Sources of Long Term Finance

The Sources of Long Term Finance are those sources from where the funds are raised for a longer period of time, usually more than a year. Long term financing is required for modernization, expansion, diversification and development of business operations.

Generally, the companies resort to the sources of long-term finance when they have an inadequate cash balance and need capital to carry out its operation for a longer period of time.

Objectives of Long-term Financing

- To purchase new asset or equipment
- To finance the permanent part of the working capital
- To enhance the cash flow in the firm
- To invest in R&D operations
- To construct or build new construction projects
- To develop a new product
- To design marketing strategies or increase facilities
- To expand business operations

The long term financing could be done internally, i.e. within the organization or externally, i.e. from outside the organization.

Internal Sources of long-term finance

1. Retained Earnings

A new company can raise finance only from external sources such as shares, debentures, loans etc. But, an existing company can also generate finance through its internal sources, i.e., retained earnings or ploughing back of profits. When a company does not distribute whole of its profits as dividend but reinvests a part of it in the business, it is known as ploughing back of profits or retention of earnings. This method of financing is also known as self-financing or internal financing.

Ploughing back of profits is made by transferring a part of after tax profits to various reserves such as General Reserve, Reserve Fund, Replacement Fund, Dividend Equalization Fund etc. Such retained earnings may be utilized to fulfill the long-term, medium-term and short-term financial requirements of the firm.

Advantages

1. It is the cheapest method of raising capital

2. It has no specific cost of capital

3. It increases the net worth of business

4. There is no dilution of control of present owners

5. It does not require any pledge, mortgage etc. like other loans.

6. It provides required capital for expansion and development.

7. Firms do not need to depend on lenders or outsiders if retained earnings, are readily available.

8. It increases the reputation of the business.

Disadvantages

1. It may lead to cause of dissatisfaction among the shareholders as they receive-a low rate of dividend.

2. Management may fail to properly use the profits retained.

3. Ploughing back or reinvestment of profit means depriving the shareholders a portion of the earning of the company. As a result, share price may come down in the market.

4. It may lead to over-capitalization because of capitalization of profits.

External Sources of Long Term Finance

1. Equity-Shares

Equity Shares, also known as ordinary shares, represent the ownership capital in a company. The holders of these shares are the legal owners of the company. They have unrestricted claim on income and assets of the company and possess all the voting power in the company.

In fact, the foremost objective of a company is to maximise the value of its equity shares. Being the owners of the company, they bear the risk of ownership also. They are entitled to dividends after paying the preference dividends. The rate of dividend on these shares is not fixed and depends upon the availability of divisible profits and the intention of the directors.

They may be paid a higher rate of dividend in times of prosperity and also run the risk of no dividends in the period of adversity. Similarly, when the company is wound up, they can exercise their claim on those assets which are left after the payment of all other claims including that of preference shareholders.

Advantages

1. It is one of the most important long-term sources of funds.
2. There are no fixed charges attached to ordinary shares. If a company earns enough divisible profits it will be able to pay a dividend but there is no legal obligation to pay dividends.
3. Equity share capital has no maturity date and hence the company has no obligation to redeem.
4. The firm with the longer equity base will have greater ability to raise debt finance on favorable terms. Thus issue of equity share increases the creditworthiness of the firm.
5. Dividend earnings are exempted from tax in the hands of investors. However, the company paying equity dividend will have to pay tax on it.

6. The equity shareholders enjoy full voting right and participate in the management of the company.

7. The company can issue further share capital by making right issue or bonus issue etc.

8. If the company earns more profit, more dividend is paid. So the value of goodwill of the company increases, It ultimately leads to appreciate the market value of equity shares of the company.

9. In India, returns from the sale of ordinary shares in the form of capital gains are subject to capital gains tax rather than corporate tax.

Disadvantages

1. Dividends payable to ordinary shareholders are not deductible as an expense for the purpose of computation of tax but debenture interest is tax deductible. So, the cost of equity capital is usually higher than other source of funds. Further, the rate of return required by equity shareholders is higher than the rate of return required by other investors.

2. The company has no statutory obligation for the payment of dividend on equity shares. So, the risk of getting the dividend by the equity shareholders is very high. They may get higher rate of dividend or lower rate of dividend or no dividend at all.

3. The issue of new equity shares to outsiders dilutes the control of existing owners. So small firms normally avoid equity financing as they may not like to share control with outsiders.

4. The problem of over-capitalization may arise because of excess issue of equity shares.

5. trading on equity is not possible, if the entire capital structure is composed of equity shares.

6. Unlike debenture holders, equity shareholders do not get fixed rate of return on their investment. So the investors expecting regular flow of permanent income are not interested to invest equity shares.

2. Preference Shares

Preference share capital is another source of long-term financing for a company. As the name suggests, these shares carry preferential rights over equity shares both regarding the payment of dividend and the return of capital. These shares carry a fixed rate of dividend and such dividend must be paid in full before the payment of any dividend on equity shares. Similarly, at the time of liquidation, the whole of preference capital must be paid before any payment is made to equity shareholders.

