Chapter 20: Financial planning in the short term

Some used abbreviations:

- EAR = effective annual rate
- APR = annual percentage rate

Forecasting short-term financing needs

Forecasting the future cash flows of a firm is the first step in short-term financial planning. The two goals of this: determining whether the firm has a surplus or a cash deficit for each period and deciding whether that surplus or deficit is temporary or permanent.

Firms need short-term financing for three reasons;

1. Seasonal working capital requirements. Seasonality: firms dealing with a fluctuation in sales and cash because of seasonality, often have short-term financing needs.
2. Negative cash flow shocks: when cash flows are temporarily negative for an unexpected reason, the situation is called a negative cash flow shock. These negative cash flow shocks can create short-term financing needs.
3. Positive cash flow shocks: although this surprise is good news, it still creates demand for short-term financing due to a negative cash flow during the first period.

Cash budget: A forecast of cash inflows and outflows on a quarterly (or sometimes monthly) basis used to identify potential cash shortfalls. This allows a manager to identify potential cash shortfalls.

The matching principle

A possible policy that minimizes the transaction costs, to maximize the value of the firm, is the matching principle. The matching principle states that firm's short-term cash needs should be financed with short-term debt and that long-term cash needs should be financed with long-term sources of funds.

Permanent working capital is the amount that a firm must keep invested in its short-term assets to support its continuing operations. This is a long-term investment, because this investment is required so long as the firm remains in business. According to the matching principle, a permanent investment in working capital should be financed with long-term sources of funds.

Temporary working capital is the difference between the firm's actual level of investment in short-term working capital needs and its permanent working capital requirements. This is a short-term need and according to the matching principle this portion should be financed with short-term financing.

Because of seasonality the net working capital of a firm may differ during the year. The result is a minimum in a period and a maximum in another period. This minimum level of working capital represents the permanent working capital of a firm. The difference between this minimum level and the higher levels in other period represents the temporary working capital requirements. Not all firms follow the matching principle, there are also alternatives.

Besides following the matching principle, a firm can also finance its permanent working capital needs with short-term debt. An aggressive financing policy is the financing part or all of a firm's permanent working capital with short-term debt. A firm might choose this alternative when agency costs and asymmetric information is important.

Because the value of short-term debt is less sensitive to the firm's credit quality than long-term debt, the value of the firm will be less affected by management's actions or information. Consequently, short-term debt can have lower agency and lemons costs than long-term debt and this policy can benefit shareholders. Meanwhile, the firm exposes itself to funding risk: the risk of incurring financial distress costs should a firm not be able to refinance its debt in a timely manner or at a reasonable rate.

Conservative financing policy is when a firm finances its short-term needs with long-term debt. To implement this policy effectively, there will necessarily be periods when excess cash is available. These are the periods when the firm requires little or no investment in temporary working capital.

The next sections focus on the specific financing options that are available: bank loans, commercial paper and secured financing.

Bank loans

The commercial bank is one of the primary sources of short-term financing. Typically, bank loans are initiated with a promissory note: a written statement that indicates the amount of a loan, the date payment is due and the interest rate.

Three types of bank loans: a single, end-of-period payment loan, a line of credit and a bridge loan.

1. Single, end-of-period payment loan

In this case, the firm pays interest on the loan and pays back the principal in one lump sum at the end of the loan. The interest rate may be variable or fixed.

With a variable rate, the rate will vary with some spread relative to a benchmark rate.

- A prime rate is the rate banks charge their most creditworthy customers. However, large corporations can often negotiate bank loans at an interest rate that is below this prime rate.
- A London Inter-Bank Offered Rate (LIBOR) is a rate of interest at which banks borrow funds from each other in the London interbank market.

2. Line of credit

A line of credit is a bank loan arrangement in which a bank agrees to lend a firm any amount up to a stated maximum. This flexible agreement allows the firm to draw upon the line of credit whenever it chooses. Lines of credit are frequently used to finance seasonal needs.

