SOURCES OF FINANCE

OUTLINES

- Equity/debt financing and associated risks.
- Short, medium and long term finance.
- The nature and importance of internally generated funds.
- The nature and role of capital market- types of share capital including right issues, the SEC Convertibles, warrants etc.
- Investment and Securities Act.

Sources Of Finance

EQUITY/DEBT FINANCING AND ASSOCIATED RISKS

Equity capital: Equity financing means exchanging a portion of the ownership of the business for a financial investment in the business. The ownership stake resulting from an equity investment allows the investor to share in the company's profits. It represents the personal investment of the owner(or owners) in a business and is sometimes called *risk capital* because these investors assume the primary risk of losing their funds if the business fails.

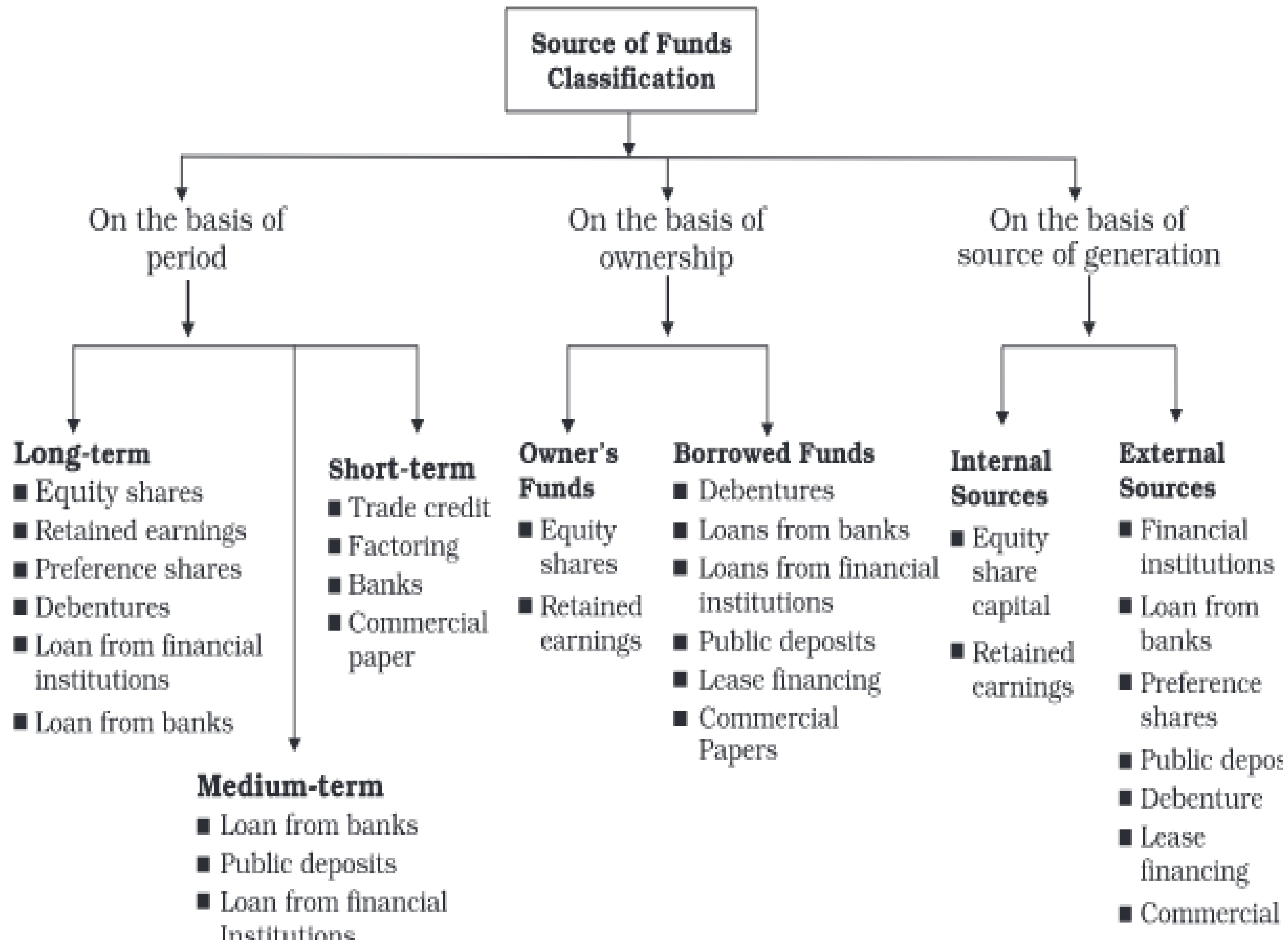
Equity financing, in the world of small business, means raising capital by selling shares of a business to investors. Unlike debt financing, the capital raised through equity financing isn't paid back in monthly installments with interest. Instead, investors put money into a business and become partial owners of that business. They are then entitled to a share of the business's profits over time. Most investors expect a return on their investment within three to five years.

