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Financial Instruments

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A fundamental question for any business is how to finance its operations. At the most basic level, there is a choice between equity and debt – however there are many different financial instruments that can be used to finance a business, including some that have the characteristics of both equity and debt. This article examines a range of financial instruments and identifies situations when they are appropriate.

How to Finance?

Key issues to be considered when financing a business include:

- Availability of finance when needed
- Costs of finance
- Flexibility

Previous articles in this series have already identified that equity costs more than debt and that a suitable capital structure can optimise the cost of capital. However, different financial instruments offer different degrees of flexibility as well as incurring different costs. In essence, the holders of these instruments take different degrees of risk and therefore seek different returns. If we consider a basic business, this is likely to be funded by a mixture of equity and debt – the basic differences between equity and debt are:

Debt	**Equity**
Repayable	Usually permanent
Interest payments must be made	Dividends discretionary
Interest tax-deductible	Dividends paid out of after-tax earnings
Paid out before equity in a liquidation	Last in-line in a liquidation
Lower cost to company	Higher cost to company
Lender can protect downside by security/ covenants	Shareholders' downside limited to amount paid for shares
No upside	Unlimited upside

However, there are

- many different types of debt,
- hybrid instruments (such as convertibles and warrants) which have obligations to repayment and payment of interest like debt but also rights to participate in the growth of the business as equity
- different types of equity, with different rights, particularly in any winding-up

From the company's point of view, a high degree of debt is attractive because that will lower the cost of capital (due to the lower riskiness and tax-deductibility of interest). However the amount of risky debt that a company can accept is also a function of the business risk, represented by the volatility of future cashflows:

See Diagram 1

Before examining individual instruments, it is helpful to set out instruments in terms of riskiness (defined as ranking in a liquidation and as reflected in the extra return demanded).

See Diagram 2

Generally, the further an instrument is to the right of this table, the higher the effective cost to the company and the higher the return expected by the provider of capital. The return in the form of ordinary shares will include dividends and capital growth, whereas the other instruments may have stated 'interest rate' type returns on either a fixed or floating rate basis. In some cases, the returns expected from hybrid instruments may exceed those of preference capital due to the equity-kicker component.

We will now examine the different characteristics of each type of instrument.

Equity

There are two basic types of shares – ordinary shares and preference shares

Ordinary Shares

Investors who hold the ordinary shares of a corporation (common stock in the United States) are the owners of the company. They have the right to share in the success and failure of the business indefinitely. In most countries, ordinary shareholders of publicly listed companies have the following common rights:

- a share in the profit of the business through the payment of dividends
- voting rights at annual general meetings
- limited liability in the event that the company goes into liquidation
- last claim on the assets of a company that goes into liquidation
- information in the form of an annual report including financial statements

As noted above, ordinary shareholders receive a return through dividend payments as and when declared by the directors. Most shareholders also anticipate return through capital appreciation of the share price. Theoretically, ordinary shareholders' returns are unlimited.

Preference Shares

Preference shares (preferred shares) are shares which have defined rights to the profits and distributions of capital of a firm. These rights are usually limited to a specified dividend amount, which must be paid prior to the payment of dividends to ordinary shareholders. Common characteristics of preference shares include:

- a fixed dividend which is usually set as a percentage of the nominal or par value of the share. (eg a preference share with a par value of 100p might carry an eight per cent dividend or 8p payable annually)
- limited voting rights. Preference shares typically have no voting rights unless the payment of dividends is in arrears.
- priority to ordinary shareholders in a winding up. Preference shareholders will receive the par value of their shares before ordinary shareholders. Both types of shareholders are subordinate to all debt holders.
- generally a source of permanent capital.

Dividends on preference shares are often cumulative—that is any arrears in the payment of preference shares must be caught up before non-cumulative or ordinary share dividends may be resumed. Non-cumulative shares are the opposite of cumulative If a company misses a dividend payment on a non-cumulative preference share, it is not required to make up the dividend.

In many jurisdictions, preference shares are counted as capital for banks and other financial institutions, which makes them attractive for issuers concerned about dilution of ordinary shareholders, but will provide capital for regulatory purposes.

Hybrids

Convertibles

Hybrid securities contain elements of both equities and debt. The most common hybrid in the UK is the convertible bond (sometimes referred to as a convertible debenture). Also issued are convertible preference shares. In this section, convertible bonds are discussed, but most of the principles apply to convertible preference shares as well.

A convertible bond pays interest (preference shares issue dividends) like a straight bond but additionally, gives the investor the option to 'convert' the bond into shares of the company at some date in the future. The conversion price is set at the time of issue and is typically above the share price at the time of issue (the conversion premium - typically around 25%). The right to convert the bonds into shares cannot be separated from the bond itself. In order to exercise the right to purchase the shares, the investor must surrender the convertible bond to the trustee who will deliver the specified number of shares to the investor.

The interest rate paid is lower than that on a straight bond issued by the company for the same maturity because the option to convert has value for which investors are willing to pay. The coupon rate on the bond and its conversion premium are linked: the higher the conversion premium, the higher the coupon.

