

Chapter

9



Sources of Finance

Lecture 9

MGM424 Financial Management

Prepared by
Dr. Mohamed Hamouda

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Sources of Finance

What Do You Need to Know for Your Exam?

- Define different sources of finance
- Advantages and Disadvantages of different sources of finance
- Purpose of different sources of finance

Exam Q – Anne wanted to raise £60,000 of start-up capital from a venture capitalist rather than arranging a bank loan. To what extent do you agree with her?

KEEP YOUR UNIT SUMMARY SHEET UP TO DATE!

What is Finance?



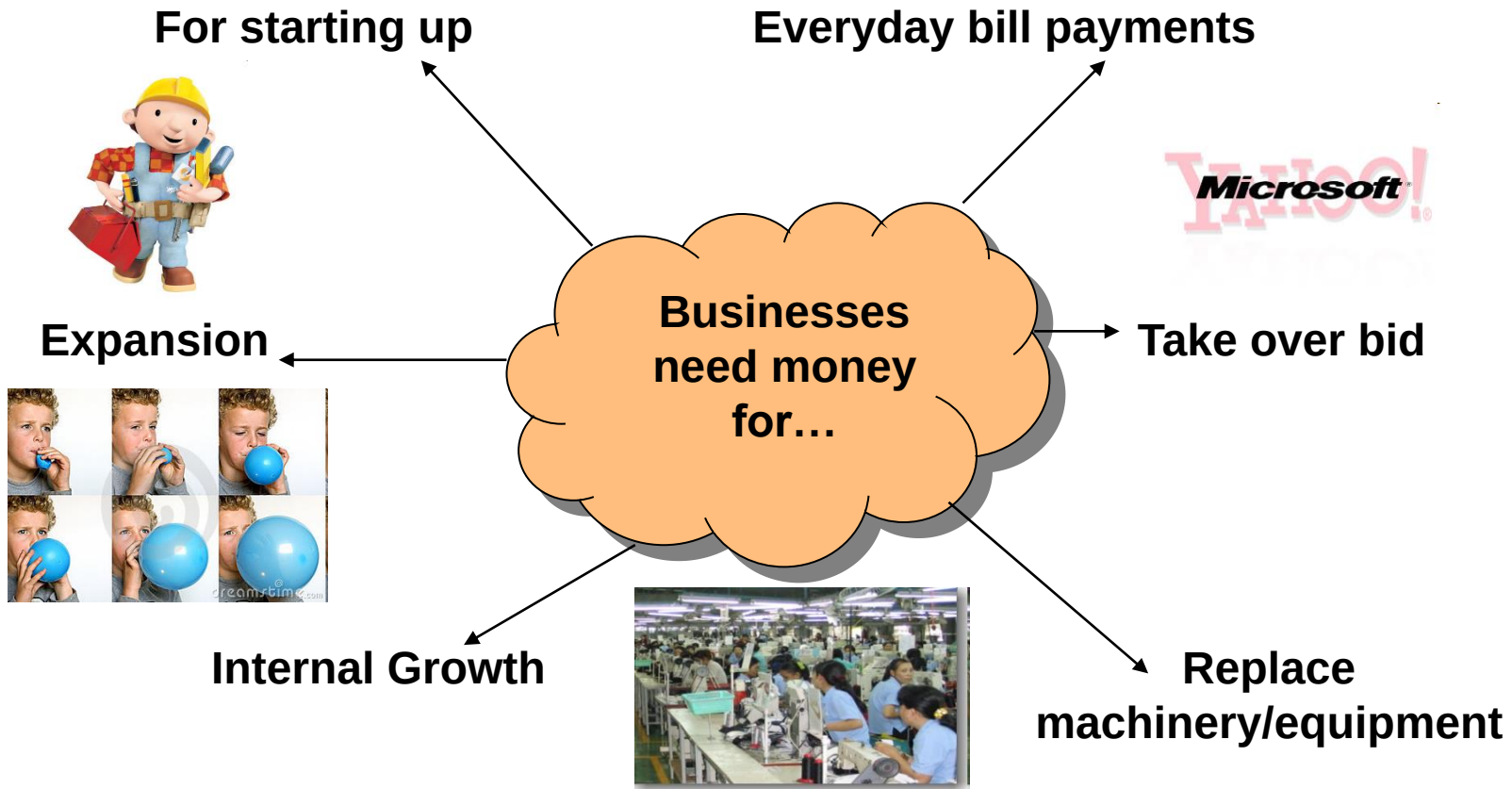
Definitions

FINANCE – This is money



SOURCES OF FINANCE – This is
WHERE we get finance from

Why Do Businesses Need Finance?



