Financing Policy

Topics

- Financing Choices
- Corporate Bonds
- Common Equity
- Convertibles and Warrants
- Financing Decisions

Financing Choices

Firms may raise funds from

- Internal sources
- External sources
  - Debt
  - Equity
- Sources of long-term financing
  - Long-Term Debt
  - Common Stock
  - Preferred Stock

Corporate Bonds

- Bond issues are the dominant source of new financing for U.S. Corporations. Corporate bond issues represent half of the total bond market.
- Some corporate bonds are backed by specific collateral.
  - Mortgage bond: backed by real property pledged as a collateral.
  - Collateral bonds: backed by financial assets.
  - Debenture bonds: not backed by specific collateral, but, in the event of a default, they have general claim on the otherwise unpledged assets of the issuer.
  - Subordinated debenture bonds: not backed by collateral, and have general claim after debenture bondholders have been paid.

Corporate Bonds

Bond Indenture

- A legal document which covers the major provisions in a bond agreement, administered by an independent trustee.
- Includes other terms such as the sale of assets, issuance of other bonds, dividends payment changes, and other issues that may change the profitability and solvency of the issuer.
  - Amount of Issue, Date of Issue, Maturity, Par value
  - Annual Coupon, Dates of Coupon Payments
  - Sinking Fund Provision
  - Call Provision
  - Put Provision
  - Convertibility

Bond Rating

- Bond ratings: Measure of default risks
  - Moody's Investors Services, Inc.
  - Standard & Poor's
- Better ratings are generally associated with
  1. better financial leverage,
  2. larger firm size,
  3. larger and steadier profits,
  4. large cash flows, and
  5. lack of subordination to other debt series.
- Junk bonds: Generally, they are rated below investment grade.

Common Equity

- What is equity?
  - Paid-in capital
  - Capital surplus
  - Retained earnings
- How do you measure value of equity?
  - Book value
  - Market value

Common Equity

- One of fundamental rights of equityholders is right to vote.
  - Straight voting
  - Cumulative voting
  - Proxy voting
- Sometimes, there exists more than one class of stock with unequal voting rights, thus creating different levels of equity value.
  1. Marketable controlling interest value
  2. Marketable noncontrolling interest value
  3. Nonmarketable controlling interest value
  4. Nonmarketable noncontrolling interest value

Common Equity

- Equityholders are also entitled to receive dividends.
- Dividends awarded to individual equityholders are taxable, thus creating double taxation problem.

Warrants

- Warrants: Call options that give the holder the right, but not the obligation, to buy shares of common stock directly from a company at a fixed price for a given period of time.
- Warrants tend to have longer maturity periods than exchange traded options.

Convertible Bond

- Convertible Bond: The owner of convertible bonds has an option to convert them to common shares.
- A convertible bond is similar to a bond with warrants.
- The most important difference: The owner of a convertible bond has to give up the bond in order to exercise call option, while the owner of a bond-warrants can exercise the warrant for cash and keep the bond.

Financing Decisions

- Financing decisions
  - Determine amount of debt and equity to sell/buy
  - Decide timing of debt or equity issue
  - Pay dividends (or not)
- Value creation through financing decisions by
  - Introducing new securities
  - Utilizing tax (or other) advantages
  - Financial manipulation? Deception?