Financial Analysis and Management Assignment

I declare that this assignment is all my own work and that I have acknowledged all materials used from the published or unpublished works of other people. All references have been duly cited.

Student name:

Course

Professor

University Name

Due Date

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Introduction

Finance is a major requirement for each organization. Asset investments in every business are made by the use of finance. Such finance can either obtain by business from equity financing or debt financing. Equity and debt financing have various options. Organizations choose the source of finance on the basis of requirement and availability. This report is written for making a critical evaluation regarding external sources of finance. In addition to this report will discuss the consideration required to make while choosing the source of finance. Moreover, weighted average cost of capital (WACC)is a total cost of financing bore by the organization in exchange for obtaining finance from the various sources. In the measurement of WACC, weights are given on the basis of finance provided by each source of finance. The report will also explain regarding he one important financial tool i.e. WACC and explain the effect of capital source on WACC.

An external source of finance

An external source of finance refers to the source of finance arranged from outside the business. it does not include retained profits and reserves of the organization. However, an organization can make external financing by the way of equity issues and debt financing. following are the external source of finance available for public companies,

Equity share capital

Public companies do not have any restrictions on issue of the equity shares. Equity shares provide ownership rights to the equity shareholder. Increase in the equity share capital in the organization results in the dilution of ownership rights of the existing equity shareholders. Equity

share capital financing is a costlier source of finance then the debt source of financing because dividend to equity shareholders does not provide tax shield to the organization(Hennessy & Whited 2007). Raising capital by the way of equity share capital results in various legal formalities and documentation.

Moreover, equity share capital can be issued by the way of an initial public offer or right issue. Initial public offer without right issue does not provide any extra rights to the existing equity shareholders in public offerings; however, right shares can provide any extra rights to the existing equity shareholders in public offerings.

Moreover, equity share issues bringthe following advantage for the organization,

a. Equity share capital does not create any obligation for the organization regarding the payment of dividends like debt capital.
b. Equity share capital is not needed to secure any assets of the organization.
c. Equity shareholders do not have rights to appoint any person on the eve of nonpayment of the dividend.

Preference share capital

Preference share capital is having some attributes of the equity share capital and some attributes of equity share capital. Preference share capital has preferred rights than the equity share capital for payment of dividend and the repayment at the time of liquidation. Preference shares can be cumulative or noncumulative. Cumulative preference shares have rights to accumulate its unpaid dividends and noncumulative preference shares do not have any such rights(Piketty 2015).

Moreover, preference share issues bringthe following advantage for the organization,

d. Preference share capital does not create any obligation for the organization regarding the payment of dividends like debt capital.
e. It does not have voting rights hence does not dilute the voting rights of the other existing equity shareholders.
f. Preference share capital is not needed to secure any assets of the organization.
g. Preference shareholders do not have rights to appoint any person on the eve of nonpayment of preference dividend.

Debentures

A debenture is an also a source of finance. This source is preferred by the organization who wants to finance their assets by the use of debt capital in place of equity capital(Kochhar & Hitt 1998). A debenture is a security like equity shares but it is not an equity source. This source requires interest as well as principal repayment. This is a cheaper mode of finance because interest paid on the debentures is tax deductible. Procedure for issuing debentures is also required legal expenses as well as extensive documentation. As debentures are debt capital hence they require collateralizing the assets of the organization.

Moreover, debenture issues bring the following advantage for the organization,

h. It does not have voting rights hence does not dilute the voting rights of the other existing equity shareholders.
i. Debenture capital provides finance to the organization at a cheaper rate than the equity capital.

Term loan

The term loan is an also a source of finance. This source is preferred by the organization who wants to finance their assets by the use of debt capital in place of equity capital. This source requires interest as well as principal repayment. This is a cheaper mode of finance because interest paid on the term loan is tax deductible(Kregel 2004). The term loan is debt capital hence they require assets as security. Procedures for raising term loan are not difficult like the debentures. It needs to take a loan from banks or financial institutions. It does not need to make higher legal documentation related expenses.

Moreover, term loan bring the following advantage for the organization,

j. It does not have voting rights hence does not dilute the voting rights of the other existing equity shareholders.
k. Debenture capital provides finance to the organization at a cheaper rate than the equity capital.

