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Sources of finance

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Finance can come from two sources:

- Internal Sources of Finance - is money obtained from the businesses own assets or from profits left in the business (retained profits). This form of finance is usually available from already established businesses.
- External Sources of Finance - is money obtained from sources outside the business such as institutions or individuals willing to provide the funds.

Short-, medium- and long-term finance

Short-term finance. This is money needed for the day-to-day running of a business (working capital). This is finance that lasts for one year or less. These are expected to be paid within 12 months. Examples: bank overdrafts, trade credit & debt factoring.

Medium-term finance. This is money used to purchase assets such as equipment and vehicles. This has a duration of between one and five years. Examples: leasing, medium-term bank loans and grants.

Long-term finance. This is funding obtained for the purpose of purchasing long-term fixed assets or other expansion requirements of a business. The duration may be anywhere from five to 30 years. Examples: long-term bank loans and debentures.

Internal Sources of Finance

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Personal funds. This is a key source of finance for sole traders and comes mostly from their own personal savings.

- investments shows commitment to the business to investors
- cheap and easily available
- no interest

However, it is a great risk for sole traders and the amount needs to be large to start and maintain a business.

Retained profit. This is profit that remains after a business has paid tax to the government and dividends to shareholders. It is money that is kept and reinvested back into business.

- cheap as no interest charges
- permanent and does not need to be repaid

- Start-ups will not have retained profit

Dragon's Den and Shark Tank - Venture Capitalists

Aspiring entrepreneurs pitch to five multi-millionaires, with the expertise - and the money - to turn great ideas into incredible fortunes.

Dragon's Den - Ten Tree Apparel

Shark Tank - Grinds Coffee Pouches

Making the financing decision

The size and profitably of the business are key considerations when managers make a financing choice. Small businesses are unlikely to be able to justify the cost of converting to plc status.

The following factors also influence finance choice:

- purpose of use of funds
- time (should match time of the investment)
- cost
- status and size of business
- amount required
- state of the external environment
- legal structure and desire to retain control
- size of existing borrowing (gearing)
- flexibility

External Sources of Finance

Share capital. This is money raised from the sale of shares of a limited company and is also known as equity capital. Buyers are known as shareholders. Ltd's do not sell shares to the general public but plcs do on major stock exchanges. Once a share is sold ownership is given and it cannot be retracted.

It is a permanent source of finance that does not need to be repaid by the business. There are also no interest charges. However, dividends do have to be paid to shareholders when the business makes a profit and for plcs the ownership of the company can be diluted or change hands as it is bought and sold on the public stock exchange.

Loan capital. This is also known as debt capital and is money sourced from financial institutions such as banks. Interest is charged on the loan and an amount including interest and the loan payment is usually paid monthly.

This form of finance is accessible and can be arranged quickly. The repayment is spread out over a predetermined period of time, reducing the burden to pay it as a lump sum. Large organizations can negotiate for lower interest rates. Owners still have full control of the business.

However, the loan will have to be repaid even if the business is making losses. Failure of paying back the loan may lead to the seizure of firms assets.

Evaluation - Internal sources of finance

- This type of capital has no direct cost to the business although there may be an opportunity cost and if assets are leased back after being sold, there will be leasing charges.
- Internal finance does not increase the liabilities.
- There is no risk of loss of control by original owners as no shares are sold (if a plc or Ltd.)

However, it is not available for all companies, for example newly formed ones or unprofitable ones with few spare assets.

Top 5 Global IPO'S - Initial public offering

Why do businesses need $?

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Finance is required for many business activities such as:

- Setting up a business requires start-up capital of cash injections from the owner(s) to purchase essential capital equipment and possibly premises.
- Businesses need to finance their working capital which is the money needed for the day to day running of the business. Working capital also has an accounting meaning that we will explore later.
- Business expansion needs finance to increase the capital assets held by the firm and will likely involve higher working capital needs.
- Expansion can be achieved by taking over another business. Finance is then needed to buy out the owners of the other firm.
- Special situations such as a decline in sales could lead to cash needs to keep the business stable.
- Apart from purchasing fixed assets, finance is often needed to pay for research and development into new products or invest in new marketing strategies.

The above examples will need different types of capital.

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Sale of assets. This is when a business sells off unwanted or unused assets to raise funds. This includes obsolete machinery or redundant buildings. Businesses could also sell off any excess land or equipment they may not be using.

At other times a company may decide they do not need to own an asset so will sell it and lease it back. This is known as sale and lease back.

- It is a good way of raising cash from capital that is tied up in assets that are not being used.
- There are no interest or borrowing costs incurred.

- It is an option usually only available to established businesses.
- It can be time consuming to find a buyer.

