

## **SOURCES OF LONG-TERM FINANCE**

### **Introduction**

India is geared up to achieve 8% growth rate p.a. Any economy needs finance to grow as finance is called —Life Blood of the businesses. Companies need finance mainly for two reasons – To meet the long-term requirements and for meeting the day to day requirements i.e. working capital requirements.

The long term decisions of the company include setting up the business, diversification, modernization, expansion and such capital expenditure decisions. These decisions are for the long term and it takes a long gestation period to see the benefits. Since these decisions involve enormous investment and are irrevocable in nature, long-term funds are best for them. In this, Asset-Liability management plays a paramount role. Companies should be prudent in meeting the long-term requirements by the long-term sources of funds instead of short-term sources of funds. If this is done otherwise, meeting the long-term requirement by the short-term sources then there would be a mismatch and this would lead to interest rate risk and interest burden and the company will have to face liquidity risk eventually.

### **Types of Capital**

Companies can issue three types of capital – Equity, Preference and Debenture (Loan) capital. These sources distinguish amongst themselves on the risk, return and ownership pattern.

### **Equity Capital**

Equity shareholders are the owners of the company. After paying a part of profit to the preference shareholders and other creditors of the company, they enjoy the residual profits of the company. Their liability is limited to the amount of share capital they contribute to the company. The benefit of equity capital to the issuing company is that without any fixed commitment for the payment of dividends, it offers lifetime capital with limited liability for repayment. Considering the cost of capital, the cost of equity capital is higher than any other form of capital as –

- The equity dividends are not tax deductible expenses.
- The high cost of issue.
- The equity shareholders enjoy voting rights, so excess of equity capital in the company's capital structure leads to dilution of effective control.

### **Preference Capital**

Preference shares combine the attributes of equity shares and debentures. Like in the case of equity shareholders, there is no mandatory payment to the preference shareholders and the preference dividend is not tax deductible (unlike in the case of the debenture holders, wherein interest payment is mandatory). The preference shareholders earn a fixed rate of return for their dividend payment similar to the debenture holders. In addition to this, the preference shareholders have preference over equity shareholders to the post-tax earnings in the form of dividends and assets in the event of liquidation. Preference shareholders generally do not have any voting rights. They may be entitled to conditional voting rights.

Most preference shares in India carry a cumulative dividend feature, requiring that all past unpaid preference dividends be paid before any ordinary dividends are paid. In India, both redeemable and perpetual preference shares can be issued. Perpetual or irredeemable preference shares do not have a maturity date. Redeemable preference shares have a specified maturity. In India, redeemable preference shares are not often retired in accordance with the stipulation since there are no serious penalties for violation of redemption feature. The call feature permits the company to buy back preference shares at a predetermined buy back or call price. Call price may be higher than the par value. Normally, it decreases with the passage of time. The difference between call price and par value of the preference share is called call premium.

Preference shares may or may not be convertible. A convertible preference share permits preference shareholders to convert their preference shares, fully or partly, into ordinary shares at a specified price during a given period of time.

Preference shares allow more flexibility and fewer burdens to a company. The dividend rate is less than that of equity shares and it is fixed. In addition, the company can redeem it when it does not require the capital. Normally, when a company reconstructs its capital, it may convert preference capital into equity capital. Occasionally, equity capital may be converted into preference capital. For example, IDBI in 1994 proposed to convert its equity capital as preference capital.

### **Debenture Capital**

A debenture is a marketable legal contract whereby the company promises to pay its owner, a specified rate of interest for a defined period of time and to repay the principal at the specific date of maturity. A debenture is a long term promissory note for raising loan capital. The firm promises to pay interest and

principal as stipulated. The owners of debentures are called debenture holders. An alternative form of debenture in India is Bond. Bonds are issued primarily by public sector companies in India.

Debentures are usually secured by a charge on the immovable properties of the company. If the company issues debentures with a maturity period of more than eighteen months, then it has to create a Debenture Redemption Reserve (DRR), which should be at least half of the issue amount before the redemption commences. The company can also attach call and put options. With the call option, the company can redeem the debentures at a certain price before the maturity date and similarly, the put option allows the debenture holder to surrender the debentures at a certain price before the maturity period.

