LONG TERM FINANCE

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REQUIREMENT OF BUSINESS

- Short-term Funds: Short-term funds are required for meeting working capital needs. The various sources of short term finance are loans, trade credit etc..
- Long-term Funds: Long-term funds are the base for the financial structure of a Firm. Generally financial needs more than 5 years. Funds required for purchase of fixed assets and for expansion

Long term Funds

- Equity Shares
- Preference Shares
- Debentures
- Retained Earnings
- Term Loans
- Lease Financing
- Hire Purchase
- Venture Capital
- Private Equity

1. Equity Shares

- Equity Shares are **ordinary shares or common shares**
- The holders of the equity shares are the **owners of the company**
- Equity shareholders get **dividend** if the company earns profit
- Equity shareholders take **more risk** towards dividend
- They are entitled to get **dividend after the income claims of others are satisfied**

FEATURES OF EQUITY SHARES

- Permanent Capital – repaid only at the time of liquidation
- Right to Dividend
- Control
- Limited Liability (The liability is limited to issue price of shares)
- Pre-emptive Right: When the company issues additional shares, the existing shareholders have a right to purchase the same proportion

Reporting of Ordinary Shares

- The capital represented by ordinary shares is called equity share capital
- It appears on the left hand side of the balance sheet
- Authorized Share capital
- Issued Share capital
- Subscribed capital
- Paid up capital
- Reserves and Surplus

Merits of Equity Shares

- To Investors:

  -- Capital Gains

  -- Interest in Company's Activities

  -- Best for Investment – suitable for risk taking person

  -- More Income (Dividend is not fixed)

- To Company:

  -- Permanent Capital

  -- Flexibility in payment of dividend

  -- Borrowing Strength – base for borrowing

Demerits of Equity Shares

- To Investor

  -- Uncertainty of Income

  -- Irregular Income

  -- Capital Loss

  -- Less Attractive to Modest Investors

  -- Loss in liquidation

- To Company

  -- Higher Cost (Tax on dividend, Flotation costs are high)

  -- No Benefit of Leverage if it issues equity share only

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- Earnings Dilution – Issue of additional shares, declines EPS
- Ownership dilution
- Difficult to remove over capitalization

PREFERENCE SHARES

- Preference capital enjoys hybrid form of financing
- Preference share enjoy two preferences: the dividend is paid prior to equity shares. Secondly, preference shares are redeemed before equity shares at time of liquidation
- The dividend is fixed
- The preference shareholder do not enjoy the right to vote

Features of Preference Shares

- Maturity
- Fixed Dividend
- Control – No voting rights
- Claim on Income and Assets – At the time of liquidation
- Hybrid Security –features of both debenture and equity
- Convertibility
- Cumulative

Types of Preference Shares

- Cumulative Preference Shares
- Non-Cumulative Preference Shares
- Redeemable Preference Shares
- Irredeemable Preference Shares
- Convertible Preference Shares
- Non-Convertible Preference Shares
- Participating Preference Shares – share in surplus profits
- Non-Participating Preference Shares

Advantages of Preference Shares

- To Investor

  -- Priority in re-payment of Capital

  -- Best Security

  -- Regular and Fixed Income

  -- Less Risk

- To company

  -- No interference in Management

  -- Availability of wide capital market – less progressive investors prefer to invest

  -- No mortgage of Assets

Disadvantages of Preference Shares

- To Investor

  -- Dividend at fixed rate

  -- No voting Rights

- To Company

  -- Costly - not tax deductable

  -- Commitment to pay dividend

  -- Permanent Burden – no profit, the comp have to pay dividend

Debentures

- Debenture is an instrument issued by the company under its common seal acknowledging to some persons
- They are generally redeemable after stipulated period
- Debenture is a long term, fixed-income, financial security
- Debenture holders are creditors of the firm
- Debentures carry fixed rate of interest

FEATURES OF DEBENTURES

- Maturity
- Fixed Rate of Interest : annually, semi-annually, quarterly
- Preference in Payments
- Charge on Assets and Income
- Tax Deductibility
- Control
- Indenture - AGREEMENT
- Security: Secured and Unsecured

TYPES OF DEBENTURES

- Redeemable Debentures
- Irredeemable Debentures
- Unsecured Debentures – which do not carry charge on assets
- Secured Debentures
- Convertible Debentures (PCDs & FCDs) : less interest rate
- Non-Convertible Debentures
- Bearer Debentures – debentures are easily transferable
- Registered Debentures – have to sign the transfer deed
- First Debentures – who have first claim on the asset
- Second Debentures

