CARL VON OSSIETZKY universität OLDENBURG
FAKULTÄT II
FINANCE AND BANKING

Introduction to Corporate Finance: Introduction to Long-Term Financing

Readings:

Hillier et al., Chapter 14

Overview of Lecture

- Ordinary Shares
- Corporate Long-Term Debt: The Basics
- Preference Shares
- Patterns of Financing
- Hierarchies in Long-Term Financing
- Islamic Financing

Financing in the News

Wolfsburg, 2010-04-14

Volkswagen Aktiengesellschaft successfully completes its capital increase 2010

Volkswagen Aktiengesellschaft has successfully completed its capital increase. 99.30% of the subscription rights were exercised which resulted in 17,382,798 new preference shares having been subscribed for at the subscription price of EUR 65 per new preference share. These were subscription rights which had not been assigned to the Global Coordinators BofA Merrill Lynch, Citi, Deutsche Bank, HSBC Trinkaus and J.P. Morgan prior to the capital increase.

The remaining 122,081 new preference shares, which were placed with qualified institutional investors subject to claw-back on March 26, 2010 and for which subscription rights were not exercised, will now be delivered to these investors.

In total 64,904,498 new preference shares were placed in connection with the capital increase at the subscription price of EUR 65 per new share. The net proceeds for the company amount to approximately EUR 4.1 billion.

“We would like to thank our shareholders for this impressive sign of confidence in the successful course of our company. With the successful capital increase Volkswagen strengthens its solid financial basis, which is an important prerequisite for the successful implementation of our mid-term strategy. Our long-term goal remains to become the economically and ecologically leading automotive group worldwide by 2018”, says CEO Prof. Dr. Martin Winterkorn.

Source: http://www.volkswagenag.com/vwag/vwcorp/info_center/en/news/2010/04/Bezugspreis.html

Ordinary Shares

- Par and No Par Shares
- Authorised vs Outstanding Shares
- Retained Earnings
- Market Value, Book Value and Replacement Value
- Shareholders' Rights and Classes of Shares
- Dividends

Ordinary Shares

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NORSK HYDRO ASA Equity Share Capital December 31,2007 (in millions Norwegian Krone)	
Ordinary Share Capital	1,370
Additional Paid in Capital	360
Other Reserves	(1,348)
Retained Earnings	57, 950
Treasury Stock	(4,283)
Total Equity	54,049

Example 14.1: Par Value and Additional Paid in Capital

Suppose 100 shares of equity have a par value of £2 each and are sold to shareholders for £10 per share. What is the total additional paid in capital and total par value?

⇨ Additional paid in capital = (£10 - £2) x 100 = £800
Total par value = £2 x 100 = £200

What difference does it make if the total capital contribution is reported as par value or additional paid in capital?

⇨ The par value is locked in and cannot be distributed to shareholders except upon the liquidation of the corporation

Example 14.2: Equity Accounting

- Suppose Louest Rouge plc was formed in 1910 with 10,000 shares of equity issued with each share valued at £1 par value. Because the shares were sold for £1, the first balance sheet showed a zero amount for capital surplus. By 2009, the company had become very profitable and had retained profits of £100,000. The shareholders’ equity of Louest Rouge in 2009 is as follows:

Louest Rouge plc Equity Accounts 1 January 2009	**£**
Ordinary shares; par £1; 10,000 shares outstanding	10,000
Additional paid-in capital	0
Retained earnings	100,000
Total shareholders’ equity	110,000

$$\text{Book value per share} = \frac{£110{,}000}{10{,}000} = £11$$

Example 14.2: Equity Accounting

- Suppose the company has profitable investment opportunities and decides to sell 10,000 shares of new equity. The current market price is £20 per share. What is the effect of the sale of shares on the balance sheet?

