CORPORATIONS HAVE MANY OPTIONS, BUT NO EASY CHOICES

When a corporation needs money, the choice it makes about how to get it can tell you a great deal about the company. It is not an easy choice, as the company must weigh the advantages and disadvantages of each option against its needs and financial situation. Each of the choices can have significant consequences in the future. As you read and discuss this introduction to the capital markets, think about the strengths and weaknesses of each alternative. Pay attention because when you are finished you will become an instant expert, an investment banker, called in to give advice to an indecisive corporation. The alternatives are listed below.

Retained Earnings

The amount of profit (net profit after dividends) a company keeps to buy new equipment, buildings, and other resources that the company uses to expand and modernize.

Advantages/Disadvantages

- Using the corporation's net profit, putting it back into the company can be done quickly and without finance charges because this option is internal. It does not require going outside to ask for money.
- No debt. This is not a loan.
- Does not increase control by others over the firm, since no new stockholders are brought on board as owners.
- Not all companies have retained earnings available, especially companies that are experiencing growth and expansion. That is why many companies can't use this option.

Debt: Take a Loan

Short-term loan from financial institutions such as a commercial bank, savings and loan, credit union, insurance company. Banks are usually unwilling to lend long-term, and if they do, they will want significant collateral.

Long-term loan through corporate bonds. The corporation borrows from the public and issues IOUs through corporate bonds. Owners of these IOUs received fixed interest payments from the borrowing corporation until the IOU is repaid at a given date in the future.

Advantages/Disadvantages

- Because they aren't shareholders, bondholders can't vote and exercise control. The relationship ends when the debt is paid.
- Interest on the debt is tax deductible. This reduces the burden of making the interest payments because it reduces the corporation's tax liability.
- Increases that firm's debt (liabilities). Could make the company look bad.
- The bond represents a fixed obligation. The money will have to be paid back-both interest payments and principal-at maturity. This obligation could cause a cash-flow problem. Since interest must be paid whether there are profits or not, taking on debt is always a risk.

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Equity: Selling Ownership, Shares of Stock in the Corporation

Preferred stockholders receive special treatment because company dividends, usually fixed, are distributed to them before being paid to holders of common stock. The equity alternative involving preferred stock is similar to getting a loan, since preferred stockholders usually cannot vote.

Owners of common stock receive a share of a company's profits-or bear a share of its losses up to the amount invested in the stock. They vote for the board of directors who appoint the management of the company. The corporation decides if stockholders receive a dividend, but they can vote and exercise control.

Advantages/Disadvantages

- No debt. Money received from sale of stock does not have to be repaid, since stockholders are owners, too. Not as risky as bonds. Company looks stronger financially.
- Firm does not have to pay dividends, so future net profit (retained earnings) can be put back into the company.
- Give up some control, since stockholders can vote. They could limit or interfere with the major owner/manager of the firm and the firm's current direction.
- Dividends are paid out of profit and are not tax deductible like interest.

Making the Decision

When a corporation uses retained earnings, the decision is made internally and implemented by means of an accounting procedure. No outside approvals are required. For these reasons, use of retained earnings is a preferred way of obtaining financing.

Loans from financial institutions require agreements between the corporation and the lending institution regarding the amount of money loaned, the interest to be paid, the length of the loan, and the amount of the payments.

Corporations that decide to sell ownership in their company (stocks) or sell debt (bonds) "go" to the capital markets. They usually turn to an investment banker who gives them advice on what securities to issue and what steps need to be taken to sell these securities. The investment banking system acts as an intermediary between the demand for and supply of money in the capital market. These markets allow buyers and sellers to find each other, and reduce the costs of trade. These stocks (initial public offerings), and bonds are sold in the primary market, then traded in the secondary markets. Obviously, these capital markets, essential sources of corporate financing, allow businesses to start up and expand, and the effect of this is to foster economic growth by creating jobs and income for workers and by providing goods and services for consumers and other businesses.

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Case Studies for the Investment Banker (that's you!)

Now, you're the investment banker – what do you advise? Using your knowledge about the possible sources of corporate financing, review the following cases and decide which type of funding you would recommend. Play the role of an investment banker. Weigh the advantages and disadvantages of each alternative, considering the needs and objectives of the firm.

Your group should prepare a recommendation for each of the four businesses below, using PowerPoint. You should have two slides for each case. Be prepared to present your report to the class.

Case A: Andrew's Free Wheelin Bicycle Company, Inc.

Andrew's Free Wheelin Bicycle Company, Inc., would like to expand soon. The plan is to build another plant in a nearby city. Free Wheelin's financial position is excellent. While it is highly profitable, it does not have enough profit available for capital investment. It has little debt. Its tax liabilities are very high. The company does not want to give up any additional control.

Case B: Paddy O'Reilly's Irish Pub, Inc.

Paddy O'Reilly's Irish Pub, Inc., was originally a family-run business; it went public several years ago. At the time, the O'Reillys wanted to open operations in several cities. Now they have many locations throughout the Midwest. Those expansions were funded by corporate bonds. The family still owns 70 percent of the stock. Although the company has not shown a profit for the last two quarters, its financial condition is not critical; but more debt could strain the already strained cash flow. The O'Reillys would prefer to maintain their image of a growing, prosperous firm. They need money for modernization of their kitchens to meet environmental protection laws and to become more efficient.

Case C: Joe's Lawn Service, Inc.

Joe's Lawn Service, Inc., is in a strong financial position. Summer is coming-a time when Joe's business makes most of its money. Joe would like to buy another truck and hire a few more workers. He just needs some money for a few months for operating costs-working capital. The company will earn more than enough in the summer to pay it back.

Case D: Molly's Magnificent Fashions, Inc.

Molly's Magnificent Fashions, Inc., has shown significant growth and profit ever since Molly's designs became popular and in great demand. Molly anticipates continued profit. The company has a chance to expand by leasing space in a very desirable shopping center, but it must move quickly because others are in competition for the prime location.