Overdrafts - The bank allows the business to withdraw more money than it currently has in its account. This is called overdrawing from the account. This is prearranged with the bank up to a certain amount (limit). It is a very flexible source of finance but does carry interest charges on the overdrawn amount and the overdrawn amount can be asked to be paid back at very short notice.

Trade credit - This is an agreement between businesses that allows the buyer of goods or services to pay the seller at a later date. The credit period offered is usually from 30 - 60 days. A major advantage is that by delaying payments to suppliers, businesses are left in a better cash position than if they paid cash immediately. However, they do lose out on the opportunity for discounts if paying cash. As well, any delay in payment could lead to poor supplier relations.

Role of finance for businesses

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Capital expenditure - this is money spent to acquire items in a business that will last for more than a year and will be used over and over again. These are known as fixed assets and include machinery, land, building, vehicles and equipment. These fixed assets are long term investments needed for the purpose of generating income and to assist businesses to succeed and grow.

Revenue expenditure - this is money spent on the day-to-day running of a business. These payments or expenses include rent, wages, raw materials, insurance and fuel. Revenue expenditures need to be paid immediately in order to keep a business functioning.

Venture capital. This is financial capital provide by investors to high-risk, high-potential start-up firms or small businesses. Venture capitalists usually fund start-ups that find it difficult to access money from other financial institutions. Venture capitalists take great risks and could lose all of their money but the rewards can be great. Venture capitalists expect a share of future profits or a sizable stake in the business in return for their investment.

This allows start-ups unlikely to get bank loans the possibility of finance. The venture capitalists also generally provides business guidance where it is needed. The disadvantage is that the venture capitalists may set high profit targets and when these are not met they usually increase their equity stake in these firms.

Debt factoring. This is when a business sells its invoices to a third party known as a debt factor. It is a financial agreement where the factor takes on the responsibility for collecting the debt. When a business sells goods on credit it creates a debtor. Any delay in the debtors payments can cause finance problems. One way to solve this is to sell the debts owed (for less) to a debt factoring company. The business gets the payment (at a discount) and the debt factoring company collects the full amount for themselves. They do lose part of their profits and if a debt collector uses harsh methods to collect that debt they can lose loyal customer.

Leasing. This is where a business enters into a contract with a leasing company to acquire (use) assets such as machinery, equipment or property. This allows a firm to use the asset without having to purchase it with cash. An advantage is that a firm does not have a high initial capital outlay to purchase the asset. As well, the leasing company is responsible for repair and maintenance of the asset. However it can turn out to be more expensive in the long run and the asset is owned by the leasing company.

Business angels. Also known as angel investors, these are very affluent individuals who provide finance capital to small start-ups or entrepreneurs in return for ownership equity in their businesses. They invest in high-risk businesses that show good potential for high returns or future growth. They may provide a one-time initial capital injection or continually support the businesses through their lifetime. An advantage is that they give more favorable financial terms as they are known to invest in the person rather than how viable a business venture is. They also focus on helping the business succeed by using their extensive business experience coupled with good financial capital.

The key disadvantage is that angel investors may assume a good degree of control or ownership in the business they invest in.

Evaluation - debt or equity capital

Which method of long-term finance should a company choose? There is no easy answer and some businesses will use both debt and equity financing.

Advantages of debt finance:

- As no shares are sold the ownership does not change.
- Loans will be repaid eventually so there is no permanent increase in liabilities.
- Lenders have no voting rights at the AGM.
- Interest charges are an expense and are paid before corporate tax is deducted while dividends on shares have to be paid from profits after tax.
- The gearing of the company increases. (ratio analysis)

Advantages of equity capital:

- It never has to be repaid - it is permanent capital.
- Dividends do not have to be paid every year, whereas interest must be paid each year

Grants. These are funds usually provided by a government, foundation, trust or other agency to business. In most cases businesses will be expected to write a proposal on how they plan to use the money. Often those who give the grant are very selective. Some foundations such as the Bill and Melinda Gates Foundation offer grants to US based organizations with a focus on promoting CSR. A key advantage is that grants do not have to be paid back. The downside is that most come with "strings attached" depending on the objective of the grant maker.

Subsidies. A subsidy is financial assistance granted by a government, a NGO, or an individual to support business enterprises that are in the public interest. Farm subsidies are common. In most cases the cash subsidies are given to help these industries survive in a very competitive environment by being able to sell at low market prices. Subsidies do not need to be repaid. Often however, there is political interference in the subsidization process.

Microfinance (recap from Unit 1)

Microfinance is the provision of very small loans by specialist finance businesses. This approach to providing small capital sums to entrepreneurs has grown in importance in recent years.

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TWO BUSINESSES - BOTH NEED FINANCE

There are many differences between Haldia Petrochemicals Ltd (HPL) and the six Khadki villagers who plan to build private water wells. However, there are two similarities - they are both situated in India and they both require finance.

