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EXTERNAL FINANCING SOURCES FOR BUSINESSES

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Abstract

Businesses obtain long-term external financial capital either by borrowing or by obtaining equity funds. This article describes the characteristics of external financing sources for businesses, like bonds and applies the time-value-of-money techniques to see how to value bonds. Also in this article, we'll discuss the characteristics of stocks and tools used to identify them.

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Time value of money is one of the most important concepts in finance. Here, we will see applications of time-value concepts to the investor and how an investor can evaluate a company's prospects and estimate appropriate prices for its securities. Many investors lack the time or ability to analyze securities, so they will purchase a mutual fund, which is a professionally managed investment pool. Businesses obtain long-term financing from internal funds, which are generated from profits, and from external funds, which are obtained from capital markets. Some firms will have little need for external funds. They may be able to generate sufficient internal funds to satisfy their need for capital, or they may require little investment in fixed assets (for example, company's operating in service industries). Other businesses, such as high-tech firms that experience rapid growth, cannot generate enough internal funds for their capital needs and may be forced to seek financing, often from the capital markets. The proportion of internal to external financing varies over the business cycle. During periods of economic expansion, companies usually rely more on external funds because the funds needed for investment opportunities outstrip the firms' ability to fi nance them internally. During periods of economic contraction, the reverse is true. As profitable investment opportunities become fewer, the rate of investment is reduced and reliance on external capital markets decreases.

A **bond** is an agreement or contract between lenders and the borrowing organization; typically, a company or government body. As such, the lenders or bondholders of a corporation have certain rights and privileges not enjoyed by the company's owners (those holding shares of common stock). A debt holder may force the company to abide by the terms of the debt contract even if the result is reorganization or bankruptcy of the company. The periodic interest payments due to the holders of debt securities must be paid or else the creditors can force the company into bankruptcy. Bondholders have legal status as creditors, not owners, of the firm. As such, they have priority claims on the firm's cash flows and assets. This means that bondholders must receive their interest payments before the fi rm's owners receive their dividends. In the case of bankruptcy, the debt holders must receive the funds owed to them before funds are distributed to the firm's owners. Because of this first claim on a firm's cash flow and assets, debt is a less risky investment than equity. Offsetting, the advantages of owning debt is its lower return. The interest payments creditors receive usually are considerably less over a period of years than the returns received by equity holders. Also, as long as the corporation meets its contractual

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obligations, the creditors have little choice in its management and control except for those formal agreements and restrictions that are stated in the loan contract. Bonds can be sold in the public market, following registration with the SEC, and traded by investors. There is a “private” market, too; bonds can be sold in a private placement to qualified investors, typically institutional investors such as insurance companies and wealthy individuals. Other forms of debt capital exist in addition to bonds.

Mortgage bonds, despite their name, are not secured by home mortgages. Rather, they are backed, or secured, by specifically pledged property of a firm. As a rule, the mortgage applies only to real estate, buildings, and other assets classified as real property. For a corporation that issues bonds to expand its plant facilities, the mortgage usually includes a lien, or legal claim, on the facilities to be constructed. When a parcel of real estate has more than one mortgage lien against it, the first mortgage filed for recording at the appropriate government office—generally, the county recorder’s office—has priority. The bonds outstanding against the mortgage are known as fi rst mortgage bonds. The bonds outstanding against all mortgages subsequently recorded are known by the order in which they are filed, such as second or third mortgage bonds. Because first mortgage bonds have priority with respect to asset distribution if the business fails, they generally provide a lower yield to investors than the later liens.

An **equipment trust certificate** is a type of mortgage bond that gives the bondholder a claim to specific “rolling stock” (movable assets), such as railroad cars or airplanes. The serial numbers of the specific items of rolling stock are listed in the bond indenture and the collateral is periodically examined by the trustee to ensure its proper maintenance and repair. There are two basic types of mortgage bonds.

A **closed-end mortgage bond** does not permit future bond issues to be secured by any of the assets pledged as security under the closed-end issue. Alternatively, an **open-end mortgage bond** is one that allows the same assets to be used as security in future issues. As a rule, open-end mortgages usually stipulate that any additional real property acquired by the company automatically becomes a part of the property secured under the mortgage. This provides added protection to the lender.

