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COMPANY'S FINANCING THROUG INDEBTING

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Abstract: Financing through indebtment can be accomplished by bond emission or loans provided by financial institutions. Loans are almost exclusively gotten through public resort to savings. We can have different types of bonds: ordinary or specially, mediate between own fonds and financial debts, each one with strongnesses and weaknesses. We can also use for financing eurobonds. We also set out the most important characteristics of the credit institutions with advantages and disadvantages that occur by using them.

Key words: financing, indebtment, capital market

The effect that financing through indebtment or own equity can have over managerial team control position; can influence the decision regarding the capital structure of the company.

When the managerial team holds the control of the company and in case of further shares issue they can't buy other shares, in order to maintain the control position the management team can finance new projects through borrowed capital.

If the managerial team is not involved in company's control, she can ask for financing through issue and selling of new shares, when the financial situation of the company is so precarious that new debts will bring the company near bankruptcy. Not paying the liabilities assumed by the company will draw for sure the change of the managerial team. On the other hand the insufficient use of the borrowed capital can have as consequence of an overtaking risk.

Estimation regarding control can't have direct solutions regarding own or borrowed equity utilization for company financing, because the capital that protects managerial team motives differs by situation. However, every time the managerial team is not confident they can take in consideration the effects of capital structure upon company control.

Stable financing of the company through indebting can be realized by loans on the mandatory market or by medium or long term loans supplied by the financial institutions. Direct contribution of the mandatory market in financing private companies is small in comparison with loan offered through banks. However, this contribution appears as being more important, if we have in mind that banks and financial institutions secure most of their resources from this market. Companies not listed on the Exchange prefer the banking system in order to obtain a financing through indebtment. Loans on long term are also called consolidated debts.

1. Financing through mandatory loan

Often, own equity is enough for the company, and his increasing is done difficulty because the investors reticence caused by loss risk. Moreover, financing through banking indebtment is also difficult because of the high cost and restrictive conditions of the credit contract done by the banking institutions.

The before mentioned elements determine company to refer to mandatory loans as an alternative method of financing on long term his operations. It is extremely important to distinguish the elements that make a difference between debt and credit instruments. Debt is *„a financial title that materialized the engagement of a lender in front of a creditor that*

offers the funds for use. These engagements anticipate the deadlines for financial flows that define the manners of reimbursement of the capital and remuneration of the creditor"[1].

Differently from bank loans, debt *instruments* (bonds, treasury bills, treasury bond) are negotiable on a secondary organized market (exchange, mortgage market, monetary market etc).

This manner of financing can be used only by listed companies on a regulatory market because it is done exclusively by saving. Nevertheless there are loans through collective bonds issued by financial groups that allow the insufficient size companies to enter the bond market. Even big companies can use the collective mandatory loans when they need small amounts for financing. Mandatory loan represent „a credit contract between investors (creditors) assembly and a sol lender (debtor) that allows financial resources acquirement on long term and high values, needed for company development and respecting some deadline liabilities"[2]. Investors receive debt securities, bonds that are rated and negotiable on capital market. That ones can reclaim invested capital through selling the title on the market at the rated price or they can wait until the scheduled deadline.

Bonds issued by the companies are „negotiable title that, in the same issue, confer same securities rights for the same nominal value"[3] upon the issuer. That one obliged himself to pay for the borrowed amount an interest rate prescribed through the issuing prospect and at deadline they will reimburse the nominal value[4].

In the last time bonds appeared that have the role of risk limitation inducted by interest rate fluctuation and the bond price volatility.

There had been created, also, special bond that allows owners to became shareholders. This ones represent hybrid financing methods, mediators between own funds and financiall liabilities. When issued, they present characteristics of a mandatory loan (usually with fix interest rate): the payment of an annual coupon and fiscal deduction of the annual interest. Concomitantly, mandatory loan is associated a particular characteristics, that allows the issuer company to hope that she will realize a future rising of the social capital that allows at deadline a consolidation of own funds. We can enumerate: bonds convertible in share, bonds with subscription bills in shares, bonds reimbursable in shares. For convertible bonds, those who subscribe initial title receive a conversion option of this title in shares, at a conversion rate noted in the initial contract, option that can be exercised if the conversion is in the advantage of the bond holder.