HPL is a large company that has operated at a loss for several years. It needed finance quickly to prevent the business from collapsing. Finance proposals include converting loans into shares (reducing interest payments) and selling more shares to existing shareholders. The latter option was chosen and 520 million shares were issued at 25.10 Rupees each.

The six Khadki villagers needed finance to dig water wells. These would have a social benefit as well as being potentially profitable. Although poor, they each saved 100 Rupees per month for a year. Their request for a loan of 25000 rupees was rejected by a commercial bank, as the villagers had no collateral (they had no property to back the loan). However, they obtained the loan from a micro-finance bank. The interest rate was 6% per year. They repaid the loan withing tow years and they have since returned to borrow bigger amounts to finance even deeper wells. Without this "micro-finance" their business would not have started.

To consider:

- Explain the different financial needs in these two cases.
- Why were the commercial banks unwilling to lend money in both cases.
- Explain the two different sources of finance used.

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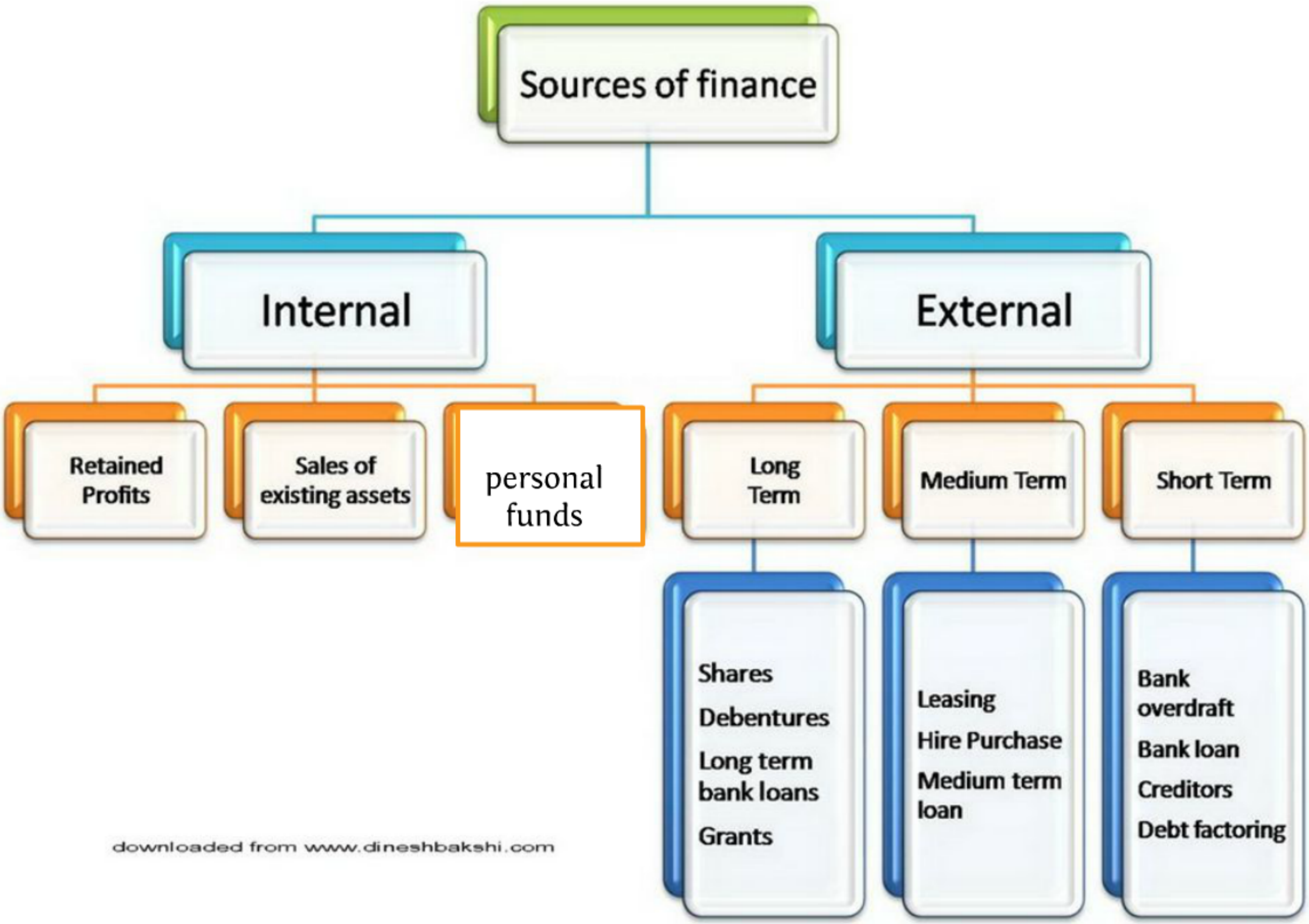

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