UNIT 8 SOURCES OF LONG TERM FINANCE

Structure

8.0 OBJECTIVES

After studying this unit you should be able to:

- List different sources of long term finance
- Discuss the characteristics of equity finance and preference capital and how a company can issue new equity finance
- Explain different types of debentures/bonds their features merits and demerits
- Discuss term loan, and venture capital

8.1 INTRODUCTION

Finance is the money necessary to be raised for an enterprise. The requirement may be for short periods or long, which would determine the type and source of finance. Money can be raised for short-, medium- or long-terms. Long-term finance is typically finance of maturities of over five years.

Long-term finance is required for medium to long-term purposes to meet the cost of acquisition of fixed assets for diversification, expansion, modernisation as also, to meet permanent working capital requirements. There have been findings that firms grow faster and are more productive when more long-term finance is available to them. Government subsidies do not produce the same effect and in some cases are associated with less productivity and growth.

The sources of finance can be in the national currency, which in India is the Indian Rupee. Since liberalisation of the economy, finance can also be availed in India in foreign currency such as the US Dollar, Great Britain Pound, Euro etc.

In this unit you will learn above different sources of long term finance their features and advantages.

Long-term finance can be categorised into three broad groups depending on the sources of funds viz. a) own b) borrowed and c) other.

a) Own funds include 1) equity share capital 2) preference share capital 3) convertible preference share capital 4) reserves or retained earnings

b) Borrowed funds include those raised from 1) convertible debentures 2) non-convertible debentures 3) fixed deposit 4) term loans 5) lease/hire purchase/suppliers' credit

c) Other funds can be 1) subsidies 2) factoring 3) venture capital 4) ADR/GDR/bond issues 5) seed capital

Borrowing and lending are beneficial if it is more widespread. If a large amount of money were to be borrowed, for a long period of time, one would find it difficult to find a lender. If however, a debt were transferable, it would be easier to find many people willing to lend the same amount over shorter periods of time. The ability to transfer debt is made possible by the use of credit instruments. These are written evidences of the extension of credit. By selling the credit instrument, debt is transferred from one person to another.

Money is generally, made available through financial contracts referred to as financial instruments. Their terms and conditions largely determine the nature of the instruments. These instruments become the sources of finance. Credit instruments have some common features such as identity of the debtor, amount of debt, arrangements as to maturity and payments of interest.

Some instruments essentially have short terms and are used for short-term requirement of funds while others finance long-term requirement of funds. Capital markets are the source of long-term finance where as source of short-term finance is called the money market. The entities that participate in the capital market are government, banks, financial institutions, and businesses.

Generally, the type of capital that a company can acquire requires a provision in its articles of incorporation. The decision on capital structure (mix of debt and equity) is generally taken on the basis of the effect of taxes the company and its claim holders pay, cost of raising it or its investment policy. Debt enjoys tax benefit over equity as allowed by governments. Further, in the case of debt, tax is paid on before-tax earnings.

An investment policy would help as otherwise companies may simply decide to stop investment when faced with too much debt, since revenues from investment would largely go to pay off debt, while cost of raising funds would be borne by all investors, especially equity holders. Too little debt can also be bad; especially in mature industries where companies not disciplined by the need to service debt, can fritter away excess cash in unprofitable investments. Long-term debt is the preferred mode of finance since it is less onerous to service, considering both interest and principal do not have to be paid in the short run.

The first step in sourcing involves ascertaining resource requirements and defining borrowing parameters such as maturties and sourcing. Even though the sources are many, markets and instruments may not be accessible to all borrowers. Companies then have to do a cost analysis to decide the source or sources to be tapped.

In this Unit, we shall discuss about retained earnings, equity capital preference capital, debentures, bonds, term loans and venture capital in detail. Let us start with Retained Earnings.

8.2 RETAINED EARNINGS

These are the earnings of an entity and it includes surplus or net income or profit, for the current accounting year after distribution of dividend i.e. the amount available for carrying forward into the next accounting period. It also includes accumulated profits of past periods left invested in the business but not definitely allocated for any purpose. Retained earnings can be appropriated for contractual agreements requiring such appropriations provided it is permitted by the board of directors.

Retained earnings are those earnings, that are kept as reserves in various reserve accounts. They are shareholder funds and are used for purposes of capital or current expenditure of the company. When they reach a level of accumulation, with due regard to taxation, they may be distributed as bonus shares, to the existing equity holders, in a certain ratio to their equity holdings.

There is a general belief that dividend yield is the most important indicator of stock value. Nevertheless, companies can create value for shareholders with earnings that are not paid out as dividends. Retained earnings can be used for buying back share, retiring debt or reinvesting for growth which action can increase future earnings per share. If the return that the organisation receives from its retained earnings matches that which can be achieved by the individual investor, the dividend payout will not matter. Retained earnings can finance only a part of investment programmes since they are generally insufficient to provide all the needed funds.

Some companies do not pay dividends at all, because they wish to retain the funds for expansion. They do not think it necessary to formalise the retention of earnings by declaring a stock dividend and would argue that there were no advantages in issuing more shares, thereby imposing a burden on the management to maintain future earnings. If earnings could not be maintained, the dilution effect would take place (retained earnings, when invested, earn a smaller amount than do previously invested funds, hence earnings are said to be diluted). Alternatively, companies may not pay dividends because they cannot afford them with their present and future expectation of profit. Perhaps the company is in receivership or is being reorganised.

Retained earnings offer such advantages as not having to approach lenders or shareholders, eliminating costs of issue and losses by virtue of underpricing.

8.3 EQUITY CAPITAL

The stock/shares of a company issued to investors for money or property or out of accumulated earnings constitutes its equity capital and it is divided into a number of equal parts of shares, usually with a specified par value.