Louest Rouge plc Equity Accounts 31 December 2009	**£**
Ordinary shares, £1 par, 20,000 shares outstanding	20,000
Additional paid-in capital (£20 – £1) × 10,000 shares	190,000
Retained earnings	100,000
Total shareholders' equity	310,000

$$\text{Book value per share} = \frac{£310,000}{20,000} = £15.5$$

Shareholders’ Rights

Share in dividends	Share in net assets in liquidation
Vote	Share in new equity issued (pre-emptive right)

Corporate Long-Term Debt: The Basics

Interest vs dividends

Is it debt or equity?

Basic features of long term debt

Different types of debt

Repayment

Seniority

Security

Indenture

Long-Term Debt Example: Siemens

Status	Currency	Notional amount (mln.)	Coupon	Issuance	Maturity	Issuer
Senior Unsecured	EUR	1550	5.25%	11.06.2008 Tap: 28.08.2008	12.12.2011	SFM
Senior Unsecured	USD	750	5.5%	16.08.2006	16.02.2012	SFM
Senior Unsecured	USD	500	3M US$ Libor + 0.15%	16.03.2006	16.03.2012	SFM
Senior Unsecured	EUR	2000	4.125%	20.02.2009	20.02.2013	SFM
Senior Unsecured	EUR	1000	5.375%	11.06.2008	11.06.2014	SFM
Senior Unsecured	USD	500	5.625%	16.03.2006	16.03.2016	SFM
Senior Unsecured	USD	1750	5.75%	16.08.2006	17.10.2016	SFM
Senior Unsecured	EUR	2000	5.125%	20.02.2009	20.02.2017	SFM
Senior Unsecured	EUR	1600	5.625%	11.06.2008 Tap: 28.08.2008	11.06.2018	SFM
Senior Unsecured	USD	1750	6.125%	16.08.2006	17.08.2026	SFM
Subordinated, unsecured	EUR	900	Until 14.09.2016: 5.25% Thereafter: 3M Euribor + 1.25% + 1% step-up	14.09.2006	14.09.2066 Optional redemption: 14.09.2016	SFM
Subordinated, unsecured	GBP	750	Until 14.09.2016: 6.125% Thereafter: 3M Euribor + 1.25% + 1% step-up	14.09.2006	14.09.2066 Optional redemption: 14.09.2016	SFM

SFM = Siemens Financieringsmaatschappij N.V., The Netherlands

Source: http://www.siemens.com/investor/en/debts_ratings/bonds.php

Preference Shares

Stated value

Cumulative and non-cumulative dividends

Are preference shares really debt?

Equity vs Debt

Equity versus Debt

Feature	Equity	Debt
Income	Dividends	Interest
Tax status	Dividends are taxed as personal income. Dividends are not a business expense.	Interest is taxed as personal income. Interest is a business expense, and corporations can deduct interest when computing corporate tax liability.
Control	Ordinary shares usually have voting rights.	Control is exercised with loan agreement.
Default	Firms cannot be forced into bankruptcy for non-payment of dividends.	Unpaid debt is a liability of the firm. Non-payment results in bankruptcy.

