Short-term financing

Lecture for Corporate Finance

SILESIAN UNIVERSITY
SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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Outline of the lecture

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- Short-term financing
- Selected types from debt-financing
- Reasons
- Working capital management
- Selected types of internal financing

Short-term financing

All corporations make short-term financing decisions periodically. Beyond the trade financing, firms obtain short/term financing decisions to support other operations.

Because MNCs have an access to additional sources of funds, their short-term financing decisions are more complex than those of other companies.

Financial managers must understand the possible advantages and disadvantages of short-term financing with foreign currencies so that they should make short-term financing decisions that maximize the value of the company.

In businesses, it is also known as working capital management. This type of financing is normally needed because of uneven flow of cash into the business, the seasonal pattern of business, etc. In most cases, it is used to finance all types of inventory, accounts receivables etc. At times, only specific one time orders of business are financed.

Spontaneous financial sources

- Spontaneous are financial sources which are arising without any contract. These are commercial credits and accruals.

- **Commercial credits** are credits arisen from relationship between supplier and customer, where the supplier gives some deadline till it is necessary to pay a bill. Within this period the customer have a product and money being paid for this product and they can use both.

- **Accruals** are for example employees' salaries which are paid with delay. Until their pay-off the company can use them.

Contracting financial sources

Contracting financial sources is based on contracts. There are bank loans, operative leasing, issue of short-term securities and factoring.

A common type of business loan is the **working capital loan** (sometimes called a self-liquidating loan), which is designed to support ongoing business operations. There is a lag between the time when a firm needs cash to purchase raw materials used in production and the time when it receives cash inflows from the sales of finished products.

A working capital loan can support the business until sufficient cash inflows are generated. These loans are typically short term, but they may be needed by businesses on a frequent basis

Working capital

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- Working capital is not a typical short-term financial source.
- It represents operating liquidity available to a business. Along with fixed assets (e.g. equipment), working capital is considered a part of operating capital.

- A company needs that current assets exceed its current liabilities.

- If not, then it may run into trouble paying back creditors in the short term.

The level of working capital

The level of working capital depends on company's policy. An aggressive policy means that a company chooses to operate with lower levels of shares, debtors and cash for a given level of activity or sales.

The aggressive policy will increase profitability since less cash will be tied up in current assets, but it will also increase risk since the possibility of cash shortages or running out of share is increased.

A conservative and more flexible working capital policy would be associated with maintaining a larger cash balance, perhaps even investing in short-term securities, offering more generous credit terms to customers and holding higher level of share.

Risk will be reduced but at the expense of reducing profitability. A moderate policy would tread a middle path between the previous approaches.

Company’s policy

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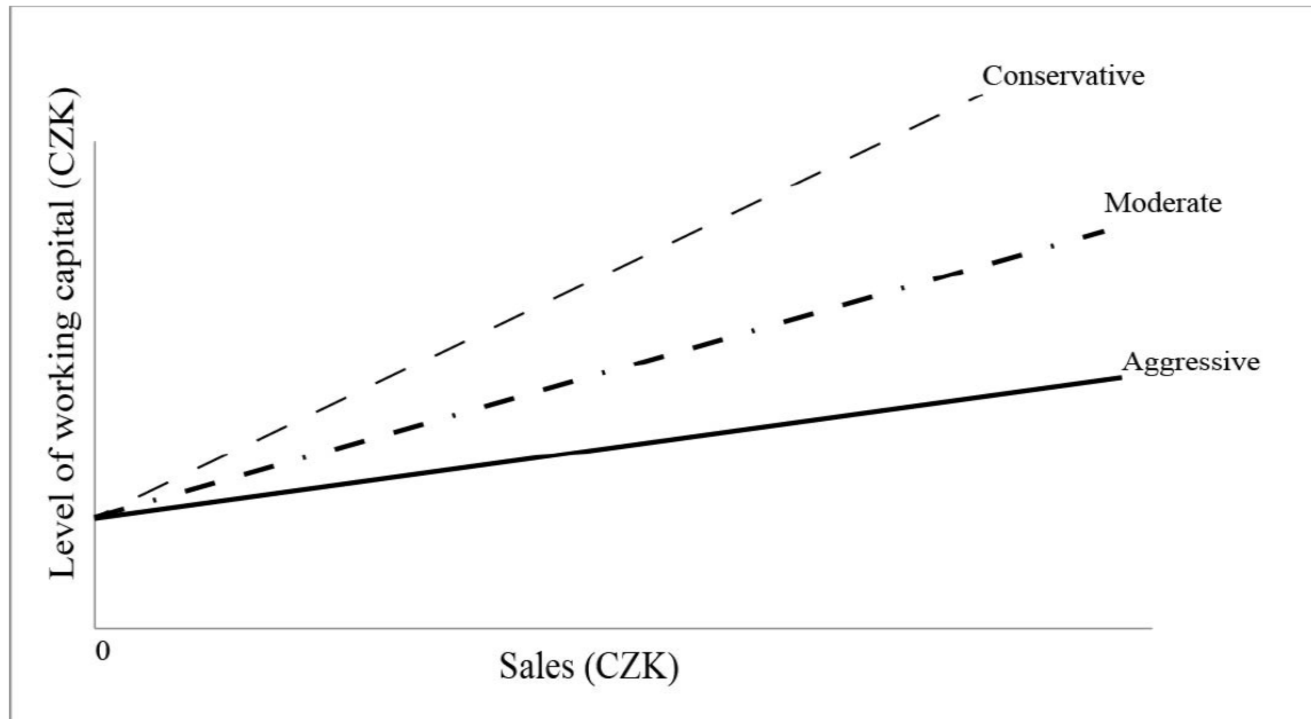