The interest rate on a debenture is fixed and known. It indicates the percentage of the par value of the debenture that will be paid out annually or semi-annually or quarterly in the form of interest. Thus, irrespective of whatever might be the market price of the debenture, say, with a 12% interest rate, and a Rs. 1000 par value, it will pay out Rs. 120 annually in the form of interest until maturity. Paying the interest is legally binding on a company. Debenture interest is tax deductible for computing the company's corporate tax.

Debentures are issued for a specific period of time. In India, a debenture is generally redeemed after seven to ten years in instalments.

The yield on a debenture is related to its market price; therefore, it could be different from the coupon rate of interest. Two types of yield could be distinguished. The current yield on a debenture is the ratio of the annual interest payment to the debenture's market price. For example, the current yield of a 12% Rs. 1000 debenture currently selling at Rs. 800 is -

$$\begin{aligned}\text{Current Yield} &= \text{Annual Interest} / \text{Market Price} \\ &= 120 / 800 \\ &= 0.15 \text{ or } 15\%\end{aligned}$$

The yield to maturity considers the payments of interest and principal over the life of the debenture. So, it is the internal rate of return of the debenture. The yield to maturity is the discount rate that equates the present value of the interest and principal payments with the current market price of the debentures.

In liquidation, the debenture holders have a claim on assets prior to that of share holders. However, secure debenture holders have priority over the unsecured debenture holders.

### **Types of Debentures**

Debentures can be classified based on the conversion and security. A few types of debentures are discussed below:

- Non-Convertible Debentures(NCDs)
- Fully-Convertible Debentures(FCDs)
- Partly-Convertible Debentures(PCDs)

#### **Non-Convertible Debentures (NCDs)**

NCDs are pure debentures without a feature of conversion. They are not repayable on maturity. The investor is entitled for interest and repayment of principal.

For example, ICICI offered for public subscription unsecured redeemable debentures of Rs. 1000 each. These bonds are fully non-convertible and so, here, the investor is not given the option of converting it into equity. Interest on the ICICI debentures will be paid half yearly on June 30 and December 31 each year. The company plans to redeem these debentures at par on the expiry of five years from the date of allotment that means the maturity period is five years. However, ICICI has also allowed its investors the option of requesting the company to redeem all or part of the bonds held by them on the expiry of three years from the date of allotment, provided the debenture holders give the prescribed notice to the company.

#### **Fully-Convertible Debentures (FCDs)**

FCDs are converted into shares as per the terms of the issue with regard to price and time of conversion. These debentures can be converted into equity shares after a specified period of time at one stroke or in instalments. In the case of a fully established company with an established reputation and good stable market price, FCDs are very attractive to the investors as their debentures are getting automatically converted to shares which may at the time of conversion be quoted much higher in the market compared to what the debenture holders paid

at the time of FCD issue. Nowadays, companies in India are issuing FCDs with zero rate of interest.

### **Partly-Convertible Debentures (PCDs)**

These debentures issued by companies in India have two parts: a convertible part and a non-convertible part. Such debentures are known as partly convertible debentures. The investor has the advantage of both convertible and non-convertible debentures combined into one debenture. For example, Proctor and

Gamble Ltd (P and G) issued 4,00,960 PCDs of Rs. 200 each to its existing shareholders in July 1991. Each PCCD has two parts: convertible portion of Rs. 65 each to be converted into one equity share of Rs. 10 each at a premium of Rs.

55 per share at the end of 18 months from the date of allotment and non-convertible portion of Rs. 135 payable in three equal instalments on the expiry of 6th, 7th and 8th years from the date of allotment.

### **Advantages of Debentures**

- ❖ Is a cheaper source of finance because, investors consider debentures as a less risky investment and therefore require a lower rate of return and interest payments are tax deductible.
- ❖ Since debenture holders do not carry voting rights, debenture issue does not cause dilution of ownership.
- ❖ Debenture holders do not have share in extra ordinary earnings of the company. So the payments are limited to interest.
- ❖ In the periods of high inflation, debenture issue benefits the company. Its commitment of paying interest and principal which are fixed decline in real terms.

