to bond holders but superior to that of equity holders. This is why preference shares are generally referred to as hybrid securities. In ordinary terms, the equity holders do not receive dividend until the claims of preference shareholders have been satisfied. While the interest payments on bonds are tax deductible expense, interest payment on preferred stock are not regarded as tax deductible expense.

Characteristics of Preference Shares

Preference shares have the following characteristics

a) **Preference to income:** Preference share holders receive their claims before the equity holders. However, bond holders have priority over the preference share holders. Preference shares could be cumulative, in which case, their dividend could be accumulated and paid at a future date in the event of liquidity problems. It could also be participating preference, where the shareholders are entitled to a fixed dividend income per year plus a further share in any other profits. On the other hand, non cumulative preference shares loose their right to income for the year if the management fails to pay dividend that year.

b) **Right to conversion:** Preference shareholders have the right to convert their stock holdings to common stock.

c) **Voting Rights:** Conventionally, the preference shareholders do not have voting rights. However, if their interest payments have not been made for a number of years, they may be allowed to exercise voting rights during election of new directors.

Merits of preference shares as a source of finance

1. Interest payment on preference shares may be deferred to another year when earnings are not adequate to settle it. In other words, the charge on the firm can be shifted to a more convenient period.
2. Generally, earnings on preferred stock are less than that of equity holders.
3. Firms usually mortgage their assets to bond holders, but that is not the case with preference shares.
4. Preference shareholders have prior claim to the assets of the firm than the equity stock holders.

Demerits of preference shares as a source of finance

1. Issue costs of preference shares are higher than that of bonds.
2. Unlike bonds, interests on preference shares are not tax deductible.

Debenture Stock

These are generally referred to as long term loans. Debenture denotes a document which shows the indebtedness to a company.

Debentures may be secured or unsecured. They are unsecured when the holders have no lien on any asset of the company. This makes unsecured debentures very risky. However, people engage in unsecured debentures due to high returns on investment often associated with it.

Secured debentures are subdivided into:

i. Floating charge
ii. Fixed charge
iii. Hybrid charge

Floating Charge: A debenture is said to have a floating charge when the charge covers all the assets of the company but excluding any asset on fixed charge. In the event of default, the holder of a floating charge has rights over all the assets of the company without a fixed charge.

Fixed Charge: A debenture with a fixed charge is secured on one or more specific assets. In the event of failure to pay the required interest and principal, a receiver may be appointed to dispose the asset or assets so secured to the benefits of the debenture holders.

Hybrid Charge: This combines the features of floating and fixed charges. In other words, part of the loan may be secured to some specific assets of the company while the remaining part may be secured on other assets.

Debentures may also be redeemable or irredeemable. A debenture is redeemable when its date for redemption is specified. It is usually written in the form of a range e.g. June 2014 - June 2020.

It is irredeemable when no date is fixed for redemption, though the borrower can redeem the debt whenever convenient and thereafter settle with the debenture holder.

Advantages of using Debentures for Financing

1. **Cost savings:** Issue costs of debentures (investiga-tion, underwriting, etc) are much less than that of equity stock. Again, interest payments on debentures are tax deductible.
2. **Retention of ownership structure:** The use of debentures to raise funds does not distort ownership structure of firms unlike equity stock.
3. **Maintenance of capital structure:** Firms that are over-capitalized through leverage, can rectify it when debentures mature. This means that debentures can be used to adjust capital structure according to the needs of the company.
4. **Preferred in depressed economy:** Debentures are generally preferred in depressed economy to equity stocks. Investors have more confidence on the margin of safety for debentures than equity stocks whenever the economy is in a state of recession. Again, it is more difficult to sell common stock during recession.

Disadvantages

1. **It attracts a fixed charge:** The debenture holders are entitled to fixed charges, which must be paid whether the firm makes reasonable earnings or not. Dividend payments are usually suspended in common stock financing are usually suspended when corporate earnings decline.
2. **Redemption of Debentures:** Once debentures mature, funds must be made available for their redemption. Sometimes, the maturity dates could be when the firms are in financial difficulty.

22.4 Determinants of Corporate Choice of Finance

1. **Cost of the Finance:** Every finance has an associated cost. In choosing source of finance, companies consider the costs to be incurred in the process as this will affect the weighted average cost of capital (WACC).

2. **Duration of the project:** One of the golden rules in financial management is that long term projects should be financed from long term sources and vice versa. This is important because if repayment of the finance becomes due before the project begins to yield revenue, the company might find repayment difficult.

3. **Degree of risk:** High level risk projects require equity financing, since the use of other debt instruments with high interest rates and capital repayment would further heighten the risk.

4. **Ownership structure:** If shareholders do not want dilution of their ownership structure, they would prefer meeting their financial needs through retained earnings or right issues. Other external sources may directly or indirectly result in loss of control especially as some creditors may take charges on assets or secure restrictions on the company in other ways.

5. **Future need for finance:** Some projects require capital at different stages in addition to the initial amount. When this is the case, the use of convertible loan stocks is advocated.