Company’s policy

It is very simple, if the firm is maximizing sales while maximizing the level of working capital, it is very safe and that working capital management is very conservative.

In contrary, if the level is very small, it means risk and aggressive working capital management.

Financing working capital

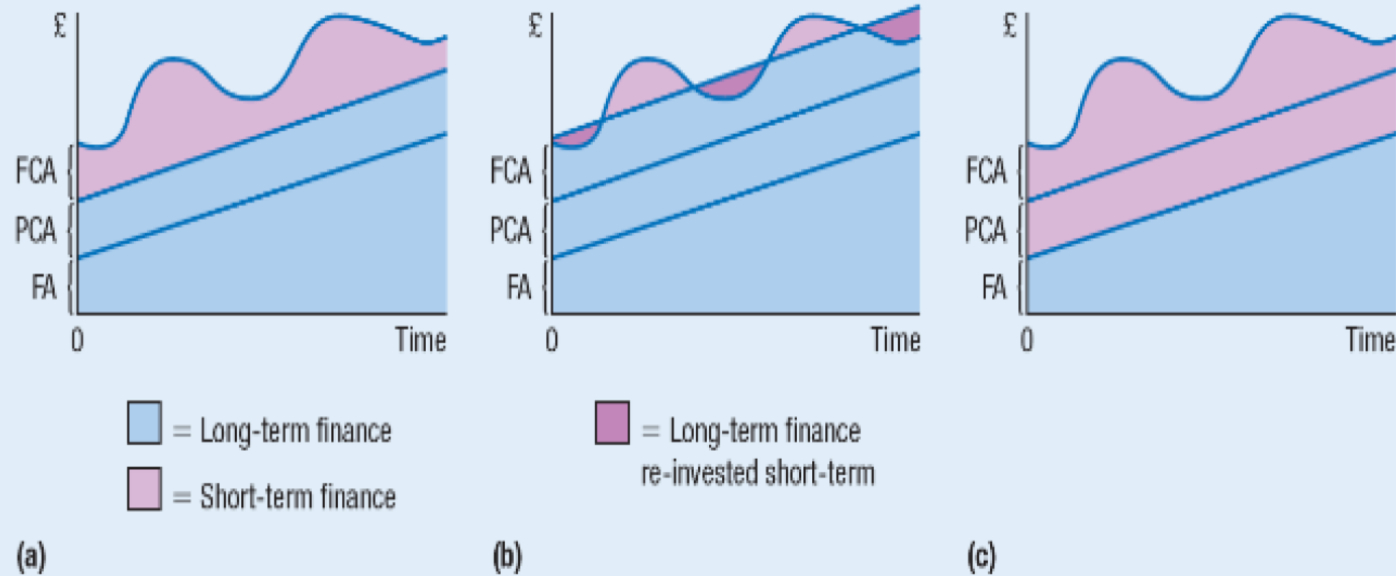
To assist in the analysis of policy decisions on the financing of working capital, we can divide a company’s assets into three different types: fixed assets, permanent current assets and fluctuating current assets.

