Part

I

CORPORATE FINANCE TRANSACTIONS

Chapter 2

SOURCES OF CAPITAL

Corporate finance at its most fundamental level is about how companies raise capital to run their businesses. Corporate financiers must understand the various sources of corporate funding and how they are combined to achieve an optimal capital structure.

The corporate financier advises on when and how to issue securities, at what price securities should be issued and, in some instances, how to repurchase securities. To do so, s/he must be familiar with the basic funding sources and know where to turn for assistance when considering more complex forms of finance. This chapter provides some detail on the characteristics of the main financial instruments available to companies.

During a company's life, its reliance on different forms of capital will change as illustrated in Figure 2.1.

The timing of the use of certain forms of finance will vary and not all companies will make use of each form of

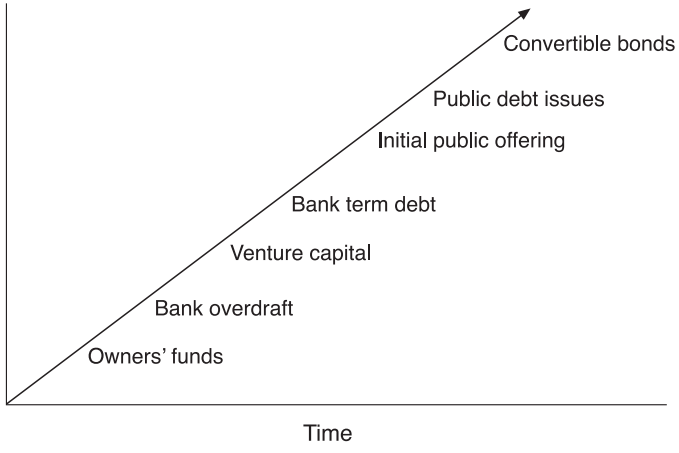

Figure 2.1 Financing life cycle.

capital. However, as you can see from the figure, there are two main forms of capital: debt and equity. The remainder of this chapter describes the primary forms of debt and equity that are available to UK corporations.

A good rule of thumb to keep in mind is that long-term assets such as plant and equipment should be financed with long-term liabilities (long-term debt or equity). Short-term assets such as stocks (inventory) or debtors (accounts receivable) generally can be financed with short-term liabilities.

DEBT SECURITIES

Debt securities generally pay a periodic return to investors (interest payments, also referred to as the *coupon*) and return the initial investment to the holder on a predetermined date ('maturity'). Payment of interest and repayment of principal on debt securities are legal obligations of the issuer. Debt can be issued to the public ('debt securities') or raised from banks and other financial institutions ('bank loans'). Firms can issue either long-term or short-term debt. Short-term debt is defined as debt with a maturity of less than 1 year. The public market for short-term debt securities is called the *money market*. A short primer on bond valuation is included in Chapter 8 for readers who require it.

Money market securities

Money market securities are tradable securities with a maturity of less than 1 year. Governments, banks and

other financial institutions, and corporations issue money market securities. Corporations also invest in the money markets when they have excess cash. The largest money market in most countries is that of government-issued *Treasury Bills* (*T-bills*). All other money market securities are priced in relation to T-bills. The UK Government issues T-bills with 3- and 6-month maturities.

The main corporate money market instrument is *Commercial Paper* (*CP*). CP is a negotiable (i.e., it trades in the secondary market) promissory note. CP has a maturity (set on the issue date) of between 1 day and 1 year (note that American CP has a maturity of between 1 and 270 days). It is issued by large corporations on an unsecured basis. This means that companies simply promise to repay the purchasers of CP. If there is a default, CP holders do not have recourse to specified assets of the company, as would a mortgage lender if you stopped making payments on your house. CP issued in the Euro-markets is known as *EuroCommercial Paper* (*ECP*).

Both CP and ECP are the preserve of large corporations. Companies issue CP because the rate of interest paid is normally lower than that on bank overdrafts or loans. Issues can be arranged at very short notice and tailored to the exact funding requirements of the issuer.

Bankers' Acceptances (*BAs*) are tradable short-term corporate promissory notes that have been guaranteed ('accepted') for payment by a bank. BAs are issued by

smaller companies or companies whose credit ratings don't allow them access to the CP market.