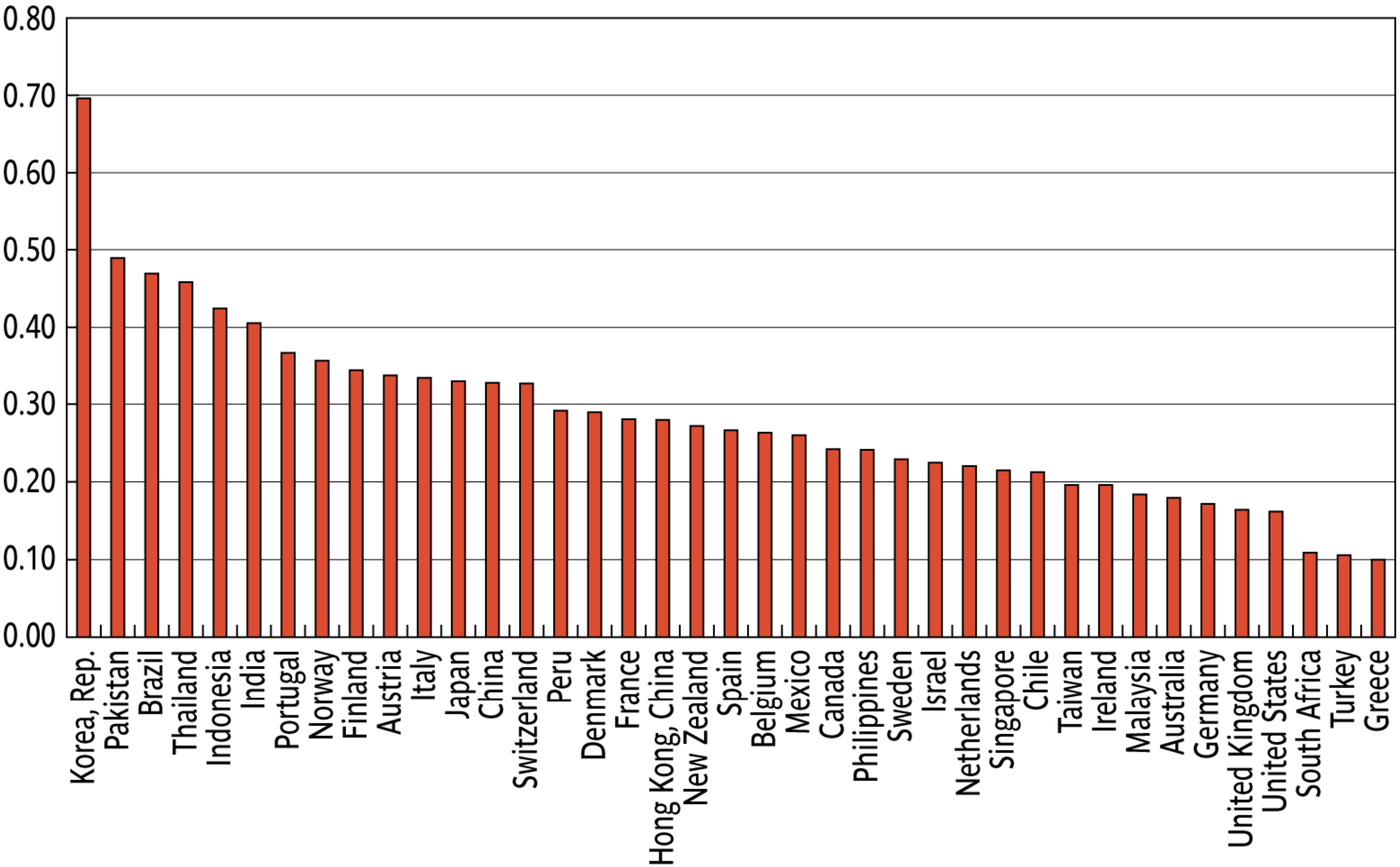
Bottom line: Tax status favours debt, but default favours equity. Control features of debt and equity are different, but one is not better than the other.

Patterns of Financing

Source of capital	Germany	Japan	United Kingdom	United States
Internal	78.9%	69.9%	93.3%	96.1%
Bank finance	11.9%	26.7%	14.6%	11.1%
New security issues and other	9.2%	3.4%	–7.9%	–7.2%