Debenture bonds are unsecured obligations and depend on the general credit strength of the corporation for their security. They represent no specific pledge of property; their holders are classed as general creditors of the corporation equal with the holders of promissory notes and trade creditors. Debenture bonds are used by governmental bodies and by many industrial and utility corporations

Corporate equity capital is the financial capital supplied by the owners of a corporation. This ownership claim can be represented by a paper stock certificate, although today most record keeping is done electronically. Shares are usually traded 100 shares at a time (called a “round lot”) or multiples thereof. An “odd lot” is a trade involving less than 100 shares. When stockholders sell their shares, the broker forwards the assigned stock certificate to the company and the secretary of the corporation destroys it. A new certificate is issued to the new owner, whose name will then be carried on the stock record. For larger corporations an official transfer agent, generally a trust company or a bank, is appointed for this task. The larger corporations may have an independent stock registrar to supervise the transfer of securities. When an investor sells stock, the stock certificate must be delivered to the stockbroker within three business days (called T + 3). When stock is purchased, adequate funds must be brought to the broker within three business days. As technology advances, so do regulations. In past years, the requirement was T + 5. It is now T + 3, and the requirement for T + 2 for settling trades is scheduled to occur in late 2017. Instantaneous settlement, called straight through processing (STP), will occur when all systems are electronically tied together. Stock certificates can be kept in the owner’s name and in his or her possession. Many investors find it convenient, however, to keep their stock holdings in street name. Stock held in street name is kept in the name of the brokerage house, but the broker’s accounting system keeps track of dividends, proxy voting, and so on. Some investors find it convenient to keep shares in street name as there is then no need for the investor to safeguard the certificates, and delivery of the certificates within the T + 3 time frame is automatic. Equity securities

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of the corporation may be grouped broadly into two classes: common stock and preferred stock.

Common stock represents ownership shares in a corporation. Ownership gives common stockholders certain rights and privileges that bondholders do not have. Common shareholders can vote to select the corporation's board of directors. The board of directors, in turn, exercises general control over the firm. In addition to voting for the board, common shareholders may vote on major issues facing the firm, such as corporate charter changes and mergers.

Preferred stock is an equity security that has a preference, or senior claim, to the fi rm's earnings and assets over common stock. Preferred shareholders must receive their fixed dividend before common shareholders can receive a dividend. In liquidation, the claims of the preferred shareholders are to be satisfied before common shareholders receive any proceeds. In contrast with common stock, preferred stock generally carries a stated fixed dividend. The dividend is specified as a percentage of par value or as a fixed number of dollars per year. For example, a preferred stock may be a 9 percent preferred, meaning that its annual dividend is 9 percent of its par or stated value. In such cases, unlike common stock, a preferred stock's par value does have important meaning, much like par value for a bond. The dividend for no-par preferred stock is stated in terms of a dollar amount, for example, preferred as to dividends in the amount of $9 annually. The holder of preferred stock accepts the limitation on the amount of dividends as a fair exchange for the priority held in the earnings and assets of the company. Preferred stock may have special features. For example, it may be cumulative or noncumulative.

Cumulative preferred stock requires that before dividends on common stock are paid, preferred dividends must be paid for the current period and for all previous periods in which preferred dividends were missed. Unlike debt holders, the preferred stockholders cannot force the payment of their dividends. They may have to wait until earnings are adequate to pay dividends. Cumulative preferred stock offers some protection for periods during which dividends are not declared.

Callable preferred stock gives the corporation the right to retire the preferred stock at its option. **Convertible preferred stock** has a special provision that makes it possible to convert it to common stock of the corporation, generally at the stockholder's option. This, like many of the special features that preferred stock may have, exists primarily to attract investors to buy securities at times when distribution would otherwise be difficult. Preferred stock that is cumulative and convertible is a popular financing choice for investors purchasing shares of stock in small firms with high growth potential. Participating preferred stock allows preferred shareholders to participate with common shareholders when larger dividend payouts are available. Holders get a larger dividend, if sufficient earnings exist and if common shareholders will be getting a dividend larger than the preferred shareholders. It is a rarely used feature except in some private equity and venture capital investments.

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