R29 Sources of Capital

Version 1.0

1. Introduction

Companies have multiple short-term and long-term financing choices. Short-term funds without explicit interest rates are part of working capital management, for example: accounts payable. The goal of effective working capital management is to ensure that a company has adequate ready access to the funds necessary for day-to-day operating expenses.

Long-term funds raised through other debt and equity obligations are part of the firm's capital structure. The goal of effective capital structure management is to balance the risks and costs of the firm's long-term finances.

This reading covers:

- Internal and external sources of capital
- Primary and secondary sources of liquidity
- Evaluating a company's liquidity position
- Evaluating the short-term financing choices available to a company

2. Corporate Financing Options

Exhibit 1 from the curriculum shows the main internal and external sources of capital for a company.

Internal	**External**		
	Financial intermediaries	**Capital markets**	**Other**
• After-tax operating cash flows • Accounts payable • Accounts receivable • Inventory & marketable securities	• Uncommitted lines of credit • Committed lines of credit • Revolving credit • Secured loans • Factoring	• Commercial paper • Public & private debt • Hybrid securities – preferred equity, convertibles • Common equity	• Leasing

Large profitable companies often use internal financing as the primary source of funds for financing growth.

2.1 Internal Financing

Companies can generate internal financing from short-term operating activities in many ways such as:

- Generating more after-tax operating cash flows.
- Increasing working capital efficiency, e.g., by shortening the asset conversion cycle.
- Converting liquid assets to cash, e.g., by selling inventories.

Some important terms related to internal financing are:

- **Operating cash flows**: Calculated as 'net income + depreciation – dividends.' This is the cash available for investment after interest, tax, and dividend payments are made. Companies with high, relatively stable after-tax operating cash flows have a greater ability to use internal financing.
- **Accounts payable**: Represents amounts due to suppliers of goods and services. They often have associated trade credit terms. For example, the terms '2/10 net 30', mean that if the payment is made within 10 days, the company will get a 2 percent discount else the entire payment must be made within 30 days.
- **Accounts receivables**: Represents amounts owed by customers. They can be thought of as being the opposite of accounts payables. The sooner the company can collect its accounts receivables, the lesser the need to use other sources to finance operations.
- **Inventory**: Represents goods waiting to be sold. Since holding inventory costs money, efficient companies try to hold as little inventory as necessary and sell it as quickly as possible.
- **Marketable securities**: Represents financial instruments such as stocks and bonds, that can be sold quickly and converted to cash. Companies invest in marketable securities to earn a higher rate of return as compared to simply holding cash.

2.2 Financial Intermediaries

Financial intermediaries can include both bank or non-bank lenders. The main type of financing options available through these sources are:

- **Uncommitted lines of credit** – They are the least reliable form of bank borrowing. The bank can refuse to honor the request to use the line. An uncommitted line is therefore very unstable.
- **Committed lines of credit** – Also called regular lines of credit, they are more reliable than uncommitted lines. The bank makes a formal commitment to honor the line of credit. The interest rate charged is usually the bank's prime rate or a money market rate plus a spread that depends on the borrower's creditworthiness. Banks typically also charge a commitment fee e.g., 0.50% of the full amount or the unused amount of the line.
- **Revolving credit agreements (Revolvers):** They are the most reliable form of short-term bank borrowing. They involve formal agreements similar to those used for regular lines of credit. Revolvers differ from regular lines in two ways (1) they are in effect for multiple years and (2) they are often used for much larger amounts.

- **Secured (“asset-based”) loans**: The options discussed above are unsecured loans. Secured loans are loans in which the lender requires the company to provide collateral in the form of an asset. For example, a company can use its accounts receivables as a collateral to generate cash flows through the ‘assignment of accounts receivable’.

  A company can also sell its accounts receivables to a lender, typically at a substantial discount. This is called a factoring arrangement. In an assignment arrangement, the company retains the collection responsibilities, whereas in a factoring arrangement, the company shifts the collection responsibilities to the lender.

Web-based lenders and non-bank lenders are recent innovations that operate primarily on the internet. They typically offer loans in relatively small amounts to small businesses in need of cash.

2.3 Capital Markets

Commercial paper: Is a short-term, unsecured instrument typically issued by large, well-rated companies. It has maturities typically ranging from a few days to 270 days.

Debt vs. equity financing: The main differences between debt and equity obligations are summarized in Exhibit 2 of the curriculum.

	Debt	**Equity**
Legal Agreement	Company has a contractual obligation to debtholders	Shareholders are residual owners of the company
Claim Priority	Debtholder interest and principal payments have priority	Residual claimants to distributions and corporate assets
Distributions	Periodic, contractual interest payments and repayment of principal at maturity	Discretionary dividend payments declared by the Board of Directors
Taxation (some variation across jurisdictions)	Interest payments are tax-deductible expenses	Dividend payments and share repurchases are not tax-deductible expenses
Term	Stated term to maturity	No finite term
Voting Rights	Generally, no voting rights	Voting rights
Cost to Company	Generally lower cost to company	Generally higher cost to company
Investor Risk	Generally lower risk to investors	Generally higher risk to investors

Long-term debt: Has a maturity of at least one year. Notes have maturities from one to ten years, and bonds have maturities of at least ten years.