- The biggest disadvantage of using equity to fund a business is that equity investors actually own a percentage of the business in which they invest, Fleming said. Therefore, if the business owner gives up too much of an equity stake (more than 49 percent) in his or her business, he or she can quickly lose control of the business.

Debt capital: is the financing that a small business owner has borrowed and must repay with interest. Although borrowed capital allows entrepreneurs to maintain complete ownership of their businesses, it must be carried as a liability on the balance sheet as well as be repaid with interest at some point in the future. In addition, because lenders consider small businesses to be greater risks than bigger corporate customers, they require higher interest rates on loans to small companies because of the risk–return tradeoff—the higher the risk, the greater is the return demanded. cost of debt financing often is lower than that of equity financing. Because of the higher risks associated with providing equity capital to small companies, investors demand greater returns than lenders. Debt financing (loans) may be short term or long term in their repayment schedules.

***Note**:* The cost of equity is always higher than the cost of debt because of the risk they bear i.e. in the event of a default shareholders are at the bottom of the creditor hierarchy in liquidation. Therefore, this greatest risk means that shareholders expect the highest return of long-term providers of finance.

Classification of Sources of Funds



Short, Medium and Long term Finance

Long, medium and short-term sources of funds: On the basis of period, the different sources of funds can be categorized into three parts. These are long-term sources, medium-term sources and short-term sources.

The long-term sources: fulfill the financial requirements of an enterprise for a period exceeding 5 years and include sources such as shares and debentures, long-term borrowings and loans from financial institutions. Such financing is generally required for the acquisition of fixed assets such as equipment, plant, etc.

Medium-term sources of finance: Where the funds are required for a period, more than one year but less than five years, These sources include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.

Short-term funds: are those which are required for a period not exceeding one year trade credit, loans from commercial banks and commercial papers are some of the examples of the sources that provide funds for short duration.

Short-term financing is most common for financing of current assets such as accounts receivable and inventories. Seasonal businesses that must build inventories in anticipation of selling requirements often need short-term financing for the interim period between seasons. Wholesalers and manufacturers with a major portion of their assets tied up in inventories or receivables also require large amount of fund for a short period.

The Nature and Importance of Internally Generated Funds

INTERNALLY GENERATED refers to the creation of either tangible or intangible results within the confines of one entity, e.g. internally generated funds are those funds that are realized through the efforts or operations of the entity itself, i.e. the funds were not borrowed or realized through other external means.

Internal funds are those generated from or within the business itself. The most important internal source is profit, or more accurately, cash flow. The amount available, of course, is a function of how much is generated and retained in the business.

A non-recurring source of internally generated capital may be found by wringing out cash tied up in the balance sheet. This might include selling some machinery or equipment that is not necessary or is too expensive, or the unlocking of cash tied up in working capital.

Internal funding comes from excess cash after expenses. This means you use profits to fund your project or advertising.

Bank Financing: When you use company funds, you do not have to pay interest to the bank.

Selling Stock: One way to raise money for your business projects is to sell stock to investors.

Government Grants: A business may qualify for government grants under certain circumstances. Minority grants can help minority-owned businesses to expand. With internal funding, you can start on your project immediately, with no approval required other than that of management and your stockholders.

Selling Assets: Some businesses try to fund new expenditures by selling assets. Internal funding keeps all assets in the company and incurs no additional expenses beyond the cost of the project itself.

Importance of Internally Generated

1. They are long term finance and nobody can ask for their payments.
2. Since there is no additional equity to be issued, there is no dilution of control and ownership in the business.
3. There is no fixed obligation of interest or instalment payments.
4. Retained earnings as an internal source of finance are cost effective considering the fact that there is no issue cost attached to it which ranges between 2 – 3 %.
5. Investing retained earnings in the projects, with IRR better than ROI of the business, will directly have positive impact the shareholder's wealth and thereby the core objective of management will be served.