- An uncommitted line of credit is a line of credit that is an informal agreement and does not legally bind a bank to pride the funds a borrower requests.
- A committed line of credit is a legally binding written agreement that obligates a bank to provide funds to a firm (up to a stated credit limit) regardless of the financial condition of the firm (unless the firm is bankrupt) as long as the firm satisfies any restrictions in the agreement.
- A revolving line of credit is a line of credit, which as company can use as needed that involves a solid commitment from a bank for a longer time period, typically two to three years.

- An evergreen credit is a revolving line of credit with no fixed maturity.

3. Bridge loan

A bridge loan is a type of short-term bank loan that is often used to “bridge the gap” until a firm can arrange for long-term financing. These bridge loans are often quoted as discount loans with fixed interest rates.

A discount loan is a type of bridge loan in which the borrower is required to pay the interest at the beginning of the loan period. The lender deducts interest from the loan proceeds when the loan is made.

Common loan stipulations and fees that affect the effective interest rate on a loan are

- Commitment fees

The commitment fee is associated with a committed line of credit, this fee increases the effective cost of the loan to the firm. The “fee” can be considered as an interest charge under another name.

- Loan origination fee

A loan origination fee is a common type of fee, which a bank charges to cover credit checks and legal fees that a borrower must pay to initiate a loan. This fee reduces the amount of usable proceeds that the firm receives.

- Compensating balance requirements

This means that the firm must hold a certain percentage of the principal of the loan in an account at the bank. This will reduce the usable loan proceeds.

Commercial paper

A commercial paper is a short-term, unsecured debt issued by large corporations that is usually a cheaper source of funds than a short-term bank loan. The interest on commercial paper is typically paid by selling it at an initial discount.

Commercial paper is referred to as either direct paper or dealer paper.

- A direct paper is a commercial paper that a firm sells directly to investors.
- A dealer paper is a commercial paper that dealers sell to investors in exchange for a spread (or fee) for their services.

Secured financing

Firms can also obtain short-term financing by using a secured loan. A secured loan is a type of corporate loan in which specific assets, most typically a firm’s accounts receivable or inventory, are pledged as the firm’s collateral. Common sources for secured short-term loans are commercial bank, finance companies and factors. Factors are firms that purchase receivables of other companies.

A firm can use accounts receivable or inventory as security for a loan:

Accounts receivable as collateral can be used as security for a loan by pledging or factoring

1. Pledging of accounts receivable: an agreement in which a lender reviews the credit sales of the borrowing firm and decides which credit accounts it will accept as collateral for the loan, based on its own credit standards.

2. Factoring of accounts receivable: an arrangement in which a firm sells receivables to the lender (i.e. the factor) and the lender agrees to pay the firm the amount due from its customers at the end of the firm's payment period.

A financing agreement may be with recourse or without recourse.

- With recourse: a financing agreement in which the lender can claim all the borrower's assets in the event of a default not just explicitly pledged collateral.

- Without recourse: a financing agreement in which the lender's claim on the borrower's assets in the event of a default is limited to only explicitly pledged collateral.

Inventory as collateral for a loan can be used in three ways

1. A floating lien (general lien or blanket lien) is a financing arrangement in which all of a firm's inventory is used to secure a loan. The is the riskiest option from the lender´s point of view.

2. A trust receipts loan (or floor planning) is a type of loan in which distinguishable inventory items are held in a trust as security for the loan. As these items are sold, the firm remits the proceeds from their sale to the lender in repayment of the loan.

3. A warehouse arrangement is when the inventory that serves as collateral for a loan is stored in a warehouse. There are two methods to set up such an arrangement:

    - A public warehouse is a business that exists for the sole purpose of storing and tracking the inflow and outflow of inventory, providing the lender tighter control over the inventory.

    - A field warehouse is a warehouse arrangement that is operated by a third party, but is set up on the borrower's premises in a separate area so that the inventory collateralizing the loan is kept apart from the borrower's main plant.

Short-term financial plan

A short-term financial plan tracks a firm's cash balance and new and existing short-term financing. This planning allows managers to forecast shortfalls and to fund them in the least costly manner.