F2 | 1 | Long-Term Finance

Long term finance

Finance is key to a business's growth. If businesses lack the money to implement long-term plans or projects, they may turn to long-term finance options.

Sources of finance

There are a number of sources of long-term finance, including capital markets and bank borrowing.

Capital markets

Capital markets (or stock markets/exchanges) look at an entity's capital as a purchasable commodity. Each single portion of capital is a share, which when purchased gives the holder ownership of that portion of the entity.

Example

If a business is valued on a capital market at £100,000, a single share worth £10 would equate to a 0.0001% ownership stake in the business.

Roles of capital markets

- Primary function – Providing businesses with the opportunity to raise both debt and equity finance
- Secondary function – Providing investors with the opportunity to trade with each other

Bank borrowings

Banks can provide both short-term (fewer than 12 months) and long-term (more than 12 months) loans, without impacting an entity's ownership. Both represent amounts which need to be paid back with interest.

Key terminology regarding the status of companies

Definition
Public company Sells shares to the public and therefore is in part publicly owned. **Private company** Doesn’t sell shares to the public and therefore owned by private investors. **Limited company** Abbreviation of `limited liability’, meaning shareholders only risk the loss of their investment in a particular company, not their personal assets. **Unlimited company** Investors have no safety net and may need to repay debts from their private assets/funds. **Listed company** A company that is listed/quoted/floated on a stock exchange. **Unlisted company** A company selling shares without being listed on a stock exchange.

A number of combinations stem from these definitions	
Listed Public Company	Limited liability company selling shares publicly through a stock market.
Unlisted Public Company	Limited liability company selling shares to the public without using a stock market.
Private Limited Company	Limited company which doesn’t sell shares to the public.
Private Unlimited Company	Unlimited company which doesn’t sell shares to the public.

Equity finance

Equity investments are the buying and holding of shares on a stock market by individuals or firms.

There are two main ways by which an investor can make a return on an equity instrument:

- **Dividends** – Part of a company's profits, which are paid to its shareholders
- **Capital gains** – Increases in the value of an investor's shares over time

Ordinary shares (common stock)

These are the most common type of share.

Ordinary shares	
Dividends	Not compulsory, so shareholders seek an increase in share value to earn a return on investment.
Winding up/liquidation	In the event of winding up, these shares are the lowest priority and ordinary shareholders will be compensated last.
Voting rights	Ordinary shares bestow holders with the right to vote in shareholder meetings.
Risk	The most risky investment in a company, with a high return required as a result.

Preference shares (preferred stock)

Provides its holder with a number of beneficial rights over holders of ordinary shares.

Preference shares

Dividends	They carry a fixed dividend and companies are obliged to pay dividends to preference shareholders before ordinary shareholders.
Winding up	Higher priority than ordinary shares in the event of winding up, however still subordinate to bonds or debt.
Voting rates	No voting rights, so holders have no say on important company issues.
Risk	Lower risk, but usually more expensive than ordinary shares. More likely, but smaller, returns.
Status	More like bonds and are therefore considered to be hybrid instruments, containing elements of both equity and debt.

Four kinds of preference share

Cumulative preference shares	Shares receiving a regular dividend from the issuing company. Missing payments in any year must be made up in a subsequent period.
Non-cumulative preference shares	Similar to cumulative shares except no payment is received for previous periods when a dividend was not received.
Participating preference shares	Provides the shareholder with the opportunity to earn extra dividends based on certain company targets being achieved.
Convertible preference shares	Give the holder the right to convert the preference share to an ordinary share at a later date

Debt finance

Debt finance allows companies to raise finance without giving up ownership. Essentially, a company is selling a promise to repay a fixed amount (with interest) at a later date.

Definition
Security A method for lenders to protect themselves from losing the money they have loaned, if the recipient of the loan can't repay their debts.

There are two main kinds of security used for securing debt finance:

- **Fixed charge** – Secures debt against a specific asset, e.g. land, which the debtor would gain ownership of if the loan is defaulted upon. This is the less risky option for the debtor
- **Floating charge** – Secures debt against general assets, e.g. inventory. This is the riskier option for the debtors as there can be uncertainty surrounding what these assets may include or their value

Debt covenants

Conditions or covenants used by lenders to protect themselves against default by the borrower. Loans are made conditional on certain requirements.

Types of debt covenants	
Ratio limits	Lenders may request that certain financial ratios remain at a minimum level.
Dividend restrictions	Limits the amount an entity can pay in dividends to shareholders.
Financial reports	Regular financial reports must be provided to the lender in addition to the financial statements.

Types of debt finance

Debt finance is mainly obtained from banks and capital markets.

