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FINANCIAL MANAGEMENT | BASIC

Video Transcription: Different Sources of Finance and the Risk-Return Relationship

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Hi, my name is Paul and, in this video, we are going to be looking at the various sources of finance that are available to management.

And if you remember our big-picture diagram of financial management, this is really one of the core first decisions that management needs to make. Once it has decided on what the business is going to be about, or the service that is going to be provided, they are going to need some finance in order to get their dream started, to get things rolling.

And so, we are going to be honing in, in particular, on the financing decision and looking at the sources of finance that are available to management.

We will then be taking a look at a case study, Walt Disney, trying to apply the theory to a real-life example. And then finally, what we are going to be doing is thinking through the risk-reward ratio of how management gets it right when considering sources of finance. So, let us consider the menu of options that is available to management. You have got the whole realm of equity finance: shares, retained earnings… You have got a whole bunch of options that are available of management there, where essentially they ask outside shareholders to provide funds or they don't pay out a dividend and retain funds in the business so that they become a source of finance. So, there is equity finance.

Then there is debt finance. Here, simplistically, the company needs others to provide finance that will get repaid over time. You are familiar with loans from banks and terms like mortgages, debentures… You need to be familiar with all the terms that are appearing now on the screen because these have different characteristics and you need to understand them. So if there are some terms here that you are not familiar with, be sure to study further and get to grips with what these instruments provide when management makes use of them.

Finally, you've got hybrid instruments, which are combinations of equity and debt, and you need to understand how they blend these two elements together to form these hybrid instruments. There is a vast amount of creativity here. Why? Because many people have applied their minds to solving this tricky problem of how to get finance available to firms so that they can start operating. So you have got equity, debt and hybrid instruments, which you need to understand and that you need to be on top of.

Some characteristics, which you have got to pay special attention to: the first is the timeline. Some of these options will be short-term, others will be long-term; shares are held forever really; short-term finance can sometimes be for as short as one month. Other characteristics are that some will require repayments, which are variable or fixed over time. You will need to understand the difference that that makes, when management need to repay that finance. Some require you to provide security and that will reduce the cost but also makes you feel a little bit of the riskiness of the move because your asset is sitting as security and if things were to go bad and repayment could not happen, that asset would need to be handed over to your providers of finance. I am just trying you to give you some of the characteristics, which are important for you to appreciate the differences that sit here. Because really, what you have here is not just a list of names for the same thing. No, they have distinct characteristics, which you need to understand and which you need to explore.

So, having done that, having seen what is on the menu, you now need to consider what would be the optimal sources of finance. And what is very important to realise, is that there is no one-size-fits-all. It really does depend on the business and the context that it finds itself in. And that is why I would love us to look at Walt Disney. I really enjoy studying this company because I think most people understand what it gets up to. Mickey Mouse, we are familiar with, Donald Duck… But, when you look at Walt Disney, what do they actually do to make money? And you see that there actually are some vastly different divisions.

You will see that there is a division that makes movies, for instance. Animated movies that delight families and then at the same time Walt Disney also owns some theme parks, which operate rides out of Euro Disney in Paris, as well as in the States. And within the same company, therefore, you have got totally different operations.

So, let us just look at these two: films and theme parks. If you had to decide on your source of finance to make the investment in a theme park, what would you consider to be appropriate? I hope you would realise that these decisions are connected. You are going to need to look at your investment decision as well as your financing decision, in order to make wise decisions.

So, let us start with the theme park. The theme park would need a lot of land and you would hope that it would operate for decades to come. It is a long-term asset. So, when you are looking to get a source of finance for the theme park, I think it would be appropriate to get a source of finance that also is long-term in nature, so as to match the investment that you are about to make.

Contrast that to the movie-making business. Walt Disney has a script; it needs some months to put this script into a format, which can be watched by people around the world. This is a risky undertaking. Whilst a theme park has got land that can act as security, there is no such thing for a movie. And so what you notice here is that the financing looks very different. Whilst, for a theme park you might be using some long-term debt; for movies, what they actually do is they use a portion of equity and they invite outside investors to help share in the risk of producing that movie, so as not to take the full costs onto themselves. If it is successful, sure they must share profits with others but if it falls over, they are not sitting with multi-multi-multi-million rand or dollar losses.

So, Walt Disney has to make financing decisions related to what its investment ideas are, and they are trying their best to match those, as they go along. For a theme park, long-time debt makes sense, but for a movie, they are going to create some equity in that movie and it is going to be reducing their risk, in that way.

Now apply this thinking to businesses that you see everyday. Think to yourself, "what would be appropriate for this business?" The start-up business that is incredibly risky? If they use debt, they might find that if the debt becomes due they just do not have the cash available to make the payment. So, probably in that early stage, equity might be the best way for them to go. But contrast that to a large South African multinational, like MTN. They are collecting cash every month from contract customers; they can predict when the cash is coming in. It is beautiful annuity income that is flowing towards them. They are far more likely to be able to make debt payments and therefore to take on extra debt when deciding on their sources of finance.

I hope you understand just how important it is, therefore, to get into the shoes of management when making the sources of finance decision and not just understand the financing decision but to have a good understanding of what the operations and the investment horizons look like.

So, the source of financing decision requires layered thinking. You need to understand what the finance is going to be used for. Is it a theme park; is it a movie? Because the riskier it is, the less debt you want to use and the more long-term it is, the more you want to use long-term sources of finance. You then try and figure out “what are the cash flows from this investment expected to be?” If the cash flows are expected to be up and down, you do not want to be making fixed payments. You would probably need to get a source of finance that allows you to be making irregular payments. It is fascinating because you are layering things like taxes, you are layering BEE in a South African context, and you find yourself having to consider so many factors when it comes to source of finance. In early years, the complexity sits in the first few layers, but as you go on towards your final years, you will notice that you revisit this topic with a deeper level of understanding, every time.

Finally, what I would love to show you is this graphic that really helped me understand this whole area of risk-and-return. You see, when you are making the source of financing decision, you could make some really risky decisions and maybe you have heard in the past that the more risk you take on, the more your return is going to be and maybe a graph like this is how it is being shown. Sloping upwards to the right, as you increase your levels or risk, so your expected return goes up.

But that is the key word. It is “expected return” and so, as you look notice that the distribution of those expected returns widen as you increase your risk. You see, you might hope to get yourself on that slope line but likewise you could find yourself a faraway off as you increase your risk.

And so, reality, that if management decide to pile on a lot more risk by adding a considerable amount of debt and making it short-term, such that repayments are due soon, they might find themselves in a situation where, if returns do not match expectation, they run themselves out of business.

I am not telling you not to take on risks, I am just telling you to be very aware that sources of finance can provide an incredible source of risk if you are not careful and do not understand what you are doing.

So if you are an MTN, you will notice that your band, your expected year returns are tight. There is not a lot that can go wrong. But if you are a start-up business that is in its early days, you could be the next Facebook but you could also be looking for a new job in the next three months – that distribution of returns is so wide.

And so it is a concept, which you will revisit in many other disciplines as you go through your business career, but I hope you understand it in this context of “sources of finance”. Management want to get the lowest source of finance, the cheapest source of finance, but if that comes with considerable risks, it could out them in a situation, where shareholders will not see value created in a long-term.

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So, understand the different instruments that are on the menu, apply to the context you find yourself in, knowing it is not just one size fits all. And then, finally, always consider the risks that you are undertaking because it might mean that value gets destroyed in the long-term.

I hope you have enjoyed just a few of the layers getting added to this “sources of financing” decision that you need to make. And as you progress in your studies, look forward to more layers getting added in due course. All the best.