Fixed assets are long-term assets such as buildings, machinery from which a company expects to derive benefit over several periods.

Permanent current assets represent the core level of investment needed to sustain normal levels of trading activity, such as investment in stocks and investment in the average level of company’s debtors.

Fluctuating current assets correspond to the variations in the level of current assets arising from normal business activity.

Different approaches to financing of working capital



Financing of working capital

Maturity matching or hedging approach is a strategy of working capital financing wherein short term requirements are met with short-term debts and long-term requirements with long-term debts. The underlying principal is that each asset should be compensated with a debt instrument having almost the same maturity.

FA – Fixed assets
PCA – Permanent current assets
FCA – Fluctuating current assets

Operative leasing

- An operative leasing is short-term leasing used often for buying equipment, or devices, which could become quite quick very old and unsightly.

- The company does not have to buy it, but only lease it for several years and repeat it.

- In this way its equipment is still on the latest or technical acceptable state.

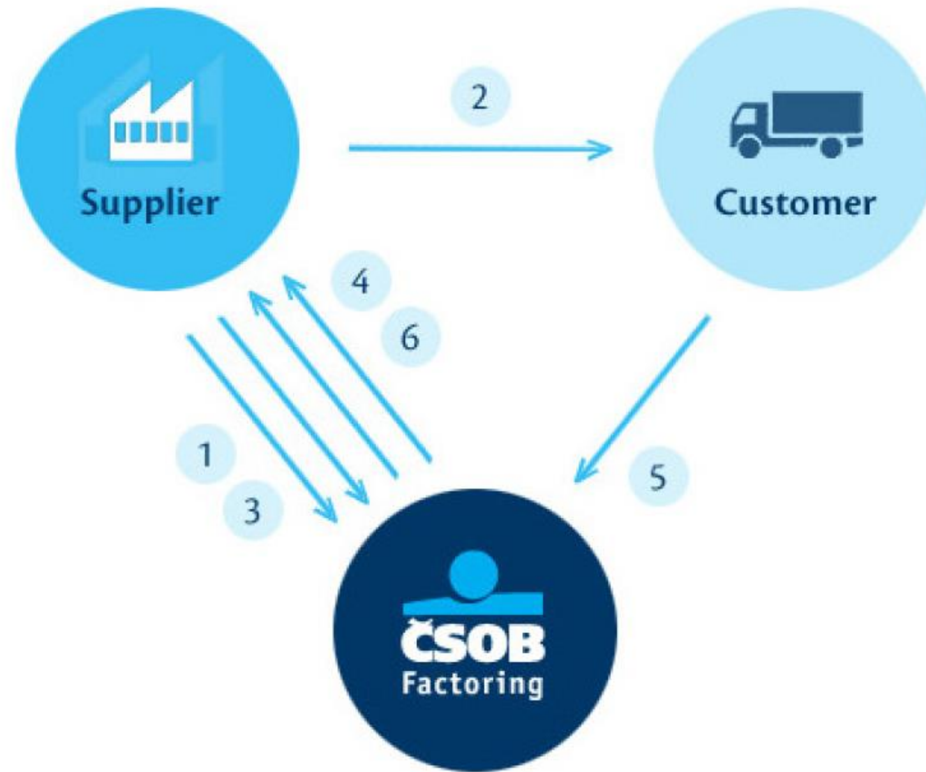
Factoring

- Factoring is a financial transaction which leads to getting money. A company sells its accounts receivables (invoices) to a third party (called a factor) at a discount.

- In the figure at next slide is an example of a possible contract between factoring company and business company and description, how their relationship works.

- In case of non-recourse factoring the factor, rather than the company, carries the risk of bad debts.

Process of Factoring



Process of Factoring

For a customer it is not any difference there cause it is just a payment for goods and services.

There is a bit complicated relation between Supplier (a firm), and a finance company offering the factoring.

How does Factoring work?

