Short-Term Financing

Liability Structure of a company
If capital markets where perfectly competitive then the type of financing a company chooses would be irrelevant.

Imperfection and Incompleteness
In the real world financing evolves cost other than the interest charges involved. These costs include information costs, floatation costs, bankruptcy costs, loan restrictions and restrictive covenants.

Floatation costs -if flotation costs are fixed it will create a bias toward larger and longer term loans. Large Bankruptcy costs will also create a bias toward longer term loans.

Information costs may prohibit certain firms from obtaining bond direct financing.

Restrictions will keep some financial intermediaries from making certain loans.

Restrictive Covenants may keep firms from following optimal strategy after the loan is made.

Permanent and Temporary Financing
Firms can use short term financing to cover short term fluctuations in costs while using long term financing to finance long term (fixed) assets.

Maturity of Debt
Unfortunately the fluctuations in costs are not known with certainty. Therefore a safety margin should be built in to the companies term financing to allow for unexpected fluctuations. We need a buffer between cash flow and payments of debt.

Maturity: The Risks Involved

In general, the shorter the term to maturity on a loan the greater the probability that the company will not be able to meet it obligations.

There is the risk the debt may not be able to be turned over.

In addition, relative to fixed rate long term loan, the uncertainty associated with future rates may make the cost of rolling over the debt more expensive. This may be a positive if income has a strong correlation with interest rates, therefore this can act as a buffer against economic fluctuation.

In general however, for most companies the longer the maturity of debt the less risk the company is taking on.

Maturity: The Cost Trade-off

Long term debt is more expensive, since the holder of the debt take-on more interest rate risk. In addition if fund are not need continuously the firm ends up paying interest on funds that are not needed.

In a case like this a firm may want to have enough long term debt to cover average expected fund requirements. Therefore, the firm will have unused funds that they pay interest on when fund requirements are low (slow periods) and it will have to borrow on a short term basis when fund requirements are higher.

Agency and Signaling Issues

The firm has long term debt holders it has a incentive to take on risky projects and stay away from safer projects (even if it has a greater return than required for the risk level). This will benefit stockholder at the expense of debt holders.

Using short-term debt, collateral or restrictive covenants will make lenders more willing to provide funds. In addition, using short term debt may act as a signal to debt holders that the company is undervalued. Therefore when the firm is fully valued the company can turnover its short term debt when they are fully valued (better credit rating) at a lower rate of interest.

Credit Financing
Trade Credit as a Means of Financing

Terms of Sale
COD and CBD - No Extension of Credit
Cash on Delivery and Cash Before Delivery

Net Period - No Cash Discount

Net period with Cash Discount

Datings (usually seasonal)
Helps company smooth cash flow

Since trade credit will increase when the firm produces more it is a built in way to finance when funding requirements increase (pro-cyclical).

Payment on the Final Due Date
Some company charge interest on trade credit or in the form of higher price for the actual good. If no interest is charge and there is no discount for early payment there is no cost to trade credit.

If a discount is given then there are opportunity cost from not taking the discount. Suppose the terms are 2/10 net 30. If the company pays on the 30th it incurs large opportunity cost. For this company it keeps the use of 98% of the funds for use for another 20 day after the discount period. The interest rate on a annual basis on the $98 (we would have save $2)for every $100 owed is

$2=98*(20/365)r$
$\Rightarrow \quad (2/98)*(365/20)= r =37.2\%$

This is a really high rate.

If the terms are 2/10 net 60 and the firm waits until the 50th day to pay the interest rate will be lower

$(2/98)*(365/50)= r =14.9\%$

Therefore the longer a company is able to putoff paying the smaller the interest penalty will be from not taking the discount.

Stretching Accounts Payable
This runs the risk of lower the companies' credit rating. Therefore if the company is considering paying late it has to consider the benefits of have increased funds against the cost of a possible lower of the companies rating and/or lack of future trade credit. Many times a company may negotiate an extension of terms.

Advantages of Trade Credit
Benefits: ready form of short term credit, with little negotiations or costs.
Costs: forgone discount and possible lower of ratings.
In addition a firm may not want to use all of there available trade credit and instead keep it in reserve.

Who Bears the Cost?

Whether cost of trade credit will be beared by the supplier or the buyer will depend on the elasticity of demand for the product. If the buyer can do without or find other suppliers easily then the supplier is likely to take on most of the cost to trade credit.

Accrual Accounts as Spontaneous Financing
You don't pay employees every minute therefore employees give loans to their employers.

Built-in Financing
Not discretionary, but in certain cases can be used as emergency financing. If this is done with wages the company may lose employees or productive will suffer.

Accrued Wages and Pay Period Changes
The longer the pay period the longer the financing. However the are constraints put on by labor market conditions and unions.

