HYBRID SOURCES OF FINANCE OF CORPORATION

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Abstract

Hybrid capital represents the capital obtained through the issuance of hybrid securities, i.e. securities which have the characteristics of both debt and equity securities. These are relatively new forms of securities which originated in countries with a developed capital market due to the lack of possibilities for financing through classical debt and equity securities. Hybrid capital, i.e. hybrid sources of finance mostly consist of: (a) capital from the issue of preference shares, and (b) capital from the issue of hybrid bonds. The aim of this paper is to present both types of securities as well as the possibilities and limitations of their application in the finances of a modern corporation.

Keywords: securities, hybrid capital, preference share, loan stock

INTRODUCTION

Nowadays, securities represent one of the most important instruments of company financing and have become a much more prominent form of financing compared to conventional loans in modern developed economies. The issue of securities can raise significant financial assets to finance various needs of a company. Therefore, it is extremely important to know the characteristics, types and functioning of certain securities in the modern financial practice. Securities are written documents that contain a written obligation of the issuer of the security to fulfill the obligation recorded in this document towards the rightful holder of the security. This means that the issuer of a security has the obligation to settle only the obligation to which he committed in writing and may not be held responsible for commitments given orally, which are not contained in the written document. In this regard, it should be noted that for a company the financial claim may be in the form of equity capital (shares) or debt (bonds). Similarly, it follows that shares are equity securities, while bonds are debt securities. However, there are relatively recent forms of securities with characteristics of both debt and equity securities. These are called hybrid securities and originated from the inability of corporate companies to be financed by traditional debt and equity securities. Hybrid securities, i.e. hybrid sources of company financing usually consist of: (1) the capital from the issue of preference shares, and (2) the capital of the issue of hybrid bonds.

CAPITAL FROM THE ISSUE OF PREFERENCE SHARES

Apart from obtaining capital by the issue of ordinary shares, a company can obtain it by the issue of preference shares. Preference shares are actually hybrid securities which combine the characteristics of ordinary shares and bonds. On the one hand, preference shares are similar to ordinary shares in that they do not have fixed maturity period, default of dividend payment on these shares cannot lead to bankruptcy of the company, and dividend expenses are included in the tax base. On

the other hand, preference shares are similar to bonds in that dividends are limited. In this regard, the amount of dividends on preference shares is usually fixed either as a cash amount or as a percentage of the nominal value of a share. In addition, the issue of these shares often requires coverage as in the case of bonds, i.e. there is no limit to the amount of capital which can be obtained by the issue of these shares. Generally, preference shares do not carry voting rights, except in the case where a company has not paid preferred dividends for a certain period to its shareholders. In this context, preference shares simultaneously have characteristics of both equity and debt securities, i.e. are considered hybrid securities. Therefore, the equity capital from the issue of these shares is considered a hybrid source of financing. This capital is treated as equity capital and it is especially recognized in the balance of the corporation. In fact, it is treated as the capital from the issue of preference shares (preference share capital). This capital is sometimes treated as a debt and sometimes as equity capital, depending on the type of financial analysis. In this regard, the capital from the issue of preference shares can be viewed from different aspects. From the standpoint of ordinary shareholders, this capital is similar to debt since preferred dividends represent a fixed expense, which reduces income of ordinary shareholders. From the standpoint of bondholders, this capital is similar to equity capital from the issue of ordinary shares since claims for interest have priority over the claims in the form of dividends. From the standpoint of management, capital from the issue of preference shares lies between debt and equity from the issue of ordinary shares. Since the inability to pay preferred dividends cannot lead to bankruptcy of the company or bankruptcy of the issuer, this leads to the conclusion that it is safer to use capital from the issue of preference shares rather than financing from debt. The main motives of a corporation to issue preference (privileged) shares are multiple and they are primarily reflected in the following: (a) the expansion of the possibilities of using the limited financing sources, as the capital by investors is attracted because they are not willing to buy ordinary shares due to the uncertain amount of dividends, (b) avoiding greater differentiation between shares and costs incurred on that basis, (c) the preservation of existing rights of management by ordinary shareholders, (d) possible increase of the income of the ordinary shareholders originating from favorable financial structure of the company. On the other hand, preference shares are very attractive for investors, especially those who prefer more secure investments with a return that is higher than the interest rates. The very name of these actions (priority) speaks in their favor. Unlike ordinary shares, preference (priority) shares have a number of very important characteristics, namely: (1) the right to a preferred dividend, (2) the right to participate in the distribution of funds from the liquidation of companies in the event of bankruptcy, (3) the convertibility, and (4) the redemption.

