Lecture 18

SOURCES OF FINANCE AND GOVERNMENT POLICIES

Learning Objectives

- Sources of finance for small and medium-sized businesses.
- Types of financial assistance

Finance is needed throughout a company's life. The type and amount of finance required for a business depends on many factors: type of business, success of firm and state of the economy. There are two main types of money that a company needs.

Capital expenditure: Used for buying fixed assets where large sums of money are involved but they are not purchased often e.g. new premises.

Working capital: Day to day money required for running the business. There are two main sources of finance, these are internal sources and external sources.

Internal sources include:

Retained profit - profit made is reinvested into the business. Controlling working capital - reducing costs, delaying outflows and speeding up inflows. Sale of assets - Assets the company owns can be sold and then leased back, which frees up a large amount of capital in the short term.

External sources of finance:

Increasing trade credit - delaying payments on purchases for as long as possible.

Factoring - use a company to collect all debts.

Overdraft - an agreement with a bank to be allowed to overdraw a certain amount.

Grants - an agreed amount of money given for a special reasonby government or other organisation.

Venture capital - people invest in the company when it is unable to float on the stock market.

Debentures - business equivalent of a mortgage. Loan for a set length of time at a set interest rate.

Share issues - selling of new shares to raise capital.

Owners savings - the owners investing money into the business.

Bank loans - medium or long term loans but interest is charged.

Leasing - instead of buying. Top of Form

Sources of finance for small and growing businesses

Introduction

In this revision note, we concentrate on how small and medium- sized businesses ("SME's") obtain finance.

SME's can be defined as having three main characteristics:

- Companies are not quoted on a stock exchange – they are "unquoted"
- Ownership of the business is typically restricted to a few individuals. Often this is a family connection between the shareholders
- Many SME's are the means by which individuals (or small groups) effectively achieve self-employment

The SME sector is a vital one in the UK economy. In 1999, the Department for Trade and Industry (DTI) estimated that there are 3.7 SME businesses in the UK. Sole traders account for the majority of the businesses in the UK (63 per cent) but a smaller proportion of the number of employees (23 per cent) and an even smaller proportion of turnover (9 per cent). As a proportion of all businesses in the UK, SME's account for some 55 per cent of employment and 45 per cent of turnover.

Why do SME's find financing a problem?

The main problem faced by SME's when trying to obtain funding is that of uncertainty:

- SME's rarely have a long history or successful track record that potential investors can rely on in making an investment;
- Larger companies (particularly those quoted on a stock exchange) are required to prepare and publish much more detailed financial information – which can actually assist the finance-raising process;
- Banks are particularly nervous of smaller businesses due to a perception that they represent a greater credit risk.

Because the information is not available in other ways, SME's will have to

provide it when they seek finance. They will need to give a business plan, list of the company assets, details of the experience of directors and managers and demonstrate how they can give providers of finance some security for amounts provided.

Prospective lenders – usually banks – will then make a decision based on the information provided. The terms of the loan (interest rate, term, security, repayment details) will depend on the risk involved and the lender will also want to monitor their investment.

A common problem is often that the banks will be unwilling to increase loan funding without an increase in the security given (which the SME owners may be unable or unwilling to provide).

A particular problem of uncertainty relates to businesses with a low asset base. These are companies without substantial tangible assets, which can be, use to provide security for lenders.

When an SME is not growing significantly, financing may not be a major problem. However, the financing problem becomes very important when a company is growing rapidly, for example when contemplating investment in capital equipment or an acquisition.

Few growing companies are able to finance their expansion plans from cash flow alone. They will therefore need to consider raising finance from other external sources. In addition, managers who are looking to buy-in to a business ("management buy-in" or "MBI") or buy-out (management buy-out" or "MBO") a business from its owners, may not have the resources to acquire the company. They will need to raise finance to achieve their objectives.

Sources of finance for SME's

There are a number of potential sources of finance to meet the needs of small and growing businesses:

- Existing shareholders and directors funds ("owner financing")
- Overdraft financing
- Trade credit

- Equity finance
- Business angel financing
- Venture capital
- Factoring and invoice discounting
- Hire purchase and leasing
- Merchant banks (medium to longer term loans

A key consideration in choosing the source of new business finance is to strike a balance between equity and debt to ensure the funding structure suits the business.

The main differences between borrowed money (debt) and equity are that bankers request interest payments and capital repayments, and the borrowed money is usually secured on business assets or the personal assets of shareholders and/or directors. A bank also has the power to place a business into administration or bankruptcy if it defaults on debt interest or repayments or its prospects decline.

In contrast, equity investors take the risk of failure like other shareholders, whilst they will benefit through participation in increasing levels of profits and on the eventual sale of their stake. However, in most circumstances venture capitalists will also require more complex investments (such as preference shares or loan stock) in additional to their equity stake.

