Significant development has taken place in the debt and corporate bond market in the last ten years. The major Australian corporations such as Telstra Corporation Limited have now started to borrow in the form of corporate bond.

You are required to generally discuss the nature of debt finance, and the reasons for and against the use of debt in corporation finance by referring to the appropriate finance theories and practices, and evaluate the recent financing practices of Telstra Corporation Limited.

ABSTRACT

To engage in business the financial mangers must find three solutions. Firstly, long-term investments which is capital budgeting, secondly cash raising required investments which is financing decision and thirdly managing its day-to-day cash and financial affairs which is decisions involving short-term finance and net working capital. Overall, Companies require finance collected from debt which is called debt finance. Even large companies like Telstra is preferring dent than equity for finance.

CORPORATE FINANCE

To start any kind of a firm mangers are required to buy raw materials, workforce to sell and produce finished goods etc. Investments must be made in assets such as inventory, machinery, land and labor. The amount of cash invested in assets must be matched by an equal amount of cash raised by financing which is called *corporate finance.*

'*Corporate finance might seem an intricate and complicated subject involving an infinite variety of complexities. Or to others it might bring to mind a gl amorous picture of making fabulous fortunes in stocks and bonds on the New York Stock Exchange (Donaldson and Pfahl, 1969)'* . These activities are associated with finance and with the financing of corporations.

Before the firms can collect corporate finance a detail financial planning must be done using professionals if it is a huge firm. The first step of the financial planning would be how to obtain corporate finance. *'The young adults' first exposure to the financial system may have arisen either from borrowing or saving. For many, the introduction to the realm of finance came via the credit system when they "charged it" at a store. Others received their initiation when found it necessary to borrow from a credit union or from a consumer finance company… (Donaldson & Pfahl, 1969)'.*

Most of the finances today are borrowed in the firm of debt finance in corporations. The world today, has more been a debt world than ever where credit cards swapping is done more frequently than cash transactions.

'We ridicule the government in Washington which has been taking on greater and greater debt. So great in fact, that by 1986 each child being born in this country already owes two thousand dollars (Dunton, 1987)' .

NATURE OF DEBT FINANCE

Companies can raise finance in the stock market through the issue of ordinary shares. But it can create a number of difficulties. *'Unless the return earned on the additional capital raised is the same as, or greater than, the return earned on the existing capital, shareholders will suffer a reduction in the return on their investment in the company; and unless the fresh capital is raised through a right issue, i.e, the additional ordinary shares are offered to shareholders in proportion to their existing holding, it is possible for the existing shareholders to lose control of the company (Paish & Briston, 1982)'.*

Companies may prefer to raise the additional capital required through a loan rather than by issuing additional equity. It is because lenders of capital have no right of control in a company, nor do they have any rights to participate in the profit beyond receiving the agreed interest on money lent. This is interest is payable to the lender of capital whether or not the company yields profit in that year. If the company is unable to meet the interest due on the loan, the lender has the right to put the company into liquidation and to receive payment of both principal and interest out of the proceeds of the sale of the company's assts.

TYPES OF DEBT FINANCE

The debt finance may be divided into two types: short-term debt and long-term debt.

The banks are especially the providers of the **short-term debt**. These debts are normally repayable either on demand or after a period of weeks or at most months. The lenders are entitled to receive a fixed annual rate of interest, irrespective of whether the borrowers earn enough to pay it or not.

Long-term debts are made in the form of bonds and securities. '*A bond loan can either created directly in one-on-on contact with a large, institutional fund supplier or sold through the public market (Dorsman, 2004)'* .

The bond loan if made from the public market is sold in smaller denomination in order to make liquidity and tradability larger. Thus, even the smaller investors could benefit from buying bonds. Interest payments and the repayment of the principal are then done in the future. The bond price is not just a function of the series of cash flows related to the bond, but also the set of right and duties held by lenders and bond issuers respectively. Therefore, the more rights a lender receives, the lower the interest rate.

In simple words, *'A bond is a certificate showing that a borrower owes a specified sum. In order to repay the money, the borrower has agreed to make interest and principal payments on designated dates. (Ross, Westerfield & Jaffe, 1999)'*

DEBT AND EQUITY

'Debt implies that capital is made available to the company on condition that it will pay back principal to the lenders at some pre-specified date in the future. In the case of equity, companies do not have an obligation to redeem the principal (Dorsman, 2004)'. This means, the difference is whether or not to payback the principal in pre-specified date in the future. '*The distinction between debt and equity is very important for tax purposes. So one reason that corporations try to create a debt security that is really equity is to obtain the tax benefits of debt and the bankruptcy benefits of equity (Ross, Thompson, Christensen, Westerfield & Jordan, 2001)'*

Again, '*Debt may be better than equity in some cases, worse in others. Or it may be no better no worse. Sometimes all financing choices are equally good. (Stern & Chew Jr, 1986).*

The case for or against debt financing must therefore be built up from a more detailed look at the firm and capital markets. A smart financial manager ends up asking specific questions as mentioned by Stern and Chew Jr, 1986 such as

a) Is there a net advantage to borrowing for my firm?
b) What are the odds that a given capital structure will bring financial embarrassment or distress? What would be the cost of such financial trouble?
c) Is subsidized financing available? Is so, are strings attached?
d) Should my firm's existing dividend policy constrain its financing choices?
e) What are the costs of issuing securities under alternative financing plans?

FEATURE OF DEBT FINANCE

'*Debt instruments have certain principal features in common: a stated maturity, a stated principal amount, a stated coupon rate of interest, a mandatory redemption schedule and covenant restriction designed to protect bondholders (Finnerty, 1986)'*.

A company will generally select a shorter maturity if it expects its credit standing to improve or if it expects interest rate to fall.

ADVANTAGES OF DEBT FIANANCE

The main advantage of debt finance is collecting finance when needed. Instead of storing excess cash the company utilizes it.

If the firm seek external funds, it is better to issue debt than equity securities. It is because the rule is, 'Issue safe securities before risky ones'. *' Moderate debt financing is generally regard*

ed as sound business practice, providing the firm can earn a rate of return on the incremental investment greater than the interest payable on the debt (Slatter, 1984)'.

'*Aside from generating tax shields, debt financing can be advantageous when there are conflicts of interest between owners and managers (Crane, Merton, Froot, Bodie, Mason, Sirri, Perold & Tufano, 1995)'.*

Debt is cheaper than equity because it forces managers to pursue firm value maximization. Equity is more expensive because it gives mangers the discretion to pursue goals other than value maximization.

DISADVANTAGES OF DEBT FIANANCE

One of the main disadvantages of debt finance is risk. It is risky for businesses to have debts if it does not make good profit. Moreover, too much debt can be costly for a company as well.

Also, tax can be a disaster. A firms tax status has predictable, material effects on its debt policy. For e.g., firms with large tax loss carry forwards may also be firms in financial distress, which have high debt rates almost by definition.

Firms do have target rations of debt to equity. If debt weighs too heavily in their capital structure, they acquire equity by retaining earnings or issuing stock. If the debt ratio is too low, they favor debt over equity. But firms are never precisely on target. They are continually flexible by changing business conditions.

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