

# Selecting sources of finance for business

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This article considers the practical issues facing a business when selecting appropriate sources of finance. It does not consider the theoretical aspects of such decisions (Modigliani and Miller) which are covered in Paper 3.7, *Strategic Financial Management*. Nor does it provide detailed descriptions of various sources of finance. These are well covered in manuals and textbooks.

A business faces three major issues when selecting an appropriate source of finance for a new project:

1. Can the finance be raised from internal resources or will new finance have to be raised outside the business?
2. If finance needs to be raised externally, should it be debt or equity?
3. If external debt or equity is to be used, where should it be raised from and in which form?

## **Can the necessary finance be provided from internal sources?**

In answering this question the company needs to consider several issues:

- How much cash is currently held? The company needs to consider the amount held in current cash balances and short-term investments, and how much of this will be needed to support existing operations. If spare cash exists, this is the most obvious source of finance for the new project.
- If the required cash cannot be provided in this way then the company should consider its future cash flow. A cash budget can be prepared, but it is probably too detailed at this stage. A cash flow statement as shown in Example 1 on page 36 would probably be more practical.
- If the company's projected cash flow is not sufficient to fund the new project then it could consider tightening its control of working capital to improve its cash position.

Pressurising debtors for early settlement, running down stock levels and lengthening the payment period to creditors could increase cash resources. Note however, there are dangers in such tactics. For example, lost customer / supplier goodwill and production stoppages due to running out of stock etc.

If the necessary finance cannot be provided internally then the company has to consider raising finance externally.

## **The debt or equity decision**

Here a company needs to consider how much it should borrow. This is a very important decision and several British companies have experienced major problems with this decision in recent years e.g. Marconi, British Telecom and NTL. Issues to be considered include:

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- The cost of finance. Debt finance is usually cheaper than equity finance. This is because debt finance is safer from a lender's point of view. Interest has to be paid before dividend. In the event of liquidation, debt finance is paid off before equity. This makes debt a safer investment than equity and hence debt investors demand a lower rate of return than equity investors. Debt interest is also corporation tax deductible (unlike equity dividends) making it even cheaper to a taxpaying company. Arrangement costs are usually lower on debt finance than equity finance and once again, unlike equity arrangement costs, they are also tax deductible.
  - The current capital gearing of the business. Although debt is attractive due to its cheap cost, its disadvantage is that interest has to be paid. If too much is borrowed then the company may not be able to meet interest and principal payments and liquidation may follow. The level of a company's borrowings is usually measured by the capital gearing ratio (the ratio of debt finance to equity finance) and companies must ensure this does not become too high. Comparisons with other companies in the industry or with the company's recent history are useful here.
  - Security available. Many lenders will require assets to be pledged as security against loans. Good quality assets such as land and buildings provide security for borrowing – intangible assets such as capitalised research and development expenditure usually do not. In the absence of good asset security, further borrowing may not be an option.
  - Business risk. Business risk refers to the volatility of operating profit. Companies with highly volatile operating profit should avoid high levels of borrowing as they may find themselves in a position where operating profit falls and they cannot meet the interest bill. High-risk ventures are normally financed by equity finance, as there is no legal obligation to pay equity dividend.
  - Operating gearing. Operating gearing refers to the proportion of a company's operating costs that are fixed as opposed to variable. The higher the proportion of fixed costs, the higher the operating gearing. Companies with high operating gearing tend to have volatile operating profits. This is because fixed costs remain the same, no matter the volume of sales. Thus, if sales increase, operating profit increases by a larger percentage. But if sales volume falls, operating profit falls by a larger percentage. Generally, it is a high-risk policy to combine high financial gearing with high operating gearing. High operating gearing is common in many service industries where many operating costs are fixed.
  - Dilution of earnings per share (EPS). Large issues of equity could lead to the dilution of EPS if profits from new investments are not immediate. This may upset shareholders and lead to falling share prices.
  - Voting control. A large issue of shares to new investors could alter the voting control of a business. If the founding owners hold over 50% of the equity they may be reluctant to sell new shares to outside investors as their voting control at the AGM may be lost.
  - The current state of equity markets. In a period of falling share prices many companies will be reluctant to sell new shares. They feel the price received will be too low. This will dilute the wealth of the existing owners. Note this does not apply to rights issues where shares are sold to the existing owners of the company. New issues of shares on the UK stock exchanges have been
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rare over the last few years due to the bear market. At the time of writing there is some evidence that the bear market is coming to an end.

After consideration of the above points the company will be in a position to decide between the use of debt or equity finance. The last major decision is what type of finance should be used and where should it be raised?

### **Equity Finance**

A detailed consideration of the different sources of equity finance is beyond the scope of this article and students are recommended to consult their textbooks or manuals for more detailed coverage. However, here are a few general points on the subject:

- For companies who already have shares in issue rights, issues are mandatory under company law. This means that any new shares have to be offered to existing shareholders in proportion to their existing holdings. This is to protect existing shareholders from the company selling shares to new investors at a low price and diluting the wealth of existing shareholders. This requirement may be overcome if existing shareholders are prepared to vote to 'waive their pre-emption rights'.
- The current status of the company is important. Companies listed on the London International Stock Exchange or quoted on the Alternative Investment Market (AIM), can raise new equity finance by selling new shares on these markets by way of rights issues, offers for sale or placing. Other companies who lack access to the stock exchange find it more difficult to raise equity finance and may need to turn to venture capitalists if they require equity finance.