The overall objective in raising finance for a company is to avoid exposing the business to excessive high borrowings, but without unnecessarily diluting the share capital. This will ensure that the financial risk of the company is kept at an optimal level.

Types of Financial Assistance

The financing tools available to manufacturers take many forms, but four types predominate: debt, equity, tax incentives, and grants. Different tools are best suited to different needs, and manufacturers need to understand these variations in order to come up with the best fit with their financing needs.

Debt–Loans, Loan Guarantees, and Other Tools

Most public assistance to manufacturers seeks to make financial resources more available to businesses through loans, loan guarantees, and various types of interest

subsidies. Manufacturers should recognize that the general goal of all these programs is this: to make loan capital more available at the best rates and terms possible.

At the same time, manufacturers need to understand the context in which all these programs operate, namely, that they are usually available to all qualifying businesses, no matter what sector of the economy. Most programs only limit company participation on the basis of size (usually, number of employees or annual sales). The Small Business Administration (SBA) is the leading Federal agency in this arena; many States have similar programs in place as well. These programs either subsidize the cost of capital or help ensure its availability. Typically, rates of interest are at or below prevailing market rates, depending on the program's objectives and constituency. These debt programs often are used to help attract capital for expansion projects or general business operation. They also seek to support promising firms that private lenders view as high risk, as well as otherwise solid companies unable to meet standard commercial lending terms.

Depending on the specifics of any given program (i.e., what's eligible for assistance, private match required, etc.) manufacturers can use them for a variety of business capital needs—financing building construction, acquiring equipment and machinery, funding plant expansions, or supporting export activity. Some programs meet a company's need for working capital, chronically in short supply for smaller manufacturers. In recent years, SBA loan guarantees have helped a number of manufacturers who needed capital to incorporate new technologies or make important efficiency improvements.

Debt programs are designed to improve the availability and affordability of capital. Manufacturers need to realize, though, that most public program officials follow their own guidelines to minimize risk, and these may be rigid as well. They are accountable to State or Federal agency oversight, and are just as concerned about business failure as their private-sector counterparts. Therefore, to the extent, they can, manufacturers need to shape their requests for financial assistance to meet the requirements of the program being considered. As a result, capital access remains a problem for many new or small operations, despite considerable State and Federal attempts to improve it.

Although debt financing is the primary Federal financing approach, and well suited to many situations, manufacturers need to realize that debt programs will not work in every case. Loans and loan guarantees may not fit with the financial needs of various new or expanding business situations, modernization or efficiency improvements, or of manufacturers engaged in technology-related projects. Many such firms, while economically sound overall, have initial cash-flow difficulties, and debt programs require a constant stream of repayments beginning almost immediately. Manufacturers trying to modernize or diversify often must borrow considerable sums to invest in production facilities and equipment. As small manufacturers are only too well aware, many small firms fail—not from lack of demand for their products or services—but because they cannot meet debt installments. The time lag on accounts receivable, for instance, can cause an insurmountable cash-flow barrier for small businesses.

Equity

Equity-finance programs can address concerns over cash flow, because they do not feature a strict repayment schedule. Equity programs make capital more available through direct investment (and a potential return based on the success of the company), rather than by lump-sum loan proceeds (which must be repaid in installments). They promote development by investing funds in capital-poor but otherwise competitive enterprises, many of which are technologically innovative. Equity programs on a significant scale are a relatively new public-sector financial assistance phenomenon. A few States have explored venture capital-style assistance programs. At the Federal level, only SBA's Small Business Investment Company (SBIC) operates as an equity assistance program.

In terms of equity programs, manufacturers need to realize that, in practice, SBA and similar State programs makes equity investments much like a private equity investor or venture capitalist. SBA and its program partners—licensed Small Business Investment Companies (SBICs) are looking for deals that work. Investors, (in the case of SBA programs, through the SBICs), take an ownership interest in a company in exchange for funds. Equity is a riskier channel of investment than debt. If there are no profits or the business folds, the investor makes nothing or even loses its money. On the other hand, if

the company does well, the investor (private, State or SBIC) can reap a substantial return.

Equity programs operate more like a stock purchase than a debt investment, structured to give a company relief from redeeming its obligation until a certain level of return is reached. In contrast to debt financing, equity usually is more "patient" money. Because returns are a function of profit, and profit is linked to the company's success, they are not expected immediately. The timing and size of payments are geared to the company's financial condition, thus removing early cash-flow pressures and giving the firm time to use its cash to advance restructuring or modernization efforts. At the same time, though, investors usually expect a greater return on an equity investment than traditional lenders do from loans.

Tax Incentives

The only significant Federal tax incentives specifically targeted to manufacturers are industrial development bonds (IDBs) which can be used for a variety of financial needs including site preparation and equipment acquisition. IDBs are available in every State, and each State sets its own eligibility conditions and authorizes its own set of issuing entities; typically, they include State agencies, local governments, development authorities, and similar organizations.