Advantages of Debenture

- To Company

  -- Lower Rate of Interest

  -- Freedom in Management – No dilution

  -- Tax-Benefits

  -- Less Costly

  -- Controlling Over-Capitalisation (by redeeming)

  -- Ideal Source: when stock market is dull, share cannot be issued at an attractive premium

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- To Investors

  -- Fixed and Stable Income

  -- Safety Investment

  -- Liquidity : It can be used as collateral security

  -- Fixed Maturity Period

Disadvantages of Debentures

- To Company

  -- Legal Obligation – default in risk

  -- Increase Financial Risk

  -- Redemption Pressure : huge outflow

  -- Restrictive Conditions – may impose restriction on borrowings

- To investors

  -- No control

  -- No Extra Profit

Retained Earnings

- Undistributed profits used to finance the requirements of the business
- The retention is also known as internal financing
- The retained earnings are transferred to general reserve fund
- It is the cheapest source of financing compared to external source of financing

Advantages of Retained Earnings

- A cushion to absorb shocks : competitive pressure and tackle uncertainty
- Economical method of financing
- Facilitates growth & Strong financial position
- Enables to redeem long-term liabilities

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- Stable dividend
- Reduces external dependence
- No dilution of control
- Increases value of shares

Disadvantages of Retained Earnings

- Dissatisfaction of shareholders
- Evasion of Tax : it reduces revenue to government
- Misuse of Retained Earnings : investing in unprofitable areas
- Limits the freedom of Investors : do not have freedom invest in better securities

TERM LOANS

- Term loans are borrowings from financial institutions
- It may be repayable after 1 year but less than 10 years
- Term loans differ from short term loan
- Short loans are provided for working capital requirements whereas, term loans are provided for long term needs such as expansion, diversification

Features of Term Loans

- Maturity
- Direct contact : financial institution and borrower. The terms and conditions are decided through negotiation between parties
- Security –Collateral security
- Restrictions : nominate their representatives as director, restriction on impose on dividend
- Repayment Schedule

Advantages

- Less Costly
- Easy Repayment : The burden of repayment is spread over many years
- Financial Discipline
- Flexibility – tenure of loan and terms of repayment are finalized based on the need and resource of borrower
- No Dilution of Control : no voting rights

Disadvantages of Term Loans

- Obligatory Payments – Failure leads to threaten
- Increase in Financial Risk – Interest is to be paid even if there is no profits
- Restrictive Conditions – which reduces the freedom
- Fall in earnings of the shareholders
- Term loans carry fixed rate of interest

Lease Financing

- A lease may be defined as "a contractual arrangement in which a party owning an asset **(lessor)** provides the asset for use to another **(lessee)** over a certain period for consideration in form of periodic payment **(rentals)**"

Equipments suitable for leasing

- Plant and machinery

- Business cars

- Commercial vehicles

- Agricultural equipment

- Hotel equipment

- Medical and dental equipment

-Office equipment

Essential Elements/Rules for Leasing

- Parties of the contract
- Asset
- Valid contract - anything which cannot be used without consuming it cannot be leased out
- Ownership separated from user
- All the liabilities emerging from the ownership shall be borne by the lessor
- But the liabilities attributable to the use of the property shall be borne by the lessee

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- The period of the lease must be determined in clear terms
- The lessee cannot use the leased asset for any other purpose other than the purpose specified in the lease agreement.
- The lessee is liable to compensate the lessor for any damage to or loss of the leased asset
- A property owned by two or more persons can be leased out and the rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.

Contd..

- It is necessary for a valid lease that the leased asset is fully identified by the parties.
- It is permissible that different amounts of rent are fixed for different phases during the leases period provided
- The lease period shall commence from the date on which the leased asset has been delivered to the lessee
- The leased asset shall remain in the risk of the lessor throughout the leased period in the sense that any damage or loss caused by any factors **beyond the control** of the lessee shall be borne by the lessor

Contd..