Long-term debt

Debt with maturity greater than 1 year is also issued by governments, financial institutions and corporations. This debt is commonly referred to as the *bond/fixed income/fixed interest market* and comprises the largest segment of the capital markets. Fixed rate debt is the most common form of long-term debt: the coupon (interest payment) is set at the time of issue and continues at that level until maturity.

Longer term government securities in the UK are referred to as Gilts while long-term US government securities are Treasury Bonds. They are issued at par (£100 face value) and pay interest twice annually. The prices of bonds fluctuate with prevailing interest rates: rising as interest rates decline, falling as interest rates rise. Corporate bonds follow the same fluctuations and are priced in relation to Government Bonds.

Companies and financial institutions also issue long-term debt to finance capital investment and operations, known commonly as *bonds*, *notes* or *debentures*. The interest rate payable by these institutions varies based on the credit risk and maturity of the bonds. The interest rate will always be higher than that payable on government bonds issued in the same currency with the same maturity. This is known as the 'spread'. The spread over government bonds typically increases as maturity

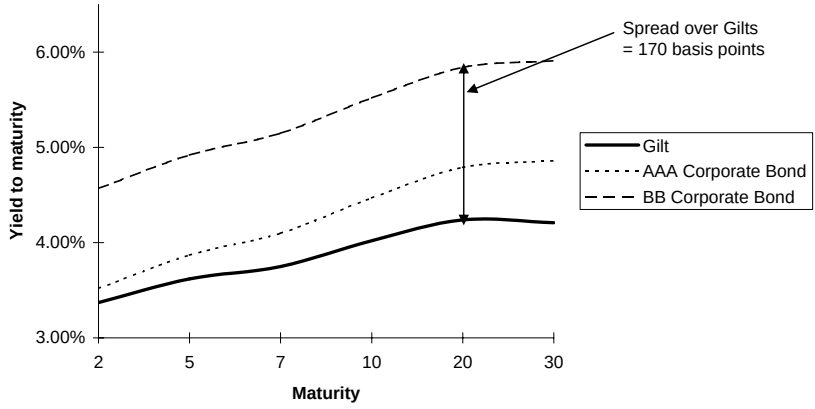

Figure 2.2 Global bond new issues.

increases or credit quality declines (as illustrated in Figure 2.2).

By far the largest corporate bond market is the US with $4,129 billion nominal value outstanding at year end 1999. The advent of the euro has led to a rapid increase

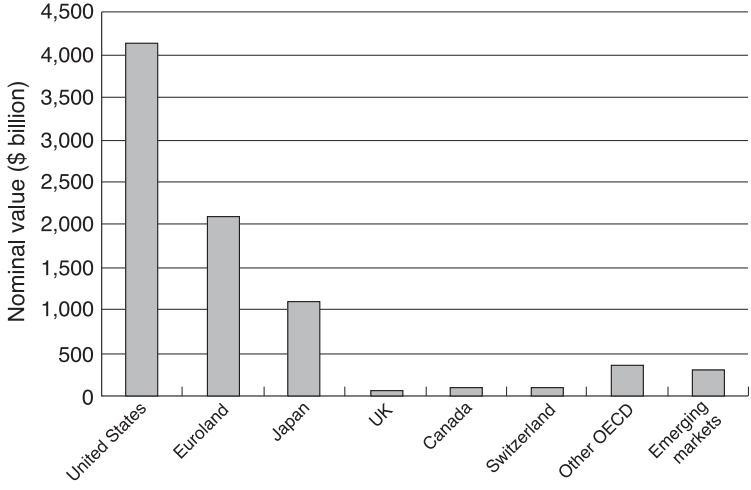

Figure 2.3 Bonds outstanding by country of issuer.

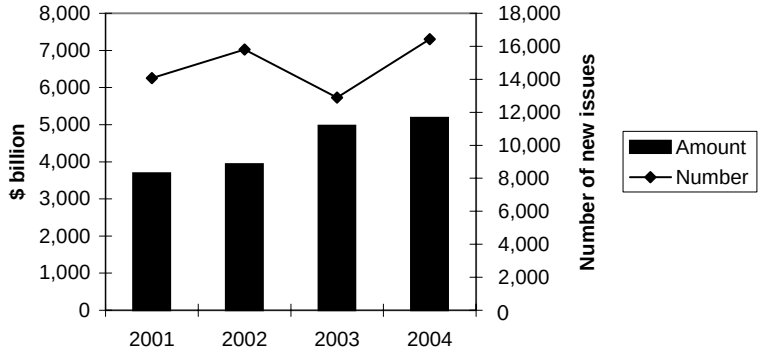

Figure 2.4 Global bond new issues.

in issues by European corporations. At the end of 1999, there were $2,110.9 billion (nominal amount) of bonds outstanding issued by companies in 'Euroland'.

