Decisions, decisions

Matt Holden continues with part two of his three-part series on what you need to know about finance sources

I'll continue my assessment of the relevance of business and financial risk in financing decisions with an illlustration.

Illustration

Smith and Co are seeking to raise £50m to finance a potential overseas expansion project. The board is undecided as to how to raise the finance. The choices being discussed around the table are a one-for-four rights issue at an issue price of £2 per share or a £50m 8% five-year loan stock.

The most recent financial statements are below:

Income Statement:

	£000	
Revenue	79,000	
Variable costs	(12,000)	
Gross Profit	67,000	Business risk
Fixed costs	(47,000)	
PBIT	20,000	Interest cover – the 'link'
Finance charges	(5,000)	
PBT	15,000	Financial risk
Tax	(3,000)	
PAT	12,000	

SOFP:

Assets:	**£000**
Non-current	200,000
Current	57,000
Total	257,000

Liabilities:	
Share capital (50p shares)	50,000
Retained reserves	116,000
Long term liabilities	45,000
Current liabilities	46,000
Total	257,000

To help form an opinion, you need to tell the board how the new finance will influence the key ratios identified in my first article. Therefore, you always need to calculate a before and after (that is, the 'effect').

Current situation:

Financial Gearing = £45m/(£50m+£116m) x 100 = 27.1% (initial opinion would suggest this is a reasonable level of gearing).

Interest Cover = £20m/£5m = four times (number of times PBIT 'covers' current level of interest, again appears safe).

Operational Gearing = (£47m/£69m) x 100 = 68.1% (appears high and so business risk is high).

What does is all mean for the financing decision?

Financial gearing does not appear too high (although a comparison to some relevant benchmark would always be useful) and so there appears to be room in the capital structure to take on more debt. Therefore the loan stock is a possibility.

However, the high operational gearing and corresponding high business risk needs to be considered. The high level of fixed operating costs mean that PBIT is sensitive to changes in sales volume as fixed costs remain whether sales volume increase (upside risk) or decrease (downside risk). Consequently, PBIT is volatile (variable) as a result of the high operational gearing. So what has this to do with financing and financial risk decision making? Well, the volatile PBIT impacts upon interest cover. If PBIT is volatile then interest cover can change irrespective of a change in the level of interest charges with debt levels.

Therefore, in deciding whether to take on more debt and compulsory interest charges and with it more financial risk, it is essential to consider the amount of headroom in the interest cover ratio. This, in turn, is also affected by the volatility of PBIT caused by the level of business risk. Consequently, the link that interest cover provides between business and financial risk is an essential consideration in financing decisions.

Moreover, minimum interest cover is likely to be a covenant within the deeds of any long-term debt arrangement. Breach the covenant and the business may end up having to repay the money borrowed – banks could do with the capital back to help fund the growth in the housing market that the government is so keen to drive!

The third article will assess the impact the choice of finance has upon the ratios calculated above – see next month's PQ magazine. PQ

• **Matt Holden, Reed Business School**