Loans through ordinary bonds

Can issue bonds only stock companies that have minimum two years of existence, that have minimum two balance sheets approved by the shareholders and can guaranty through own patrimony, or through banks or bank consortium. Capital must be acquitted entirely. The issue decision is taken by the ordinary general assembly with a majority of minimum 2/3, but realizing the loan is delegated, usually, board of directors or managers. Investment of the titles is done by a bank syndicate that guarantees the successfully

1 Vernimmen P., Finance d'entreprise, Ed. Dalloz, Paris, 2002,pag. 513
2 Buglea A., Investițiile şi finanțarea lor, Ed. Univesrsității de West, Timițoara, 2002
3 1 Depallens G.,Jobard J.P, *Gestion financiere de l'entreprise*, Ed. Sirey, Paris, 1990, pag.719
4 Buglea A., Întreprinderea şi piața financiară, Ed. Marineasa, Timişoara, 1999, pag.162

ending of the operation. Indebtnessers that are organized and have civil personality are represented by chosen attorney, remunerated by the issue company.

For the company the bond issue has the following ***advantages*:**

- liabilities cost is limited to the interest paid, if bonds are issued with fix interest, and the bond owner does not participate at profit increase if company is successfully;
- interest paid by the issuer is a deductible fiscal expenditure, shortening the specific cost of this financing resources;
- power dilution is avoided in company when financing through mandatory loan is used, because creditors can't vote;

Disadvantages of bond issue are:

- interest are fixed costs, and if company's profit fluctuate, it can affect net profit size, including shareholders winnings;
- interest must be paid at a fixed deadline and measures should be taken in order that treasury can support this payments;
- supplementary bond issue determine bankruptcy risk and increase liabilities cost decreasing the fiscal advantages mentioned before;

Big size companies can mobilize necessary capital for investment financing and import export operations on international capital market, through issue of Euro-bonds and foreign bonds.

Because we can use them as financing instruments we will try to express an opinion regarding financial characteristics of Euro-bonds and foreign bonds.

Euro-bonds are security title placed in other countries different from the currency that is used for the loan. Currency in which Euro-bonds are issued can be the currency of the country that ask for the loan or can be another foreign currency that is available and negotiated outside of the origin country.

Characteristics that individualized and distinguish national bond are:

- ❖ the existence of an international issue union, that assure the placement in the whole world;
- ❖ privileged fiscal status, because this are dispensed from income source taxation in issuing countries;

Most used are Euro-bonds with fix interest, because of the *advantages* this can bring, and because of some conjunctive situations:

- ✓ issuer company is not obliged for the detailed information publish regarding financial situation;
- ✓ it is a tradition for European companies for issuing this kind of title;
- ✓ governments, international institutions and some public capital companies are forbidden issuing title with variable income;

Euro-bond issue has advantage and disadvantaged.

Advantages:

- ❖ smaller issuing cost than national bond issue;
- ❖ attracting more amounts on longer time period;
- ❖ protective possibilities against currency risk and unfavorable evolution of the interest rate;

Disadvantages of Euro-bonds:

- ❖ accessible only for big companies, other companies not having access on international markets;

- loss possibility because of unfavorable currency curs;
- being bearer title, there is the possibility of steeling;

Using *bonds as company financing instrument* attracts some *advantages*:

- mandatory loans interests are paid prior to dividends even when the company has no profit;
- bond issuing costs is lower than share issuing cost;
- mandatory loans cost is lower then own equity cost, risk is lower then bonds comparing that shares can bring a lower profitability rate for the owner;
- in case of company liquidation, bond owner are privileged to shareholders, this ones recuperates priority securities after selling company's assets;
- financing through bond issue does not imply decision and control power dilution risk, because bond can't give right of vote.

Mandatory loans have also *disadvantages*:

- implies a higher risk grade for company's shareholders, because the amounts payed as interest determines the rising of net profit volatility for shareholders;
- rising of financial risk determines shareholders to ask for a higher profitableness rate, that rises the own equity cost;
- at maturity company must reimburse the equivalent of sold title and the due interest regardless of profit;
- bond issue rises the indebtness level of the company, fact that can trouble the economic-financial equilibrium and can restrict ulterior access to other financing resources.

2. Medium and long term bank loans

This type of loans represents a settle alternative for financing the company by long term. Bank loans by long term are obtain from a commercial bank and they have to be repay until the expiration date, which is more than a year. They are negotiated directly between the bank and the company who needs the credit.

In general the banks have their own system for evaluating clients' allowance, which are asking the loans, evaluation which can be realized using the credit scoring method. For this the banks establishes some criteria in order to evaluate the company ability for payment and solvent, property form, patrimony situation, warranty manners for the amounts asked, etc. The answers for every criterion are marked with a number of points and are well-balanced with an importance coefficient). According with the amount of point accumulated, the company can be classified in one of the five classic credits categories, marked from A to E, depending on loan repayment risk.

