

Commercial Papers As An Alternative Means Of Raising Capital For Company

INTRODUCTION:

The international market is faced with a global recession which has led to the conventional methods of funding a company that is debt (in the form of bank loans, bank overdraft and direct loan) and equity in the form of Initial Public offer, rights issue etc). Aside the recession, Companies are faced with the high cost of borrowing and rising capital. There is a need for companies to source for other means of raising cheap capital. Commercial Papers (CPs) present itself as a viable alternative of raising cheap capital for companies.

DEFINITION:

Commercial Papers (CPs) have been defined as:

A CP is an unconditional promise by a person to pay to the order of another person a certain sum at a future date. Such an instrument may or may not carry the bank's guarantee. Where the bank guarantees the CP to make it more marketable in the money market, the instrument acquires the force of a BA and the bank incurs a contingent liability. Where the CP is not secured or guaranteed by the bank (clean CP), it needs not be reported as a contingent liability.¹

Investopedia, the world largest online financial dictionary defines commercial papers as

An unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days. The debt is usually issued at a discount, reflecting prevailing market interest rates.²

What can be gleaned from the definitions above are stated as follows:

- a) CPs are debt instruments;
- b) CPs are usually unsecured although in some jurisdictions companies now issue asset backed commercial papers;
- c) They are short term in nature usually not more than 270 days which can be rolled over;
- d) They are issued by corporate entities both private and public companies what is important is that the company possess good credit rating from a recognized credit rating agency;
- e) They are issued to cover short-term receivables and meet short term financial obligations such as an LPO or a new project. They are however not used to fund fixed asset acquisition or long term funding;

¹ See Central Bank of Nigeria's guidelines on the acceptance

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- f) CPs like its cousins overdraft, bank borrowing and bonds pays fixed interest which are in some cases higher than interest payable on bonds;
- g) The interest payable on a CP are typically less than that of a bank loan;
- h) It is usually sold to investors at a discount with the interest immediately from the face of the note to the creditor. Although recently some CPs are sold based on the face value and upon maturity both the face value and the interest would be paid to the investor;
- i) Issuance of CPs are not regulated by the Securities and Exchange Commission (SEC)

Commercial papers can be issued in 2 forms namely:

1. Direct Commercial paper Issue: whereby the Issuer issues the CP directly to investors without passing through an intermediary or a third party. In this case what the issuer does is to announce the current rates of commercial papers and their maturity for the investor to choose.
2. Dealer Commercial Paper issue: this is where the issuer issues the CP through a dealer like an Investment Bank. In such a situation, the dealer would arrange for the marketing and sale of the CP and also provide advisory services like the maturity period, rates and timing.

How do commercial papers work?

Commercial papers are usually issued at a discount to the face value. What this means is that the investor acquires the paper at an amount that is lesser than the face value. Upon maturity, the investor would receive the face value of the CP. The differential between the price at acquisition and the price at maturity is the interest the investor receives for investing in the CP.

Prior to 2009 CPs issuance were not uniformed and were poorly handled by bankers and discount houses. But in November 2009 in the wake of global financial crisis and the Nigerian banking crisis, the Central Bank of Nigeria issued :XXXXXXXXXXXXXXXXX this guidelines it must be stated were not to regulate the issuers of CPs but to regulate the activities of bankers and discount houses as regards issuance and investment in CPs. The highlights of the guidelines were:

1. A CP qualifies as a financing vehicle under these guidelines if:
 - a) the issuer has 3-years audited financial statements, the most current not exceeding 18 months from the last financial year end; and
 - b) the issuer has an approved credit line with a Nigerian bank acting as an issuing and payment agent (IPA), where the bank guarantees the issue.
2. Investors in CPs shall be made aware of the identity of the issuer.
3. CPs shall only be guaranteed and not accepted since the intermediating bank is only a secondary obligor.
4. When a bank invests in a CP by disbursing its own funds, the transaction shall be reported on balance sheet and treated as a loan. However, if the bank merely guarantees the instrument, it shall be shown off-balance sheet as a contingent liability.

5. Resale of CPs by banks/discount houses shall be accompanied by adequate documentation which should be provided to Examiners on request.

The major benefit of issuing commercial paper includes:

1. CPs serves as a cheaper source of funds for corporate institution. Because the interest payable under the CP is cheaper than interest payable on bank loans, CP would provide a cheaper means of fundraising for companies.
2. Liquidity: CPs holders need not wait till maturity as there are avenues for selling CPs prior to maturity.
3. Does not require regulatory approval: CPs does not require the approval of the SEC before it can be issued. Thus reducing paperwork and other related issues that would be typical with bond issuance and bank loans.
4. Because CPs are used to finance receivables they are backed by the earnings of the issuer they help boost the liquidity and earnings of the issuer.

Despite the benefits of companies issuing CPs, there are risks associated with this class of asset. The most common risk of investing in CPs is an event of default of the issuer.

In 2008, when Lehman Brothers went bankrupt this led to a liquidity crisis in the American CP market, the United States Federal Reserve Bank proposed a set of rules to prevent further crisis in the CP market. Notably amongst these rules was the creation of an Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), which extended “nonrecourse loans” (secured loans on which lenders can seize pledged collateral to minimize loss upon default) at the primary credit rate to U.S. depository institutions and bank holding companies to finance their purchases of high quality ABCP from money market mutual funds

It is suggested that the FMDQ being the champion of CP issuance in Nigeria should be able to create a similar structure that would guaranteed CPs issued by companies in her platform.

In conclusion, the aim of any business is to reduce its cost and increase her earnings. It is fast becoming obvious that the high cost of obtaining capital from banks and other financial institutions coupled with the tedious process of obtaining capital from the conventional means would invariably reduce the earnings of the Company. CPs would help a company cut cost whilst maintaining its standard.