1. The right to a preferred dividend. Preferred dividend has a priority in the allocation of net income, which means that owners of preference shares are entitled to receive dividends before any distribution to ordinary shareholders. In addition, the obligation for preferred dividends exists only if a company generates a sufficient amount of net income. However, there is a special type of the so-called cumulative preference shares, in which the unpaid dividends do not lose value immediately and irreversibly, but the right of shareholders is accumulated and transmitted to the several following periods (usually three years). The unpaid cumulative preferred dividend is recorded in the books of the company as a liability for unpaid dividends. If within the prescribed period, the company does not achieve the required amount of income for the payment of unpaid dividends, then the accumulated right of the shareholders is

withdrawn, i.e. the value is lost.

2. The right to participate in the distribution of funds from the liquidation amount - in the case of company bankruptcy. This right of preference shareholders holds a priority only in relation to the others and by order comes immediately after creditors. The size of this participation is determined by the nominal value of preference shares with possible increase in accumulated unpaid dividends.

3. Convertibility of preference shares. This feature of preference shares refers to the entitlement of shareholders to be able to convert their preference shares into ordinary shares within certain deadlines and thereby become regular shareholders. From the standpoint of a company, convertibility is desirable for two reasons: *firstly*, this instrument enables reduction of financing costs, and *secondly*, a favorable impact on the value of the ordinary and preference shares is achieved.

4. Redemption of the preference shares. Although preference shares do not mature, the issuer companies reserve the right to redeem them. This right is usually used in cases when market interest rates drop significantly, or when shares are issued at a very high rate of return, or the company has cash which it cannot invest profitably. In these situations, the company avoids unnecessary financing costs by redeeming and purchasing preference shares. If the redemption of shares is planned in advance, then the company can create a special-purpose reserve for redemption. During the redemption and purchase of shares, apart from payment of nominal value, the company usually pays a certain redemption premium, which usually amounts to 10% of the nominal value of a share. In this regard, issue of preference shares is not recommended without established premiums for redemption, since without them the redemption is difficult to execute. Normally, the redemption system is so designed that the initial premium declines within successive periods, in order to disappear completely after a certain time. From the standpoint of issuer company, financing by the issue of preference shares has certain advantages but certain disadvantages as well. The advantages are reflected in the fact that with the issue of these shares there is no division of control over the operations of the issuer company, as well as in the fact that the dividends are fixed, and consequently, most of the profit remains with the shareholders in the event of profit growth, i.e. there is no danger of liquidation in the event of low profit. Through issue and placement of these shares, companies can relatively quickly gather the necessary capital which they are under no obligation to return, because it is considered a part of their owned capital and in some cases the company may delay the payment of preferred dividends (cumulative preference shares). Depending on the degree of urgency of the need for equity, preference shareholders may also be given the right to vote and in some cases even an increased voting rights in relation to ordinary shareholders (e.g. in case the capital can be obtained only by changing the owner). However, financing by the issue of preference shares has certain disadvantages. The disadvantages are reflected in the fact that there is a higher cost of capital after taxation in relation to the debt, because the preferred (priority) dividends are subject to taxation, which also makes the basic disadvantage of financing companies in this way. Nevertheless, if the company pays a small tax or does not pay it at all because it is not profitable, then the fact that interest on debt is not subject to taxation does not have much significance for the company. Namely, if the business is situated in a lower tax group, it is much more likely that it will go to funding by issuing preference shares rather than through long-term debt. From the standpoint of investors, investing in preference shares has certain advantages but disadvantages as well. The advantages are reflected in the fact that preference shares provide a steadier income than ordinary shares, that they have a priority in

payment in the event of liquidation of a company and that more than a half of the reported preferred dividends by the corporate company are not taxed because they are usually company-owned. In this case, the motive of investors to invest in preference shares is clear: lower risk, but still high enough income, particularly in relation to that which could be obtained by investing in debt securities. However, investment of capital in preference shares has certain disadvantages as well. The disadvantages are reflected in the following: limited profit, the absence of the right to an additional dividend, and for individuals, lower income after tax from the income from the bonds, which are also less risky. In order to avoid tax paying, the so-called convertible preference shares have been used increasingly in recent years. This is especially true in cases of voluntary integration of companies (mergers) where the purchase of shares of one company by another is not made in cash, but the preference shares are exchanged for ordinary shares of the company that is being merged. In this way, taxation is avoided since the exchange of securities is not subject to taxation (shareholders of the merged companies receive preference shares by which tax payment on capital shares is de facto postponed). Such transactions allow the shareholders of the merged companies, who are interested in profit, to obtain preference shares, i.e. the shareholders who are interested in capital income, to obtain convertible preference shares, which are convertible into ordinary shares. In modern conditions, most companies withdraw and replace preference shares with bonds, since the preferred dividends are taxed and interest on the bonds is not. However, where neither bonds nor ordinary shares are a suitable solution, the company usually turns to the issue of preference shares in order to increase long-term capital. In this regard, public companies often use the issue of preference shares in order to improve their capital structure, as they are capital-intensive and that there is a high share of debt (bonds) in their capital structure. These companies invest significantly in equity capital which is why the costs of depreciation are also high reducing the effect of tax rates on the increase in the costs of capital, i.e. the basic disadvantage of company financing by issue of preference shares is partially neutralized with respect to the issue of bonds.