State and local governments offer most of the tax incentives to promote manufacturing including abatements, investment incentives, exemptions or moratoriums for capital improvements, and incentives for job creation. State and local tax incentives often are linked to or packaged with Federal financing assistance. They are offered on the premise that reducing taxes lowers the cost of doing business in an area, making it more attractive for companies to locate there or to maintain or expand existing operations. The latter rationale often is cited when long-time manufacturing companies seek help to retool. Thus, manufacturers can make a stronger case for State and local tax relief or tax-code linked assistance by showing the community impact and local benefits of their proposed project.

Grants

Many manufacturers, when they decide to seek public financing assistance, think of grants. Grants are direct transfers of money to the recipient, usually with no payback

obligation. Manufacturers need to know that little direct grant assistance is available, and the competition for it is fierce—and not just from other companies, but also from healthcare facilities and social service organizations. The average grant dollar amounts for each project are kept as low as possible because grants are designed to help leverage other sources of financing. Many grants are cost-shared—requiring financial commitments from grant recipients. Most grants are done as "pass throughs"—funds are provided to an intermediary, such as a city or development organization, which, in turn, provides funds to the private company. Virtually all Federal grant assistance is delivered this way. In short, manufacturers can tap several types of public resources, and use them in a variety of ways to help finance manufacturing efficiency and modernization projects, develop new technologies and products, and help attract private investment. The most suitable approach depends on the specifics of any given program, the current development climate in a given area, and the financial requirements of the companies wanting to carry out improvements. It is limited only by the creativity of the participants.

Short Term Financing

Provides information about short term financing for businesses, it also provides some examples of sources of short term financing.

What is Short Term Financing?

Short term financing is essentially to provide capital deficit businesses funds for a short term period of a year or less.

What is short term financing for?

These funds are usually for businesses to run their day-to-day operations including payment of wages to employees, inventory ordering and supplies.

An example of short tern financing could be when a firm places an order for raw materials, it pays with finance and anticipates to recoup this finance by selling these goods over the period of a year.

Difference Between Short Term and Long Term Financing

In contrast long-term financing decisions are involved when a firm purchases a special machine that will reduce operating costs over, say, the next five years.

Following from the earlier explanation that short term borrowing should be used for working capital requirements for day to day operations of a business. Industries with

seasonal peaks and troughs and those engaged in international trade will be heavy users of short term borrowing finance.

Short Term Financing and Lenders

Lenders favor businesses that exhibit strong management, steady growth potential and reliable projected cash flow (demonstrating the business ability to pay the monthly interest payments on this line of credit from its projected.

However Lenders normally charge a higher base rate of interest for operating loans reflecting this relatively weaker security position

Example of Short Term Financing Sources

There are many methods for which a firm can seek short terms financing some of these include:

- Overdrafts
- Short-term loans
- Bills of exchange
- Promissory notes/commercial paper
- Inventory loan
- Letters of credit
- Short term Eurocurrency advances
- Factoring

Long Term Financing

Provides information on long term financing including financing sources and products.

What is long term financing?

Long term financing provides capital deficit businesses funds for the period over 1 year. It contrasts to short term financing because short term financing provides funds for the period of 1 year or less Whether an established corporation or new business entity it is common that many small and large companies have some kind of debt throughout the life of their business.

These businesses normally turn to lenders not only to expand their companies or to purchase equipment, but also to finance operating capital to even out cash flow.

What is Long-Term Debt Financing used for can include:

- Fixed Assets
- Large Capital Equipment Purchases
- Large Scale Construction Projects
- Expansion of Facilities

Corporations Vs Companies

Depending on what type of business entity you are. Which could be a sole proprietorship; partnership or corporation can affect the debt products available for the business.

Non-Corporations are limited to using debt finance while Corporations can use both debt and equity products in their long term financing strategies.

Where does the financing come from?

The basic sources of long term financing products depending on the business entity are from:

- Debt
- Equity
- Derivatives .

Types of Long term debt products include:

- Debentures
- Secured and unsecured notes
- Convertible notes
- Fixed deposit loans
- Mortgages
- Eurobonds
- Interest rates swaps
- Forward rate agreements (FRA's)
- Interest only futures
- Option on future contracts.

- Convertible notes
- Subordinated debt
- Preference shares

Medium - Term Finance

The period of one year to five years may be regarded as a medium-term. Medium term finance is usually required for permanent working capital, small expansions, replacements, modifications, etc.

Medium-term finance may be raised by

- Issue of shares
- Issue of debentures
- Loans from banks and other financial institutions
- Public deposits (for existing concerns)
- Ploughing back of profits (for existing concerns)