Money Market Credit

Commercial Paper Market
Corporate bond with less than 1 year to maturity
Although with tech it is easier to get commercial paper issued it is still hard for small and medium size firm to get.

Bankers' Acceptances
Usually for foreign transactions. Bank guarantee payment of trade credit.

Eurodollar loans
Eurodollars are accounts in foreign (non-US) banks denominated in dollars. Eurodollar loans are loans from foreign bank in US dollars.

Short-Term Loans
Most are self-liquidating where the assets purchases generate enough income to pay off the loan.
Today there are more types of loans

Line of Credit
Arrangement between a bank and its customer specifying the amount a bank can borrow and for how long.

- Conditions
  Specifies how long the loan can stay active and how much can be borrowed. The company may want a line to insure it will have enough funds to meet unanticipated fund requirements.
- Not a legal obligations
  The bank may refuse to honor the credit line if conditions warrant (credit change or economic conditions)

Revolving Credit Agreement
This is a legal agreement. The firm must pay a commitment fee on the unused portion of the loan.

Transaction Loans
Borrow for a specific purpose and pay when the task is completed. Usually to complete contracts and pay back loan after the contract is completed and the task is paid for. In these cases the lender may want to look at both the credit of the contractor and the customer of the contractor.

Secured Loans and Term Financing

Secured Lending Arrangements
When borrower can get unsecured loans they must use secured loans

Some Theoretical Notions
The cost of secured loans is higher that that of unsecured loans (administrative and opportunity). These costs are passed on to the borrower. Therefore many firms use secured loan only if they are unable to get unsecured loans. In addition a company may use a secured loan to solve the underinvestment problem. This way the debt is tied to a certain project and other projects will not affect the debt holders.

Collateral Value
Marketability and potential cash flow over life of loan

Assignment of Accounts Receivable

Quality and Size of Receivables
Usually only advances a part of receivables based on those receivables customer with good credit risk. The fewer customers the firm has the easier it is for the bank to collect if it has to.

Procedure
Customers pay the firm (no notification) and the firm pays the lender. Every payment the lender will get the percentage of the payment that it lent for and the firm gets the rest.
Customer pays the lender directly (notification).

Advantage of the Lending Arrangement
This will increase with economic activity so when receivables increase the firm will automatically have funds to finance the products for the receivables.

Factoring Receivables
This involves selling the firm receivables to a buyer(both present and future). Not all may be accepted by the buyer. This is similar to firm specific finance companies.

Factoring Costs
commision or sell the recievables at a discount. In addition if the firm can collect before the recievables are recieved there is usually an interest charge.

Flexibility
In this case since the buyer agrees to buy future account recievable as well as present it give the firm flexibility. It can draw on the recievable fund when needed.

Inventory Loans
Again the marketability of the inventory is a top concern. Perish ability and price stability is also of concern.

Floating Lien
Pledge of inventory without specifying the exacted inventory or receivable.

Chattel Mortgage
Creditor has a lien on specific inventory and it cannot be sold without the creditor consent.

Trust Receipt Loans
The creditor gets paid as soon as the inventory gets sold on a piece by piece basis. Usually done for durables like cars

Terminal Warehouse receipt Loans
Inventory in a public warehouse which the lender can take control of if necessary.

Field Warehouse Receipt Loans
Inventory stored in the firm's warehouse. Usually put aside and pledged as collateral for a loan.

Intermediate-Term Loans
Can be used when market condition are unfavorable for long term loans.

Term Loans
Borrow direct from bank or finance company with condition specific to the firm. (payment period, fix or flexiable rate, principle payments (balloon), etc.)

Revolving Credit
Usually credit extended for more than 1 year. (actual loan may be less because of specified clean up period or need of firm)

Equipment Financing
Use existing or buy equipment and use it as collateral. Again depend on marketability and life of equipment.

Medium-Term Notes
Medium term notes have the advantage that they are slightly more marketable than long term bonds and it allow the firm to spread it debt over different term to maturity. Information cost however restrict its use for medium and small companies.

Protective Covenants and Loan Agreement
Restrictions and the behavior of the borrower. (Maintain financial condition.)

Remedies under Default
Gives the lender the right to step in should the borrower not meet the covenants. The lender can demand payment (force bankruptcy) or negotiate with the borrower of what it needs to do to put it back in compliance.

General Provisions

Working Capital
Set minimum. (seasonal)

Dividends/ Share Repurchase
Limit these things

Capital Expenditures
limit (sometimes to deprecitation)

Other Debt
limit to make sure other don't have legal debt claim.

Routine Provisions
Negative pledge clause (collateral pledged to two lenders)
Leasing property
Mergers and acquisition

Special Provisions
Usually firm specific

Negotiating Restrictions and the Option Pricing Theory

- The OPT Setting
- Equity Holder Motivation
- Lender Restraint