Corporate Treasury

Vol. 2 – Sources of funds: A treasurer's conundrum

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Introduction

While Vol. 1, 'The ever evolving landscape of treasury in India', dealt with centralised and decentralised treasury functions as well as treasury as a cost centre or profit centre, this article aims to address another issue which is commonly faced by treasury functions, i.e. sources of funds available in the modern era and the various challenges faced by corporates.

The never-ending requirement for funds germinates from the continuous business expansion undertaken by corporates. This is particularly true in the Indian scenario as India is growing at a steady rate. To be at par with developed nations, an unhindered supply of funds is a prerequisite. The onus of arranging funds lies with the treasury department.

Traditionally speaking, funds could be in the form of equity or debt. Equity would mean the money provided by shareholders, without any repayment clause or charge creation on the assets, whereas debt would come along with repayment clauses, security for the loan and high finance costs. Striking the right mix of debt and equity would help a company to achieve the optimum capital structure. This would enable the company to fund its business requirements with minimum associated costs.

The treasury department takes responsibility for the company's liquidity—ensures that a company has enough cash available at all times to meet the needs of its primary business operations. Due to the complexity involved in the selection of avenues from which funds are to be raised, the treasury function becomes even more critical. Increasing interest rates and cost of capital prompt treasurers today to evaluate their financing decisions more carefully.

Factors to be considered before raising funds

The financing decision is an important activity undertaken by the treasury department. This involves judiciously choosing the source of funds, keeping in mind the cost implications for the organisation. The financing decision would aim to arrive at the optimum capital structure, ensuring a balance in the debt and equity mix of the company. This decision would also be based on the investment plans and risk appetite of the company. Thus, it becomes important to carefully understand the outflow of funds to decide the course of inflow of funds.

Currently, the market offers numerous ways to obtain finance. With each passing day, a different product is getting evolved to meet the requirements of the growing industries. There are a number of ways to finance a business and a range of lenders and investors to choose from when the treasury function is making financing decisions. The treasury function will at first have to understand the financing requirements along with the volume of funds to be raised in order to arrive at a cost-effective method of raising funds.

Some of the key factors to be considered at the time of deciding the source of finance are enumerated below:

Financing requirements

To start with, the fund requirement should be clearly ascertained. The quantum of funds required and the associated cost should also be kept in mind. The cost of funds should be compared to returns that the company will be able to generate and the financing decision should be based on that. The tenure, long term or short term, would also need to be evaluated to select the finance options. Once the options are selected, an analysis needs to be done for the requirements that the lender will need to fulfil before sanctioning the loan. The treasury should be aware of such requirements while deciding which form of finance to opt for. Also, attention should be paid to the gearing that the company will be subject to post obtaining the finance. It is always favourable for the company to have a low gearing ratio.

Repayment terms

Another aspect to be kept in mind is how long the financing arrangement is structured to last. Longer loans can build up a significant amount of interest over time, but loans with shorter terms can require larger periodic payments. Consider the amount of the periodic payment and how often it is required to be paid. The repayment terms should also be in line with the cash-generating capacity of the business. Due regard should be given to the moratorium period of the loan in case of certain businesses which are not able to generate enough cash flows during the initial periods.

Financing costs

One of the most vital factors to be kept in mind while deciding the financing source is debt servicing ability. The entire cost of servicing the debt, be it fixed or floating, should be added up before taking the decision. Common costs for loans include interest rates, origination fees and brokers' fees. Financing through investment can carry very different costs. Money from venture capitalists, for example, may not require repayment for years, at which time the investor may expect to be repaid at a steep premium all at once. Financing through stock offerings can lead to a change in management and a shift in strategic focus. The loan has to be serviced throughout the tenure. The overall expenditure throughout the tenure of loan should be assessed well so that there are no defaults in servicing the loan.

Once the requirements are decided, the treasury function will start looking out for options for finance. Traditionally, the main source of finance was equity from promoters and bank loans. Companies would try to maintain a balanced composition between equity and debt. However, with the evolving economies, new forms of finance are available that enable companies to enjoy funds at lower cost or as per their requirements. Let us understand the different types of finance options available.

