NATIONAL FINANCE OLYMPIAD 2015

The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Long Term Business Financing Strategy For A Pakistan Business

Byco Petroleum Pakistan Limited

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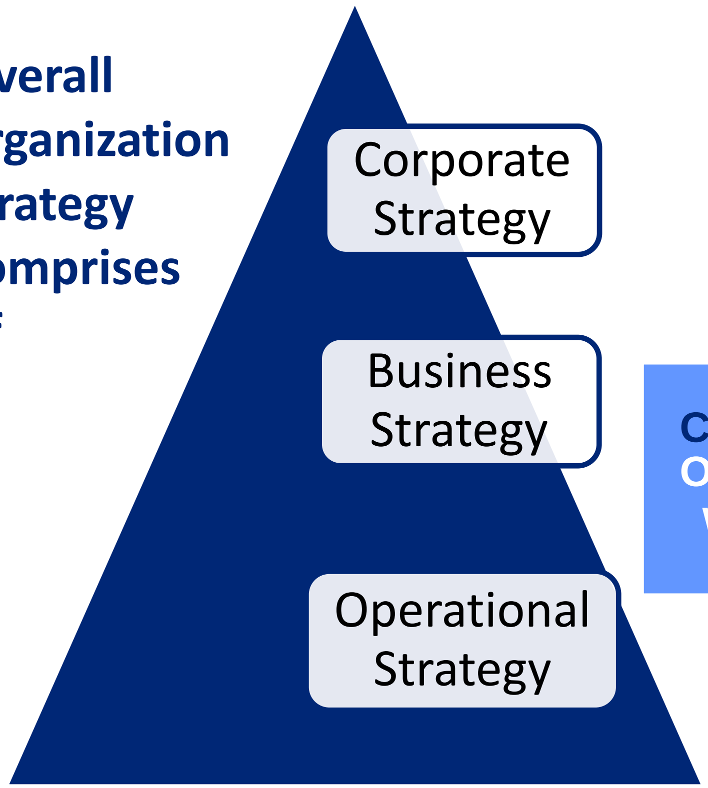
Why We Need Financing Strategy

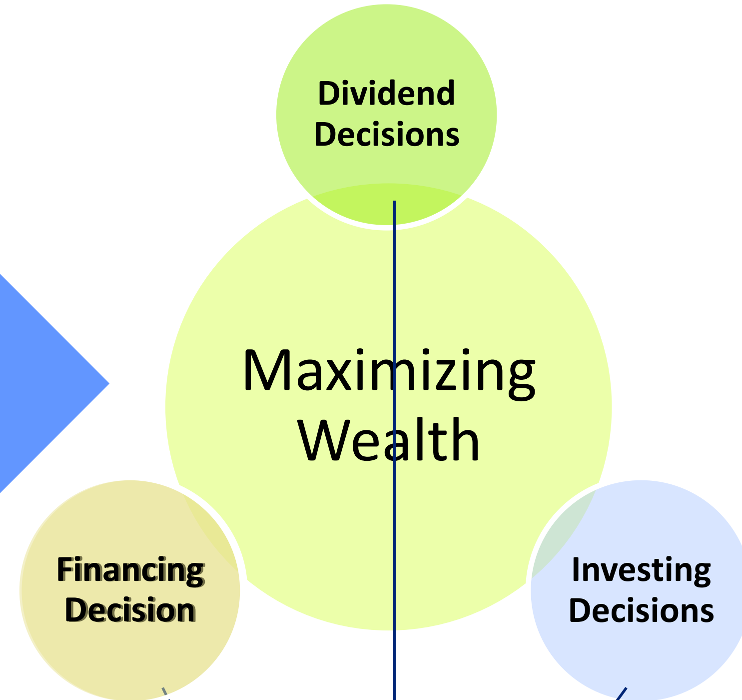
1. **How Financing Strategies are driven ?**
2. **Financing – Prerequisite for business**

How Financing Strategies are Driven ?

Overall organization strategy comprises of



Commercial Objective of an Organization is to Maximize wealth of the shareholder



Financial Strategy: To achieve objective of maximizing wealth through Financing, Investing & Dividend Decisions

Corporate Strategy	Type of business, Markets to operate
Business Strategy	Business unit level decisions and market competitiveness
Operational Strategy	Functional Areas

Financing – Prerequisite for business

Financing decisions relate to acquiring optimum finance to meet financial objectives and seeing that Non-current Assets and working capital are effectively managed

Investment Decisions cannot be taken without consideration of where and how the funds are to be raised to finance them

Enterprises need finance for investment and acquire it either by internally generated finance or externally generated finance, which are closely related to the ownership structure, financial market development and enforcement of law of a country

Access to external finance is a key determinant of a firm's ability to develop, operate, and expand

Types & Sources of Finance

1. **Matching Approach**
2. **Characteristics of Equity & Debt Financing**
3. **Sources of Finance**

Matching Approach

A company's balance sheet is the result of its financing and investment behavior.