CAPITAL FROM THE ISSUE OF HYBRID BONDS

A bond is a debt security with a fixed income, whose issuer undertakes to pay to the person indicated on the bond (bond to the name of) or to bearer thereof (bonds to the bearer) a nominal value of a bond and pay interest for a certain period of time. Depending on whether they contain certain characteristics of shares or not, bonds may be pure and hybrid. Bearing in mind the nature and objectives of this paper, our following elaboration will be dedicated to hybrid bonds exclusively. In this context, it should be first said that the following are considered hybrid bonds: (*1) Bonds with the obligation to be exchanged for shares; (2) Bonds with the right to participate in profits; (3)Bonds with premiums; (4) Bonds with warrants;* (5) *Convertible bonds.*

Observing the significance of these hybrid bonds, we will try to briefly explain each of them, in the previously stated order. In addition, given the special importance of bonds with warrants and convertible bonds, they will be given a little more attention.

1. Bonds with the obligation to be exchanged for shares - are the bonds that give the right to a fixed profit in the form of interest, but also an obligation to, with the expiry of the maturity period, under specified conditions, be exchanged for shares, whereby this right, i.e. the obligation of exchange can be transferred independently of the bonds.

2. Bonds with the right to participate in profits - are bonds which in addition to the right to a return of principal and payment of fixed interest give their owners the right to

participate in profits which depends on the size of the dividend to be paid on this basis.

3. Bonds with premiums - are bonds which in principle assume that customers prefer games of chance, so these bonds are issued with a minimum interest rate or without it. After that, the saved interests are collected so that, by using a lottery system, certain bond owners will have the premium paid. In addition, the owner of such bonds shall be entitled to a refund of the nominal value, as well as a certain amount of minimum fixed interest, and possibly to the premium as well.

4. Bonds with warrants - are as a rule, long-term bonds, which apart from the fixed profit to their owner provide a warrant as well. Each warrant gives the holder the right but not the obligation to buy a specified number of ordinary shares directly from the issuer at a specified price within a specified period of time. In addition, a warrant specifies the number of ordinary shares that its holder can purchase, the exercise price of the warrant and the expiry time. Warrants which entitle the holder to buy a certain number of ordinary shares at a fixed price can be considered a long-term purchase options on shares which were sold with the bond. If the execution of the warrant occurs, there is an additional payment for the purchase of shares or the holder of the bond must pay to the issuer an additional amount for the shares above the price of the original bonds. Warrants are often referred to as benefits in the purchase of shares because in order to lend the assets to a company, the investors provide benefits in the form of warrants with the right to purchase shares of the company. Warrants are usually issued at the public offering of bonds with new share issues. Bearing in mind the fact that they have hybrid characteristics i.e. characteristics of both bonds and shares, issuing of these securities is frequent in practice because they make equity investment attractive to lenders. Consequently, the company that wants to be financed by issuing bonds with warrants, issues the attached warrants together with bonds, provided that the agreement on the issue of bonds is determined by the moment when the warrants are detachable from the bond (usually immediately after the issue). The main reason for the issue of bonds with warrants is reflected, on the one hand, in that the company may issue cheap bonds attaching warrants to them that allow the interest rate on the bonds to be below market interest rates on pure bonds, and on the other hand, the issue of these bonds allows the company to issue ordinary shares at a premium above the current market price, so that the issue of these bonds is de facto a delayed sale of ordinary shares at relatively high prices. Additionally, it should be borne in mind that today all warrants are detachable from bonds and that they can be traded with separately. After detachment of warrants, bonds with low interest rates remain issued, which allows the issuer to obtain additional capital independently of bonds. The main bonds and detached warrants are purchased by various types of investors for various reasons. From the standpoint of investors, the issue of bonds with warrants provides potential investors with the opportunity to become ordinary shareholders of the company. The status of ordinary shareholders provides them with significantly greater rights in terms of profit (dividends and capital income) as well as participation in decision-making in relation to decisions about the company. Bonds with warrants are attractive to a larger number of customers because the realization of warrants in the future can realize a substantial capital income if the market price of ordinary shares rises above the option price. In any case, bonds with warrants are attractive to investors because they have flexibility in terms of keeping or sale of these bonds, with or without a warrant. In addition, if a liquidation of the issuer occurs, the investor must be paid before the shareholders because bonds have priority in payment. But the placement of bonds with warrants bears the risk attached to the warrants, whereby the warrant does not bring the income. From the standpoint of the issuer company, issue and sale of