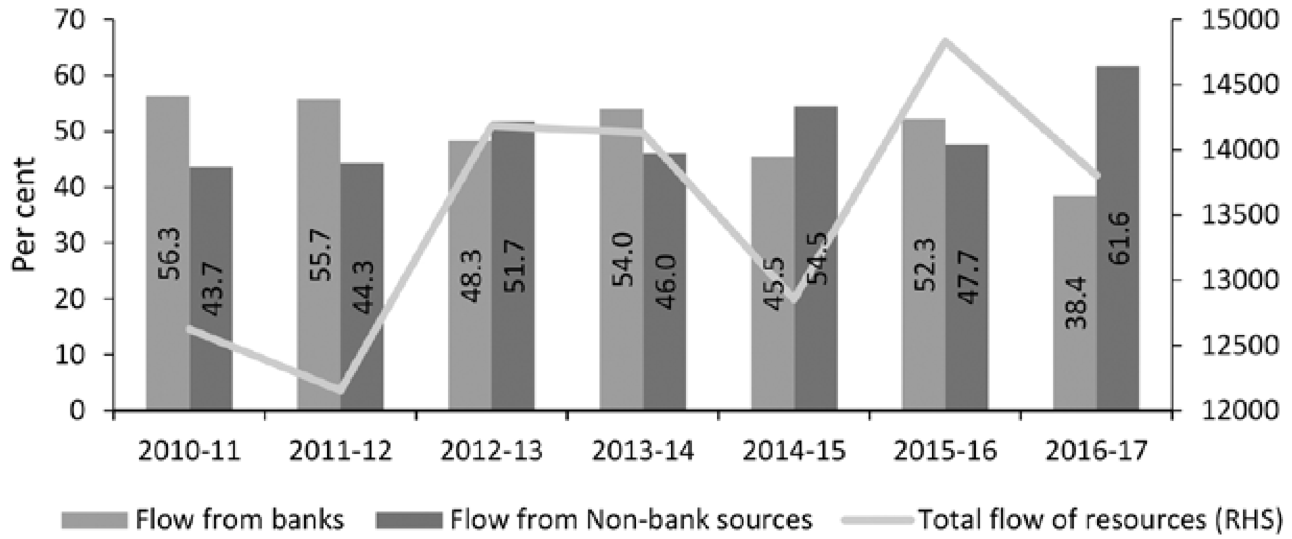
Sources of finance for the treasury function

The major sources of funding for the corporate treasurer are:

I) Bank funding

II) Non-bank funding

Chart 1: Flow of funds to the commercial sector in India



Source: RBI

Bank funding

As the name suggests, bank funding refers to all the sources of funds that a treasurer can access from a banking institution. This may be by way of loans, working capital funding, and fund-based and non-fund based instruments.

Banks are essentially those financial intermediaries who accept deposits for the purpose of lending. The second most important function of commercial banks is to lend money to individuals and institutions who need short-term and long-term funds. Funds are raised by banks for corporate clients in various forms. In fact, there are specialised bank branches or subsidiaries that do this job for corporates. Banks play an important role in financing the requirements of corporates. For several years, banks have been a major source of funding for corporates. However, this situation is now being challenged by credit disintermediation bypassing banking channels, which has attained critical mass. In 2011, the share of bank loans in credit to the commercial sector was around 56%. By 2017, banks' share had plummeted to around 38%.[1]

Challenges in bank funding

The following are the major challenges faced by corporates in obtaining funds from banks:

- Regulatory compliance: With increasing guidelines from regulators, specific rules need to be complied with to ensure that the loan request is approved. If you do not fit in the 'commercial loan box', then the chances that the loan will get approved are minimal.
- Credit ratings: It is difficult to obtain bank loans without a substantial track record. There are credit ratings that need to be attained for a bank to even consider advancing a loan and a company's past loan history plays a major role.
- Documentation: Excessive documentation is also one of the major problems faced by corporates. A banker will essentially help you compile the loan documents and due diligence paperwork to be submitted. As part of these loan documents, cash flow projections, balance sheets and past financials need to be in place. Also, based on our experience in assisting banks evaluate the way in which large corporates are able to service their loans, significant emphasis is given to the evaluation of key ratios such as debt ratios and debt service coverage ratios as well as the evaluation of the value of collaterals against the loan amount.

Currently, the Indian banking industry is aiming to strengthen credit norms and selective lending, thus reducing the non-performing asset (NPA) numbers. This is in contrast to the approach followed by banks until a few years ago, when it would be easier to avail loans. This turnaround in the approach is the outcome of stern action taken by the regulator and global credit defaults. In the near future, the regulations around credit monitoring are going to be strengthened and thus, we foresee challenges in obtaining finance easily from banks.

