Chapter 16

Financing

Learning Objectives

❶ Identify the common methods of debt financing for firms.

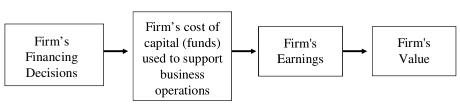
❷ Identify the common methods of equity financing for firms.

❸ Explain how firms issue securities to obtain funds.

❹ Describe how firms determine the composition of their financing.

❺ Explain the alternative remedies for firms that are failing.

Debt vs Equity Financing



Four Factors in Determining Creditworthiness

- The planned use for the borrowed funds.
- Financial condition of the firm.
- Outlook of the industry and environment of the firm.
- Available collateral.

Major Types of Financing

① Debt financing
- Act of borrowing funds.

② Equity financing
- Act of receiving investment from owners (by issuing stock or retaining earnings).

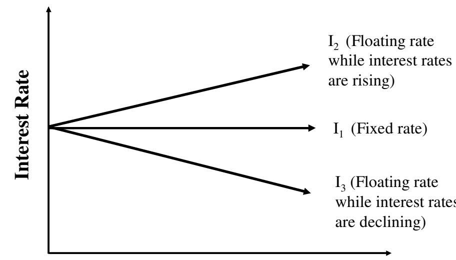
Methods of Debt Financing

- **Borrowing From Financial Institutions**
  Fixed-rate loans
  Floating-rate loans
- **Issuing Bonds**
  Secured
  Unsecured
  Call Feature
- **Issuing Commercial Paper**

Providers of Debt Financing

- Commercial banks
- Savings institutions (aka "thrifts")
- Finance companies
  - Provide loans to less established firms with higher risk of default - charge higher interest rates
- Pension funds
- Insurance companies
- Mutual funds
- Bond mutual funds

Three Interest Rate Charge Scenarios



Methods of Equity Financing

The act of receiving investment from owners by retained earning or issuing stock.

- **Retaining Earnings**
  Keep earnings after taxes for expansion.
- **Issuing Stock**
  Common.
  Preferred.

Initial Public Offering (IPO)

Advantages of IPOs:
- Gain access to more funds.
- Obtain funds without increasing existing debt level.

Disadvantages of IPOs:
- Must inform shareholders of their financial condition.
- Expenses associated with reporting of information must be filed with SEC.
- Difficulty in encouraging stock purchase.
- Ownership structure is diluted.
- Investment banks charge high fees.

Issuing of Securities

Origination
- Investment bank advises firm on amount of stock and bonds to issue.

Underwriting
- Investment bank guarantees a price to the issuing firm.

Distribution
- Prospectus is distributed to investors.

Capital Structure

The composition of debt versus equity financing.

•**Use of Debt**
Interest payments are tax deductible.
Can claim interest payments during year as expense.
Increased risk of default.
May result in high interest payments.
Creditors may not be willing to provide additional credit.

•**Equity Financing**
Eliminates many of the above concerns.

Other Methods of Obtaining Funds

- Financing from suppliers
  - Supplier's willingness to wait for payment, saves the firm some financing costs
- Leasing
  - Rent assets for a specified period of time

Benefits of Supplier Financing

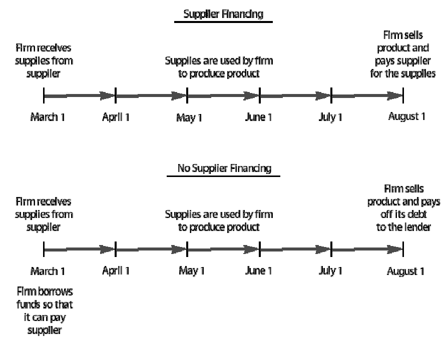
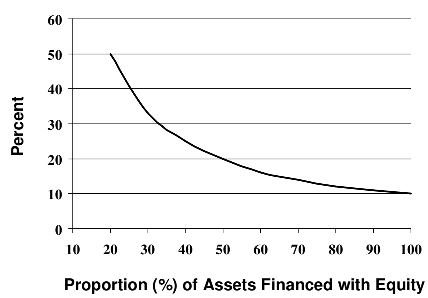
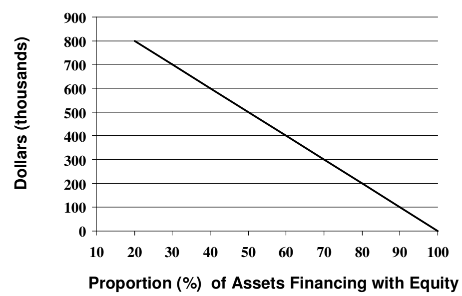


Exhibit 16.5

Return on Equity & Financial Leverage



Interest Expense & Financial Leverage



Four Remedies for Business Failures

❶ Extension: provides additional time to generate cash to cover payments

❷ Composition: firm will provide creditors with a portion of what they are owed

❸ Private Liquidation: creditors may informally request that a failing firm liquidate its assets and distribute the funds to the creditors.

❹ Formal Remedies:

→ Reorganization

→ Liquidation under bankruptcy