Common equity: Represents ownership in a company. It is considered a more permanent source of capital.

Preferred equity: Are hybrid securities that have the characteristics of both bonds and common equity.

Other hybrid securities: Convertible debt and convertible preferreds are hybrid securities issued by companies and are convertible into a fixed number of the companies' common shares.

2.4 Other Financing

Leasing obligations: A lease is a debt instrument where the asset owner (the lessor) gives another party (the lessee) the right to use the asset e.g., a property or equipment. In return, the lessee agrees to make a set of contractually fixed payments.

2.5 Considerations Affecting Financing Choices

Firm-Specific Financing Considerations

- <u>Company size</u>: Large companies with strong operating cash flows rely more on internal financing. Whereas, small companies with negative or unpredictable cash flows rely more on external financing, especially private equity.
- <u>Riskiness of assets</u>: Companies with higher volatility of operating cash flows and companies with high degree of business risk prefer equity financing over debt financing.
- <u>Assets for collateral</u>: If a company has good assets (e.g. real estate in prime locations) that can be offered as collateral, it will have easy access to debt financing and its borrowing costs will be low. On the other hand, companies that have assets that are unique, highly specialized, and intangible will find it difficult to borrow.
- <u>Public vs. private equity</u>: The securities of large publicly traded companies are liquid and trade frequently. In contrast, private company claims are not liquid and do not trade in secondary markets.
- <u>Asset liability management</u>: Companies try to match the maturity structures of their assets and liabilities. A mismatch can create problems. For example, if long-term assets are financed with short-term obligations, the company's profitability will be affected if the short-term financing rates go up.
- <u>Debt maturity structure</u>: Short term debt is generally cheaper than long term debt. A company can choose to continually refinance using new short-term debt instead of using long-term debt. But this will expose the company to rollover risk. The interest rates may go up it may be unable to refinance due to company-specific or general economic conditions.
- <u>Agency costs</u>: Debtholders try to protect their interests by putting in place bond

covenants that impose restrictions on the company. The company should evaluate the effects of these covenants while choosing debt financing.

- Bankruptcy costs: Bankruptcy usually results in a net loss to the suppliers of capitals. They are therefore averse to financial structures (e.g. too much debt) that increase the risk of bankruptcy.
- Flotation costs: Floatation costs include legal fees, registration fees, audit fees, underwriting fees etc that are incurred when a publicly traded company issues new debt or equity securities. These costs affect a company's financing decisions.

General Economic Considerations

- Taxation: Since interest payments are tax deductible, companies have an incentive to use more leverage. However, this should be balanced with the risk of financial distress.
- Inflation: If inflation is expected to rise companies would prefer to borrow at a fixed rate, whereas investor will prefer to lend at a variable rate, and vice versa.
- Government policy: Government policies can be used to stimulate specific industries. For example, the government may provide loans at lower interest rates or provide loan guarantees. Such policies can reduce the cost of borrowing for a company an influence its financing decisions.
- Monetary policy: To stimulate their economies central banks around the world have sometimes driven interest rates to historically low levels. Many companies used these opportunities to increase leverage, refinance existing debt, and repurchase common stock instead of making capital investments.

3. Managing and Measuring Liquidity

Liquidity is the extent to which a company is able to meet its short-term obligations using assets that can be readily converted into cash (by selling or financing).

3.1 Defining Liquidity Management

Liquidity management refers to the ability of an organization to generate cash when and where needed.

Two sources of liquidity for a company are:

1. **Primary sources:**
    - Cash sources used in day-to-day operations.
    - For example, cash balances, trade credit, lines of credit from banks, etc.
2. **Secondary sources:**
    - For example, liquidating assets, filing for bankruptcy, negotiating debt agreements, etc.

- The main difference between the two is that using primary sources has no effect on the operations of a company while using secondary sources may negatively impact a company's financial position.

A company's liquidity position is affected by cash receipts and the amount of cash it has to pay.

Drags on liquidity reduce cash inflows. For example, bad debts, obsolete inventory, uncollected receivables, etc.

Pulls on liquidity accelerate cash outflows. For example, earlier payment of vendor dues, reduced credit limits, etc.

3.2 Measuring Liquidity

Liquidity contributes to a company's credit-worthiness. Credit-worthiness is the perceived ability of the borrower to pay what is owed in a timely manner, despite adverse conditions. A high credit-worthy company is one that has the ability to make interest payments on a loan as they come due.

High credit-worthiness allows a company to:

- Obtain lower borrowing costs.
- Obtain better terms for trade credit.
- Have greater flexibility.
- Exploit profitable opportunities, as the company can raise money relatively quickly to invest in profitable projects.