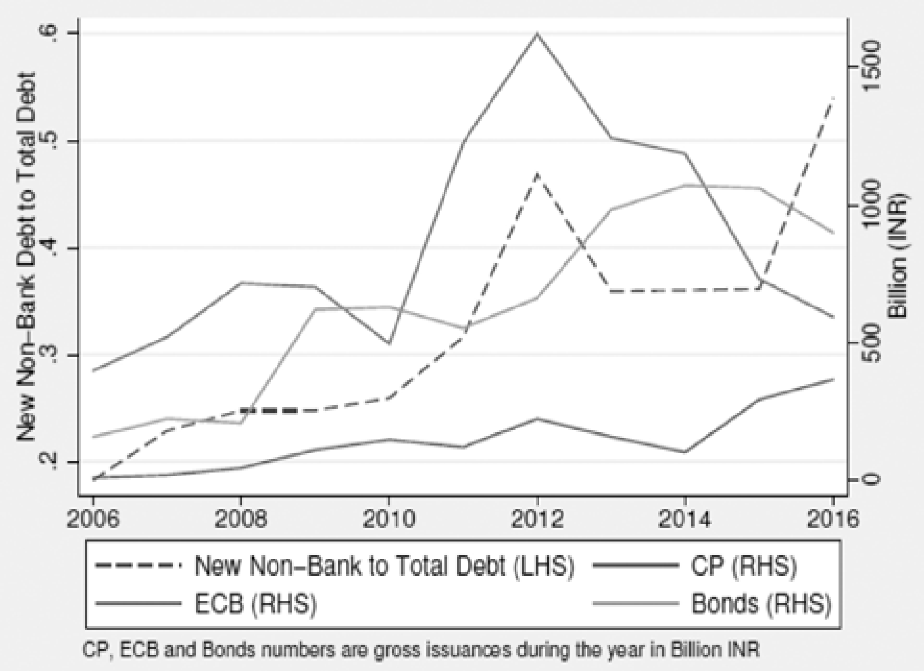
Non-bank funding

Non-banking sources refer to the raising of finance from sources other than banks. These may include raising the money through the capital market, money market, institutional investors, private equity and other corporate institutions. The money can be raised through various instruments and products like issue of equity and preference shares, debentures, bonds, commercial papers and corporate deposits.

Considering the tightening of loopholes in the lending norms by the banking industry, it is becoming difficult for corporates to rely solely on bank loans. Thus, the non-banking sources of finance are equally important. The continuous stress over banking assets has led to the birth of various non-bank debt sources.

Over the last decade, non-bank funding sources for the Indian corporate sector have evolved tremendously. This has resulted from business expansion, both within Indian and outside India. While privately owned corporates tend to stick to bank loans, public companies are foraying into various markets to explore more options. As per a memo released by the RBI, the share of non-bank sources of credit (commercial papers, corporate bonds and external commercial borrowings) has increased from 44% in 2010–11 to 62% in 2016–17.[2]

Chart 1: Flow of funds to the commercial sector in India



Source: RBI (https://rbidocs.rbi.org.in/rdocs/MintStreetMemos/MSMNO06290917.pdf)

The figure shows the fresh debt raised by non-financial firms from various funding sources. The dashed line (left scale) shows the fraction of fresh debt raised through the non-bank soruces which inclues CP, ECB and corporate bonds.

The Indian bond market has witnessed slow growth as both investors and borrowers did not tap the segment. However, with government support to boost the bond market, there has been an increase in the inflow of funds. The government has also allowed investors to invest in lower rating bonds, thereby making available more funds for borrowing.

The bond market has seen a remarkable pickup in the last three years. Among non-bank sources, the highest increase in fresh debt raised in 2016–17 was from bonds, followed by external commercial borrowing and commercial papers.[3]

Borrowers can also arrange for funds from private investors, both domestic and foreign, in the form of both equity and debt.

