

## **CHAPTER 14: LONG-TERM FINANCING: AN INTRODUCTION**

Assigned problems: none

This chapter is straightforward. The topic of straight or cumulative voting is not covered in my class or exams. While you should certainly read the Chapter, I will emphasize the following material in class (since the rest of the Chapter is easily read by students).

New business investment in the U.S. was \$983 billion in 2001, consisting of:

1. \$855.2 billion in long-term assets (capital spending)
2. \$127.8 billion in Net Working Capital (the addition to short-term assets that is not offset by the addition to non-interest paying liabilities).

\$776.6 billion of this total \$983 billion spent in 2001 came from internally generated cash flow of corporations. Reinvested or retained cash flow is known as **Internal Equity**, since this money could otherwise be paid to the shareholders.

If not reinvested or retained within the firm, the internally generated cash flow should eventually be paid out to shareholders. In any case, when a firm pays out dividends or repurchases its stock, it is returning its excess capital or surplus cash (Free Cash Flow to Equity or FCFE from Chapter 5) to the capital markets.

Cash should be retained or reinvested in a corporation to the extent that positive Net Present Value opportunities exist within the corporation.

Since \$983 billion was spent by businesses in 2001 and internally generated cash flow was \$776.6 billion, the difference of \$206.4 billion had to be financed externally by corporations. External financing can be either in the form of new debt or new equity (*external equity*) that is issued

Note that net new equity issuance was *minus* 49.3 billion in 2001. Corporations actually repurchased more equity than they issued. Keep in mind that the growth firms are issuing the new stock and the older, more mature firms are generally repurchasing stock.

### **Patterns of Financing**

The pattern of financing by U.S. non-financial companies is illustrated in (figure 14.1). Important characteristics of long-term corporate financing activities are:

- Internal financing (retained cash flow) is by far the most important source.

- Spending exceeds funds from internal financing for most companies and this deficit is funded by issuing debt or issuing new equity (external equity). This is known as “external financing”.
- New *external* equity is rarely used.
- During the 1980’s NET equity issuance was actually negative. In the U.S. economy, meaning that the amount of cash spent to repurchase shares was greater than the amount generated by issuing new shares.

### **Donaldson's 'Pecking Order' Hypothesis**

Gordon Donaldson [1961] (referenced in the text) proposed the following financing “**pecking order**” to describe the order in which firms seek funds:

- 1<sup>st</sup> choice: Internally generated cash flow has dominated as a source of long-term financing.
- 2<sup>nd</sup> choice: When a firm has insufficient cash flow from internal sources, it draws down cash and marketable securities.
- 3<sup>rd</sup> choice: As a last resort, a firm will use externally generated cash flow. Debt is used before equity.

The pecking order explanation is roughly consistent with the observed U.S. financing patterns. We will return to the pecking order issue in Chapter 16.

### **Debt versus Equity:**

It is a mistake to assume that one form of financing is superior to the other. An individual or institution can become an investor in a firm in one of two ways, by purchasing its (1) debt securities or (2) equity. How a firm is financed with debt and equity only establishes who has what contractual claim on the corporation’s cash flow that is generated by the assets.

Debt or bonds represent borrowed cash that must be paid back with interest. The debt’s *explicit* cost of capital or interest expense is considered a cost of doing business and therefore it is tax deductible. Debtholders do not own the firm, nor do they have any voting rights. However, they are protected by a bond contract or indenture that establishes the legal rights of the bondholders and specifies all terms of the bond issue. Debtholders always have a claim on the firm that is superior to that of the equity (equity is a *residual* claim) and can force the firm into bankruptcy if the firm defaults on its debt obligation.

*Convertible* bondholders have the option to convert their bonds into a predetermined number of shares of common stock.

*Callable* bonds can be repurchased by the issuing firm.

*Mortgage* bonds are secured by some asset of the firm.

*Debenture* bonds are only backed by a corporation's ability to earn future cash.

*Subordinated* bonds have a claim on the firm that is junior or subordinate to some more senior issue of bonds.

The owners of the common stock or common equity are the corporation's owners and owners certainly have voting rights in the firm.

Preferred stock is equity but generally does not carry voting rights. Most preferred stock pays a fixed dividend, and generally falls into the broad category known as *fixed income* securities. Preferred dividends must be paid first before dividends can be paid to common stock. Be aware that preferred stock can be highly customized; some are convertible into other securities.