- The lessee is liable to compensate the lessor for any damage to or loss of the leased asset caused by any misuse or negligence on the part of the lessee.
- The lessor cannot increase the rent unilaterally and any agreement to the contrary is void

Types of Leasing

- Operating Lease - the lessor is responsible for maintenance, repair and technical advice. It is also called service lease. The lessor does not depend on single lessee for his recovery cost
- Financial Lease – the lessee is responsible for maintenance and repay cost of asset, long period and not-cancelable. It ensures the lessor for amortization of entire cost plus return.
- Sale and Lease Back
- Net Net Net Lease: Maintenance, taxes and insurance by lessee

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- Direct Lease

  -- Bipartite Lease (equipment supplier cum lessor & lessee) similar to operating lease

  -- Tripartite Lease (equipment supplier, lessor and lessee)

- Leveraged Lease (the lessor, financial institution, lessee)
- Closed ended and open-ended lease: In closed ended lease, the asset gets transferred to the lessor at the end. In case of open ended lease, the lessee has the option of purchasing at the end

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- Domestic Lease
- International Lease

    -- Import lease (lessor and lessee in same country but equipment supplier is located in different country

    -- Cross Border Lease

Advantages of Leasing

- To the Lessee:

  -- Financing of Capital Goods : no initial investment

  -- Enhances working capital position of the company

  -- Less Costly than any other sources of financing

  -- Simplicity – simple documentation compared to loans

  -- Tax Benefits

  -- Obsolescence Risk is Averted : free to replace with latest technology

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- To the Lessor:

  -- Full Security (repossession of asset if the lessee defaults)

  -- Higher than usual rent

  -- Positive cash flow

  -- Non-refundable option money

  -- No maintenance, no land lording headaches

  -- Tax Benefit

  -- Peace of mind

Disadvantages of Leasing

- To the Lessee:

  -- High Cost : lease rent is costly

  -- Loss of Moratorium Period : do not take care of gestation period

  -- Risk of being Deprived of the Use of Asset : winding up

  -- No alteration or change in asset

  -- Loss of ownership incentives - depreciation , other allowances. Incase of lease , the lessee is not entitled to such benefits

  -- Penalties on Termination of Lease – lessee is required to pay penalty if he terminates before the expiry of lease period

Contd..

- To the Lessor

 -- High Risk of Obsolescence

 -- Competitive Market : risk

 -- Price Level Changes - fixed amount of rentals will affect

 -- Long term Investment – long time to recover the cost of lessor

Hire Purchase

- Hire Purchase means **hiring of an asset** for a period of time and at the end of the period, **purchasing** the same
- A **contract** on hire with an option of purchase, in which the **owner** of goods lets them out on hire to the **hirer** for a fixed term at an **agreed rental** to be paid at mutually agreed installments, further agrees that if the hirer keeps them for an **agreed period** and regularly payment on rent, they **shall become the hirer's property**

Terms of Hire Purchase

- Payment will be made in Installments
- Possession of goods is given to the buyer immediately
- Ownership remains with the vendor till the last installment
- Seller can repossess the goods in case of default in payment

Advantages of Hire Purchase

- Hire purchase is **cheaper** than a ('unsecured') personal loan
- Hire purchase is relatively **quick** as it is offered directly by most dealers
- Deposits are lower than with personal loans
- Fewer Defaulters

Disadvantages of Hire Purchase

- Encourages Lavish Expenditure
- Future Income is Mortgaged
- Higher Installment Price
- Difficulty in Re-Sale of Goods

Difference Between Leasing and Hire Purchase

Point of Difference	Leasing	Hire Purchase
Ownership	Ownership is not transferred	Ownership is transferred
Depreciation	Cannot be claimed by the lessee	Can be claimed by the hirer
Margin Money	No Margin Money	Margin equal to 20-25 percent of the cost of equipment
Maintenance	In case of an operating Lease, the lessor has to bear the maintenance cost	The hirer has to borne the maintenance cost

Venture Capital Financing

- Venture capital fund is usually used to denote mutual fund or institutional investors
- They provide equity finance or risk capital to little known, unregistered, highly risky, young and small business
- Suitable for companies with limited history that are too small to raise in public markets
- New technology, New concepts and New products that do not have track record

Features of VC

- Nature of Firms: Small and Medium-Sized Firm
- Highly risk and highly return based Financing
- Equity and Quasi-Equity Financing
- Reduces Financial Burden of Companies at initial stage
- Continuous Involvement – providing loans, managerial skills or any other support
- Suitable for risk oriented and high technology based industry

Advantages of Venture Capital

- They bring large sum of equity finance and bring a wealth to expertise to business
- It encourages new entrepreneurs and their innovative ideas
- It would benefit the growing economy

Disadvantages of Venture Capital

- Deal with VC is long and complex process
- Persons required to draw a detailed business plan, entrepreneur need professional help
- Control May get out of entrepreneurs.
- Legal and Accounting Fees whether or not success in securing funds

PRIVATE EQUITY

- Private equity investment is generally made by private firm, venture capital firm
- Not publicly traded
- Private Equity Started in 1960s, it expanded rapidly in mid-2000s
- The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time.
- Providing funds for firms that are financially distress or start-up companies