Modes of financing for start-ups

Small Industries Development Bank of India (SIDBI)
http://smallb.sidbi.in

Finance is required by a business enterprise at almost every stage of the business life cycle. MSMEs often find it difficult to arrange adequate finance for their operations as well as for expansion and growth. These enterprises can raise finance by various methods. Below are some of the ways to raise long term and short term capital.

Sources of long term capital

Reinvestment of profits

Profitable companies do not generally distribute the whole amount of profits as dividend but, transfer certain proportion to reserves. This may be regarded as reinvestment of profits or ploughing back of profits. As these retained profits actually belong to the shareholders of the company, these are treated as a part of ownership capital. Retention of profits is a sort of self financing of business. The reserves built up over the years by ploughing back of profits may be utilised by the company for the following purposes:

- Expansion of the undertaking
- Replacement of obsolete assets and modernisation
- Meeting permanent or special working capital requirement
- Redemption of old debts

The benefits of this source of finance to the company are:

- It reduces the dependence on external sources of finance
- It increases the credit worthiness of the company
- It enables the company to withstand difficult situations
- It enables the company to adopt a stable dividend policy
- It increases the debt raising capacity of the company

Loans from commercial banks / financial institutions

Medium and long term loans required for setting up projects can be obtained from banks and \or financial instituitions for all viable projects. Similarly, funds required for modernisation and renovation schemes can be borrowed from them. Such loans are generally secured by mortgage of the Company's properties, pledge of shares, personal guarantees etc.

Public deposits

Companies often raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. The Companies Act permits such deposits to be received for a period up to 3 years at a time. Public deposits can be raised by companies to meet their medium-term as well as short-term financial needs. The increasing popularity of public deposits is due to:

- The rate of interest the companies have to pay on them is attractive.
- These are easier methods of mobilising funds than banks, especially during periods of credit squeeze
- They are unsecured

Risk capital

Risk capital denotes the provision of capital where the provider reduces the risk burden of the entrepreneur, and in turn bears some part of the overall risk involved in a productive activity. As per a definition widely used in India – The term 'risk capital' includes equity as well as mezzanine/ quasi equity financial products that have features of both debt and equity. Risk Capital is an important instrument for not only start-ups and innovative / fast growing companies but is also critical to those companies looking at growth. Risk capital substitutes promoter's contribution, thereby reducing the capital to be brought by the entrepreneurs. Under such cases, Risk capital is one of the most viable options for raising capital for MSMEs. Some of the major risk capital options available for MSMEs include Venture Capital, Angel Investment and Public Listing.

Issue of shares

It is the most important method. The liability of shareholders is limited to the face value of shares, and they are also easily transferable. A private company cannot invite the general public to subscribe for its share capital and its shares are also not freely transferable. But for public limited companies there are no such restrictions. There are two types of shares :-

- Equity shares: the rate of dividend on these shares depends on the profits available and the discretion of directors. Hence, there is no fixed burden on the company. Each share carries one vote.
- Preference shares: dividend is payable on these shares at a fixed rate and is payable only if there are profits. Hence, there is no compulsory burden on the company's finances. Such shares do not give voting rights.

Issue of debentures

Companies generally have powers to borrow and raise loans by issuing debentures. The rate of interest payable on debentures is fixed at the time of issue and the debentures have a charge on the property or assets of the company, which provide the necessary security. The company is liable to pay interest even if there are no profits. Debentures are mostly issued to finance the long-term requirements of business and do not carry any voting rights.

Sources of short term capital

Trade credit

Companies buy raw materials, components, stores and spare parts on credit from different suppliers. Generally suppliers grant credit for a period of 3 to 6 months, and thus provide short-term finance to the company. Availability of this type of finance is connected with the volume of business. When the production and sale of goods increase, there is automatic increase in the volume of purchases, and more of trade credit is available.

Factoring

The amounts due to a company from customers, on account of credit sale generally remain outstanding during the period of credit allowed i.e. till the dues are collected from the debtors. The book debts may be assigned to a bank and cash realised in advance from the bank. Thus, the responsibility of collecting the debtors' balance is taken over by the bank on payment of specified charges by the company. book debts may be assigned by the seller to a FACTOR, who who will provide about 80 - 85 % or more of the value of the book debt, as advance to the seller. The FACTOR will also undertake the task of collecting the amount representing the debt (credit sales) from the debtors. Factoring is an important avenue of raising short funds against the receivables for the MSME units. The charges payable to the FACTOR is treated as cost of raising the funds

Discounting bills of exchange

This method is widely used by companies for raising short-term finance. When the goods are sold on credit, bills of exchange are generally drawn for acceptance by the buyers of goods. Instead of holding the bills till the date of maturity, companies can discount them with commercial banks on payment of a charge known as bank discount. The rate of discount to be charged by banks is prescribed by the Reserve Bank of India from time to time. The amount of discount is deducted from the value of bills at the time of discounting. The cost of raising finance by this method is the discount charged by the bank.

Bank overdraft and cash credit

It is a common method adopted by companies for meeting short-term financial requirements. Cash credit refers to an arrangement whereby the commercial bank allows money to be drawn as advances from time to time within a specified limit. This facility is granted against the security of goods in stock, or promissory notes bearing a second signature, or other marketable instruments like Government bonds. Overdraft is a temporary arrangement with the bank which permits the company to overdraw from its current deposit account with the bank up to a certain limit. The overdraft facility is also granted against securities. The rate of interest charged on cash credit and overdraft is relatively much higher than the rate of interest on bank deposits.