These are shares which carry the following two rights:

(i) The right to receive dividend at a fixed rate before any dividend is paid on other shares.

(ii) The right to return of capital in the case of winding-up of company, before the capital of the equity shareholders is returned.

Long-term funds from preference shares are raised by a public issue of shares. It does not require any security nor ownership of a firm is affected. It has some characteristics of equity capital and some of debt capital. It resembles equity as preference dividend, like equity dividend is not tax deductible payment.

Advantages

1. The company can raise long-term funds by issuing preference shares.
2. Preference shareholders normally do not carry voting right. Hence, there is no dilution of control.
3. There is no legal binding to pay preference dividend. A company will not face any legal action if it fails to pay dividend.
4. There is no take-over risk. The shareholders become sure of their dividend from such investment.
5. There is a leveraging advantage since it has fixed charges.

6. Preference share capital is generally regarded as part of net worth. Hence it increases the creditworthiness of the firm.

7. Assets are not secured in favour of preference shareholders. The mortgageable assets of the company are freely available.

8. Preference shareholders enjoy the preferential right as to the payment of dividend and return of capital.

Disadvantages

1. The dividend paid to preference shareholders is not a tax deductible expense. Hence it is a very expensive source of financing.

2. Preference shareholders get voting right if the company fails to pay preference dividends for a certain period.

3. Preference shareholders have preferential claim on the assets and earnings of the firm over equity shareholders.

3. Debentures

Debentures are one of the frequently used methods by which a company raises long-term funds. Funds acquired by issue of debentures represent loans taken by the company and are also known as 'debt capital'. A debenture is a certificate issued by a company under its seal acknowledging a debt due by it to its holders. In USA there is a distinction between debentures and bonds. There, the term bond refers to an instrument which is secured on the assets of the company whereas the debentures refer to unsecured instruments.

But, in India no such distinction is made between bonds and debentures and the two terms are used as synonymous. According to Section 2 (30) of the Companies Act, 2013, "the term debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not."

Debenture holders are the creditors of the company. They have no voting rights in the company. Debenture may be issued by mortgaging any asset or without mortgaging the asset, i.e., debentures may be secured or unsecured.

Interest on debenture is payable to debenture holders even when the company does not make profit. The cost of debenture is very low as the interest payable on debentures is charged as an expense before tax.

Advantages

1. The cost of debenture is much lower than the cost of equity or preference share capital since interest on debenture is a tax-deductible expense.

2. There is a possibility of trading on equity (i.e., greater return on equity capital can be given, if the company is able to earn higher rate of return than the fixed rate of interest paid to the debenture holders.)

3. There is no dilution of control of the company by the issue of debentures. As the debenture holders have no voting rights, so the issue of debenture does not affect the management of the company.

4. Interest on debenture is a charge against profit. It is an admissible expense for the purpose of taxation. Hence; tax liability on the company's profits is reduced which result in the debentures as a source of finance.

5. Investors prefer debenture investment than equity or preference investment as the former provides a regular flow of permanent income.

6. During inflation, debenture issue is advantageous. The fixed monetary outgo diminishes in real terms as the price level rises.

7. Debentures are secured on the assets of the company and, therefore, carry lesser risk and assured return on investment.

8. At the time of winding-up, the debenture holders are placed before the equity or preference share capital providers.

9. Debentures can be redeemed when a company has surplus fund.

Disadvantages

1. The cost of issuing debentures is very high because of higher rate of stamp duty.

2. Debenture financing involves fixed interest and principal repayment obligation. Any failure to meet these obligations may paralyze the company's operations.

3. Debenture financing increases the financial risk of the company. This will, in turn increase the cost of capital.

4. Trading on equity is not always possible.

5. There is a limit to the extent to which funds can be raised through long-term debt.

6. The debenture holders are treated as creditors of the company. They have no voting rights of the. Company so the debenture holders become less interested in the affairs of the company.

4. Loans from Financial Institutions

Financial Institutions are another important source of long-term finance. In India, a number of special financial institutions have been established by the Government at the national level and state level to provide medium-term and long-term loans to the industrial undertakings.

Financial institutions established at the national level include Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Reconstruction Corporation of India (IRCI), Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC) etc.

Financial institutions established at the state level include State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs). For example, In Haryana, Haryana

State Financial Corporation (HFC) and Haryana State Industrial Development Corporation (HSIDC) have been established.

Characteristics

1. Maturity – Maturity period of term loans provided by Financial Institutions ranges between 6 to 10 years.

2. Direct Negotiation – Terms and conditions of such loans are directly negotiated between the borrower and the financial institution providing the loan.

3. Security – Such loans are always secured. While the assets financed by loans serve as primary security, all the present as well as the future immovable assets of the borrower constitute secondary security.

4. Restrictive Covenants – To protect their interests the financial institutions impose a number of restrictive terms and conditions. These are called covenants. These covenants may be in respect of maintaining a minimum current ratio, not to create further charge on assets, not to sell fixed assets without the lender's approval, restrain on taking additional loan, reduction in debt-equity ratio by issuing additional shares etc.