# Recommendations of Financing Alternatives

## Submitted By Independent Financial Advisor


### Abstract

The report is briefly outlining the financing options available for the company for financing the proposed expansion under the constraints defined by the company



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## Introduction

Printers Ltd. is a private limited company owned by three young family shareholders. They are also the active directors of the company. The company developed a specialization in high quality printing of reproductions of famous paintings and drawings. At present the business is doing good therefore the company is intending to diversify into art book printing, which will require the purchase of new printing machinery for £2m and an additional investment in working capital of £0.5m. At present he company owns its factory premises which is freehold, however against the purchase of the printing machines, a long term bank loan at floating interest rates, repayable over 5 years, 2 years remaining.

Therefore, the company is intending to evaluate the various option available for obtaining new machinery and financing working capital needs so that business could diversify.

## The three constraints

While evaluating the available options for obtaining new machinery and financing working capital needs, the three major shareholders are of following views:

a. The company is not in position to finance the required capital for purchase of new machinery and fund the required working capital
b. The shareholders also do not want to increase the leverage further as it may push the company into bankruptcy in case the company unable to service the debt
c. Also, shareholders do not want to dilute their control

The above three constraints are vital as constraint "a" indicates that there is no unencumbered reserves available with the firm which may be used for purchasing the equipment and financing the working capital loan. Constraint "c" indicates that existing shareholders do not want to share the control and therefore possibility of bringing an additional equity investors getting ruled out. Constraint "b" indicates that there is a fear of bankruptcy against the higher debt among the shareholders.

However as per pecking order theory of capital structure, it is being suggested that any firm should prioritize its source of financing first preferring its internal accrual, followed by debt and lastly by raising further equity. The above inference based on the postulate that cost of financing increases with asymmetric information (Myers and Majluf ,1984). In this case since the company already expressed its inability to fund through internal accruals, therefore the next best option is to use debt for financing the equipment purchase and meeting working capital needs. However, higher debt increases the fixed obligation of the firm. Therefore in case of fluctuation in EBITDA either because of demand fluctuation or because of crashing the prices or because of increase in cost, the probability of default increases. Owing to higher probability of bankruptcy, additional debt always comes at higher cost.

Based on above discussion a set of option is evaluated and recommendations are made which is summarized in subsequent sections.

## Options analysis

Following options need to be evaluated for financing the equipment and obtaining the working capital requirement.

1. Own funds
2. Fully recourse debt
3. Raising additional equity
4. Lease model
5. Overdraft
6. Non-Recourse debt – Creation of Special Purpose Vehicle

Further, above mentioned options are evaluated in terms of benefits, shortcomings and strategic fit for the firm.

***Own Funds:*** Own funds are referred to funds which is existing with the business as reserves and surplus. At times own funds are also referred as funds infused by existing shareholders as paid-up capital. The advantage and disadvantage with respect to the case is summarized below:

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|---|
| Pros:<br>i. As per pecking order theory of allocation of capital, first priority should be given to own funds<br>ii. It reduces the financial leverage of the firm and hence reduces the probability of default |
| Cons:<br>i. Most of the times internal accruals are insufficient to fund the expansion<br>ii. Investing entire reserves into expansion project impairs the ability of firm to meet contingencies |

iii. Own funds are equity. Further in general cost of debt is lower than the cost of equity. Therefore cost of funds analysis must be done before deciding the capital structure of new or expansion project (Brealey et. al, 2008)

Though, own funds have its own merits, but company already express its inability to fund the project through accruals.

***Fully recourse Debt:*** Debt is the obligation which a company borrow either from any institution, banks, non-banking financing company, or from markets. Fully recourse debt is the debt for which additional debt is taken on the balance sheet of the existing company.

The advantage and disadvantage with respect to the case is summarized below:

Pros:

i. Since the firm is raising the debt on its own balance sheet, therefore it is easy to get

ii. Interest rate would be lower as lenders gets the comfort of existing business and cash flows

Cons:

i. In case the new business could not do well, the existing business need to bear the burden of additional debt

ii. The probability of default of entire business is high as all the debt and business are combined into one entity (Chatterjee & Rose, 2012).

The option may be explored, however the shareholders already expressed their concern. The shareholders do not want to increase the financial leverage of the firm.

***Raising Additional Equity:*** Additional equity may be infused on-boarding additional equity investors.

The advantage and disadvantage with respect to the case is summarized below:

Pros:

i. It reduces the financial leverage of the firm and hence reduces the probability of default

Cons:

i. The stake of existing shareholder would be diluted which is not appreciated by

| |
|---|
| existing shareholders.<br>ii. Own funds are equity. Further in general cost of debt is lower than the cost of equity. Therefore cost of funds analysis must be done before deciding the capital structure of new or expansion project (Brealey et. al, 2008). |

The option may be not be explored as the shareholders already expressed that they do not want to lose the control over the firm.