Global new issues of bonds ebb and flow with general economic conditions and interest rate expectations. Even in relatively slow years, new issues of bonds top $4 trillion. Yes, trillion (see Figure 2.4). While corporate financiers typically do not get involved in debt issues for their clients, they may make recommendations about general capital structure and market conditions that lead clients to a new issue.

Floating rate notes

Floating rate notes have coupons or interest payments that vary with market conditions. The coupon rate is typically reset every three or six months. The most common reference rate for floating rate securities is the *London Inter-Bank Offer Rate* (*LIBOR*). LIBOR is the rate of interest that major banks charge each other

and is set every day for a variety of currencies. Banks set rates for US dollar LIBOR, Sterling LIBOR and Euro LIBOR (or *EURIBOR*) among many others. Since the coupon is reset frequently, the price of a floating rate note is not as volatile as that of a fixed interest bond.

Illustration of different forms of debt finance

Box 2.1 is an excerpt from the Annual Report and Accounts published by British Telecommunications plc (*BT*) for the year ended 31 March 2005. It shows how large corporations issue debt in different maturities and in different currencies.

EQUITY

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 (e.g., a preference share with a par value of 100p might carry an 8.0% dividend or 8p per share payable annually).
- Restricted voting rights. Preference shares typically have no voting rights unless the payment of dividends is in arrears.

Box 2.1 BT balance sheet 31 March 2005 – loans and other borrowings.

	2005 £m	2004 £m
US dollar 8.875% notes 2030 (min. 8.625%)	1,604	1,606
5.75% bonds 2028	596	596
3.5% index-linked notes 2025	278	270
8.625% bonds 2020	297	297
7.75% notes 2016 (min. 7.5%)	692	691
Euro 7.125% notes 2011 (min. 6.875%)	755	734
US dollar 8.375% notes 2010 (min. 8.125%)	1,754	1,795
US dollar 8.765% bonds 2009	123	123
Euro 11.875% senior notes 2009	—	3
US dollar convertible 2008 (0.75%)	88	97
US dollar 7% notes 2007	573	596
12.25% bonds 2006	229	229
7.375% notes 2006 (min. 7.125%)	399	398
Euro 6.375% notes 2006 (min. 6.125%)	1,923	1,861
US dollar 7.875% notes 2005 (min. 7.624%)	1,861	1,902
US dollar 6.75% bonds 2004	—	597
Total listed bonds, debentures and notes	£11,172	£11,875
Lease finance	993	1,099
Bank loans due 2007–2009 (average effective interest rate 9.7%)	240	480
Floating rate note 2005–2009 (average effective interest rate 3.8%)	90	101
Floating rate loan 2006 (average effective interest rate 5.6%)	92	140
Bank overdrafts and other short-term borrowing	2	2
Total loans and other borrowings	£12,589	£13,697

(*cont.*)

Commentary:
BT presents its long-term debt first, in chronological order, with issues with the longest maturity at the top. Here we can see that the longest maturity bond expires in 2030, 25 years from the date of the annual report, while one issue outstanding at the end of the 2004 fiscal year matured during the 2005 financial year (US dollar 6.75% bonds).

The company has issued debt in US dollars and euros as well as sterling. The company relies primarily on fixed rate debt, with only £320 in floating rate debt outstanding (both notes and bank loans).

- Priority in winding up. Preference shareholders will receive the par value of their shares before ordinary shareholders. Both types of shareholders rank behind all debt holders.

Dividends on preference shares are often cumulative – i.e., any arrears in the payment of preference shares must be caught up before 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.

Ordinary shares

Investors who hold the ordinary shares of a corporation (common stock in the US) 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 privileges at annual general meetings to elect the board of directors;
- limited liability in the event that the company goes into liquidation;
- last claim on the assets of a company that goes into liquidation;
- to receive information in the form of an annual report including financial statements.