Why Do Businesses Need Finance?

- Starting Up – Buildings, machinery, raw materials and office equipment
- WORKING CAPITAL – Short term finance required for the day-to-day running of a business
- Unforeseen Events – Sudden decline in sales, large customer fails to pay on time or pay expenses quickly

“Different sources of finance have different implications for a business, so it is important that the most appropriate method of finance is chosen for the purpose that the business has in mind”

Sources of Finance

Sources of Finance
can be either:

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graph TD; A[Sources of Finance can be either:] --- B[Internal]; A --- C[External];
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Internal

External

Internal Sources of Finance

INTERNAL SOURCES OF FINANCE – Finance which is raised internally, it does not increase the debts of the business.

Examples:



Retained profit
Personal savings
Sale of unwanted assets
Sale and leaseback

External Sources of Finance

EXTERNAL SOURCES OF FINANCE – Finance provided by people or institutions outside the business, creates a debt that will require payment.

Examples:

Loans
Overdraft
Shares
Debentures



Time Periods for Finance



Finance is generally considered to be either:

SHORT TERM

UP TO 3 YEARS

**MEDIUM
TERM**

3 – 10 YEARS

**LONG
TERM**

OVER 10 YEARS

Short-term Finance

- Short-term Finance is needed for the day-to-day running of a business and is usually for a period of up to 3 years
- In order to understand short-term finance it is necessary to understand the concept of **CASH FLOW**

Cash Flow

CASH FLOW – A business needs sufficient inflows of cash to finance its day-to-day outgoings.

INFLOWS refers to money received by the business

EXAMPLES:

- Sales revenue
- Capital
- Loans
- Grants



OUTFLOWS refers to money paid out by the business

EXAMPLES:

- Purchases
- Rent & Rates
- Wages & Salaries

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Why is Cash Flow Important?

Think of a business as a bath without a plug...

Cash Flows In!!!

There should always be cash available – so the bath is never empty!



If the bath is ever empty the business is in **TROUBLE** – it has a **CASH FLOW PROBLEM**.

Cash Flows Out!!!

If this is not the case the business needs short-term finance to overcome this problem!

Sources of Short-Term Finance

All **commercial banks** offer various methods of short-term finance for businesses:

- Overdraft
- Short-term Loan



Other sources of Short-Term Finance:

- Hire Purchase (External)
- Trade Credit (Internal)

External Short-term Finance

OVERDRAFT - The bank allows the business to draw more money from their bank account than they actually have in it.

<u>Advantages</u>	<u>Disadvantages</u>
Very quick to arrange	Only suitable for smaller amounts
Only pay interest on amount overdrawn	Has to be repaid within a short amount of time
A good short term solution to a cash flow problem	Interest or charges are paid

SHORT-TERM LOAN – An amount of money is borrowed from the bank, then repaid (with interest) over a set period of time (0 – 3 years).

- Tends to be used to **buy specific pieces of equipment** or to purchase a particular consignment of raw materials in order to **fulfil a contract**
- **Not a safety net** in the way an overdraft is



Continued...

<u>Advantages</u>	<u>Disadvantages</u>
Easy and quick to set up	Interest payable
Small or Large amounts of money can be borrowed	If repayments cannot be kept up, the business risks getting a poor credit rating or being made bankrupt
Structured repayment term	

Factors Influencing a Bank's Decision to Lend

Type of Product?

Purpose of the Finance?

Past Trading Record?

Current Financial Position?

Business Proposal?

Financial Projections?

Nature of the Market/Sales forecast?



Banks Use this Information to...