Long and medium term loans in special are allocated for financing the modernism and development investments, comparing with the short term loans which have a more specialized character.

The characteristics of main credit instruments

The long and the medium term bank loans are as some credits instrument in lei or circulating currency: credits for modernizing and re-technology, credits for buying the

technology equipment from import, credits for add equipment to the existing ones, credits for fitting out, simple constructions, for innovations, researches and for exporting.

All those forms of medium and long term loans have their specific characteristics and can be differentiate through the repay methods and the interest rate used.

The interest rate for long and medium term credit banks can be fix or variable. The variable rates are modified periodically, usually every semester, depending on interest level on the market. The nominal interest rate depend by interest rate evolution on the banking market, by increasing the rate in according with client quality risk premium and by increasing according with the type credit (increasing bank rate). On the credit cost has a influence also the bank commissions a established according with risks and duration, as well for bank services.

In the situation of utilizing a fix interest rate, the level will be established close to the liabilities interest rate with the same expiration and the same risk rate and the bank loan as well.

If the interest rate is variable, it will be superior to reference bank interest with some percents interest and can be adjusted annually, semester, trimester, monthly or based on specified clause in loan contract.

For all credit categories, the bank establish certain expiration through negotiating with companies, according with the revenue evolution and according with payment terms of commercial contracts. When needed, credits can be rescheduled, they can be delayed or reimbursing term can be postponed, one rate or the whole credit, but without over passing the maximum allowed terms. Rescheduling can be realized two times until total reimbursement, asking by thee one who requests the credit.

For the debt amounts, the banks ask for guarantees that can be offered by debtors or guarantors. These guarantees can be real or personal.

Engagement of bank credits by company is done quickly flexible (when needed), and at a cost determined by the market existing conditions, company rating and the good relationship bank-client. Practically, between the financial situation of the company that ask for the credit and the accordant credit there is a relation of interdependence. The obtained credit reflects the financial situation of the asking company and a good financial retaining generates favorable conditions for getting new credits.

International capital markets allow getting credits financial and commercial advantageous for bigger company with a good market rating.

Euro-credits allows a flexible financing on short, medium and long term, then when there are restriction regarding getting the loans or capital outgoings.

Financing on short and medium term implies Euro-credits with fix interest rate, and for long term financing Euro-credits with variable interest rate. It assures the asking company the possibility to get in few weeks the needed capital in the currency that suits its needs or in multiple foreign currencies. These ones have a lower cost because financing banks are not under mandatory reserves rules: in these cases they have in mind the quality of credit applicant and assure a bigger dispersion of the fixed costs, because the debt amounts are very big.

Distinct from Euro-credits, which are financial nature credits, foreign bank loans are commercial, awarded for financing imports and exports. These ones are expressed in creditor bank national currency or another country currency.

Indifferent from the financing instrument used, the one that ask for capital must have in mind the income risk probability that can generate the increase of the borrowed capital cost.

We estimate that variable rate bank loans are more advantageous then the fix rate, because the loan cost in first case follows the currency market evolution, thus if the interest rate decrease, implicit his cost is decreasing. Besides, loans with fix interest rate contains protection elements for banking organizations in case of situations when forecasting regarding interest rate evolution are false.

Despite advantages offered, a bank loan with fixed interest rate can be sometimes dis-advantageous, respectively when a strong increase of the interest rate generates a higher cost of the capital than the one obtained through a fixed interest rate.

In conclusion, loans, disregarding who ensure the capitals, represent an important way of obtaining funds necessary for a company. The capital borrowed have the advantage that the interest is tax deductible, but also the disadvantage that it must bee pay even if the company has no profit. Loans are fast, confidential and discrete without producing change in capital structure. In mean time, obligation to pay interest and principal are constrains for inefficient companies.

Companies can have difficulties regarding financing through indebtment, following problems can appear:

- interest payment is a priority before dividends, essential fact especially in case of decreasing profits;
- obligation of paying interest, disregarding the profit volume

When assuming higher risks, shareholders ask a better rentability then creditors for the capital involved. In consequence, financing through indebtment is cheaper then other financing modalities, many companies asking for attracting capital through indebtment.

Considering the fast rhythm of industry development, of deep introducing in our life of modern civilization elements, a major and vital problem is environment protection.

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