Modes of financing for startups

Smallb.in, An Initiative of Small Industries Development Bank of India

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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.

Global SME Finance Facility

The Global SME Finance Facility is a blended-finance partnership focused on helping to close the financing gap faced by SMEs in emerging markets. Catalyzing access to finance for SMEs, the facility has a goal of generating one million new jobs in the SME sector. The facility dedicates its efforts toward the most underserved SME segments, such as SMEs in fragile countries, very small enterprises, and women-owned SMEs.

A global partnership, the facility responds to a G-20 call for expediting SME financing and growth. To support this growth, the facility provides funding, risk mitigation and advisory assistance to financial institutions. This helps institutions expand lending to SMEs in challenging markets and segments. In addition, the facility aids governments with improving their nations› financial infrastructure, enabling capital to flow more efficiently to SMEs.

In its first years, the facility has proven the power of its multi-pronged approach and partnership model. By 2016, the facility had supported 56 client financial institutions. These institutions lent more than $6 billion through 67,000 new loans to SMEs. The facility›s activities had helped generate 414,000 new jobs after four years. Joining forces with other organizations accomplishes more than any single one can. For this reason, the IFC-managed facility blends commercial financing from IFC and the European Investment Bank with donor funding from the UK Department for International Development (DFID) and the Netherlands Ministry of Foreign Affairs.

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Starting a business: source of funds

SME Corporation Malaysia

http://www.smecorp.gov.my

How much money do you need?

It depends on your type of business and how quickly you plan to expand. You should sit down and write out how much your expected expenses will be for at least the next 24 months and how much you project to bring in as far as income on a monthly basis. There are several companies that can help you get started with funding your business. You can refer back to your business plan or start asking yourself what type of expenses do you need the money for? Generally, for a start-up business, there will be a few costs involve:

- **Cost of sales:** Product inventory, raw materials, manufacturing equipment, shipping, packaging, shipping insurance, warehousing
- **Professional fees:** Setting up a legal structure for your business , trademarks, copyrights, patents, drafting partnership and non-disclosure agreements, attorney fees for ongoing consultation, retaining an accountant
- **Technology costs:** Computer hardware, computer software, printers, cell phones, PDAs, website development and maintenance, high-speed internet access, servers, security measures, IT consulting
- **Administrative costs:** Various types of business insurance, office supplies, licenses and permits, express shipping and postage, product packaging, parking, rent, utilities, phones, copier, fax machine, desks, chairs, filing cabinets – anything else you need to have on a daily basis to operate a business
- **Sales and marketing costs:** Printing of stationery, marketing materials, advertising, public relations, event or trade show attendance or sponsorship, trade association or chamber of commerce membership fees, travel and entertainment for client meetings, mailing or lead lists
- **Wages and benefits:** Employee salaries, payroll taxes, benefits, workers compensation

No matter what your business type, take into account everything you will spend, from the moment you dig in to the startup process, through the time you're ready to sell a product or service.

Where to get the money?

All businesses require some form of financing. The most basic rule in financing a business is to commit yourself and your savings or other resources to the business. This will ensure your whole hearted commitment to its success. This is also a strong sign of good faith and commitment for other potential lenders/investors as, if you are not seen to be willing to risk your own funds why anyone else should! Further, for a start-up business, there may not be a wide variety of sources of funds as it is still untested. Hence, you will have to come up with the capital, from personal savings or through selling off surplus assets you may have.

Personal saving

There's nothing like having your own money saved, to put into your startup. You have the satisfaction of having saved it on your own, and the knowledge that you don't owe anyone. When using your own money to finance a business, you will feel more personally invested in the project, because it is basically your money on the line. However, there is more flexibility in using your own money. For example, if your business is having a slow start, you do not need to worry about paying back a bank loan because you used your own money.

But the risk you may face is that - It's your money, and if you're not successful, the money is gone, and with it the opportunity to do anything else with it later. It can also create another financial burden. Most people have a savings account for general purposes. In other words, the money is not saved for any particular purpose and is used whenever it is needed for whatever reason. As such, draining such an account may negatively affect your financial situation if you need to dip into that savings account for an emergency. However, if the personal savings you use to finance a business was money saved for that particular purpose, you should not have any financial troubles as a result of the draining of that account. If your savings account was set up for the purpose of opening a business, this means that you planned ahead and reserved that savings account for that purpose only, and thus, will not feel the pinch in an emergency because you will have other funds available for that purpose.