It is the capital raised by issuing stock and is the asset of a company. It is limited by the company's articles of association and its bye-laws and the amount authorised towards share capital. A company issues shares of equal values amounting to the value of authorised capital. It is however, not obliged to issue all shares up to the authorised amount. Issued and outstanding shares are certificates of ownership held by the shareholder and it represents the shareholder's interest in the company, as also the amount of accountability of the company to the shareholder but is uncollectable by the latter through legal procedure. Any amount of the authorised capital stock not issued is known as unissued stock.

Common stock (equity capital) is an ownership security. When common stock is issued, there is no guarantee or contractual agreement that the dividend will remain fixed or even that the dividend will be paid. This makes income for the shareholder, unstable and uncertain. Therefore, stock prices fluctuate widely, and both principal and current income could be lost. It guarantees nothing to the owner except the right to share in the earnings of the company. If earnings do not materialise or if losses are sustained, then the stockholder must share the losses up to the asset value of the company. The significance of this statement is that there is nothing certain about earnings on common stock, and the investor can lose as well as earn a profit. However, the stockholders liability is restricted to the capital contributions/investments in stock.

It is classified as long-term source of funds, because it has no maturity. Bonds and mortgages represent debt whereas stocks represent ownership. Money market securities are expected to be cheaper to a company and offer a low return to the investor but then they require to be serviced within a short period. Equity capital is expected to give higher return to the investor than most debt securities because it exhibits a higher degree of risk.

Equity capital is used for financing new business or expanding existing ones. It represents partial ownership of a company. The investor becomes owner. The equity-issuing company is not obliged to repurchase its stock at any time in the future. Shareholders can sell the stock to other investors in the secondary market. Stocks are issued for obtaining long-term funds and investors may wish to obtain partial ownership and therefore invest long term.

More specifically, it is the contribution of the owner(s) who bear(s) the risk of ownership and is rewarded by way of dividend or profit. It is raised by promoter’s contribution or public issue of shares. Contributors to such capital have voting rights. Typically, each share of common stock has one vote. This is referred to as ordinary voting.

The advantage of this type of voting is that it allows a minority group of shareholders or an individual shareholding of a large amount of stock to be represented on the board of directors. Granting stock options for management, approving mergers, issuing debt securities, waiving the right to subscribe to new shares, changing the par value of the stock, increasing the authorised capital of the company, election to the board of directors, approval of amendment to corporate charter and adoption of bye-laws are all matters upon which the owners may vote. However many shareholders fail to vote, as a result, management normally receives majority of the votes and can elect or bring about changes as desired.

However, non-voting shares, as the name suggests, can also be issued. Historically, non-voting class of common stock was issued to allow the original voting stockholders to maintain control; non-voting stock could be sold to allow the original voting-stockholders to raise additional money without losing control of the company. Non-voting stocks are seldom used today for this purpose, as certain institutional changes have tended to work against their use.

A company uses the incentive of higher dividends to compensate the non-voting shareholder. Non-voting shares would help to keep at bay the possibility of hostile takeovers (since they have all the features of the voting share) and the chief executive of a company can refuse to register change in ownership.

The equity investor is apparently preoccupied with short-term profit and dividend announcements. In some cases, the right to vote is taken away from a portion of the common stock. A company might issue class A and class B common, for example, one class with voting rights and the other with limited rights, or none at all. The company must note that the investor is also vitally concerned with the yield earned over the period that the stock is owned, since the yield for the holding period represents the total earnings to the investor and is a measure of performance to be compared to those of other securities investments.

In some instances, companies may use bonds, scrips and notes to pay dividend on stock, when as a matter of conservative financial policy, none should be paid. The weakness of the practice is that the stockholder receiving the dividend changes his relationship to the company. He/she becomes a creditor rather than an owner. An investor could interpret these types of dividends as a sign of financial weakness rather than as benefit.

Since equity is residual claim, it is much more sensitive to a company's value than debt. As a result, if organisations want to raise equity, the market may not be ready especially if it is to be raised at short notice. Generally equity issuances are looked upon as bad news as it signals that the company is not confident of servicing additional debt or that it intends to share impending losses with new investors. Over valued companies too may be tempted to issue equity.

Usually there is little secondary market for securities that have been privately placed; for example, a bank that lends money to a company cannot easily sell that loan on to another investor, though sales of bank loans do occasionally take place. Lenders such as banks need to be compensated for the lack of marketability and therefore private placements generally, carry a higher rate of interest. In some cases, private placements can be bought and sold freely but only within a limited group of investors.

Those investments, which are issued to the public at large, are frequently listed on a stock exchange or they may be freely traded 'over-the-counter' through investment dealers. However, there are also many investments that are publicly offered but cannot be resold easily.

Public issues can take many forms. Sometimes securities are auctioned off to the highest bidders; at other times, securities are offered for sale at a fixed price. Within these two broad classifications there are many variations.

Earnings yield provides a measure of the relative valuation placed on equity claims on corporate earnings streams and for that reason, are considered by many to be a more useful measure of the cost of capital than the market price of shares alone. Their inverse, the price/earnings multiple(p/e) is more widely quoted, but provides similar information. Higher earnings yields reflect a higher cost of equity and coincide with lower levels of issuance activity.

Some companies pay a dividend of both cash and stock, which is attractive to all stockholders. The company recognises that a policy of paying some dividend is desirable and that some people desire stock dividends for tax advantages. The company itself might wish to conserve cash for investment in plant or working capital.

No amount of stock dividends will turn a company with declining earnings into an investment success. In principle, a stock dividend is valuable only if the company continues to grow and prosper. Stock dividends are desirable however, when a company must conserve cash or is experiencing rapid growth, where per-share earnings and price will not be diluted and when the investor is in the tax bracket where cash dividends are not wanted.

Dividends are declared by the board of directors. The date of announcement usually precedes the date of record by several weeks. After the date of record, the stock sells ex-dividend; that is, a person buying it after that date does not receive the declared dividend. A person who buys stock in anticipation of receiving a dividend, must make certain that he becomes a stock holder of record before the stock goes ex-dividend. He must buy the stock with the dividends 'on'. The actual date of payment will be some time after the date of record.