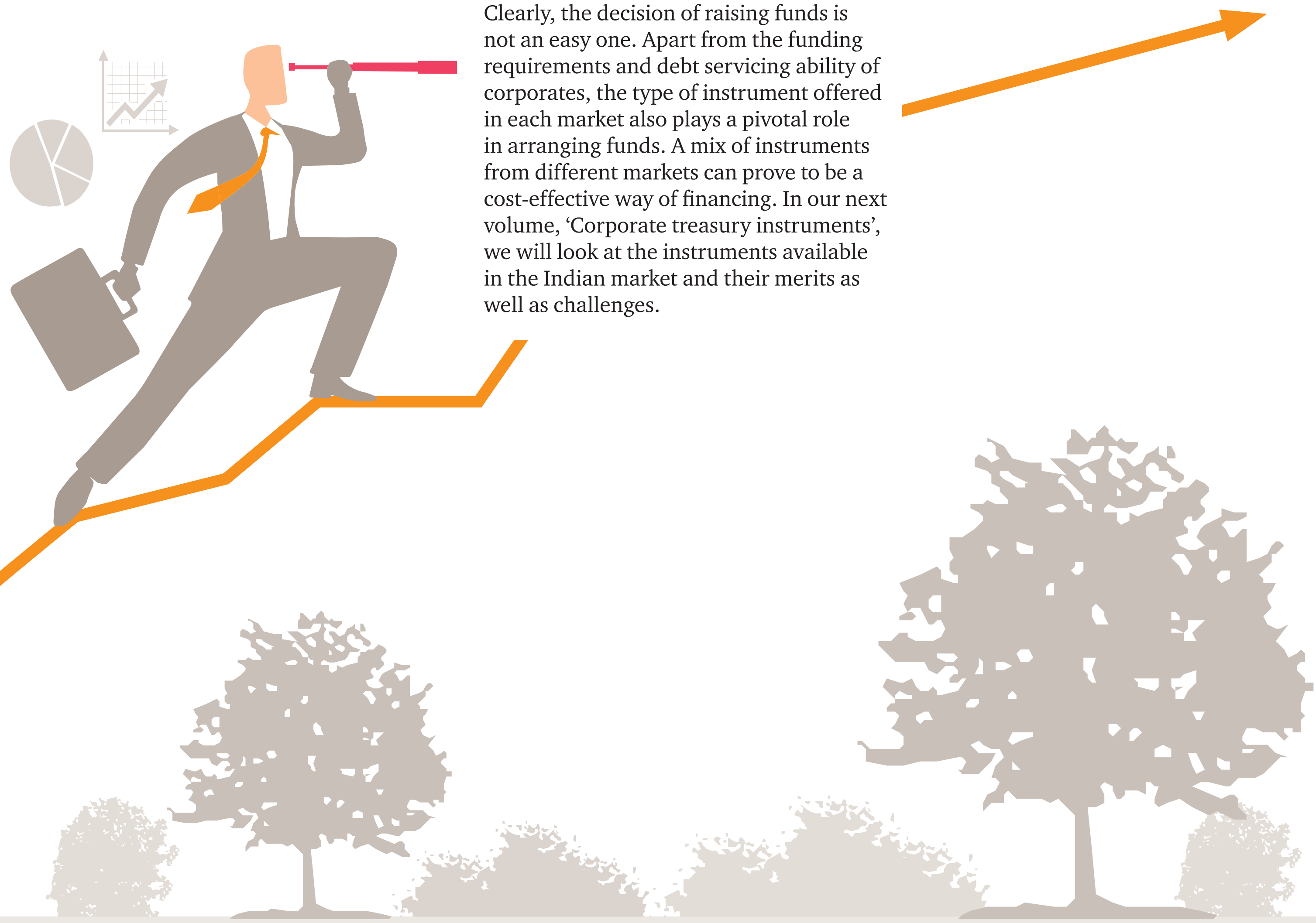
Challenges in non-bank funding

While there is an increasing trend to opt for non-conventional sources of funding, the perils associated with such sources should not be ignored. Some of the challenges are listed below:

- Higher financial costs: Non-banking sources usually entail higher financial costs in comparison with banks. Cost being one of the driving factors in the consideration of funds, it influences and changes organisational decisions.
- Substantial initial collateral requirements: Non-banking sources demand high initial collaterals to mitigate their market risks.
- More risky: Non-banking sources are considered to be more risky as they place greater emphasis on forced closure of businesses or taking up ownership of businesses to recover their funds. Banks abstain from taking an ownership position in business.
- Involvement in management: Direct investment in equity by private investors would result in the transfer of management controls and day-to-day operations of the company.

1 https://rbidocs.rbi.org.in/rdocs/MintStreetMemos/09MSM03012018.pdf
2 https://rbidocs.rbi.org.in/rdocs/MintStreetMemos/MSMNO06290917.pdf
3 https://rbidocs.rbi.org.in/rdocs/MintStreetMemos/MSMNO06290917.pdf

Looking ahead



Clearly, the decision of raising funds is not an easy one. Apart from the funding requirements and debt servicing ability of corporates, the type of instrument offered in each market also plays a pivotal role in arranging funds. A mix of instruments from different markets can prove to be a cost-effective way of financing. In our next volume, 'Corporate treasury instruments', we will look at the instruments available in the Indian market and their merits as well as challenges.

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