Issuers are often attracted to convertible bonds because they view it as the issue of deferred equity or equity at a higher price than today. Typically convertibles have a longer maturity than straight bonds issued by the same company – although, if everything goes well and the shares increase in value, the bonds will be converted prior to maturity. There is no immediate dilution of ordinary shareholders when the convertible bond is issued, thereby maintaining its earnings per share. Prior to conversion, the issuer is permitted to deduct the interest payments on the bond from its tax provision. For large companies, convertibles may be offered because of the tax deductions available. Other companies may choose to issue convertibles at a stage where they wish to secure low current financing in order to develop the business, but reward the investor with upside potential if the business is successful. In this case they may be able to attract debt (which banks may not be willing to lend), but not have to issue as much equity as they will have to concede in the convertible.

Warrants

The other common type of hybrid is the bond with equity warrants. In this case a fixed rate bond is issued (again at a sub-market rate) and a set number of warrants accompany each bond. These warrants entitle the holder to purchase a pre-determined number of shares at a pre-determined price for a fixed period.

The great difference to convertible bonds is that the warrants are separable from the bond – and they normally are separated. This approach allows different investors to trade in the bond (risk averse fixed-rate investors) and the warrants (risk-seeking investors). From the issuer's point of view, the risk is that the bonds have to be repaid but that the warrants are not exercised.

Debt

Debt comes in various forms and is provided, typically either by banks (private market) or institutions (bond or public market). Different types of debt may have different risk characteristics and therefore cost different amounts. The main differentiating characteristics between types of debt are:

- Secured or unsecured
- Priority ranking in a liquidation
- Committed or uncommitted (i.e. is the lender obliged to lend – overdrafts are a typical type of uncommitted debt

- Fixed or floating interest rate
- Currency of borrowing

The types of debt that are described below are normally used in specialist financing situations such as acquisitions, leveraged buy-outs or project financings.

Senior and subordinated debt

Senior debt is a term frequently used in acquisition financing. 'Senior' is a term used as opposed to 'subordinated' – subordinated debt ranks behind senior debt in a liquidation (and also behind other lenders). Convertible bonds are frequently subordinated to other lenders. The characteristics of senior debt will depend on the financial strength of the borrower and may not differ particularly from the terms for normal debt.

Mezzanine

In an acquisition (and frequently in the case of leveraged buy-outs), some lenders will lend more than the cashflow of the underlying business would justify. Mezzanine debt fills the gap between the amount provided by conventional debt and equity – in this sense it is an alternative to diluting the equity base. In order to enhance the return, lenders are frequently provided with warrants. This mezzanine debt will be subordinated to the senior debt and will also attract a significantly higher interest rate than the conventional debt.

Interest on mezzanine debt may be 'rolled-up' in the early years whilst the senior debt is being repaid and there is likely to be a prepayment penalty.

High Yield Bonds

High yield bonds are frequently referred to as 'junk bonds'. A high yield bond, as one might expect, generally carries a high coupon offering the investor a high yield to maturity. It does so because, high yield bonds are issued by companies with low credit ratings (BB+ or below as rated by Standard & Poor's or Ba1 by Moody's).

The high yield market allows these companies (which are typically fast growing) to access the long-term capital market. In most cases, banks will refuse to extend long-term fixed rate loans to non-investment grade borrowers. When bank credit is available, it is typically offered only on a floating rate basis at punitive interest rates.

Specialist forms of financing

Securitisation

Sometimes companies with specific assets will be able to finance those specific assets by issuing financial instruments that are then tradable. These assets may be physical (e.g. commodities), financial (e.g. credit card receivables) or others such as mortgage payments secured on loans made by a lender. The advantage is that such assets may then be financed on attractive terms, based on the risk of the underlying asset. For example, when the Tussauds group was bought out, part of the re-financing involved securitising the income streams from Madame Tussauds and Alton Towers.

Leasing

Leasing is a specialised form of asset finance. The borrower (the lessor) owns the asset and retains the capital allowances. The user (the lessee) pays lease rentals to the lessor, which are then tax deductible. Typical uses of leasing are:

- Where the lessee is a small business and does not wish to use its debt capacity to borrow for specific asset purchases (e.g. machinery)
- Where the lessee has no tax capacity and cannot make use of the capital allowances
- Where the lessee does not wish to take the risk of technical obsolescence some time into using the asset (e.g. for computer equipment or for motor vehicles)
- Where the asset being financed is very large relative to the size of the lessee's business and where there is a ready secondary market (e.g. ships or aircraft).

Conclusion

The specific type of financed to be used will vary according to:

- The nature of the asset or business to be financed
- The underlying business risk and how much financial risk can be accepted
- The desired capital structure and amount of available equity

This will mean that, normally, many businesses will just use conventional equity and debt. However, in certain circumstances such as buy-outs, acquisitions or major asset purchases other types of financing will be used – particularly if there is an underlying change in the capital structure with consequent changes in the costs of equity and debt.

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