8.5 PREFERENCE CAPITAL

Preference shares are so called, because they confer preferential right to payment of dividend at a fixed rate and for repayment of capital at the time of winding up of a company. Because of the fixed rate of dividend, they share a feature with debt instruments. Preference shares may be cumulative or non-cumulative, redeemable or irredeemable(perpetual), convertible or non-convertible and participating or non-participating.

Dividends on preference shares are said to be cumulative when it accumulates year after year if it is not paid for any year i.e. profits are insufficient to pay dividend at the full rate for the year. The unpaid dividends constitute a claim, which gets precedence over dividends on common shares. Therefore, dividends cannot be paid on common shares so long as there are arrears of dividend on preference shares.

Dividends are non-cumulative if profits are insufficient to pay in full the dividend for the year, although they are a prior claim in any given year, and they do not accumulate i.e. if dividend is not possible to be paid in any year it is lost. The company does not have an obligation to pay it subsequently.

Preference shares are redeemable when they have a limited life after which the company has to retire them. Most preference shares are redeemable. Usually the preferred stock is callable at the option of the company. The call or redemption feature allows the company to retire all or part of the issue at a price stated in the original agreement. This provides flexibility to company management but is detrimental to the investor. Dividends on preferred stock, are stated as a percentage of the par value. Dividends in arrears, because of a cumulative nature, may often force a company to change its capital structure or to recapitalise to eliminate past unpaid dividends. When recapitalisation is completed, the company will once again be in a position to pay dividend on common stock. A perpetual preference share has no maturity.

Preference shares are convertible if there is a provision for their conversion into equity capital after a specified period in a certain ratio to the existing shares. If such provision is not made, preference capital cannot be converted to equity capital. Convertible preferred stock enjoys the advantage of enabling a share in the profit of the company through capital growth of common stock. Such stocks offer the investor greater stability and security of income than do common stock and at the same time, an opportunity to hedge against loss of purchasing power caused by inflation if the common stock increases in price. The investor retains the risk of loss, however, because of yield variability. Convertibles provide a good, aggressive defensive security for the investor and are an attractive instrument when unusual uncertainty surrounds the market. If the common stock price rises, the price of the preferred will increase, and the preferred investor will share in the gain. Should the market decline, and along with it the price of common stock, preferred stock will then sell as regular preferred, offering greater security of price than the common stock.

A danger of convertible preferred stock is that it could be called for redemption. Most preferred stock issued today, particularly convertible preferred is callable at the option of the company. If it is called, the investor has the option of accepting the call or redemption price, or converting his preferred stock into common stock. A convertible preferred usually offers less risk and less reward than a common stock as a basic principle. If the preferred dividend is eliminated by a recapitalisation of the company, the investor continues to be in a relative poor position. In the recapitalisation process, preferred dividend arrearages are exchanged for either common or preferred stock. In come cases both the preferred stock and dividends are exchanged for a new preferred or combination of preferred and common stock on the theory that the company will be able to afford to pay the new dividend rate on a regular basis. One typical arrangement is to exchange the old preferred for common stock on which there is no dividend requirement. These changes help the company meet its immediate problem of being unable to pay dividends, but they usually impose more severe requirements on future dividends. The net effect is that the investor is in a junior position and does not receive any greater income than he would have if the recapitalisation had not taken place. Preferred with dividend arrearages are weak speculative securities that offer the investor high rewards along with high risks.

Some investors consider preferred stock with large arrearages an attractive outlet for their funds. The reason being that the unpaid dividends might eventually be paid in cash, or the capitalisation of the company might be changed and the arrearages eliminated by issuing stock to replace the dividends. This type of reasoning may be true in certain unusual situations, but it does not generally hold. A company that has not paid current dividend from past earnings has not had sufficient earnings to meet its claims. The circumstances that created arrearages in the first place, often continue so that these claims cannot be paid off in the future, and current dividends may not be paid. This is true of the majority of companies that have dividends in arrears. The investor who purchases the preferred with arrearages is speculating on the possibility of a windfall that is unlikely to occur.

Preference shares are participating, when they attract a share in the profits over and above the guaranteed fixed rate of dividend. The level of dividend, payable on equity shares is then specified at, and over which, dividend is required to be paid on preference capital.

Preferred stock dividends are technically, compensation to owners of the company and therefore dividends are not tax deductible. Preferred stock(unless redeemable) has no maturity and therefore represents a permanent source of finance. From a cost perspective, preferred stock is a less desirable source of capital, than bonds. Because there is no legal requirement for a company to pay preferred stock dividends, investors must be enticed to assume the risk involved by receiving higher dividends. Because dividends on preferred stock can be omitted, firms assume less risk when they issue it than when they issue bonds. However, if a company omits preferred stock dividends, it may be unable to raise new capital until the omitted dividends have been paid, because investors will be reluctant to make new investments in a company that is unable to compensate its existing sources of capital.

Preferred stock, an ownership security, has certain risks not associated with a fixed income debt security. Dividends are contingent upon earnings rather than mandatory as in the case of interest on bonds; and the preferred stock's claim on corporate assets is subordinate to that of bonds. Yet, dividends on preferred stock are usually fixed in amount, just as with bonds. In many respects, preferred stock is a unique security.

Companies have not relied heavily upon preferred stock as a major source of funds. New preferred issues have represented only a small portion of the money raised by companies through the sale of securities because preferred stock does not possess the tax advantages of bonds, yet the payment of dividends is almost as binding as the interest payment on bonds.

There are however, preferred stock attributes that make them of interest to certain investors.

1. Preference of their dividends, on earnings of the company.
2. Claim on assets over common stock in the unusual case of liquidation and in the more usual case of reorganization, refinancing or adjustment of a company's capital account.

Preferred stock is usually non-voting. Its owner does not vote to elect company directors. However, it has contingent voting rights. That is in times of financial trouble when dividend payments are in arrears, preferred stockholders would be given the right to elect some of the directors. It has no maturity date and therefore in this respect it is similar to common stock.