Matching approach to financing is where profile of the entities financing matches the profile of the assets being funded for example;

Non – Current Assets - Fixed assets - Expansion of companies. - Increasing facilities - Construction projects on a big scale	**- Equity** **- Medium & Long Term Borrowings**
Permanent Current Assets - Permanent part of working capital	
Fluctuating Current Assets Net working capital requirement including startup cost, short term operational cost, emergency repairs & maintenance and cashflow requirements	**Short Term Borrowings**

Characteristics of Equity & Debt Financing

Characteristics	Equity	Debt
Cost	High	Low
Duration	Long term / permanent	Fixed
Lending Restrictions	Not applicable	Collaterals & covenants
Gearing / Financial Risk	Reduce	Increase
Financing Foreign Projects	Increase currency risk	Hedging tool
Tax Position	No impact on Tax	Tax Beneficial
Legal restrictions	high	low

Sources of Finance

		Medium & Long Term Financing	Short Term & Working Capital Financing
1	**Equity Financing** - High Net Worth Individual - General Public through Stock Markets - Private Equity Firms - Institutional Investors - Foreign Investors - Internally generated Profits	• Ordinary Shares • Preference Shares (IPO, Placing, Right Issue)	
2	**Debt Financing** **Finance Companies** - Commercial Banks - Islamic Banks - Non Banking Finance Companies - Foreign Lenders - General Public	. Secured & Unsecured Loans • Debentures • Term Finance Certificates • Sukuk • Retail Bonds • Musharika • Leases etc….	• Trade Credit • Short Term Commercial Paper • Funded and Non Funded Facilities • Running Finance Facilities

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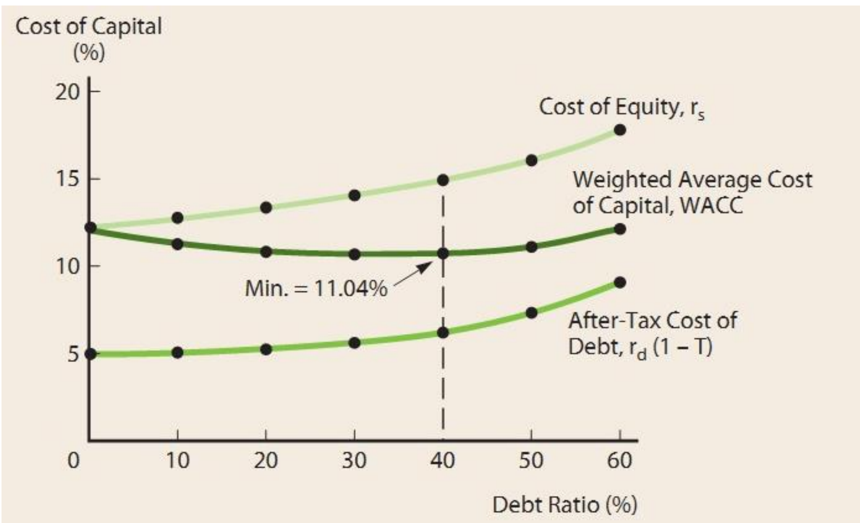
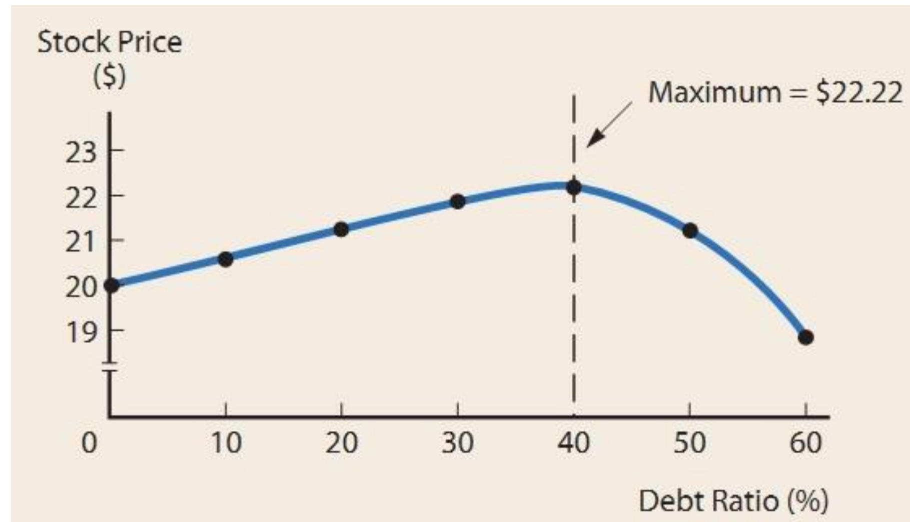
Optimal Capital Structure

1. **Objective of Optimal Capital Structure**
2. **Capital Structure Determinants**
3. **Leverage Trend in Pakistan – Case Study**

Objective of Optimal Capital Structure

A firm's optimal capital structure is defined as the structure that would maximize its value of equity.