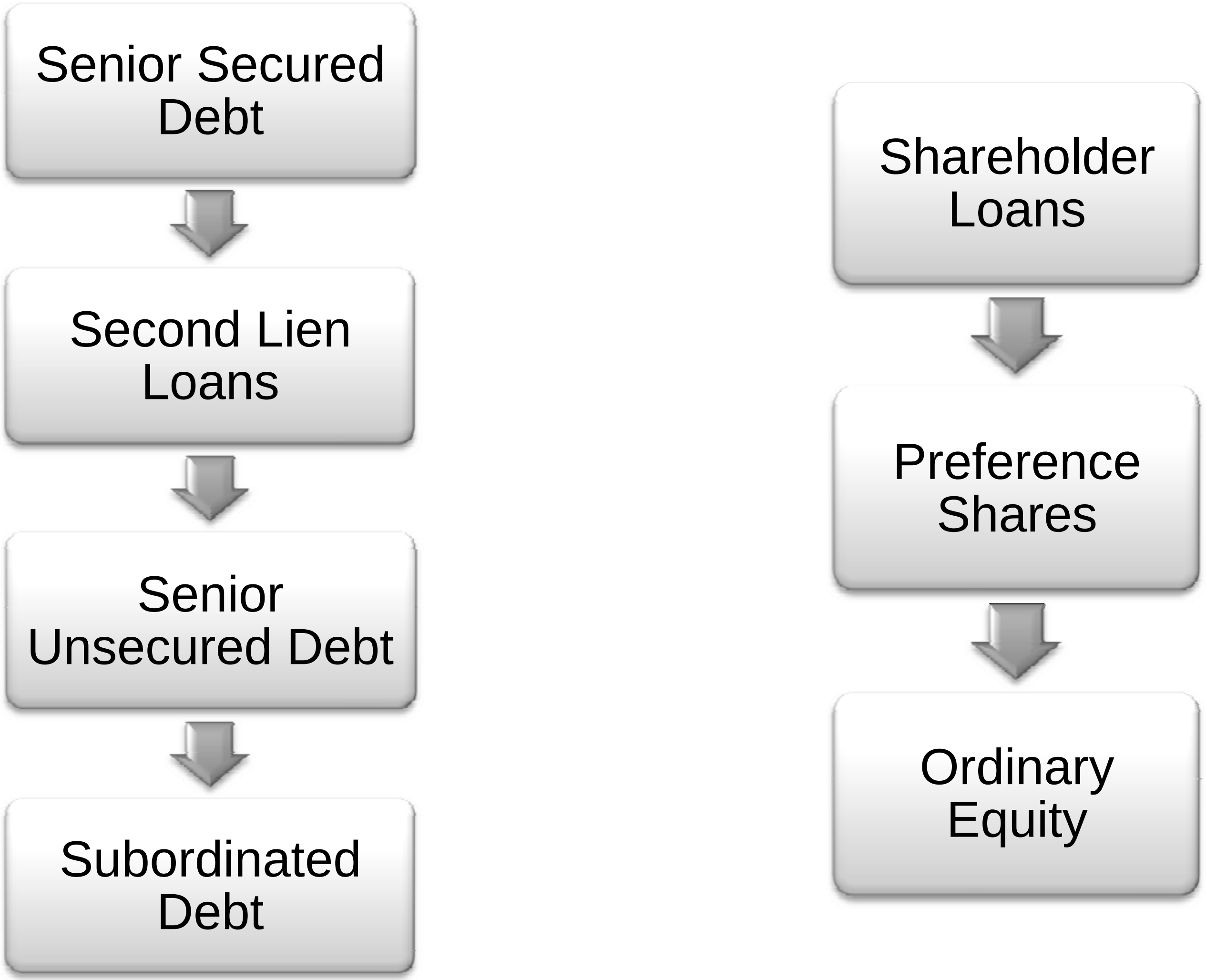
Source: Jenny Corbett and Tim Jenkinson, 'How is investment financed? A study of Germany, Japan, the United Kingdom, and the United States', *The Manchester School*, vol. 65 (1997), pp. 69–93.

International Patterns in Capital Structure



Source: J.P.H. Fan, S. Titman and G. Twite, 'An international comparison of capital structure and debt maturity choices', Working Paper (2006).

Hierarchies in Long-Term Financing



Digression: Islamic Financing

- Muslim people and Muslim companies face special investment and financing problems, because
  – charging interest on a financial instrument,
  – investing in “unethical” assets, and
  – “gambling”