Ordinary shareholders receive a return through dividend payments as and when declared by the directors. Shareholders also anticipate returns through capital appreciation of the share price. Theoretically, the return on ordinary shares is unlimited and, occasionally, some companies do provide returns of over 1,000% in 1 year. Those that do, frequently give back 50% or more of their inflated value in the following year.

Occasionally, different voting rights will be attached to ordinary shares. The most common are non-voting shares and multiple voting shares. Non-voting shares are issued typically by parties who wish to raise funds in the capital markets, but do not want to give up control of the company. Differential voting rights leads to differential valuations being ascribed to the shares. Voting or multiple voting shares will be worth more than non-voting or subordinate voting shares.

HYBRIDS (CONVERTIBLE SECURITIES)

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

Global issuance of convertible bonds depends on general economic conditions and interest rate expectations like the straight bond market. However, equity market expectations also factor into the decision the issuance of a convertible. Issuers are often attracted to convertible bonds because they are viewed as the issue of deferred equity or equity at a higher price than today. Figure 2.5 illustrates recent convertible bond new issuance.

A convertible bond pays interest (convertible preference shares issue dividends) like a straight bond but, additionally, gives the investor the option to 'convert' the bond into a specified number of 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 difference is called the *conversion premium*. The right to convert the bonds into shares cannot be separated from the bond itself. In order to exercise her right to purchase the shares, an investor must surrender the convertible bond to the trustee

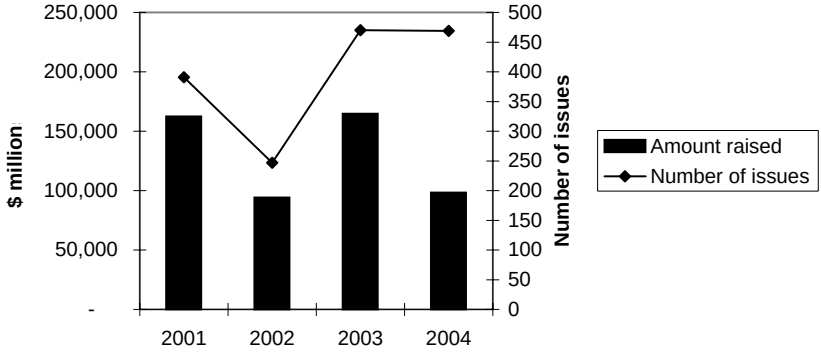

Figure 2.5 New issues of convertible bonds.

who will deliver the specified number of shares to the investor.

The interest rate paid on a convertible is lower than that on a straight bond issued by the company with the same maturity because the option to convert has a value for which investors are willing to pay. Note that the coupon on BT's US dollar convertible bond due in 2008 is a mere 0.75%, compared with a full 7.00% on its US dollar straight bond due in 2007.

The exchange feature of a convertible bond enables the holder to convert the par amount of the bond for ordinary shares at a specified price or 'conversion ratio'. The conversion ratio is set according to prevailing market conditions when the issue is launched. For example, a conversion ratio might give the holder the right to convert €100 par amount of the convertible bonds of Hightower Corporation into its common shares at €20 per share. This conversion ratio would be said to be 5 : 1 (i.e., the investor would receive five ordinary shares for each €100 par value bond on conversion).

The share price affects the value of a convertible substantially. Continuing with the example, if the shares of Hightower were trading at €10, and the convertible was trading at €100, there would be no economic reason for an investor to convert the bonds. For €100 par amount of the bond the investor would only get five shares of Hightower with a market value of €50.

But, why might the convertible be trading at €100 in this hypothetical case? The answer is that the yield of the bond justifies this price. For example, if the normal bonds of Hightower were trading at 10% yields and the yield of the convertible was 10%, bond investors would buy the convertible bond (in the hopes of the share price increasing) which would support its price. A convertible bond with an 'exercise price' far higher than the market price of the stock is called a 'busted convertible' and generally trades at its bond value.

When the share price attached to the bond is sufficiently high or 'in the money', the convertible begins to trade more like an equity. If the exercise price is much lower than the market price of the common shares, the holder of the convertible can convert into the stock attractively. If the exercise price is €20 and the stock is trading at €50, the holder can get five shares that have a market value of €250 for €100 par amount. This would force the price of the convertible above the bond value and its market price should be above €250 as convertibles usually have a higher yield than ordinary shares' dividends.