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- 1. Supplier signs a factoring contract with CSOB Factoring and becomes its client.
- 2. Goods or services are supplied to a Customer. Supplier issues an invoice with a cession clause and sends off an original to the Customer.
- 3. Then Supplier assigns his claims to CSOB Factoring, which implies that his Customer becomes a debtor of CSOB Factoring.
- 4. Supplier (client) has the right to draw an advance payment up to 90 % of nominal value of the claim including VAT.
- 5. When the claim is due, Customer is obliged to pay on CSOB Factoring account.
- 6. The difference up to 100 % of nominal value of the claim is paid to Client the same day when CSOB Factoring receives the payment from Customer (debtor).

Sources of short-term financing – debt financing in foreign currency

Companies' parents and their subsidiaries typically use various methods of obtaining short-term funds to satisfy their liquidity needs.

When financing in a foreign currency, it is increasingly the case that the bank or financial market providing the finance will not be in the country of the currency.

When this is the case term euro is used. Thus a eurodollar bank account is an account that will probably be situated in London and will be denominated in dollars. A eurobank is a bank that makes loans and accepts deposits in foreign currencies.

Eurobank loans

- Direct loans from eurobanks, which are typically utilized to maintain a relationship with eurobanks, are another popular source of short-term funds for companies.
- If other sources of short-term funds become unavailable, firms rely more heavily on direct loans from eurobanks.
- Most companies maintain credit arrangements with various banks around the world.
- Some firms have credit arrangements with more than 100 foreign and domestic banks.

Euronotes

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- Euronotes, or unsecured debt securities, are bonds issued by firms with an interest payment and fixed term after which the firms will repay the nominal (agreed) amount.

- The interest rates on these notes are based on LIBOR. Euronotes typically have maturities of 1, 3, or 6 months. Some companies continually role them over as a form of intermediate-term financing. It means they issue new Euronotes to repay ones that are maturing and need to be repaid by the company.

- The companies in this way extend the term of the loan to themselves. Commercial banks underwrite (guarantee) notes for firms and some commercial banks purchase them for their own investment portfolios.

Euro-commercial paper

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It is promissory note (an IOU note) issued by large reputable company needing to borrow for a very short term or any stated length usually about 180 days but can be for 1 year.

It is a bearer note, which means the holder is the owner rather like a currency note such as 5,- GBP only when these notes are for a minimum of 500.000,- USD.

Dealers issue this paper for the firm without the backing of an underwriting syndicate, so a selling price is not guaranteed to the issuers. Maturities can be tailored to the issuer´s preferences. Dealers make a secondary market by offering to repurchase euro-commercial paper before maturity.

Internal financing by firms 1/2

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Before a firm´s parent or subsidiary in need of funds searches for outside funding, it should check other subsidiaries´ cash flow positions to determine whether any internal funds are available.

This process is especially useful during periods when the cost of obtaining funds in the parent´s home country is relatively high.

Parents of companies can also attempt to obtain financing from their subsidiaries by increasing the mark-ups on supplies they send to the subsidiaries.

Internal financing by firms 2/2

In the case of internal financing, the funds the subsidiary gives to the parent will never be returned. This method of supporting the parent can sometimes be more feasible than obtaining loans from the subsidiary because it may circumvent restrictions or taxes imposed by national governments.

In some cases, though, this method itself may be restricted or limited by host governments where subsidiaries are located. The practice may also transgress double taxation agreements where intra (within) a company trade should be conducted „at arm´s-length“, i.e. as if they were independent companies.

Why do firms consider foreign currency financing?