Firms need to find the right balance between alternative sources of funds in order to optimize the capital structure and minimize its cost of financing, captured by the Weighted Average Cost of Capital (WACC) that is a function of the cost of debt (kd), the level of the tax rate (t), the cost of equity (ke) and the relative weights of debt and equity.

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Capital Structure Determinants

Many factors influence capital structure decisions; and determining the optimal capital structure is not an exact science. Therefore, even firms in the same industry often have dramatically different capital structures.

1	***Sales stability.*** A firm whose sales are relatively stable can safely take on more debt and incur higher fixed charges than a company with unstable sales.
2	***Asset structure.*** Firms whose assets are suitable as security for loans tend to use debt relatively heavily.
3	***Operating leverage.*** Other things the same, a firm with less operating leverage is better able to employ financial leverage because it will have less business risk.
4	***Growth rate.*** These firms often face higher uncertainty, which tends to reduce their willingness to use debt.
5	***Profitability.*** It is often observed that firms with very high rates of return on investment use relatively little debt. Although there is no theoretical justification for this fact, one practical explanation is that very profitable firms such as Intel, Microsoft, and Google do not need to do much debt financing.
6	***Taxes.*** Interest is a deductible expense, and deductions are most valuable to firms with high tax rates. Therefore, the higher a firm's tax rate, the greater the advantage of debt.

Capital Structure Determinants

7	***Control.*** The effect of debt versus stock on a management's control position can influence capital structure.
8	***Management attitudes.*** Some managers tend to be relatively conservative and thus use less debt than an average firm in the industry, whereas aggressive managers use a relatively high percentage of debt in their quest for higher profits.
9	***Lender and rating agency attitudes.*** The attitudes of lenders and rating agencies frequently influence financial structure decisions. Corporations often discuss their capital structures with lenders and rating agencies and give much weight to their advice.
10	***Economic conditions.*** Various macroeconomic factors influence financial structure decisions, since economic downturns tend to limit firms' ability to borrow and banks' willingness to lend. Corporate access to credit is the principal mechanism linking monetary policy and the real economy. At the micro level, characteristics specific to a firm influence the degree to which macroeconomic changes affect its access to external financing; specifically, firms that are more vulnerable financially—such as smaller, younger, riskier, and more indebted firms—are found to be more affected by tighter monetary policy.

Leverage Trend in Pakistan – Case Study of Non-Financial Firms in Pakistan

Data: *5 year data of 445 non-financial firms listed on KSE*
Leverage= Total Debt/Total Assets

The conclusion is as follows;

Determinant	Measure	Relationship with Leverage
Asset Tangibility	Total Fixed Assets/Total Assets	Positive but not statistically significant
Size	Log of sales	Positive
Growth	Annual Percentage Change in Total Assets	Negative
Profitability	EBT/Total Assets	Negative Most statistically significant determinant of capital structure

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Financing Businesses in Pakistan

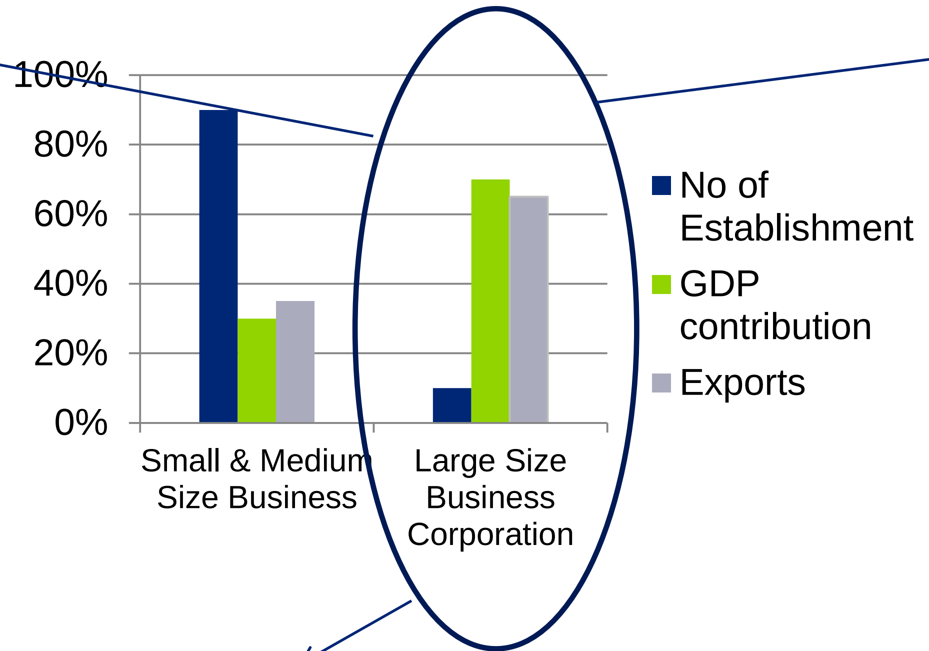
1. **Financing Strategy Formulation in Pakistan Context**