Leasing or hire purchasing

Leasing or hire purchasing source of finance can be utilized by the organization when an organization needs to finance any assets. These sources help the organization in delaying the cash expenditure require making at the time of purchasing the asset. In hire purchase transition one needs to make down payments and installment payment as per hire purchase contract and does not require making full payment upfront. It escapes the organization take a loan or makes

equity financing for purchasing assets. In the same way in financing lease one needs to make lease payments as per the lease contract and does not require making full payment upfront.

Moreover, term loan bring the following advantage for the organization,

l. It does not have voting rights hence does not dilute the voting rights of the other existing equity shareholders.
m. Leasing and hire purchasing capital provides finance to the organization at a cheaper rate than the equity capital.
n. This source of finance escapes the organization from making an upfront payment for the purchase of the asset.

In addition to above-mentioned loan term source of the externalfinance,an organization can also use a short-term source of external finance like bank overdraft, trade credits or factoring debts. bank overdraft providesshort-term credit facility from the bank at nominal interest charges or bank overdraft fees, trade credit provides the advantage of delaying payment for purchase at negligible cost and factoring debts helps in earlier receipt of money from the debtors in exchange of discounting expenses or factor commission. It also ensures the minimum or nil bad debts in the organization.

Factors need to consider while choosingthe source of financing

Making a choice between the various available sources of finance is a difficult as well as time taking the task. Making the decision for the source of financing is a critical analysis. The organization needs to consider following factors before deciding the source of finance,

Risk

The risk is an important factor associated with each financing decision. The organization always has worries regarding the implication of nonpayment of dues. This risk factor is higher in the debt financing than in equity financing because in case of nonpayment of equity dues nobody initiates litigation proceeding against the organization. However, in case of nonpayment of debts litigation proceedings can be initiated against the organization. In addition to litigation proceedings, nonpayment of debt financing hasa risk of liquidation.

Hence if the organization does not have the assurance to earn and have the cash for repayment of dues related to debts then the organization should not use debt financing. In such condition,the organization should choose equity financing.

Cost of finance

Cost of finance is a fundamental assertion needs to consider while taking the finance. Every organization hasan objection to reducing its cost of capital. This cost of capital of an organization is made with the cost of a different source of finance used in the business. Cost of finance is higher in the equity and preference share capital in comparison of debt capital. Cost of finance of the debt capital is lower because interest expenses need to be paid on debt is tax deductible. Dividend payment required to make on the equity and preference share capital are not tax deductible hence cost of equity is higher.

Control

Control of the organization comes with the ownership rights. Equity issuance dilutes the control of the existing shareholders;however, financing from any other source except the equity share capital does not dilute the control of the existing shareholders. Control is diluted in the equity

issuance because after the equity issues new equity share will also get similar voting rights as held by the existing equity shareholders. Increase in a number of equity shareholders dilutes the rights of previous holders of equity shares.

Long-term and short-term effects

While making capital financing organization also needs to consider whether finance is required for short-term funding or long-term funding. For example, if the organization needs to accomplish a special order then fund requirement will be only for short term period however in case of noncurrent asset funding organization needs loan term funding. Short-term funding requires lesser documentation formalities in comparison tolong-term funding. Additionally,the difference between short-term finance's cost and long-term finance's cost is also considerable.

Weighted average cost of capital

WACC is a financial tool. It measures the weighted average cost of all finance used by the organization for financing all assets of the organization (Brooks 2015). The percentage of cost calculated by this measure should be achieved by the organization's operating earnings. This measure denotes the cost average rate of return which needs to be earned by the organization from operating activities so that organization could become eligible to pay is the cost of finance (Fernandez 2015).

Moreover, WACC measure is required for making present value calculations of the future cash flows (Brigham & Houston 2015). This concept helps the organization in turning out to an option from the various available options of the proposed investments. WACC can help in making choice of the options having risk level similar to the existing projects or risk level different from

the existing projects. In addition to this concept is used in calculations of economic value added. In economic value added calculations organization needs the cost of capital of the organization, WACC measure can be used as the cost of capital in that analysis (Young et al. 2000). In the same way in the calculations related to valuation of the organization, WACC can be used for calculatingthe present value of the future estimated cash flows from the organization.

Furthermore, wrong calculation of WACC of the organization may result in wrong capital investment decisions, wrong firm valuation, wrong economic value added calculations and other wrong decisions which based on present value of future cash flows. Hence this concept is crucial for the organization.