The investor who buys preferred stock is interested in stability of income, and for this reason may be more interested in the safety of his/her dividend than in the net assets per share. If the company is able to maintain adequate earnings on each share outstanding, the dividend will be secure. When preferred stock represents only a small part of the capital structure, earnings per share will be extremely high and will provide adequate coverage of the investor's dividend, insuring stability of income.

Preference or preferred shares rank after bonds and floating debt but ahead of common shares. Debt interest takes priority over preferred and common dividends. When both, bonds and preferred stocks are issued, the company must demonstrate an ability to cover adequately all charges against income. The advantage of preferred stock ownership is its stability of income; if dividends are in jeopardy, the investor will lose this advantage. Preferred stock is a hybrid. It does not share in earnings of a company, nor does it have security of a bond. However, these are simply its limitations for investment, its use is not completely precluded and under some conditions is whole-heartedly encouraged.

Ordinary preferred stock is attractive to investors who want more income than they could receive from bonds. The yield on high-grade preferred stocks is unusually greater than that on investment grade bonds and there is a comparable degree of price stability. These stocks would offer the investor somewhat more income with only a moderate decrease in security. A high quality preferred stock of a sound company, with adequate assets and earnings coverage, will be more attractive to the investor having an immediate need for maximum current income and desiring stability of yield as well. The high-grade preferred fluctuates in yield but follows the pattern of money rates closely.

Check Your Progress A

1) What are the rights of an ordinary shareholder ?
2) What are redeemable preference shares ?
3) Differentiate between voting shares and non voting shares ?
4) What are cumulative preference shares ?

8.5 DEBENTURES / BONDS

Debentures and bonds are terms used for long-term (other than the general assets of the issuer) debts. They are loans taken by a company from the public. Debenture simply means a document, acknowleding a loan made to a company and, providing for payment of interest on the sum borrowed, until the debenture is redeemed that is the repayment of principal sum. It may or may not be under seal and does not necessarily imply that any charge is given on the company's assets, though such charge usually exists.

Debentures are transferable like equity shares by the execution of transfer deeds and registration of transfer in the books of the companies. Transfer deeds may not be date-stamped as in the case of equities. Stamp duty is payable on debentures and the rates vary from state to state. The rates are different from those payable on equity shares.

Unregistered debentures are bearer bonds that are freely transferable by endorsement and physical delivery, without registration with the company. There is no need for execution of a transfer deed. These are generally not favoured, due to difficulties in establishing ownership for repayment of principal and the fear of loss of the certificates. Interest is paid on production of the warrants/coupons, attached to the certificates.

Redeemable debentures are those where the principle amount is repaid after a fixed period of time, in one or more instalments, as per terms of the issue. Irredeemable debentures, can be repaid only at the will of the company i.e. there is no fixed period for repayment. Convertible debentures are those which at the option of the debentures holder can be converted into equity or preference shares, at the specified rate of conversion, after a certain period. Preferential debentures are those that may be repaid, only at the time of liquidation of the company. The latter debentures are not permitted to be issued. Interest on debenture is a debt. It is fixed and known is called contractual or coupon rate of interest. It is payable whether they are profits or not. Such interest is usually to be charged against income account before arriving at the profit for the year. The interest on debenture is generally paid in accordance with the agreed terms. A debenture should contain the provisions (a) an agreement to pay interest and (b) a provision stating that if the principal amount is not paid back at the due date. The interest shall continue to be payable at agreed date. There is no different between bonds and debentures in India. Both are debt instruments issued by corporations or government. Dated securities issued by central government, state government and semi government authorities are usually called bond in India even though there are no hard and fast rules about these. Bonds issued by the government are also called `GLITS'. Government bonds are usually known as GOI secs or Guild Edged Securities. This means that these securities are of the best quality. Individuals , firms, companies, corporate bodies, state government, provident funds, banks, insurance companies, NBFCs , etc. can invest in them.

Bonds sold by government corporations and agencies offer investment outlets for funds, individuals and institutions. These bonds may or may not, be backed by government guarantee.

In spite of large and increasing debt, governments enjoy a good credit position with domestic and sometimes foreign lenders. Most bond-rating agencies, give government bonds the highest rating. So the **first** advantage of government securities is their obvious quality and the security they afford the investor. A **second** is the stability of income they provide, particularly the long-term government securities. A **third** is their great degree of marketability. There is a broad and ready market for government securities, particularly among institutional investors, or they can be sold quickly and easily in the bond market when funds are needed immediately. Also, government bonds eliminate the market risk and the business risk because of their security of principle and stability of income. A fourth advantage is their ability to meet the investment needs of financial institutions and institutional investors.

Disadvantages are several. Unless the investor buys government bonds that are selling below par, there is no capital gain without trading in the securities. Government securities are debt instruments. The government simply guarantees to repay principal at maturity. The income is stable and secure but offers no chance for increase in the future as the interest rate is established by contract and will not be changed over the life of the bond. They do not provide guard against risks of inflation and changes in money rate. Bonds do not provide a hedge against inflation because incomes and maturity values are fixed. If yield in the market should increase, the price of the bond existing in the market place will decline and the investor will lose if the bond must be sold. Even if he can hold, the investor will lose the difference between the low rate of interest paid on the existing bond and the rates on the new bonds. If a person can invest in the bonds at a high rate of interest this risk of loss is minimised. In this situation, if yield declines, the price of the bond will go up, and the investor will gain owing to the inverse relationship between bond price and bond yields.

Bonds are classified as treasury or corporate bonds depending on the issuer. The treasury bonds, are commonly called government securities in India. Bonds may have a call feature allowing the issuer to repurchase the bonds prior to maturity. The bid price (what the buyer is willing to pay) and the ask price (what the seller is willing to sell for) are quoted on the face value which is generally Rs.100/- per bond.

It is a promise by the borrower to pay to the lender, a certain sum of money at a fixed future date. It differs from a promissory note, in that, it is issued in a series and in like tenor and account. It is generally, issued for periods not less than 5 years and up to 30 years. Although the bond is assignable, it is not negotiable.