***Lease:*** Lease is a contractual arrangement though which the one party conveys land, property, services, etc. to another for a specified time at pre decided payment terms. The advantage and disadvantage with respect to the case is summarized below:

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|---|
| Pros:<br>i. If the equipment is taken at lease then firm need not to arrange capital for purchasing the equipment.<br>ii. The lease rentals can be flexible based on negotiated terms<br>iii. Option of both financial and operational lease is available |
| Cons:<br>i. The cost of lease is generally higher than that of cost of funds<br>ii. Higher cost of operation owing to higher lease rental leading to reduced profitability (O'Sullivan and Sheffrin, 2003). |

The equipment may be sourced on operational lease basis as the Printers Limited. Therefore, Printers Ltd need not to arrange the required capital upfront. However, this also lead to lower profitability because higher lease rental lead to lower profitability. The Printers Limited should source the equipment on lease with the option to buy after 2 years. After 2 years, the current term loan would be over and firm would be in position take new loan.

***Overdraft:*** Overdrafts are a form of facility for business with fluctuations in working capital, which frequently used to ease pressures on working capital and as a support for unexpected expenditures. It’s a short term borrowing. The advantage and disadvantage with respect to the case is summarized below:

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|---|
| Pros:<br>i. It helps in meeting fluctuation in business |

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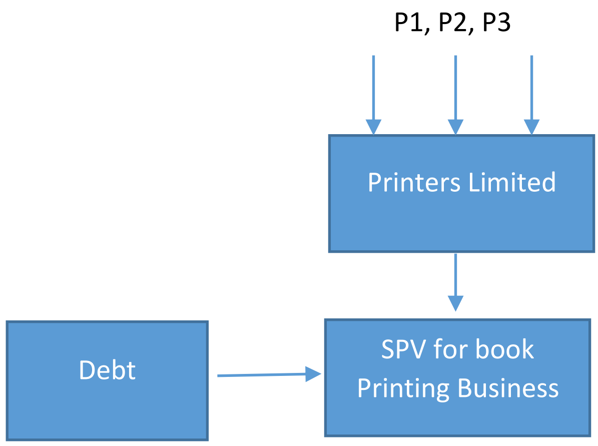
|---|
| Cons:<br>i. The rate of interest on overdraft facility is generally higher than that of rate of interest on term loan<br>ii. Higher cost of operation owing to higher lease rental leading to reduced profitability (Kapner, 2011). |

Though, the shareholders do not want to increase the debt on the balance sheet of the firm, the overdraft facility is essential for meeting the fluctuation of business.

***Non-Recourse Debt:*** Non-recourse debt can be taken if Printers Limited forms a separate subsidiary for art book printing and take additional debt on the books of newly SPV formed. This would immune the parent company i.e. Printers Limited against the business risk of art book printing business. In case the art book printing business would not do well in future, Printers Limited need not to fulfil the obligation of art book printing business. The proposed structure would be as follows:




. The advantage and disadvantage with respect to the case is summarized below:

| |
|---|
| Pros:<br>i. The Printers Limited need not to take additional debt on its balance sheet<br>ii. The Printers limited would be immune from the business risk of Book printing business |
| Cons:<br>i. 100 percent debt may not be given by financial institutions. Therefore a certain portion of capital may be put as equity by Printers Limited. An agreed debt to Equity structure may be in range of 80:20 |

| ii. | There would be dividend distribution tax involve if SPV gives dividend to parent entity (Koh, 2018) |
|---|---|

The structure suits to the needs of Printers limited provided they agree to infuse some portion as equity.

To sum up, strategic fit of above financing options may be summarized as follows:

| Option | Requirement of funds through internal accruals | Increase in financial leverage | Loss of control | Availability |
|---|---|---|---|---|
| Own funds | Yes | No | No | No |
| Fully recourse debt | No/partial | Yes | No | Yes |
| Raising additional equity | No | No | Yes | Yes |
| Lease model | No | No | No | Yes |
| Overdraft | No | Yes | No | Yes |
| Non-Recourse debt – Creation of Special Purpose Vehicle | No/Partial | No | No | Yes |

The above table indicates that "Lease Model" and "Non –Recourse Debt – Creation of Special Purpose Vehicle" are the two options which seems a feasible option for the Printers Limited, given the constraint of shareholders.

## Recommendation

Under the constraints put by shareholders, most optimal option is to source the equipment on lease with the option to buy it after two years. Since current term loan would be matured in next two years, therefore firm can raise new debt after two years. This option would ensure that Printers Limited need not to invest though own accruals, current shareholders have not lost the control and the company maintains the intended leverage. However, this option would reduce the profitability of the firm for first 2 years.

Alternatively, non-recourse debt is also an option provided the current shareholders willing to inject 20% of the required capital as equity. This option satisfies two concerns of shareholders i.e. concern of loss of control and increase of financial risk owing to higher leverage. However the third concern of inability to fund the project through equity is partially satisfied as it is proposed that at least 20% of equity is required to be infused by the sponsor or promoter into the newly formed SPV.

For working capital arrangement, the working capital loan must be funded through debt. This means that difference between current asset and current liability need to be funded by debt. It is neither prudent nor feasible to fund the working capital uncertainty. Also, the business needs to be study in details. In case there is high fluctuation in working capital requirement, overdraft facility may be availed.

## References

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