Bank finance	
Bank loans	• Provide specific amounts for a set time period, at either variable (changes with the market) or fixed (doesn't change) interest rates • Can be secured or unsecured (more expensive as higher risk) • Loans are simple, easy to arrange and flexible
Revolving credit facilities (RCFs)	• Bank facility allowing the withdrawal of funds up to an agreed credit limit • Flexible financing option, minimising interest payments as interest is only paid on the amount borrowed

Capital market finance

Debentures (bonds, loan stock, notes)	• A medium to long-term instrument used by large companies • Evidence a company has to repay a specific amount with interest • May be secured on company assets • Offered via the bond market and are freely transferable by the holder
Convertible debentures	• Debentures which can be converted into equity shares of the issuing company • Convertibility is attractive to buyers, though it often results in lower interest rates

Definition

Face value (Par/Nominal value)

The price paid for debt instruments by investors.

Coupon

The interest paid by a company on a debenture or bond.

Redemption date (Maturity date)

The date by which a company has to repay their investors.

Yield to maturity for a redeemable debt

A method of calculating a debt instrument's yield, based on the difference between the current purchase price and the redeemable value. It also takes into consideration the time value of money. The return or yield is expressed as an annual percentage rate.

Yield to maturity for redeemable debt

$$IRR = A + \frac{NPVa}{NPVa - NPVb} \times (B - A)$$

A = the first discount rate
B = the second discount rate
NPVa = the net present value using discount rate A
NPVb = the net present value using discount rate B

Example

Yield to maturity

- NPVa = £127.50

- NPVb = £50.30
- A = 12%
- B = 18%

$$\text{IRR} = A + \frac{\text{NPVa}}{\text{NPVa} - \text{NPVb}} \times (B - A)$$

$$\text{IRR} = 12 + \frac{127.5}{127.5 - (-50.3)} \times (18 - 12)$$

Yield to maturity = 16.3%

Yield to maturity for irredeemable debt

$$\left(\frac{\text{Annual interest}}{\text{Current purchase price of debt}} \right) \text{X } 100\%$$

Example

Yield to maturity for irredeemable debt

- Bond has a face value of £1,000 and a coupon rate of 10%
- Current purchase price is £800

$$\left(\frac{\text{Annual interest}}{\text{Current purchase price of debt}} \right) \text{X } 100\%$$

$$\left(\frac{\text{£100 (£1,000 x 0.1)}}{\text{£800}} \right) \text{X } 100\% = 12.5\%$$

Bond markets

The capital or bond markets are the source of long-term debt finance for stock exchange listed entities. Like the stock market, the bond market has a primary and secondary market.

Bond market

Primary market	Where new bonds are issued
Secondary market	Where bondholders can buy and sell bonds previously held

The most common process for issuing bonds is through underwriting, using the following process:

Underwriting process

- One or more securities firms or banks form a syndicate
- The book runner is the lead underwriter
- The lead underwriter advises the bond issuer about the timing and price of the bond issue
- The syndicate re-sells the bonds to investors, either as a bond placement, e.g. sold to specific investors, or using the bond market to sell to a wider range of investors
- The underwriter effectively takes the risk of being unable to sell on the issue to end investors, as they will have to buy any unsold shares

Issuing bonds physically in the bond market requires:

- Listing on a recognised exchange (listed entities will already have done this)
- Filing documentation to allow admission to trading
- The appointment of **a market maker**

Definition

Market maker

A dealer in securities or other assets who agrees to buy or sell at specified prices at all times. This ensures that the bonds have quoted buy and sell prices throughout the day to allow them to be traded.

Other long term finance

Sale-and-leaseback and warrants are two other examples of long-term finance. Established companies with significant assets may lack cash and can therefore benefit from these options.

Sale and leaseback and warrants

Sale and leaseback	Selling non-current assets and leasing them back. A drawback of this option is that any potential capital gains on leased assets are forgone.
Warrants	Securities entitling the holder to buy underlying stock at fixed prices. Can be attached to bonds or preference shares encouraging uptake and allowing the issuer to pay lower interest rates or dividends.

And finally...

Stop!

By this stage you should know:

- How companies are classified in relation to their relationship with capital markets
- The characteristics of different share types
- The difference between a fixed and a floating charge

- How to differentiate between debentures and convertible debentures
- How to calculate yield to maturity for redeemable debt
- The formula for calculating the yield to maturity of irredeemable debt
- The definition of a market maker
- Alternative methods of long-term finance

Got it?

If not, go back and re-read the study text before moving on.

Question Time

It's now time to practise questions.

If you've signed up for our practice questions or are on our fully inclusive course, here's a direct link to questions for this chapter:

Go to Practice Questions

If **you want to sign up** for our practise questions here's where you will find more details:

Sign Up for Questions