Financing Strategy Formulation in Pakistan Context

Objective: *Wealth Maximization ⟶ Financing ⟶ Optimal Capital/Financing Structure*

Pakistan 's Economic Factors affecting Finance Structure

- Improved lending conditions by reducing interest rates to 7% through monetary policy
- Pakistan ranked third in calendar year 2014 amongst the top ten best performing capital markets in the world. It shows increasing investors confidence.
- Improvements in macro-economic conditions
- Stringent Investor protection laws
- Rule of law and justice system on revival
- Political stability
- Additional taxation on dividends and accumulated profits.



Internal Characteristics affecting Financing Structure

- Large Assets Base
- Good Management and Technical Skills
- Appropriate Knowledge Base
- High Turnover
- Distributed Ownership
- Focus on Governance and Controlled Environment
- Foreign Financial Support in Case of MNCs
- Government Backing in Case of State Owned Enterprises

Accessibility to Finance

Large businesses have edge over SMEs in accessing finance and can obtain the funds both from capital markets as well as money markets. the strong company well prepared management can better negotiate with finance providers. With those thoughts in mind, management should take the following preparatory actions before approaching prospective financer:

- Assess company's creditworthiness.
- Foster strong relationships with current and prospective lenders.
- Make information package compelling

Best strategy is to identify optimum mix as access to finance is not an issue

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Financing Strategy Formulation in Pakistan Context

Objective: *Wealth Maximization → Financing → Optimal Capital/Financing Structure*

Pakistan 's Economic Factors affecting Finance Structure

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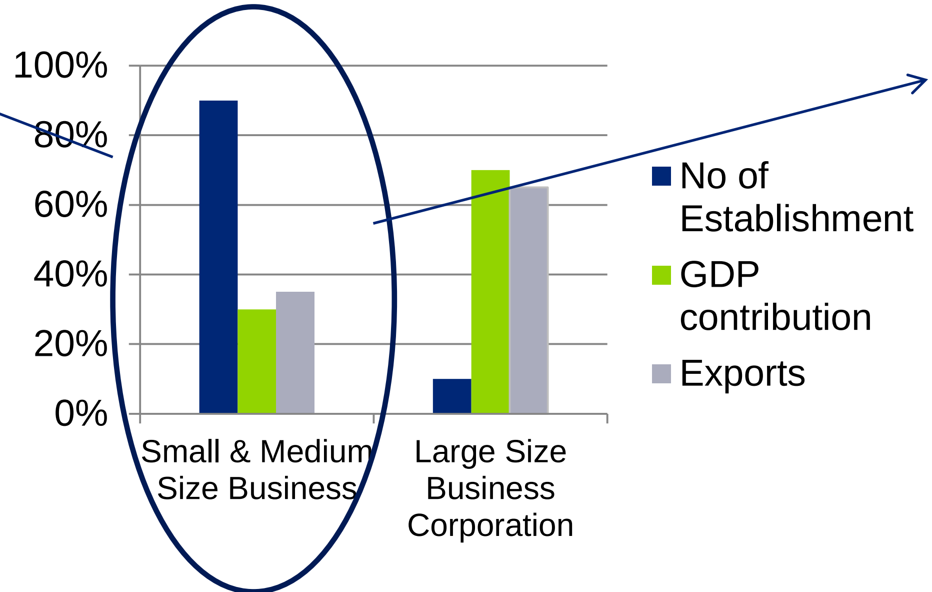

Accessibility to Finance

- SMEs are generally found to be short of institutional credit. So they have to rely on their own credit for a number of activities .
- SMEs also rely on personal savings, including financial help of family and friends and other informal financial sources
- However, all commercial banks have the mandate to provide credit to SMEs and they have their special schemes in place for this purpose.
- Further, Pakistan has a fairly developed financial system spread over most of the urban and rural areas of the country
- On top of these a number of specialized financial institutions working in support of SMEs:

Internal Characteristics affecting Financing Structure

- Small Asset base
- Lack of Management & Technical Skills
- Limited Knowledge Base
- Lack of Innovation
- Low Turnover
- Confined Ownership
- Limited Access to Global Market
- Low Importance Towards Governance and Controlled Environment

Best Strategy is to first improve the accessibility to finance and than to go for optimum mix.

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THANK YOU