It differs from a share of stock in that it is a promise to pay with different terms as to amount, interest, maturity, whereas the share contains no promise to repay. The bondholder is a creditor whereas the shareholder is the owner. Although both bonds and shares may be traded, the former are quoted as a percent of their face value. The coupon rate or interest rate, is also shown in the bond. Interest is usually paid semi-annually and is based on the face value of the bond.

Bonds, which have a single fixed maturity, are called term bonds, whereas serial bonds are those that repay the principle in a series of instalments. If, bonds are sold at a price above the face value, it is said to be sold at a premium. If bonds are sold at a premium, it would mean that the effective interest rate would be less than the nominal because the issue would receive more than the face value but the issuer would be required to pay interest on face value.

If the bond is sold below its face value, it is said to be at a discount. In that event, the issuer would receive less than the face value but pay interest on the face value, thus making the effective interest rate higher than the nominal.

Floating rate bonds allow the investor to benefit from a rising market in interest rates over a period of time, whereas they allow the issuer to benefit from declining rate over period of time.

Bonds classified by their ownership structure, are bearer bonds or registered bonds. The former require the owner to clip coupons attached to the bonds and send them to the issuer to receive coupon payments. Registered bonds require the issuer to maintain records of who owns the bond and automatically send coupon payments to owners. Bonds are generally, registered in the name of the investor, by the issuer.

Coupon bonds, are those that can be transferred by one investor to another by delivery along with interest coupons attached to the bond. On scheduled interest payment dates, coupons have to be detached and submitted to the issuer or its agent.

A zero coupon bond is one where there are no periodic payments of interest but one at maturity. The maturity value is the principle plus interest compounded semi-annually at the original interest rate.

The warrant bond is a type of security that offers the investor some of the same advantages as convertible bonds. One warrant is associated with one bond, but a warrant attached to the bond gives the owner the right to buy a specified number of common shares at a stated price - called the subscription price - for a limited period of time. The time-period may be as long as five years. Therefore, it is not a short-term agreement. The warrant, may be exercised separately from the bond, in which case it is called a detachable warrant. A bond having a detachable warrant could benefit the investor in one of two ways 1) if the warrant could be sold and the gain realised or 2) the warrant could be exercised and the stock bought at the option price, then sold at the market price. If, the stock were held and the ownership of the bond retained, the investment position would change. The investor would be a bondholder and a stockholder. The warrant however may be non-detachable, in which case it would be necessary to send the bond to the company's agent. He would detach the warrant and return the bond at the time the option was to be exercised.

Bonds with warrants allow investors to share in the growth of company without undue risk, by participating in the potential increase in value of the common stock. If the market price of the common stock remained below the subscription price set in the bond agreement, then the bond would be held without exercising the warrant. If the stock increased in price, the warrant could be sold and the bond retained. A profit on the warrant could be earned, and a safe debt type security could be held for investment.

Bonds with warrants, however, are not common in present-day markets as the more popular convertible bonds. The market price of the bond plus the market value of the stock from the warrant, compared with the market price of the bond plus the cash cost of exercising the warrant, will help decide the relative advantage of buying the bond or the stock. Bonds with stocks selling on a high current-yield basis might be attractive because of the expected profit potential of the growth in common stock price. The ability to share in price increases by means of warrants is not as great as it is for convertible bonds. The warrant bond offers protection against purchasing power and business risk. Bonds with warrants offer a higher yield and a higher risk than ordinary bonds.

Convertible bonds are those that may be exchanged for equity during a specified time and at a determinable or determined price. Non-convertible bonds are tradable and transferable like other debentures and may be redeemable after a specified period.

In convertible bonds the conversion is effected at the conversion price i.e. the price at which the shares of stock may be exchanged or the conversion rate i.e. in terms of the number of shares at which each bond may be converted. It makes little difference how the conversion is established; the effect in either case is the same. Convertible bonds offer the possibility of an increase in capital value. A disadvantage of such bonds is their relative lack of security compared to other corporate debt. Most are rated, lower than comparable non-convertible bonds. Many convertible bonds are subordinated to other debts, giving them a junior claim to assets in case of failure.

Convertible bonds are hybrid instruments having both debt and equity characteristics. Like straight bondholders, holders of convertibles are entitled to receive coupons and principal payments. However, the holder of convertible bonds can forego these cash flows by converting their bonds into pre-specified number of shares. Companies seek capital in this form when they believe that their stock price would rise over time and convertibles provide a way of selling common stock at a price above the existing market price. It also provides a way to lower dilution over an outright equity issue. The equity sweetener of the convertible bond, also allows for the coupon to be lower. Thus, convertible debt can be a cheaper source of finance as the equity makes it less sensitive to changes in risk. Therefore, compensation for increases in risk will not be required.

Value can be shifted from debt to equity by increasing risk of the company's projects since limited liability protects equity if the company should perform poorly.

Bonds go some way to limit a company's ability to increase risk. Therefore, shareholders may actually wish to increase risk while the actual value of the company falls.

Undervalued companies would be tempted to issue debt, whereas over valued ones may be tempted to issue equity. Convertibles fall somewhere in between when under-valuation is not grossly so. Thus, a company signals its value by its choice of capital.

Bonds, that are perceived to have high risk are referred to as junk bonds. As a result, they offer relatively higher yields. Issuers may wish to expand without issuing new stock so that profits can be distributed to existing shareholders. The higher yields contain a risk premium.

The call provision normally requires the firm to pay a price above par value when it calls its bonds. The difference between the bonds call price and par value is the call premium. Call provisions have two principal uses. One is, should market interest rate decline after a bond issue is sold, the firm may end up paying higher rate of interest than the prevailing rate for a long period of time. Under these circumstances the corporate can consider selling new issue of bonds with a lower interest rate and use the proceeds to retire old issues by calling the old bonds. Bondholders may consider the call provision as disadvantage because it would reduce their return and disrupt their investment plan; as a result corporate pay slightly higher rates of interest on bonds that are callable.

