Example of essay on long-term financing

Business, Company

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Long-Term Financing

Question 1

Describe the major advantages and disadvantages of going public.

Going public refers to the process by which a private company floats its shares to the public and became a public company. Small companies seeking to expand and grow their company usually go public to generate the much needed capital for expansion. There several advantages and disadvantages of going public.

The first advantage is that it is a cheaper source of finance. Stock market provide small companies with debt a cheaper source of funds because there is no repayment of capital and the dividend payment on share is not obligatory unlike interest payment on debt. The second advantage is establishing a market price for the firm. This is important when marketing the firm to potential investors since investors are more concerned about the return on their investment. Thirdly, going public enables a company secures

long-term relationships with external stakeholders. Customers and suppliers seek to do business that will be around for a longtime in the foreseeable future. Going public assures external stakeholders of the company's future. Lastly, going public enables a company to have a greater access to capital and hence financial stability.

The first disadvantage of going public is loss of the company's control. Once a company goes public, there is always the risk of hostile takeovers. Secondly, the company will have made much disclosure than before in order to comply with legal requirements. This exposes the company's strategies and plans to competitors. Thirdly, there are some recurrent costs associated with going public such as public relation, annual external audit fees and director liability insurance. This increases expenses of the company. Lastly, the company will be under strict scrutiny from current and potential investors. The management will therefore be under extreme pressure to perform and deliver strong earnings that may force management to engage in creative accounting.

Question 2

A stock's current market price is $40. The annual cash dividend is $2 per share. In addition, investors expect the firm to pay a 6% dividend in common stock. The expected growth rate of the cash dividend is 5% per year. Calculate the cost of retained earnings.

Kr = (D1/po) + g

Where;

Kr is the cost of retained earnings

D1 is the expected dividends per share, D1 = D0 (1+g)

Do is the current dividend paid which is $2

P0 is the current market price which is $40

g is the expected growth rate which is 6%

Therefore;

D1 = 2(1+0. 06) = $2. 12

Kr = (2. 12/40) + 0. 06 = 0. 113 = 11. 3%

Question 3

Explain why a firm should not necessarily refund an outstanding debt issue the instant the net advantage becomes positive.

A firm can refund an outstanding debt if it contains a call or redemption option. This is a clause in a debt agreement that requires or allows the issuer of bonds to redeem them at a predetermined price and date that falls before the bonds matures. Bonds are normally redeemed at a price higher than the par value to compensate the bond bolder the interest that will be forgone. The difference between the call price and the par value is referred to as the call premium. Issuers of bonds normally redeem bonds when the prevailing market interest rate falls. This is in a bid to lower financing cost by paying off outstanding debt that have a higher interest rate and making a new issue at the prevailing market interest rate which is lower. However, in some instances, a bond issuer may redeem existing bonds for other reasons other than saving finance costs. For example, the bond issuer may want to be relieved from restrictive covenants made at the time of issuing the bonds. The net advantage of a bond is positive when the prevailing market interest rate is higher than the coupon rate on outstanding debts. This occurs when

prevailing market interest rates rises over time, therefore making the current interest rates to be higher than the interest rate prevailing at the time of issuing outstanding bonds. If the company was to make a new issue of bonds it would have to offer a high coupon rate that reflects the increase in the prevailing market interest rate. This would result in higher financing costs. Therefore, it would be advisable for the company to retain the outstanding bonds in order to minimize financing costs.

Question 4

Stephens Security has two financing alternatives: (1) A publicly placed $50 million bond issue. Issuance costs are $1 million, the bond has a 9% coupon paid semiannually, and the bond has a 20-year life. (2) A $50 million private placement with a large pension fund. Issuance costs are $500, 000, the bond has a 9. 25% annual coupon, and the bond has a 20-year life. Which alternative has the lower cost (annual percentage yield)?

Alternative 1

Value of the Bond = $ 50m

Issuance cost = $1m

Life = 20 years

Interest payments = 20*2 = 40

Interest rate = 9%

n = 20*2 = 40, PV = -($50 - $1) = -$49 PMT = 9% / 2 x $50 = $2. 25 FV = $50 R = 4. 61%

APY = (1 + 0. 0461)2 -1 = 9. 4334%

Alternative 2

Value of the Bond = $ 50m

Issuance cost = $0. 5m

Life = 20 years

Interest payments = 20

Interest rate = 9%

n = 20, PV = -($50 - $0. 5) = -$49. 5 PMT = 9. 25% x $50 = $4. 625 FV = $50 R = 9. 36%

APY = 9. 36%

Alternative 2 will have a lower cost since it has a lower APY.

References

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