The Nature and Role of Capital Markets

Capital markets are financial markets for the buying and selling of long-term debt- or equity-backed securities. These markets channel the wealth of savers to those who can put it to long-term productive use, such as companies or governments making long-term investments.

Capital markets are defined as markets in which money is provided for periods longer than a year.

A key division within the capital markets is between the primary markets and secondary markets. In primary markets, new stock or bond issues are sold to investors, often via a mechanism known as underwriting. The main entities seeking to raise long-term funds on the primary capital markets are governments (which may be municipal, local or national) and business enterprises (companies). Governments tend to issue only bonds, whereas companies often issue either equity or bonds. The main entities purchasing the bonds or stock include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf. In the secondary markets

Types of Share Capital

Share capital refers to the funds that a company raises in exchange for issuing an ownership interest in the company in the form of shares.

There are two general types of share capital, which are:

1. Common stock and
2. Preferred stock.

Common stock:

The common stockholders are paid their share of any remaining assets after all creditor claims have been fulfilled. If a company declares bankruptcy, this usually means that the holdings of all investors are either severely reduced or completely eliminated.

***Preferred stock**:*

Preferred stock is shares in the equity of a company, and which entitle the holder to a fixed dividend amount by the issuing company. This dividend must be paid before the company can issue any dividends to its common shareholders. Also, if the company is dissolved, the owners of preference shares are paid back before the holders of common stock. However, the holders of preference shares do not usually have any voting control over the affairs of the company, as do the holders of common stock.

Types of Preference Shares

Cumulative preference shares: The profits are accumulated paid. In case, the company is facing loss then the dividends accumulated on preferencible shares will be paid in the year when company gains profit.

Non-cumulative Preference shares: These preferencible share holders do not get accumulated profits.

Participating Preference shares : They enjoy voting rights.

Non-participating Preference shares: They do not enjoy voting rights.

Redeemable Preference shares: Capital should be redeemed in some cases during life time of the organization.

Irredeemable Preference shares: Here the capital is not payable during the life time of the business.

Convertible Preference shares: These shares can be converted into Equity share holders after a certain period of time.

Non-convertible Preference shares: These shares are not converted into equity shares)

Rights issues

A rights issue provides a way of raising new share capital by means of an offer to existing shareholders, inviting them to subscribe cash for new shares in proportion to their existing holdings.

A company making a rights issue must set a price which is low enough to secure the acceptance of shareholders, who are being asked to provide extra funds, but not too low, so as to avoid excessive dilution of the earnings per share

Convertible:

A bond or preferred stock that may be exchanged for common stock in the company issuing the convertible at a certain ratio and/or a certain price. A convertible security gives the holder a great deal of flexibility. It reduces risk by guaranteeing a coupon payment or dividend while also allowing the holder to take advantage of a potential, larger return through the ability to convert the security.

Warrants:

Warrants are a special type of instrument used for long-term financing. They are useful for start-up companies to encourage investment by minimizing downside risk while providing upside potential. For example, warrants can be issued to management in a start-up company as part of the reimbursement package. Warrants may be issued to purchase underlying shares or pay cash if the price of the underlying share exceeds the agreed future purchase price.

Investment and Securities Act

The Securities Exchange Act of 27th September, 1979 established the Securities and Exchange Commission (SEC) and was reenacted by the SEC Decree of 1988. it is the apex regulatory organ of the capital market. Its major objective is the promotion of an orderly and active capital market.

Investment and Securities Act, 2007

The Investment and Securities Act, 2007 is the act that repealed the investments and securities act 1999 and to establish the securities and exchange commission as the apex regulatory authority for the Nigerian capital market as well as regulation of the market to ensure the protection of investors, maintain fair, efficient and transparent market and reduction of systemic risk; and for related matters.

The Act, amongst other things, provides for-

(*a*) the establishment of Securities and Exchange Commission;

(*b*) the repeal of the Investments and Securities Act 1999;

(*c*) the enlarged powers and functions of the Commission over the capital market; and

(*d*) a set of new market infrastructures and wide-ranging system of regulation of investment and securities business in Nigeria, especially in the area of Mergers, Acquisitions and Take-Over, and collective Investment Schemes, where new provisions were made.

Revision Question

1. Prepare a comparative chart of all the sources of finance.
2. What are the role of capital market.
3. Write short notes on the following:
   1. Right issue
   2. Warrant
   3. Investment Act
   4. Security Act

Reference

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