Ratios used for assessing a company's liquidity

Financial ratios can be used to assess a company's liquidity as well as its management of assets over time. The commonly used ratios are:

Liquidity Ratios		
Ratio	**Formula**	**Interpretation**
Current ratio	Current assets ÷ Current liabilities	The greater the current ratio the higher the company's liquidity
Quick ratio	(Cash + Marketable securities + Receivables) ÷ Current liabilities	The higher the quick ratio the higher the company's liquidity
Cash ratio	(Cash + Marketable securities) ÷ Current liabilities	The higher the cash ratio the higher the company's liquidity
Activity Ratios		
Receivable turnover	Credit Sales ÷ Average receivables	It is a measure of how many times, on average, accounts receivable are created by credit sales and collected on during the fiscal period.

Number of days of receivables	365 or days in period ÷ Receivable turnover	It tells the number of days on average the company takes to collect on the credit accounts
Inventory turnover	Cost of goods sold ÷ Average inventory	It is a measure of how many times, on average, inventory is created or acquired and sold during the fiscal period
Number of days of inventory	365 or days in the period ÷ Inventory turnover	It is the length of time, on average, that the inventory remains within the company
Payables turnover	Average day's purchases ÷ Average trade payables	It is a measure of how long it takes the company to pay its own suppliers
Number of days of payables	365 or days in the period ÷ Payables turnover	It tells the number of days on average the company takes to make payments to its suppliers.
Cash conversion cycle	Days of inventory + Days of receivables – Days of payables	It measures the time from paying suppliers for raw materials to collecting cash from customers. The shorter the cycle, the better is the cash-generating ability of a company

4. Evaluating Short-Term Financing Choices

Since many short-term financing alternatives are available, a company should evaluate these options and create a planned borrowing strategy that will maximize its cost savings.

The objectives of a short-term borrowing strategy for companies are to:

- Ensure sufficient capacity to handle peak cash needs.
- Maintain sufficient sources of credit.
- Ensure rates are cost-effective.

Factors that will influence a company's short-term borrowing strategies are:

- <u>Size and creditworthiness</u>: Larger companies have additional and cheaper options as compared to smaller companies. The borrower's creditworthiness determines the access to and the cost of borrowing.
- <u>Legal and regulatory considerations</u>: Legal and regulatory constraints on specific industries can restrict how much a company can borrow and under what terms.
- <u>Sufficient access</u>: Borrowers should adequately diversify and not rely too much on any one lender or any one form of borrowing.
- <u>Flexibility of borrowing options</u>: Maturities should be managed effectively, there should not be any 'big' days when several amounts of loans mature simultaneously.

Borrowing strategies can be active or passive. Passive strategies involve little or no planning. They typically rely on just one source or type of borrowing and routinely rollover the borrowing.

Active strategies involve more planning, reliable forecasting, and comparison pricing. They help avoid the rollover trap. Many active strategies are matching strategies: loans are scheduled to mature when large cash receipts are expected. Doing this allows the company to avoid investing the cash receipts at lower rates than the borrowing costs in the interim.

Summary

LO.a: Describe types of financing methods and considerations in their selection.

The main financing options available to a company are:

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The considerations affecting financing choices are:

Firm specific considerations:

- Company size
- Riskiness of assets
- Assets for collateral
- Public vs. private equity
- Asset liability management
- Debt maturity structure
- Agency costs
- Bankruptcy costs
- Floatation costs

General economic considerations

- Taxation
- Inflation
- Government policy
- Monetary policy

LO.b: Describe primary and secondary sources of liquidity and factors that influence a company's liquidity position.

<u>Two sources of Liquidity</u>:

1. Primary sources:
    - Cash sources used in day-to-day operations.
    - For example, cash balances, trade credit, lines of credit from bank, etc.

2. Secondary sources:

- Impacts the day-to-day operations and alters the financial structure. May indicate deteriorating financial condition.
- For example, liquidating assets, filing for bankruptcy, negotiating debt agreements, etc.

Drags on liquidity delay cash inflows. For example, bad debts, obsolete inventory, uncollected receivables, etc.

Pulls on liquidity accelerate cash outflows. For example, earlier payment of vendor dues, etc.

LO.c: Compare a company's liquidity position with that of peer companies.

Financial ratios can be used to assess a company's liquidity as well as its management of assets over time. The commonly used ratios are:

Liquidity Ratios		
Ratio	**Formula**	**Interpretation**
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Number of days of payables	365 or days in the period ÷ Payables turnover	It tells the number of days on average the company takes to make payments to its suppliers.

Cash conversion cycle	Days of inventory + Days of receivables – Days of payables	It measures the time from paying suppliers for raw materials to collecting cash from customers. The shorter the cycle, the better is the cash-generating ability of a company

LO.d: Evaluate choices of short-term funding.

The objectives of a short-term borrowing strategy for companies are to:

- Ensure sufficient capacity to handle peak cash needs.
- Maintain sufficient sources of credit.
- Ensure rates are cost-effective.

Factors that will influence a company's short-term borrowing strategies are:

- Size and creditworthiness
- Legal and regulatory considerations
- Sufficient access
- Flexibility of borrowing options

Borrowing strategies can be active or passive. Passive strategies involve little or no planning. Active strategies involve more planning, reliable forecasting, and comparison pricing. They help avoid the rollover trap.