The issuer’s cost of financing with bonds, is commonly measured by the so-called yield to maturity, which reflects the annualised yield that is paid by the issuer over the life of the bond. The yield to maturity is the annualised discount rate that equates the future coupon and principle payments to the initial proceeds received from the bond offering. The yield to maturity does not include transaction costs associated with issuing the bond. An investor who invests in a bond when it is issued and holds it till maturity will earn the yield to maturity. But investors do not hold a bond until maturity, and focus on the return for the holding period. If they hold the bond for a short period (less than 1 year), the return will be the sum of coupon payments plus the difference between the selling price and purchase price as percentage of the purchase price. If the bond is to be held for a long period the yield is the annualised discount rate that equates the payments received to the initial investment. Since the selling price of the bond is uncertain if they do not hold the bond to maturity, the holding period yield is uncertain at the time they purchase the bond. Consequently, an investment in bonds is subject to the risk that the holding period return is less than that expected.

Bonds are purchased on a yield to maturity basis. The fulcrum around which yields vary is the interest rate, which is fixed in amount over life of the bond. It is usually stated as a percentage of the par value of a bond. If the market price of a bond drops, the yield to maturity or yield goes up. If the market price of the bank goes up, the yield goes down.

For corporate entities the cost of debt capital as represented by debentures is lower than the cost of preference capital or equity capital. Debenture capital has the added attraction of not diluting control as debenture holders are not entitled to vote. Besides it has no uncertainty as to the amount of burden to the company even with changes in price of the instrument. This of course, can also be an embarrassment to the corporate entity if it is unable to meet its payment obligations. The fixed cost of debenture finance could result in raising the cost of equity capital.

Check Your Progress B

1. What is a debenture ?
2. List the advantages of bond.
3. What are coupon bonds ?
4. What are convertible debentures

8.6 TERM LOANS

Financial Institutions are intermediaries in the transfer of funds from agents with free cash flows or financial surpluses to those with financial deficits. It results in funds shifting from the personal to the business sector. Banks and insurance companies perform this function. Loans can be tailored to the borrower's requirements. It is a type of debt finance which requires repayment over a period of three to ten years.

Term loans are offered mainly by banks and financial institutions primarily to finance the purchase of fixed assets such as machinery. A term loan is a specified amount of funds, loaned out for a specified period of time, and for a specified purpose. The assets purchased with the borrowed funds may serve as partial or full collateral on the loan.

Term loan is essentially a secured borrowing, secured by means of equitable mortgage of immovable, and hypothecation of movable, properties of the borrower. Maturities on term loans are commonly 3 to 5 years and sometimes as long as 10 years. Because term loans are long term, sufficient documentation is needed to specify any conditions the borrower might need to abide by. These conditions are often referred to as protective covenants, such as limit on additional debt the borrower can accumulate, a management set-up that satisfies the lending institution and furnishing of periodic information on operations. Term loans can be amortised so that the borrower makes fixed periodic payments over the life of the loan. Alternatively, the bank can request periodic payment of interest, with the principal to be paid-off in one lump-sum (called a balloon payment) at a specified date in the future. This is called a bullet loan. Several combinations are possible e.g. a portion of the loan may be amortised over the life of the loan, while remaining portion is covered with a balloon payment.

Interest rate is related to the credit risk of the proposal and the borrower. Default on repayments leads to imposition of penalty. The borrower applies to a bank/financial institution for a limit, which is sanctioned for a specified period and, upon which it draws over the defined period. If the borrower fails to draw upon the limit within the specified period, it becomes liable to pay commitment charges on the undrawn portion of the amount sanctioned.

Term loans constitute the principal assets of banks. They are direct loans to their customers. They are the bank's primary source of income but they are relatively illiquid assets. Loans are generally associated with non-negotiable credit instruments, although, bank loans may be marketed. This is however, done without the knowledge of the borrower. Interest payments and repayment of principal are generally made to the original lender.

A bank that lends money to a company cannot easily sell that loan to another investor, though sales of bank loans do take place occasionally, lenders such as banks, need to be compensated for the lack of marketability and therefore carry a higher rate of interest.

Development banks and institutions play a significant role in the supply of term loans to corporate customers. In India many industrial financing institutions have been created by the government, both at the national and regional levels to supply long-term and medium-term loans to corporate customers directly as well as, indirectly. These development financial institutions dominate the industrial finance scene in India. They comprise IDBI, IFCI, ICICI (now merged with ICICI Bank) and state financial corporations. They help in identifying investment opportunities, encourage new entrepreneurs and support modernisation efforts.

8.7 VENTURE CAPITAL

According to International Finance Corporation Venture Capital is an equity or equity featured capital seeking investment, new companies, new ideas, new production new processes or new services that offer high returns or investment. The Venture Capital may also invest in a firm that is unable to raise finance through conventional means.

Venture Capital is that capital, in the form of equity or debt, which is used to finance high-risk ventures. The ventures are generally new and sunshine industries but may also be old and risky ones.

Typically, these enterprises or industries have a high mortality rate and therefore, do not find finance from banks or private sector companies. It is here that professional investors step in with risk capital and entrepreneurial management skills to launch new products requiring sometimes, advanced technology. Such providers of capital, are called venture capitalists and have the ability to assess and manage enormous risks. Naturally, the returns expected are high. The capital investment would go hand in hand with nurturing the company by way of managerial and technical assistance.

Venture Capital differs from conventional financing in three respect

(a) It invest in equity rather than extending loans.

(b) It does not look to current income, but returns by way of capital appreciation

(c) assessment is based on potential returns rather than risks.

Venture Capitalists generally :

1. Finance new, young and rapidly growing or changing companies
2. Purchase equity securities
3. Assist in the development of new products or services or companies
4. Add value to the company through active participation
5. Take higher risks with the expectation of higher rewards
6. Have a long-term orientation

Venture capitalists carefully screen the technical and business merits of the proposed company for considering an investment. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They also actively work with the company's management, especially with contacts and strategy formulation.