### **Disadvantages of Debentures**

- ❖ Debentures carry legal obligation of interest and principal payment, which, if not paid, can force the company into liquidation.
- ❖ In the case of companies which have fluctuating sales and earnings, debentures prove to be disadvantageous due to increased financial leverage.
- ❖ At the time of maturity, debenture involves substantial cash outflows.

### **Term Loans**

Apart from Debentures or Bonds, Term Loans is another major source of debt finance. Term loans are sources of long term debt and are obtained from banks and financial institutes like IDBI, ICICI etc. As term loans are obtained for financing large projects, this method of financing is also called project financing.

Term Loans have a maturity of more than one year but less than ten years. Term loans provided by FIs generally have maturity of 6 to 10 years while the ones provided by banks have maturity of around 3 to 5 years.

Term loans are negotiated by a firm directly with a bank or FI, thereby making term loans a private placement unlike debentures that are placed for public subscription. This gives term loans the advantage of low loan raising cost as well as ease of negotiation. Also, as term loans need not be underwritten, they also avoid commission and other related costs.

Security is always guaranteed in case of term loans. Primary Security secures the term loans specifically by using the assets obtained from term loan funds. Secondary or Collateral Security is used to secure the term loans generally by using the company's current or future assets. Fixed or Floating charge can be created against the firm's assets.

In case of fixed charge, the firm needs to pay stamp duty of around 10.5% of the loan amount while for floating charge; it needs to pay stamp duty of only 0.5%.

Other than asset security, the FIs impose a number of restrictive covenants on the borrowing firms. Some of these covenants include ensuring that the firm maintains its minimum asset base by maintaining minimum capital position in terms of minimum current ratio. The firm may also be required to reduce its debt-equity ratio by issuing additional equity and preference capital. The lender can also restrain the borrowing company from incurring additional debt or even repaying existing loan. The cash outflows of the firm may also be restricted by restricting dividends or any other capital expenditure. Term loans have a provision for appointing a nominee director by FIs. The role of this nominee director is to safeguard the interests of the FIs without causing any interference.

FIs provide heavy loan assistance to the companies due to which the financial stake of these institutions is substantial. As a result, these FIs had an option of converting the part of rupee loan into equity, the terms and conditions of which are decided by FIs themselves.

The schedule for paying the interest and principal is called the repayment schedule or loan amortization. Interest charges are tax deductible. In India, the general rate of interest on term loans is above 14-15 percent. However, loans at concessional interest rates are also available for projects in backward areas. In India, amortization is executed by repayment of principal in equal instalments and paying the interest on the outstanding (unpaid) loan. This results in the decline of interest payments over the years and also, the total loan payment will not be the same for each period. Repaying the loans in instalments saves the company from paying huge amounts at the end of the maturity. Such payments are termed as balloon payments.

For example, let's say an airline company has taken a term loan of Rs. 5 crores for a period of 9 years from a FI. The interest rate charged will be 15% p.a. on the outstanding balance. That means the principal shall be repaid in nine equal year-end instalments. Now, the payment schedule will include both, the interest as well as the principal payment. The interest calculation will be on the outstanding loan amount. As the amount was borrowed at the beginning of the first year, the interest at the end of the year will be

$$0.15 \times 2,00,00,000 = 30,00,000$$

$$\text{The instalments on the principal will be } 2,00,00,000 / 9 = 22,22,222.22$$

$$\text{Thus, at the end of first year, the loan balance will be } 2,00,00,000 - 22,22,222.22 = 1,77,77,777.78$$

This balance will be used to calculate the interest rate for next year.

## Convertibles

A debenture that can be changed into a specified number of ordinary shares at the option of the owner is known as a convertible debenture. As a result, this debenture not only promises the investor a fixed income associated with it, but also the capital gains associated with the equity share once the owner has exercised its conversion option. Due to this combination of capital gains and fixed income, convertibles are also called as a hybrid security.