Financing with debt

Financing a business with debt involves securing a loan. This can be in the form of either unsecured or secured debt. Unsecured debt refers to a loan taken without having to put up any specific form of security or collateral. This involves mainly borrowing from family or friends, a credit card, line of credit and other similar means.

Secured debt, on the other hand, refers to loans where you are required to put up some form of collateral in exchange for the loan, for example, mortgage on the house or refinancing your car, among others. For secured debts, you need to be able to assure the lender about your ability to meet your payments either through your business or other means. To secure such debt is some cases you will need to present a solid business plan, evidence of your experience and of your ability to repay.

Family and friends

Raising finance from family and friends can be rewarding for both parties: you get the finance to start or expand your business, while your family and friends have the satisfaction of helping you while earning interest on their spare cash. Family and friends may accept more flexible terms and conditions that are better suited to your business than those offered by commercial banks.

Often arrangements with family and friends are informal and based purely on trust and verbal assurances. However, a formal written agreement is strongly advised in order to minimise disputes in the future. Preserving your relationships with friends and family is as important as pursuing your business opportunity.

Personal loan

Financing a business with personal loans means that you borrow the money personally to invest it in your business. This is typically used at start-up or early stages where the business has not established enough history or performance to be able to secure a loan on its own merit.

Mortgage loan

Another source for financing a business is a home mortgage loan. Some banks allow you to mortgage or refinance your house. This may be a risky move as if you are unable to make the scheduled payments, you risk losing your home. It is therefore crucial that you are confident on your continued ability to make all payments scheduled.

Insurance loan

Another source of loan could be from your insurance policy. If you have been paying for a life insurance policy that builds up a cash value you are entitled to take up a loan on the cash value amount. Many insurance companies will loan you money with the cash value as security. This is a rather expensive method of financing a business and also means reduced benefits if you are unable to clear the loan and interests accrued.

Credit cards

Credit cards can also be a source for financing a business when you are first getting started. However, this is another expensive method as the rates charged can be high and it could also affect your credit rating, required for other sources of financing.

Government small business loans

There are a variety of government small business loans and programs that can be used in financing a business, including those specifically for Bumiputeras and micro entrepreneurs. Most of these loans are administered by the Financial Institutions like the Development Financial Institutions (DFIs) and the commercial banks. While some are directly administered by the department/agency involved. Funding from these sources may be relatively easier to secure as the government department/agency guarantees your loan, if you are approved.

Grants

There are often a variety of government grant programs for specific types of startup businesses. For more information, search online on government websites. Unless they're reputable, don't pay money to sites that tell you they'll give you a big list of where you can get grant money. The risk is that - While grants are rarely required to be paid back, accountability is higher, and you might have to work within a difficult deadline, to show your progress. If you do not achieve the progress you indicated in your proposal, there may be some sort of penalty.

Bank loans

Banks lend money to existing businesses but for a start-up, it may be very difficult to get a bank loan as they do not have a track record. Banks require a sound business plan and must be convinced of the viability of your business before they agree to lend you money. Banks also normally need collateral as security. If you have a solid business plan and the lender agrees, this can often be the cheapest (interest rate-wise) loan sources available. The risk is that besides the fact that it's often hard for a startup to qualify - since there's little evidence you'll be profitable - if you do get a loan, it can be like a ticking time bomb if your business isn't doing well.

Equity financing

Equity Financing is borrowing where the investor/financier becomes a part-owner of the business in the process. This could be through venture capital or issuing shares.

Venture capital

Venture capitalists do not want to remain in your business forever. Generally, they want to see an exit strategy that will see them out in about 5 years, with a high return on their investment as their reward. In terms of areas of interest, venture capitalists are interested in both high technology and various other industries. Normally they fund businesses which have already been launched and have probably reached profitability.

The angel investor, on the other hand, is a special type of venture capitalist. Usually an individual with substantial funds, the 'angel' provides capital to start-up companies and takes a personal stake in the venture. Depending on the individual 'angel', their requests for any form of control or a quick return on investment will differ. However, similar to regular venture capitalists, they seek high returns on their investment for the risks they take on.