



SECTION - 8

CRITERIA FOR SELECTING SOURCES OF FINANCE

This Section includes

- **Issues facing business**
- **Internal financing**
- **Decision on Choice of Capital**
- **Source of Finance**

8.1 ISSUES FACING BUSINESS

8.1.1 The four major issues a company faces in selecting an appropriate source of finance for a new investment are:

1. Can the company raise the finance required from internal sources or does it have to resort to external borrowings?
2. If external financing is required, what should it be – debt or equity?
3. Where to raise the external debt or equity?
4. Cost of each of the available source of finance.

8.2 INTERNAL FINANCING

8.2.1 In evaluating availability of internal financing, the company has to take into account several factors such as the following:

- a. The current cash holding of the company, including short-term investments, cash required to support current operations and the surplus available for the new investment.
- b. Estimate cash flows with the help of a cash budget.
- c. Improve working capital management to enhance cash position. However, efforts in this direction should not lead to negative effects in the concerned areas such as loss of customer or supplier goodwill and production stoppages due to stock-outs.

8.3 DECISION ON CHOICE OF CAPITAL

8.3.1 The first point to consider is the extent of funding required. The other relevant factors to be considered are:

1. The cost of finance.

2. The current capital gearing of the company.
3. Availability of good asset security for lenders.
4. Risk, in terms of volatility of operating profit, associated with the business the company is in.
5. Operating leverage, i.e., the proportion of fixed costs.
6. Impact of large issue of shares such as dilution of earnings per share (EPS) and loss of voting control.
7. The current state of equity markets.

8.4 SOURCE OF FINANCE

8.4.1 Equity Finance:

Issues such as whether equity should be raised through a rights issue, public issue or private placement need to be evaluated from the angles of legal requirements, market conditions, promoters' willingness to dilute their holding etc;.

8.4.2 Debt Finance:

The major considerations in raising new debt finance are, the terms of the loan, rates of interest – whether fixed or floating, the market standing of the company, currency in which the loan is issued, and the covenants attached to the loan proposal by the lenders.