Calculation of weighted average cost of capital

Calculation of weighted average cost of capital is a three step exercise. These three steps are as follows,

Step 1: Calculation of weights

In the calculation of WACC firstly organization needs to calculate weights for each source of finance used by the organization. Weights for the different capital source calculated on the basis of the value of the different source of finance.

Step 2: Calculation of cost of various capital source

Cost of various sources of finance needs to impose various different techniques. In the calculation of WACC cost of capital of different finance source is importantto measure.

Cost of equity source of finance can be calculated by the dividend yield method, growth adjusted dividend yield method, earnings yield method, and expected earnings yield method or CAPM method. CAPM is the most popular method for calculatingthe cost of equity source. Under this method, marker premium is applied to the beta of the company's stock and added to the risk free rate of return (McKay & Haque 2016).

Cost of debt financing can also be calculated by using various methods those can be debt interest method, tax adjusted debt interest method or yield to maturity method. Most popular method of calculating the cost of debt is interest adjusted interest method.

Step 3: Calculation of WACC

Under these step weights of respective capital source applied to the cost of that source. Addition of all weighted costs of the different source of finance is known as WACC of the organization.

<u>Example showing the calculation of WACC</u>

Let company A is having following financing sources and other details,

Trade creditors	$ 50,000
5% short term loan	$ 100,000

10% Debentures	$ 250,000
Equity share capital	$ 600,000
Total assets	$ 1,000,000

Other data

Risk free rate of return	6%
Market premium	4%
Beta of stock	1.25
Tax rate	30%

Step 1: Calculation of weights on the basis of book values

Sources of finance	Book value	Weights
Trade creditors	$ 50,000.00	5.00%
5% short term loan	$ 100,000.00	10.00%
10% Debentures	$ 250,000.00	25.00%
Equity share capital	$ 600,000.00	60.00%
Total assets	$ 1,000,000.00	100.00%

Step 2: Calculation of cost of various capital source

Sources of finance	Calculation	Cost of capital

Trade creditors	Nil	0%
5% short term loan	5%*(1-.3)	3.5%
10% Debentures	10%*(1-.3)	7%
Equity share capital	6%+(4%*1.25)	11%

Step 3: Calculation of WACC

Sources of finance	Weights	Cost of capital	Weighted cost of capital
Trade creditors	5.00 %	0 %	0.00%
5% short term loan	10.00 %	3.5 %	0.35%
10% Debentures	25.00 %	7 %	1.75%
Equity share capital	60.00 %	11 %	6.60%
Total	100.00 %		8.70%

Hence WACC of the capital of company A is 8.7%.

<u>Effects of long term sources of finance on WACC of organization</u>

WACC of organization incorporates two components one is weights of different capital sources of finance and other ofthe cost of capital of different source of finance. In every organization,assets are financed by two types of finance source i.e. short term source of finance and long term source of finance. Normally fixed assets are financed by the short term sources of finance,however, current assets financed by the short term source of finance. Mostly organization does not want to have higher short term source of finance because this involves the

obligation of paying those short term source of finance for the period of 12 months. This also needs immediate cash requirement for repayment of short term source of finance. Hence organizations keep loan term source of finance with a higher proportion in comparison toshort term source of finance.

Moreover, various short term source of finance does not have any cost of capital like trade debtors or outstanding expenses. Some sources of finance which incorporatethe cost of capital are debt sources. Debt sources have a cheaper cost of capital in comparison of equity sources. Short term finance sources are not equity sources hence short term sources of finance does not have a higher cost of capital.

Furthermore, short term source of financehas lower weights for calculating WACC as well as lower cost of capital. Therefore, cost of short term finance also shows a lower number. It can be easily seen from the example calculation of WACC that in whole WACC of 8.7% of Company A, short term source of finance's cost of the capital part is only 0.35%.

Hence, it is concluded that when short term source of finance puts lower impact to the WACC calculations then it is quite obvious that loan term source of finance put a greater impact on the WACC calculations. Long term source of finance has higher weights for capital sources as well as higher cost of capital due to equity, in turn; it puts a greater impact on the WACC calculations.

This higher impact of loan term source of finance on the WACC makes WACC ineligible to use in short-term decision making because most of the part of WACC of capital denotes cost of capital for a longer period but not the cost of capital for a shorter period.

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