Venture capitalists mitigate the risk of investing by developing a portfolio of young companies in a single venture fund. Many times they co-invest with other professional venture capital firms. In addition, many venture partnerships manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development.

In India, these funds are governed by the Securities and Exchange Board of India (SEBI) guidelines. According to this, venture capital fund means a fund established in the form of a company or trust, which raises monies through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations.

The basic principal underlying venture capital – invest in high-risk projects with the anticipation of high returns. These funds are then invested in several fledging enterprises, which require funding, but are unable to access it through the conventional sources such as banks and financial institutions. Typically first generation entrepreneurs start such enterprises. Such enterprises generally do not have any major collateral to offer as security, hence banks and financial institutions are averse to funding them. Venture capital funding may be by way of investment in the equity of the new enterprise or a combination of debt and equity, though equity is the most preferred route.

Since most of the ventures financed through this route are in new areas (worldwide venture capital follows "hot industries" like infotech, electronics and biotechnology), the probability of success is very low. All projects financed do not give a high return. Some projects fail and some give moderate returns. The investment, however, is a long-term risk capital as such projects normally take 3 to 7 years to generate substantial returns. Venture capitalists offer "more than money" to the venture and seek to add value to the investee unit by active participation in its management. They monitor and evaluate the project on a continuous basis.

The venture capitalist is however not worried about failure of an investee company, because the deal which succeeds, nets a very high return on his investments – high enough to make up for the losses sustained in unsuccessful projects. For them potential returns outweigh risk factors. They generally invest in unlisted companies i.e. in an early stage company with little or no history. The returns generally come in the form of selling the stocks when they get the company listed on the stock exchange or by a timely sale of his stake in the company to a strategic buyer. The idea is to cash in on an increased appreciation of the share value of the company at the time of disinvestment in the investee company. If the venture fails (more often than not), the entire amount gets written off. Probably, that is one reason why venture capitalists assess several projects and invest only in a handful after careful scrutiny of the management and marketability of the project.

Venture capitalists also lend support and provide entrepreneurs with many other facilities. The even participate in management process.

Venture Capital In India

In India the need for Venture Capital was recognized in the 7th five year plan and long term policy for the government of India. Venture Capital technology development and information company of India, promoted by I.C.I.C.I. and U. T. I. A technology development fund was set up. The First private venture capital fund was sponsored by credit capital Finance Corporation and promoted by Bank of India, Asian Development Bond and the Commonwealth Development Corporation viz., Credit Capital Venture fund. The reasons for slow start to venture capital are following :

1) License Raj and IPO boom
2) Mind set for conventional financing
3) Multiplicity of regulators like RBI, SEBI, CBDT and Foreign Investment Promotion Board etc.
4) Difficult Entry and Exit routes
5) Valuation mismatches.

Regulations

SEBI has framed venture capital funds (amendment) regulations 2000.

Following are the salient features of SEBI (Venture Capital Funds)(Amendment) Regulations, 2000 :

1 **(a) Definition of Venture Capital Fund** : The Venture Capital Fund is now defined as a fund established in the form of a Trust, a company including a body corporate and registered with SEBI which:

A. has a dedicated pool of capital;
B. raised in the manner specified under the Regulations; and
C. to invest in Venture Capital Undertakings in accordance with the Regulations."

(b) Definition of Venture Capital Undertaking: Venture Capital Undertaking means a domestic company :-

a. Whose shares are not listed on a recognised stock exchange in India
b. Which is engaged in business including providing services, production or manufacture of articles or things, or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf. The **negative list** includes real estate, non-banking financial services, gold financing, activities not permitted under the Industrial Policy of the Government of India.

(c) Minimum contribution and fund size : the minimum investment in a Venture Capital Fund from any investor will not be less than Rs. 5 lacs and the minimum corpus of the fund before the fund can start activities shall be atleast Rs. 5 crores.

(d) Investment Criteria : The earlier investment criteria has been substituted by a new investment criteria which has the following requirements :

- disclosure of investment strategy;
- maximum investment in single venture capital undertaking not to exceed 25% of the corpus of the fund;
- Investment in the associated companies not permitted;
- atleast 75% of the investible funds to be invested in unlisted equity shares or equity linked instruments.
- Not more than 25% of the investible funds may be invested by way of:

a. subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year;
b. debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

It has also been provided that Venture Capital Fund seeking to avail benefit under the relevant provisions of the Income Tax Act will be required to divest from the investment within a period of one year from the listing of the Venture Capital Undertaking.

(e) Disclosure and Information to Investors: In order to simplify and expedite the process of fund raising, the requirement of filing the Placement memorandum with SEBI is dispensed with and instead the fund will be required to submit a copy of Placement Memorandum/ copy of contribution agreement entered with the investors along with the details of the fund raised for information to SEBI. Further, the contents of the Placement Memorandum are strengthened to provide adequate disclosure and information to investors. SEBI will also prescribe suitable reporting requirement from the fund on their investment activity.

2. QIB status for Venture Capital Funds : The venture capital funds will be eligible to participate in the IPO through book building route as Qualified Institutional Buyer subject to compliance with the SEBI (Venture Capital Fund) Regulations.

3. Relaxation in Takeover Code: The acquisition of shares by the company or any of the promoters from the Venture Capital Fund under the terms of agreement shall be treated on the same footing as that of acquisition of shares by promoters/companies from the state level financial institutions and shall be exempt from making an open offer to other shareholders.

4. Investments by Mutual Funds in Venture Capital Funds: In order to increase the resources for domestic venture capital funds, mutual funds are permitted to invest upto 5% of its corpus in the case of open ended schemes and upto 10% of its corpus in the case of close ended schemes. Apart from raising the resources for Venture Capital Funds this would provide an opportunity to small investors to participate in Venture Capital activities through mutual funds.