Whenever a company issues convertibles, it specifies the terms of conversion like the number of equity shares in return of the convertible debenture, the price of conversion and also the place and time of conversion option execution.

The number of equity shares that an investor can receive on exchange of his convertible debenture is called conversion ratio. Likewise, the price paid for the equity share at the time of conversion is the conversion price. The conversion ratio can be found out easily if the par value of the convertible security and its conversion price is known –

Conversion Ratio = Par value of convertible debenture / Conversion Price

In India, generally both, the conversion ratio and the conversion price are specified by the companies. The ways in which the conversion price is set in developed capital markets like that of USA and in a developing market like India is different. In India, the conversion price is set much below the share's market price prevailing at the time of issue whereas in USA, it is set much above the share's prevailing market price.

The buyers of convertibles are safeguarded against the dilution arising due to share split or bonus share issue.

The valuation of convertible debentures combines both fixed income securities as well as ordinary shares. This makes the valuation of convertible debentures more complex than that of non-convertible securities. Thus, the market value of the convertible debenture depends on market price of a share, conversion value and also the value of non-convertible or straight debenture known as investment value.

The conversion value of a convertible debenture is the product of conversion ratio and the market price of the ordinary share. i.e.

Conversion Value = Conversion Ratio X Share Price

For example, the conversion ratio for the convertible debenture of a company is 2 and the market price of its share is Rs. 150, then

$$\begin{aligned}\text{Conversion value} &= 2 \times 150 \\ &= \text{Rs. } 300\end{aligned}$$

The non-convertible debenture (NCD) is also known as a straight debenture. The value of NCD is the value of convertible debenture without the feature of conversion. This value of the convertible is known as the investment value or the security value. It is equal to the sum of the present value of future interest payments and principal redemption at the required rate of return.

## **Need for issuing convertible debentures**

- The main idea of issuing convertible debenture is to make the issue attractive so that it is fully subscribed. Generally, fixed interest convertible debentures are preferred over non-convertible because it entitles to earn a definite, fixed income with the chance of making capital gains. So the convertibility feature becomes attractive.
- When the company issues a convertible debenture, the company is effectively selling ordinary shares in future. This is done when the company considers the current market price of its share to be low, but wants to issue shares at a higher price. It is done by setting the conversion price higher than the ordinary share's prevailing market price.
- The company issues convertible debenture as a deferred equity financing to avoid immediate dilution of the earnings per share. For this, the company uses fixed income security and does not increase the number of issued shares until its investment starts paying off.
- The company may issue convertible debentures over equity financing since it is a cheaper source of finance. The company can use such funds to finance a large expansion, modernization or diversification project. By doing so, the convertible debenture holders, who initially provided cheap funds to the company can now convert their debentures into ordinary shares and participate in the prosperity of the company.

## **Warrants**

A warrant allows the purchaser to buy a fixed number of ordinary shares at a particular price during a specified period. Warrants are issued along with debentures as 'sweeteners'. Nowadays warrants are issued by big, profitable companies as a part of a major financing package. Warrants can be used along with ordinary or preference shares, to improve the marketability of the issue.

The exercise price of a warrant is the price at which its holder can buy the issuing firm's ordinary shares. The exercise ratio is the number of ordinary shares that can be bought at the exercise price per warrant. This concept is like the conversion ratio in case of the convertible securities. If the exercise ratio is 1:1, that means the holder of warrants is allowed to buy one ordinary share in exchange for one warrant at the exercise price.

The expiration date is the date when the option to purchase ordinary shares in exchange for warrants expires. Normally, the life of warrants is between 5 and 10 years. However, some warrants are perpetual-they do not have any expiration date.

A warrant can either be detachable or non-detachable. When the warrant is sold separately from the debenture or preference share to which it was originally attached, it is called a detachable warrant. A non-detachable warrant cannot be sold separately from the debenture to which it was originally attached.

Warrants entitle to buy ordinary shares. So, the holders of warrants are the shareholders of the company until they exercise their options. As a result, they do not enjoy right to vote or receive dividends. They become the company's ordinary shareholders, once they exercise their warrants and purchase ordinary shares.

