

Business financing and the capital structure

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Business financing and the capital structure Task Introduction The paper presents discussion on the following three issues: the advantages and disadvantages of using debt and equity as sources of finance; the criteria for selecting appropriate investment banker to assist a business in raising capital; and the relationship between risk and return for both common stock and corporate bonds and how diversification helps in minimizing risk.

Question 1: Debt and Equity Finance

Companies have various alternatives for raising capital. The sources are broadly categorized into two (Long-term and short-term sources). The source chosen depends on the company's financing needs. Companies can either decided to use equity or debt or a combination of the both. Whichever source is chosen; the following should be noted: Debt finance is a source that earns a fixed return (interest) to the lender. The interest is fixed at the par value of the debt (face value). This source of finance is ideal to be sought by a company that has a strong base of equity. Debt funding is only available to qualified companies based on credit ratings, and its availability is limited to the value of the security provided (Chandra, 2011).

Advantages of Using debt finance – first, the interest charged on the debt is tax allowable. Second, the cost of debt is fixed regardless of the profits made by a company and due to that, under high profits, the cost of debt becomes lower. Third, it does not involve many formalities and due to that, it is suitable when a source of finance is required urgently. Fourth, if the debt is long-term, the amount owing declines with time, thus reduces the repayment burden to the borrower. Fifth, this type of finance does not influence a company's decision since creditors do not participate in the

annual general meeting (Chandra, 2011).

Disadvantages of debt finance – first, it can only be invested with the lender's approval. Second, when used in excess, the creditors might demand a representation on the Board of Directors. The representation might affect a company's decision-making. Third, it is risky to use it during an economic decline because its usage might send a company into receivership. Lastly, it is only available for specific ventures, thus might affect the flexibility of the company's investment strategy (Chandra, 2011).

Equity capital - it is raised from the public through the sale of ordinary shares. This source of finance is available exclusively to Limited Companies. It is a changeless finance source, as the shareholders cannot review this cash except under liquidation. It is, along these lines, a base on which different funds are raised. Ordinary share capital conveys a variable return (customary profits). These shares carry voting rights and can impact the organizations choice making procedure amid the Annual General Meeting.

Advantages of shares – first, they are suitable for financing long-term projects. Second, it lowers the gearing level of a company, thus reduces chances of receivership. Third, this source boosts a company's credit rating.

Disadvantages of equity- first, the source is more expensive than the debt due to a high level of premiums required by fund providers not to mention how time-consuming the process is. Second, it leads to a reduction in the control of the company (ownership dilution) (Chandra, 2011).

Question 2: Investment banker

The primary function of investment bankers is to assist both private, and public entities raise funds in the capital market. The accompanying is a

percentage of the issues that ought to be contemplated when selecting an investment banker: first, familiarization with the process of investment banking is necessary to prevent deceit. Second, the banker should familiarize himself with the business prior to acting on its behalf. Last, choose a banker who has similar ambitions as the business (Fuller, 2010).

Risk and return

A risk is defined as the probability that the actual return will vary from the expected return with respect to the historical performance. Historically, the risk is perceived to have a direct relationship with the return. That is, when risk is high, the return is high and vice versa. Portfolio diversification refers to holding more than one asset in an investment vehicle. Negatively correlated assets (whose performance move in the opposite direction) helps reduce the risk. For instance, consider two investors A and B. A holds shares (12%) and bonds (6%) with a weight of 30% and 70%. B holds a single asset (shares that earn 12% return) (Goetzmann & Kumar, 2008).

The portfolio return for investor A = $(12\% \times 0.3) + (6\% \times 0.7) = 7.8\%$.

Whereas, the return for investor B is 12%. Assume that the return on shares decline to 9% while the return on bonds increases to 8.5%. The return for investor A = $(9\% \times 0.3) + (8.5\% \times 0.7) = 8.65\%$. While the return of investor B = 9%. Based on the analysis, the return on the diversified portfolio increase from 7.8% to 8.65% whereas the return on the individual stock decreases from 12% to 9%. The reduction in the return on equity has been offset by the increase in the return on bonds in the case of investor A.

Therefore; diversification reduces risk (Goetzmann & Kumar, 2008).

References

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