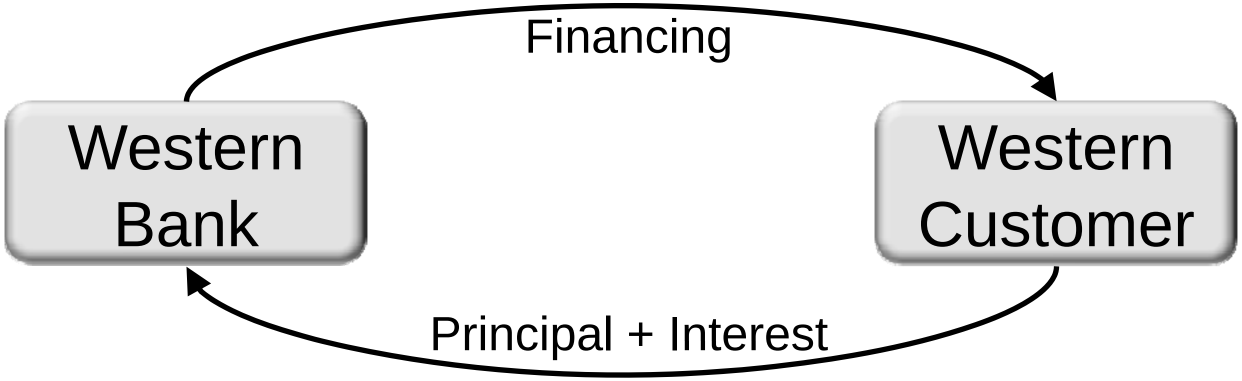
  are not consistent with Islamic (or Shariah) principles.

- Thus, there is a need (i.e., a market) for Shariah compliant financial instruments that do not involve these elements.

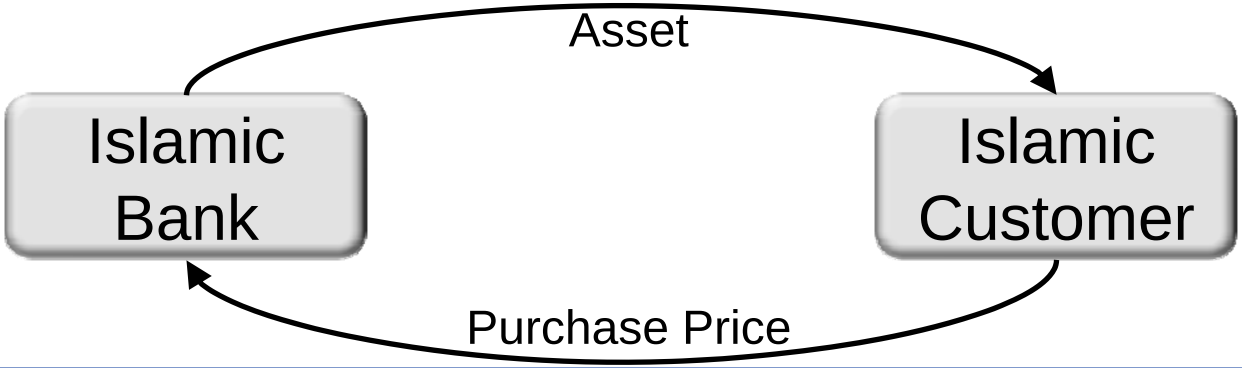
- Recently, Western banks increased their efforts in developing such instruments.

Digression: Islamic Financing

- Western banks typically exchange “money for money”:



- Islamic bank transactions are typically backed by assets:



Digression: Islamic Financing

- Among the instruments developed in this context are:

Advance Payment Sale	Stated Cost plus Profit	Goodwill Loan
Hire Purchase	Joint Venture	Leasing
Profit Sharing	Safe-keeping	Sale and Buyback

Digression: Example 14.5: Stated Cost Plus Profit (Murabaha)