### **Debt Finance**

Debt finance comes in many different forms. Students will find detailed descriptions in their textbooks and manuals. The major considerations in raising new debt finance are detailed below.

#### *The duration of the loan*

Generally, short-term borrowing (loans for less than one year) is cheaper than longer-term borrowing (loans for more than one year). This is because many lenders equate time with risk. The longer they lend for, the more risk is involved as more things can go wrong. Hence they charge a higher interest rate on longer-term lending than on short-term lending. However, short-term borrowing has a major disadvantage – renewal risk. Short-term loans have to be regularly renewed and the company carries the risk that lenders may refuse to extend further credit. This risk is at its highest on overdraft borrowing where the bank can call in the overdraft 'on demand'. With long-term borrowing, as long as the borrower does not breach the debt covenants involved, the finance is assured for the duration of the loan.

In choosing between short-term and long-term borrowing, the firm should consider the textbook rule of thumb for prudent financing: 'finance short-term investments with short-term funds and long-term investments with long-term funds'. Simply, this means use cheap short-term borrowing where it is safe to do so (investments that are short-term in nature and hence renewal risk is not a problem) but use long-term

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finance for long-lived investments.

#### *Fixed v floating-rate borrowing*

Many lenders offer the borrower the choice between a fixed rate of interest and one that floats (i.e. varies) with the general level of interest rates. Fixed-rate borrowing has the attraction of certainty (you know what interest rate you are going to pay) but on average is more expensive. This is because lenders see themselves as taking more risk on fixed-rate lending as they may lose out if interest rates increase. Generally, floating (variable) rate borrowing is cheaper, but it carries more risk to the borrower as interest payable may increase if interest rates rise. If a firm is already highly geared it may consider the risks of floating-rate borrowing too high.

#### *The status of the company*

Some types of debt finance are only available to large listed companies. Small companies are usually restricted to short-term borrowing. If long-term debt finance is available it is usually in the form of leasing, sale and leaseback, hire purchase or mortgage loans on property.

#### *Currency of borrowing*

It is important to remember that if a company borrows in a foreign currency it has to repay the loan and the interest in that currency. Currency fluctuations may add to the cost of the loan and increase the risk involved.

#### *Debt Covenants*

Borrowing money often entails certain obligations for the borrower over and above repaying the interest and principal. These are referred to as covenants. These include restrictions on the use of assets financed by the loan, restrictions on dividend payments and restrictions on further borrowing. Such covenants restrict the flexibility of the borrower and should be carefully considered before borrowing money.

### **Conclusion**

It is not possible to recommend an ideal source of finance for any project. What is important is that students appreciate the advantages and disadvantages of different financing methods and can provide reasoned advice to businesses.

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#### **Example 1**

ABC plc needs £100 million over the coming year to finance an expansion of the business. Accounting statements for the last financial year are given below.

#### **Profit and loss account for the year ended 30 June 2003:**

	<b>£m</b>
Turnover	300
Cost of sales*	(180)
Operating profit	120

Interest charges	(30)
Pre tax profit	90
Corporation tax	(24)
Profit after tax	66
Proposed dividend	(40)
Retained earnings	26

\* This includes depreciation of £16m

**Balance sheet as at 30 June 2003:**

*Fixed assets (net)*

Land and buildings	100	
Fixtures and fittings	100	
Vehicles	400	
		600

*Current assets*

Stock	120	
Debtors	200	
Cash	80	
		400

**Liabilities falling due in less than one year:**

Trade creditors	(170)	
Dividends payable	(40)	
Tax payable	(24)	
		(234)
		166
Total assets less current liabilities		766
15% debentures 2015 - 2018		(200)
Net assets		566
Issued share capital		200
Reserves		366
		566

Without the expansion sales turnover, cost of sales (excluding depreciation), dividends and working capital requirements are expected to grow by 10% in the coming year. The corporation tax bill is expected to be £120m. Tax and dividends are paid nine months after the year end.

**Required:** Calculate ABC's expected net cash flow for the year ending 30 June 2004 without the new investment. Comment on the amount of external financing required for the proposed expansion. (Note: a statement in FRS 1 format is not required).

**Solution**

Net cash flow year ending 30 June 2004

	£m
Turnover (300m x 1.10)	330.0
Cost of sales (180m - 16m) x 1.10	(180.4)
	149.6
	(30.0)
Interest	(24.0)
Tax paid (last year's bill)	(40.0)
Dividends paid	55.6
	(12.0)
Increase in stock (120m x 0.1)	(20.0)
Increase in debtors (200m x 0.1)	17.0
	40.6
Increase in creditors (170m x 0.1)	
Net cash flow	

**Comment**

Cash flow from operations is expected to be £40.6m in the coming year. If the remaining £59.4m is financed from the cash balance of £80m, then the firm will have no need to raise external finance to finance the proposed expansion.