## **Leasing**

Leasing method of long term source of finance has become very common among the manufacturing companies. Leasing facility is usually provided through the mediation of leasing companies who buy the required plant and machinery from its manufacturer and lease it to the company that needs it for a specified period on payment of an annual rent. For this purpose a proper lease agreement is made between the lessor (leasing company) and lessee (the company hiring the asset). Such agreement usually provides for the purchase of the machinery by the lessee at the end of the lease period at a mutually agreed and specified price. It may be noted that the ownership remains with the leasing company during the lease period. Sometimes, a company, to meet its financial requirements, may sell its own existing fixed asset (machinery or building) to a leasing company at the current market price on the condition that the leasing company shall lease the asset back to selling company for a specified period. Such an arrangement is known as ‘\_Sell and Lease Back’. The company in such arrangement gets the funds without having to part with the possession of the asset involved which it continues to use on payment of annual rent for the lease. It may be noted that in any type of leasing agreement, the lease rent includes an element of interest besides the expenses and profits of the leasing company. In fact, the leasing company must earn a reasonable return on its investment in lease asset. The leasing business in India started, in seventies when the first leasing company of India was promoted by Chitambaram Group in 1973 in Chennai. The Twentieth Century Finance Company and four other finance companies joined the fray during eighties. Now their number is very large and leasing has emerged as an important source. It is very helpful for the small and medium sized undertakings, which have limited financial resources.

### **Hire Purchase**

Hire purchase is a form of instalment credit. Hire purchase is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customer on payment of the final credit instalment, whereas a lessee never becomes the owner of the goods.

Hire purchase agreements usually involve a finance house.

- i) The supplier sells the goods to the finance house.
- ii) The supplier delivers the goods to the customer who will eventually purchase them.
- iii) The hire purchase arrangement exists between the finance house and the customer.

The finance house will always insist that the hirer should pay a deposit towards the purchase price. The size of the deposit will depend on the finance company's policy and its assessment of the hirer. This is in contrast to a finance lease, where the lessee might not be required to make any large initial payment.

An industrial or commercial business can use hire purchase as a source of finance. With industrial hire purchase, a business customer obtains hire purchase finance from a finance house in order to purchase the fixed asset. Goods bought by businesses on hire purchase include company vehicles, plant and machinery, office equipment and farming machinery.

### **Initial Public Offer**

When a company reaches a certain stage in its growth, it may decide to issue stock, or go public, with an initial public offering (IPO). The goal may be to raise capital, to provide liquidity for the existing shareholders, or a number of other reasons.

Any company planning an IPO must register its offering with the Securities and Exchange Commission (SEC).

In most cases, the company works with an investment bank, which underwrites the offering. That means marketing the share being offered to the public at a set with the expectation of making a profit.

### **Rights Issues**

The following definition have been provided by the Chartered Institute for Management Accountants (CIMA): A Rights issue is the raising of new capital by giving existing shareholders the right to subscribe to new shares and debentures in proportion to their current holdings. These shares are usually issued at a discount to the market price. A shareholder not wishing to take up a rights issue may sell the rights.

#### **The advantages to rights issues are as follows:**

- Rights issues are cheaper than offers for sale to the general public.
- This is partly because no prospectus is required but also because the administration is simpler and the underwriting costs are less. An offer for sale is a means of selling share to the public at large based on information held in a prospectus. Underwriters are financial institutions which agree (in exchange for a fee) to buy any unsubscribed shares at the issue price.
- Rights issues are more beneficial to existing shareholders than issues to the general public. New shares issued at a discount to the market price to make them more attractive to investors.
- Relative voting rights are unchanged as long as all the investors take up their rights.
- The finance raised may be used to reduce gearing by paying off long term debt.

### **Private Placement**

#### **Definition:**

The sale of securities to a relatively small number of select investors as a way of raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market.

Since a private placement is offered to a few, select individuals, the placement does not have to be registered with the Securities and Exchange Commission. In many cases, detailed financial information is not disclosed and a need for a prospectus is waived. Finally, since the placements are private rather than public, the average investor is only made aware of the placement after it has occurred.