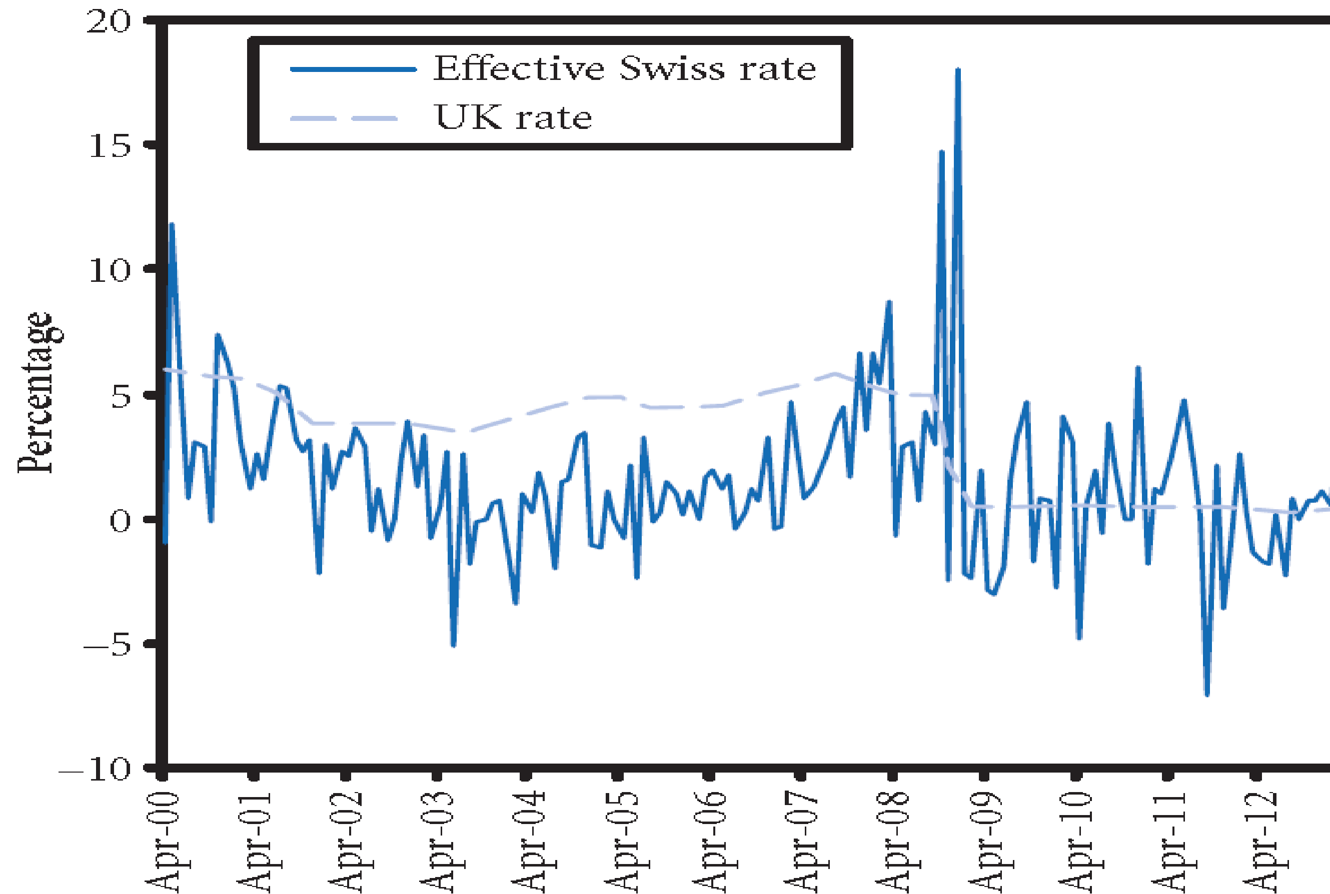
Regardless of whether a parent or subsidiary decides to obtain financing from subsidiaries or from some other source, it must also decide which currency to borrow.

Even if it needs its home currency, it may prefer to borrow a foreign currency for these reasons:

Foreign financing to offset foreign currency inflows, when a large firm may finance in foreign currency to offset a net receivables position in that foreign currency.

Foreign financing to reduce costs – even when a firm is not attempting to cover foreign net receivables, it may still consider borrowing foreign currencies if the interest rates on those currencies are relatively low and the currency stable.

Comparison of the monthly GBP cost and Swiss franc loan



The monthly GBP cost and Swiss franc loan

Comparison of two loans

We see especially different volatility of both rates, which means that Swiss market is exactly less risky. Especially due to the Global financial crisis, the Swiss interest rates decreased.

Therefore, loans in Swiss franc were highly demanded by huge corporations and this currency was still appreciating during the crisis.

Exchange rate forecasts

While the forecasting capabilities of firms are somewhat limited, some firms may make a decisions based on their estimation of the future value of the currency. In looking to future two approaches are common:

- **Develop a probability distribution** – looking at the varying rates and their probabilities, using the standard deviation and also covariance and correlation.
- **Access scenarios** – not confined to predicting the value of exchange rate. There may, for instance, be a series of scenarios whereby the value of the foreign currency falls by 5%, but the differences in scenarios is what will happening to other exchange rates or to international regulations or government policies. So this approach is more than merely approximating a distribution of exchange rates.

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Thank you for your attention!