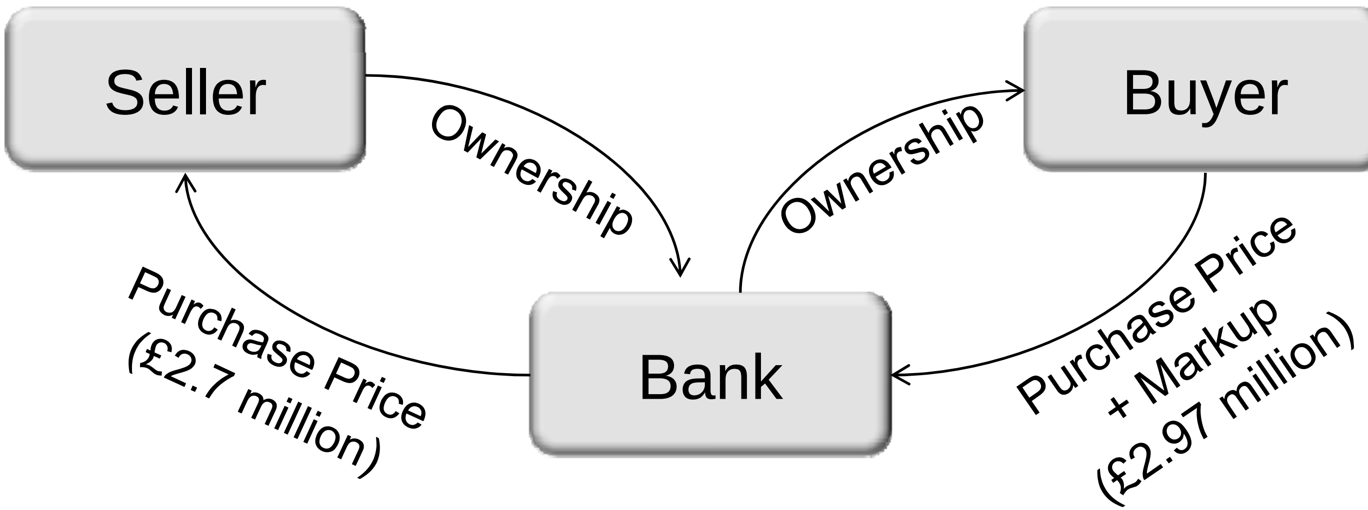
- Shukran plc is undertaking a new warehouse expansion and has commissioned a company, Temsaah ltd, to build it on the site of an existing warehouse. Temsaah need cash equaling the construction costs of £2.7 million today to finance the building of the warehouse. Unfortunately, Shukran does not have the funds in place. The CEO of Shukran goes to Bahrain Bank and enters into a Murabaha transaction.

- Bahrain Bank agrees to pay £2.7 million today to Temsaah and notifies Shukran's CEO of the cost. Given market conditions, with comparable loans currently at 10 percent, the manager of Bahrain bank enters into an agreement with the CEO of Shukran to charge a markup of £270,000 on the building to be paid in one year. This markup of 10 percent makes the Murabaha contract competitive with Western financing deals.

- In this transaction, Bahrain Bank owns the warehouse until the date of the trade. In one year, Bahrain Bank sells the warehouse for £2,970,000 (£2,700,000 cost plus £270,000 markup) and the transfer of title deeds to Shukran takes place at that date.

Digression: Example 14.5: Stated Cost Plus Profit (Murabaha)

- Deal structure:



Digression: Example 14.4: Advance Payment Sale (Bai Salam)

- Shukran plc is undertaking a new warehouse expansion and has commissioned a company, Temsaah ltd, to build it on the site of an existing warehouse. The warehouse with full facilities will take one year to build and the price of the new warehouse will be £3,000,000 in one year.

- In a Bai Salam sale, Shukran may pay £2.7 million today for the warehouse (fully specified at the time of the contract) to be ready for use exactly one year from the date of the trade.

- So, both companies lock in the price for the item to be delivered. Moreover, Temsaah ltd receives the money immediately and may use it to invest or to cover other financial obligations.

Digression: Example 14.7: Sale and Buyback (Bai’ al-inah)

- Shukran plc needs £2,700,000 to undertake a new warehouse expansion. They approach an Islamic bank who agrees to participate in a Bai’ al-inah agreement.

- In this transaction, the bank sells a building today to Shukran for £3,000,000 to be paid in one year. Immediately, the bank buys the building back for £2,700,000 today.

- In this transaction, Shukran now has £2,700,000 but must pay £3,000,000 to the bank in one year. This is very similar to a one year loan but the crucial thing is that a real asset and not money is driving the payments. This is acceptable under Islamic law.

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