Sources of finance: part 3

Matt Holden assesses the impact the choice of finance has upon the ratios we calculated in last month's issue

Having taken a view on how business and financial risk are important in financing decisions, it is necessary for a successful candidate to take the discussion further by assessing the impact that financing decisions have on the key ratios (as identified in my previous two articles – see PQ magazine, February and March 2014).

A reminder of the scenario

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

Impact on ratios

RAISING £50M DEBT FINANCE AS LOAN STOCK

Operational gearing: No effect; financing decision does not impact upon operational gearing.

Financial Gearing: (Existing debt + new debt)/equity funds
(£45m + £50m)/(£50m + £116m) x 100 = 57.2%

A substantial increase over the current gearing of 27.1%. This will increase financial risk faced by the shareholders of the business. The risk appetite of the shareholders must be considered but also consistency with any published risk management policy is essential. As always, comparison to suitable benchmarks will provide additional evidence.

Interest Cover: PBIT/(existing finance charges + finance charges with new debt)
£20m/(£5m + £4m) = 2.2 times

The interest cover has almost halved, indicating further the increase to financial risk. The headroom compared to any interest cover covenant should be considered, as it may now be too small to be acceptable to investors, especially considering the high operational gearing of this business and the volatility of PBIT this creates. Clearly, the cash flow of the business needs careful planning, as £4m of extra interest will need to be paid per annum.

NOTE: the calculations are very simplistic, keeping retained reserves the same as well as PBIT – not attempting to roll the calculation forward a year. This simplistic approach will allow you to do some easy calculations and derive judgement on the outcome in the time the exam allows (only roll the numbers forward a year if the question specifically requires you to).

RAISING £50M AS NEW EQUITY

Operational gearing: As above, no effect.

Financial gearing: Existing debt/(existing equity + new equity)
(£45m/(£116 + £50m + £50m) * 100 = 20.8%
A reduction to financial gearing and financial risk.

Interest cover: No additional interest, therefore no change to the current interest cover of four times (£20m/£5m).

The new equity reduces the financial risk faced by the investors. This business has high business risk and so the reduction to overall risk is probably the most sensible (but then I am a risk-averse tutor!). There are other considerations, however:

- Risk appetite of investors.
- Potential return from the project.
- Accuracy of any forecasts (profit and cash flow, especially with additional interest charges).
- Sensitivity analysis.
- The board's experience with overseas projects.

The conclusion is rarely clear but reaching a conclusion based upon your own analysis is important. Don't be afraid to have an opinion!

You could also mention capital structure theory; traditional view, M&M, etc, and tax shield – but that is for another day. PQ

• **Matt Holden, Reed Business School**