- Determine who qualifies for lending
- Determine what interest rate they will lend at

INTEREST RATE - cost of borrowing money (reward for savings)

- What credit limit to set
- Banks also use this information to determine which customers are likely to bring in the most revenue

Security

SECURITY – Something that acts as assurance to a lender that it will get its money back if a business is unable to pay back money it has borrowed.



If a business fails to repay the loan, the bank – as holder of the deeds – is legally entitled to sell the factory or office in order to recover any amount outstanding on the loan.

Other External Short-term Finance

HIRE PURCHASE – Pay for an item in instalments, to a hire company, over a set period of time. The item is being hired until the last payment is made.

<u>Advantages</u>	<u>Disadvantages</u>
Large sum of money does not have to be found at once	High interest is often charged
Spread payment over a period of time	Item doesn't belong to the business until the end of the term
Improved cash flow	

Internal Short-term Finance

TRADE CREDIT - Items are bought from suppliers on a **‘buy now pay later’** basis.

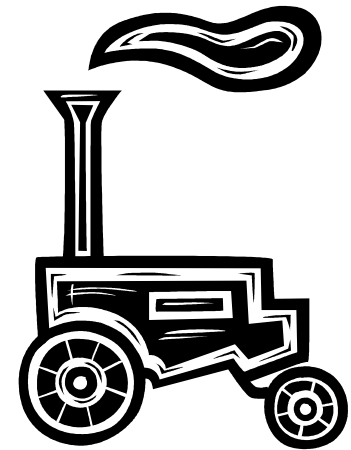
<u>Advantages</u>	<u>Disadvantages</u>
Gives the business more cash to use in the immediate future	Can only be used to buy certain goods
Does not incur interest charges	Bills usually have to be settled within 30,60 or 90 days

Medium-term Finance

- Medium-term Finance is normally thought of as being for between 3 – 10 years.

Purpose of obtaining medium term finance:

- Replace expensive equipment
- To expand
- Convert persistent overdraft into formal medium-term loan



Sources of Medium-term Finance

Various different forms of medium-term finance are available to a business:

- Medium-term Loan
- Hire purchase
- Leasing



External Medium-term Finance

MEDIUM-TERM LOAN - An amount of money is borrowed from the bank, then repaid (with interest) over a set period of time (3 – 10 years).

The **rate of interest** charged is **particularly important!**

The rate of interest payable on a medium-term loan depends on:

- How much is borrowed
- How long the money is wanted for
- The security that is provided

Businesses have the option to choose either a **variable rate** or a **fixed rate loan**.

VARIABLE RATE – interest varies with whatever decisions the Bank of England make with regard to interest rates.

FIXED RATE – interest is fixed for the duration of the loan.

Continued...

<u>Advantages</u>	<u>Disadvantages</u>
Fixed Rate: ● Know what repayment costs are going to be ● Financial planning is easier	Fixed Rate: ● If the rate falls still have to pay the higher fixed rate
Variable Rate: ● If the rate falls business pays the new lower rate	Variable Rate: ● Don't now what repayment costs are going to be ● Financial planning is more difficult

HIRE PURCHASE – Mentioned before -
can also be medium-term finance.

LEASING – Pay instalments over a set
period of time to rent an item – business
**never actually owns
the item!**

Continued...

<u>Advantages</u>	<u>Disadvantages</u>
Large sum of money does not have to be found at once	High interest is often charged
Spread payment over a period of time	Item doesn't belong to the business
Improved cash flow	
Leasing company is responsible for maintenance of item	

Long-term Finance

- Long-term finance is usually thought of as being for periods in excess of 10 years.
- This Finance is for securing the resources for **long-term growth**.



Sources of Long-term Finance

For the long-term, a business essentially has the choice of raising finance by **borrowing** or through the **issue of shares**.

Sources of Long-term Finance:

- Long-term loans (External)
- Issue of shares
- Sale and leaseback (Internal)
- Retained profit



External Long-term Finance

LONG-TERM LOAN - An amount of money is borrowed from the bank, then repaid (with interest) over a set period of time (10 years +).

- Used for **expensive** pieces of **machinery**
- Loans for buildings – **mortgages**
- Variable Rate or Fixed Rate
- **Fixed Rate** – not fixed for whole length of the loan

Advantages and Disadvantages as before!

