# CHAPTER 2: Financing Decisions

**FOCUS AREAS**

- **SHORT-TERM FINANCING**
- **MEDIUM-TERM FINANCING**
- **LONG-TERM FINANCING**

# 1. Short Term Financing

- Short-term financing usually includes loans that mature within a year or less.

- **Short-term finance**
  - **Used to raise temporary funds to cover seasonal or cyclic business peak or special funding needs involving a short time frame.**
  - **Are self-liquidating**

# Cont'd

## Goals of short-term financing:

- Finance inventories/stock during a production/ construction period. Short-term financing allows the firm to match its funds against its needs over an annual, seasonal or other cyclical period
- To achieve low-cost financing. The interest-free sources provide low-cost financing for the firm by reducing its borrowing need from interest-bearing sources

# Source of Short-term financing

i) Unsecured Interest-Free Sources

- Accounts Payable
- Accruals
- Advance Payments
- Advance for purchase of materials/ material on site

# Source of Short-term financing (cont'd)

ii) Unsecured Interest-bearing Sources

- Self-Liquidating Bank Loans
  - Single payment note
  - Unsecured overdraft facility/ Line of Credit
  - Revolving credit agreement
- Non Bank Short-term sources
  - Commercial Paper/ Bond (Treasury bond)
  - Private Loans

# Contd…

- Single payment note: lending a business customer with **as lump sum repayable** with **interest** in a single payment and at a specified maturity, usually **30 to 90** days.
- Unsecured Overdraft Facility/ Line of Credit: An agreement between Bank and Firm where by the bank agrees to make available upon demand up to a stipulated amount of unsecured short-term funds, if the bank has the funs available.
- Revolving Credit Agreement: Extended Lines of Credit to avoid the need to re examine the credit worthiness/value of a customer each time a small loan is required.

# Contd…

- Commercial Paper/ Bond (Treasury bond): **These consist of promissory notes with maturities of few days say 270 days.**
- Commercial paper is purchased by other firms that are seeking/searching marketable securities to provide a return on temporarily idle funds Individuals, commercial banks, insurance companies, pension funds and other institutions also purchase the commercial notes.

# Contd…

- Private Loans: A short-term unsecured loan may be obtainable from a wealthy shareholder, a major supplier, or any other party interested in assisting the firm through a short-term difficulty.

# Source of Short-term financing (cont'd)

iii) Secured Short-term Sources

A secured loan occurs when the borrower pledges/gurantee a specific asset, called ***collateral***, to back a loan.

- Collateral may be in the form of:
  - Warehouse receipt loan
  - Receivables
  - Physical assets

# Contd…

- Warehouse receipt loan: it is a form of short term financing that is secured by a pledge of inventory controlled by the **lender**. The lender which may be a commercial bank or finance company, selects the inventory that is acceptable as collateral for the loan.
- Receivables: Receivables are normally **quite liquid**, they are **attractive** as collateral to finance companies.
- Physical assets: Short-term financing by holding physical assets of a company which are easily convertible to cash.

# 2. Intermediate-Term Financing

- Intermediate-term financing usually includes loans with maturity greater than 1 year & less than 5 to 7 years.

- **Intermediate-term finance categories**
  - **Revolving Credit Agreement**
  - **Term Loan**
  - **Lease**

# Contd…

- Revolving Credit Agreement: This is a guaranteed line of credit whereby the bank agrees to lend money on demand in a future period, frequently **2 to 3 years.**
- Term Loan: This is a loan from bank, finance company, insurance company and other financial institutions for a period of **1-7 years** accompanied with fixed or floating **interest rates.**
- Lease: This is **an agreement that allows the use of assets without ownership of the assets.** The owner agrees to allow a user to use the fixed assets in return for a rental payment over stipulated period of time.

# (Cont'd)

- Intermediate-term financing institutions
  - Commercial Bank Loans
  - Insurance Companies
  - Pension Funds
  - Equipment Manufacturers

# 3. Long-Term Financing

- Long-term financing usually refers to the borrowing of money for a long period of time in order to invest in fixed assets relatively permanent in nature with long life.

## The Two Common sources

- **Debt: Sources can be classified into two**
  - **Term loans**
  - **Bonds**
- **Equity**
  - **Ownership money acquired through the sale of *common stocks*, *preferred stock* and *retained earnings***

# Equity Capital

i) Common Stock

- Represents ownership capital as equity shareholders collectively own the company.
  - Bear/accept risks of ownership
  - Liable only to the amount of capital
- Rights and Position of Equity shareholders
  - Right to income
  - Right to control
  - Pre-emptive right
  - Right to Liquidation

# Equity Capital (Cont'd)

ii) Preferred Stock

- Stock that carries certain preferences over the common stock is called preferred stock.
- Has some preference and restriction of basic rights
- ➢ Preference to dividends
- ➢ Preference to assets incase of liquidation of corporation etc

# Equity Capital (Cont'd)

iii) Retained Earnings

- Represents the only internal source of financing for expansion and growth

# Long-term Debt

i) Term Loans

- Represents a source of finance which is generally payable in 5 to 10 years.
- Used for **acquisition of fixed assets** and **working capital margin**

# Long-term Debt
## (Cont'd)

ii) Bonds

- Issue a bond with the promise of paying the investor (Bond holding firm) a designated interest on his money at certain scheduled intervals of time
- **Bonds** often provide more flexibility than **term loans** as they offer greater variety of choices with respect to **maturity**, **interest rate**, **security**, repayment and special features.

# End of Chapter 2