Science Policy Information Network

The Science Policy Information Network (SPIN) is a revolutionary cluster of databases equipped with powerful graphical and analytical tools that has been devised for decision-makers and specialists in science, technology and innovation (STI). SPIN is a sophisticated information system that includes:

- A detailed inventory in Spanish and English of each national innovation system in the region, with a description of their institutional structure and details of their main programmes, priorities, performance, planning and strategies for international co-operation;
- A database encompassing all the relevant legal frameworks in each country;
- An inventory with detailed descriptions of more than 900 different technical and financial science policy instruments implemented by the 33 countries in the region, divided into nine categories by objective and strategic goal, into 11 categories by type of facility and into 18 categories by type of beneficiary;
- A database containing 170 descriptions of national and international organizations and other NGOs which provide technical and financial co-operation in science and technology. These institutions are classified by area and type of co-operation, geographical focus and type of beneficiary;
- A powerful geo-referenced analytical software (Stat Planet) in Spanish and English which includes more than 450 temporal series, some of them ranging from 1950 to the present time. These time series encompass different groups of indicators: economic, social, governance, gender, environmental, ICT and STI. The Stat Planet software also allows for an analytical estimation of correlations between pairs of indicators. The evolution of different indicators can also be studied over time and compared with other regions or countries to allow decision-makers and specialists to detect different patterns in the data;
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Financing SMEs and entrepreneurs 2016

An OECD Scoreboard

Organisation for Economic Co-operation and Development

http://www.oecd.org

Financing for small and medium-sized enterprises (SMEs) has turned the corner from the downswing seen during the global financial crisis, but overall credit conditions remain challenging and access to external finance continues to be much tighter for SMEs than larger firms, according to a new OECD report.

Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard underlines that SMEs remain over-reliant on bank financing and points out the need for a diversification of financing sources and instruments. The Scoreboard provides comprehensive data on debt, equity, asset-based finance, solvency and the framework conditions for SMEs and entrepreneurs, along with an overview of policy measures to ease SMEs' access to finance in 37 countries. The OECD presented the report to G20 Finance Ministers and Central Bank Governors in Washington as part of wider discussions on developing policies to boost diversification of financing instruments, a key priority of China's G20 Presidency.

"Finance is one of the keys for unlocking the potential of small firms to innovate, upgrade and become more productive," OECD Secretary-General Angel Gurría said during a presentation of the Scoreboard with Zhou Xiaochuan, Governor of the People's Bank of China, just prior to the G20 Finance Ministers meeting on 14-15 April in Washington. "The OECD's new SME Scoreboard shows that while access and conditions to traditional credit for SMEs have improved since the worst point of the global economic crisis, governments can and should do more to tackle the longstanding obstacles to SME financing," Mr Gurría said.

Governor Zhou said: "SMEs and entrepreneurs can play an active role in achieving stronger and more inclusive growth, and it is now time to show our commitment to enabling the development of alternative funding options." He welcomed the new OECD Scoreboard, which he said would support efforts to develop policy recommendations on diversified financing for SMEs during China's G20 Presidency. "The OECD Scoreboard is a valuable tool to support G20 work, and to monitor trends and the implications of financial reforms for small and medium-sized enterprises."

The fifth annual edition of the OECD Scoreboard highlights developments in SME financing over the 2012-14 period. On the positive side, it shows that the outstanding stock of SME loans rose in 16 out of 27 countries, and new lending in 2014 surpassed 2013 levels in most countries. Similarly, credit conditions eased and interest rates on new loans to SMEs declined in 2014 in the majority of countries studied.

On the negative side, the interest rate spread between loans to SMEs and those to larger firms continued widening. This suggests that the risk perception of SME lending has increased over time. This perception appears out of synch with new data showing a clear downward trend in SME bankruptcies, which declined during 2014 in 20 out of 25 countries for which full data was available.

A special chapter in this year's Scoreboard focuses on how so-called Business Angel investors can help bridge the financing gaps for firms with high risk-return profiles during the early stages of development, and notes their importance in providing business advice, mentoring and networking opportunities. It also underlines the need to improve the evidence base to enable a better understanding of the potential of Business Angel investment to finance SMEs, and support the design of appropriate policy making.

Highlights

- Lending to SMEs improved in 2014. For most OECD countries, economic growth increased between 2012 and 2014, and financial conditions were overall favourable in the majority of participating countries, impacting SME lending favourably.
- Credit conditions generally eased in 2014, but remain overall challenging for many SMEs.
- The interest rate spread remained positive for all participating countries over the entire 2007-14 period, with SMEs consistently facing higher average interest rates for loans than large firms.
- SME bankruptcies showed a clear downward trend in contrast to previous years.
- Recent trends in non-performing loans (NPLs) are mixed, and NPLs could pose a threat to the economic recovery in some economies.
- Venture capital (VC) investments and leasing volumes showed encouraging signs of recovery, but remain below pre-crisis levels in most countries.
- The use of some alternative financial instruments continues to grow, but often from a small base.
- Evidence suggests that business angel investing plays an important role in financing young, innovative and high-growth firms.
- Loan guarantees remain the most widely used policy instrument used by governments to facilitate SME access to finance.
- SME finance remains high on the political agenda, and governments are developing new policy initiatives