ISSUE OF SHARES - A share in the business is sold to an individual or another business - also known as equity finance. This money is then used to purchase new assets.

- Shareholders are entitled to a dividend (share of company profits)

RIGHTS ISSUE – When a company issues more shares.

Continued...

This type of finance is only available to a company:

- **Private Company (Ltd)** – restrictions on the transfer of shares and value not readily available as they are not traded in a market.
- **Public Company (Plc)** – Shares are traded on the stock market.

STOCK MARKET - A market where shares and debentures are bought and sold.

Continued...

<u>Advantages</u>	<u>Disadvantages</u>
No need to repay the money invested	Need to pay the shareholders a share of future profits
Cheaper than a loan	Original owners may lose control of the business
Some businesses can raise large sums of money this way	Risky for the shareholder - the investment may be lost if the business fails

Internal Long-term Finance

SALE AND LEASEBACK – Asset is sold but then leased back – usually for a long period of time.

<u>Advantages</u>	<u>Disadvantages</u>
Large sum of money is created	High interest is often charged
Business can operate as normal after the sale	Item doesn't belong to the business anymore
Leasing company is responsible for maintenance of item	No guarantee that lease will be renewed

RETAINED PROFIT – Profit retained for the purpose of using in the future.

<u>Advantages</u>	<u>Disadvantages</u>
No need to pay interest on the money	Could have been invested elsewhere, earning a higher profit
	The business may not have enough retained profit to meet its needs
	Shareholders may become unhappy if this means lower dividend payments

Other Sources of Finance

Other sources of finance include:

- Government Assistance
- Venture Capital
- Business Angles

Government Assistants falls into two categories – assistance with obtaining a loan and regional aid.

THE SMALL FIRMS LOAN GUARANTEE SCHEME (SFLG) – Government provided security scheme which began in 2003, to enable small firms with little security to get finance.

Continued...

- Targeted at smaller businesses
- **Not** a loan from the **government** but from a bank
- Bank will want to see the usual documents
- **Decision to lend lies with the bank!**
- **Government provides 75%** of the security via the **Department for Business, Enterprise and Regulatory Reform**

REGIONAL DEVELOPMENT ASSISTANCE (RDA) –

Government financial assistance available if the business is located, or is prepared to locate, in certain areas of the UK.

- Usually areas where traditional industries have been in decline
- Business must safeguard and create jobs or grow so that it can compete more effectively at home or abroad
- Available to small and large businesses

Continued...

INCENTIVES:

- Tax incentives
- Sale of land or property at discounted rate
- Reduced rent

GRANTS:

- Investment in equipment
- Training or retraining
- Research and Development



Continued...

VENTURE CAPITAL – Individuals or firms who lend money, known as venture capital.

A venture capitalist might agree to provide a certain amount of **finance in exchange for a high % of the company's shares** and might adopt a “take it or leave it” approach.

BUSINESS ANGELS – Individuals or firms who offer management advice as well.

A Business's Choice of Finance

The business's **choice** of source of finance **depends on several factors!**

There are too many considerations...I don't know which sources to choose!!!



Continued...

- The type of business – Sole traders and partnerships cannot issue shares
- The amount of control desired – Becoming a partnership or company can weaken control
- Security – A lack of security may mean that banks are unwilling to grant a loan
- Existing levels of debt – If high banks will think twice about lending

- Internal Funds – If the business uses them for finance there will be no interest to pay; but once used the firm has no cushion to fall back on
- Length of time – How long will it take to generate the funds to pay back investment
- Current methods of finance being used – Inappropriate financial management will discourage the bank from lending

Recap...

	<u>Short-term</u>	<u>Medium-term</u>	<u>Long-term</u>
EXTERNAL	● Overdraft ● Short-term Loan ● Hire Purchase	● Medium-term Loan ● Hire Purchase ● Leasing	● Long-term Loan ● Shares ● Debentures
INTERNAL	● Trade Credit	● Retained Profit	● Retained profit ● Sale of Assets ● Sale and Leaseback

Continued...