bonds with warrants increase the participation of a cheaper long-term debt in the capital structure of the company, which will have influence on the decrease the average cost of capital of the company and increase its market value. However, it also means increasing the financial risk for the company. Given the fact that with the implementation of warrants the number of ordinary shares is increased, which actually increases the share of owned capital in the total capital of the company, logically, it follows that all of this will result in the reduction of financial risk. After all, the issue of bonds with warrants is also done with the intention of future increases in the owned capital of the company.

5. Convertible bonds – are bonds that are similar to bonds with warrants, but differ from them in that the bonds with warrants consist of two independent securities (bonds and warrants) which is not the case with convertible bonds. Namely, convertible bonds are long-term securities that give their holders the right to fixed income in the form of interest, as well as the right to convert them in a certain period of time (up to maturity) and under specific conditions, into ordinary shares, preference shares or other debt securities of the issuer company. Therefore, instead of requiring the payment of debt in the form of a nominal value of bonds, investors in convertible bonds can simply convert them into shares or other securities of the company at a fixed conversion price, which is usually higher than the current market price. The conversion allows the issuer to offer a lower interest rate which makes this type of bond less sensitive to interest rate changes than is the case with pure bonds. Therefore, this type of bonds is particularly important for companies in a situation where the market conditions deteriorate, because it allows them, on the one hand, to obtain the necessary funds under favorable terms, and on the other hand, to offer shares on a predetermined date in the future and at a price higher than the current one. Once an investor converts bonds into shares or other securities of the issuer company, convertible bonds cease to exist, as do all obligations of the issuer under them. Bearing in mind the fact that with the conversion the investor can obtain ordinary shares or other securities of the issuer, which he can sell on the market and thus gain profit, the interest rate on the convertible bonds is also lower than the interest rate on pure bonds. Namely, investors hope that the price of the conversion will be lower than the future prices of shares so that they will be able to buy shares at a lower price, or to sell them at a higher price. This option to obtain profit allows the issuer company to sell convertible bonds, which carry a lower interest rate compared to pure bonds.

CONCLUSION

A company can finance its growth and development from various external sources, and one of these sources is financing through the issue of hybrid securities - preference shares and hybrid bonds. Both types of securities have their advantages and disadvantages. However, the common ground is that the company resorts to their issuing each time when it does not have sufficient funds for the realization of a particular investment project. In addition, the main advantage of financing through the issue of securities is that it gives the user the possibility to break down long-term needs for capital into smaller sums. In this way, the company can sell the issued securities to raise a considerably larger amount of funds than they would achieve by collecting funds from a single source. One of the main advantages of preference shares is that they have no maturity date and can be treated as a permanent loan. But also, by issuing hybrid bonds company seeks to mobilize capital that is essential for the growth and development. In addition, the company opts to obtain the necessary capital by issuing bonds, rather than issuing shares, because the interest is not taxed. In addition, when choosing between the issue of shares or bonds, the company always has in mind the

so-called leverage effect that issue of bonds brings. In this regard, leverage is not only a financial operation but also the financial strategy of the company, since it allows the company to borrow capital by issuing bonds (under a fixed interest rate) so that the company would generate a higher return through the productive investment from which the debt is returned. Investors are also more likely to prefer the purchase of bonds, because they are a source of steady income, since the interest is fixed. However, in the recent practice of the financial market in Serbia, corporate bonds still have not had a more prominent application, especially when it comes to convertible bonds. It is assumed that the main reasons for non-use of bonds as a way to finance companies primarily lies with the lack of practice of issuing corporate bonds in general, the lack of adequate tax incentives in bond issuing, as well as insufficient knowledge of this option by management of corporate companies and the consequences of its application. Therefore, we believe that the potential of this instrument is not fully used because neither investors nor potential issuers have recognized the clear advantages of investing in bonds, i.e. their issuing. However, recently, due to the increased interest of foreign investors in the issue of convertible bonds as well as domestic companies that want to exploit this instrument to better manage their debt, we believe that this area is gradually becoming more prominent. Consequently, there is no doubt that the hybrid capital, i.e. hybrid securities, in the period ahead will gradually become a more significant funding modality of a modern corporate company, and logically, in the following period, hybrid financing sources will increasingly gain in importance in relation to the classic loan financing.

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