5. The following are the salient features of SEBI (Foreign Venture Capital Investors) Regulations, 2000 :

a. Definition of Foreign Venture Capital Investor : any entity incorporated and established outside India and proposes to make investment in Venture Capital Fund or Venture Capital Undertaking and registered with SEBI.

b. Eligibility Criteria : entity incorporated and established outside India in the form of investment company, trust, partnership, pension fund, mutual fund, university fund, endowment fund, asset management company, investment manager, investment management company or other investment vehicle incorporated outside India would be eligible for seeking registration from SEBI. SEBI for the purpose of registration shall consider whether the applicant is regulated by an appropriate foreign regulatory authority; or is an income tax payer; or submits a certificate from its banker of its or its promoters track record where the applicant is neither a regulated entity nor an income tax payer.

c. Investment Criteria :

- disclosure of investment strategy;
- maximum investment in single venture capital undertaking not to exceed 25% of the funds committed for investment to India however it can invest its total fund committed in one venture capital fund;
- atleast 75% of the investible funds to be invested in unlisted equity shares or equity linked instruments.

- Not more than 25% of the investible funds may be invested by way of:

    a. subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year;
    b. debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.

6. Hassle Free Entry and Exit : The Foreign Venture Capital Investors proposing to make venture capital investment under the Regulations would be granted registration by SEBI. SEBI registered Foreign Venture Capital Investors shall be permitted to make investment on an automatic route within the overall sectoral ceiling of foreign investment under Annexure III of Statement of Industrial Policy without any approval from FIPB. Further, SEBI registered FVCIs shall be granted a general permission from the exchange control angle for inflow and outflow of funds and no prior approval of RBI would be required for pricing, however, there would be ex-post reporting requirement for the amount transacted.

7. Trading in unlisted equity : The Board also approved the proposal to permit OTCEI to develop a trading window for unlisted securities where Qualified Institutional Buyers(QIB) would be permitted to participate

Check Your Progress C

1) What are term loans ?
2) Define Venture Capital
3) Differentiate between Venture Capital and Conventional financing ?
4) Give reasons for slow growth in venture capital in India.

8.8 LET US SUM UP

Long term finance is required for medium to long term purposes to meet the long term requirement ranging from 3 to 10 years.

The principal sources of long term finance are retained earnings equity capital, preference capital, debentures, term loans and venture capital equity capital represents ownership capital as equity shareholders own the firm. They enjoy the dividend and also bear the risk of ownership.

Retained earnings are the reserve earnings not distributed as dividend. It also includes accumulated profits of past years. Retained earnings can finance only a small portion of investment projects. Some companies do not pay dividend at all and with to retain the funds. Some companies do not pay dividends because they cannot afford them with their present and future expectation of profits. For retained earning companies need not have to approach the lenders. Equity capital is used for financing new or expanding business. There are two types of equity shares voting and non voting shares. The advantage of voting is that its allows a minority group of shareholders or an in divided shareholding of a large among of sock to be represented on board of directors.

Preference shares have the right to divided at a fixed rate and fro repayment of capital at the time of winding up of a company. Preference shares may be cumulative, or non cumulative, redeemable or irredeemable, convertible or non convertible and participating or non participating.

Debentures/ Bonds are long term debts i.e. loans taken by a company from the public debentures are transferable like equity shares. Interest and debentures is a debt. It is fixed. Debentures are redeemable irredeemable and preferential convertible or non convertible. Bonds are issued by government so there is no default in repayment of capital and interest on bonds term loans are loans more than one year maturity. They are offered by banks and financial institution. They are available from 3 to 10 yeas. Interest on loan is tax deductible. Venture capital is the capital provided by investors for the risky projects at an early stage on the promise high risk and high return. SEBI has made regulations 2000 relating to eligibility and investment criteria for domestic companies as well as foreign venture capital investors.

8.9 KEY WORDS

Initial/Seed Capital - Small amount of capital provided to the entrepreneur for concept testing.

First Stage - Funds raised to initiate commercial manufacturing and sales, after initial capital runs out.

Second Stage - Usually to fund working capital for initial expansion.

Third Stage - Funds provided for major growth plans, generally used for capacity expansion, marketing and working capital.

Follow-on/Later Stage - Subsequent investment made by an investor who already has an exposure in the company.

Buyout - Funds provided to enable acquisitions.

Secondary Purchase - Purchase of already issued company shares from an existing shareholder.

Bridge/Mezzanine - Financing a company just before its IPO.

IPO/Initial Public Offering - A company's first offering of stock to the public.

Equity Related Loan - Convertible debt.

Private Placement - Sale of securities to a small group of "informed" investors.

Secondary Public Offering - Any offering subsequent to IPO.

Underwriting - An investment bank acting as underwriter sells securities from the issuer to the public to ensure successful distribution. The types of underwriting are best efforts and firm commitment. With best efforts, the underwriters have the option to buy and authority to sell securities, or if unsuccessful, may cancel the issue and forgo any fees. This arrangement is more common with speculative securities and with new companies. With a firm commitment, the underwriters purchase outright the securities being offered by the issuer.

Venture Capital - Capital with which investors fund early stage, more risk oriented businesses, on the basic premise of high risk, high return.

Angels - High networth individuals who provide seed money.

Term Loans : Refers to debt finance which has a maturity of more than one year.

Venture Capital : It is the funds provided by professionals to young, and rapidly growing high risk ventures.

Convertible Preference Shares : The preference shares which can be converted is equity for a specified period.

Redeemable Preference Shares : The preference shares which can be retained after a certain period.

Bonds/Debentures : Debt instruemtn issued by corporations or government.

8.10 SELF ASSESSMENT QUESTIONS/EXERCISES

1) What are the sources of long-term finance and to what uses can they be put ?
2) What limitations does a company encounter in the use of retained earnings as a source of long-term finance?
3) When does a company resort to acquiring equity capital?
4) Discuss the nature of equity and debt instruments.
5) What features do preference shares share with bonds?
6) What functions do venture capitalists perform?