Chapter 9: Financing business activity

Why do businesses need finance?

Businesses need **finance**, or money, to pay for their overhead costs as well as their day to day and variable expenses. Here are three situations when businesses need finance the most:

- **Starting a business**: Huge amounts of finance is needed to start a business which requires buying fixed assets, paying rent and other overheads as well as producing or buying the first products to sell. The finance required to start up a business is called **start-up capital**.
- **Expanding a business**: When expanding, a lot of capital is needed in order to buy more fixed assets or fund a takeover. Internal growth by developing new products also requires a notable amount of finance for R&D.
- **A business in difficulties**: For example, for loss making businesses money is needed to buy more efficient machinery, or money is needed to cover negative cash flow. However, it is usually difficult for these firms to get loans.

All all cases, businesses need finance for either **capital expenditure** or **revenue expenditure**:

- **Capital expenditure:** Money spent on fixed assets.
- **Revenue expenditure:** Money spent on day-to-day expenses.

Sources of finance

There are many ways to obtain finance, and they can be grouped in these ways.:

- **Internal** or **external**.
- **Short-term**, **medium-term** or **long-term**.

Internal finance:

This is finance that can be taken from within the business itself. There are advantages and disadvantages to each of them:

- **Retained profit:** Profit reinvested into a business after part of the net profit has been distributed to its owners.
  - + Retained profit does **not** have to be **repaid** unlike a loan.
  - - New businesses **do not have much** retained profit.
  - - Retained profit from small firms are **not enough** for**expansion**.
  - - **Reduces payment** to owners/shareholders.
- **Sale of existing assets:** Firms can get rid of their unwanted assets for cash.
  - + Makes better **use** of capital that is not used for anything.
  - - Takes time to sell all of these assets.
  - - New businesses do not have these assets to sell.
- **Running down stocks:** Sell everything in the current existing inventory.

- + Reduces **opportunity cost** and **storage costs** of having inventory.
- - Risks **disappointing** customers if there are not enough stock left.

- **Owners' savings:** Only applies to businesses that do not have limited liability. Since the legal identity of the business and owners are the same, this method is considered to be internal.
  - + **Available quickly**.
  - + **No interest** paid.
  - - **Limited** capital.
  - - Increases **risks** for owners.

External finance:

This is money raised from individuals or organisations outside a business. It is the most common way to raise finance.

- **Issue of shares:** Same as owners' savings, but only available to limited companies.
  - + A **permanent** source of capital that does not have to be**repaid**.
  - + **No interest** paid.
  - - **Dividends** will have to be paid.
  - - **Ownership** of the company could change hands to the**majority shareholder**.
- **Bank loans:** money borrowed from the bank.
  - + **Quick** to **arrange**.
  - + **Variable** lengths of **time**.
  - + **Lower rates** offered if a large company borrows large sums.
  - - Must be **repaid** with **interest**.
  - - **Collateral** is needed to secure a loan and may be **lost**.
- **Selling debentures:** These are long-term loan certificates issued by limited companies.
  - + These can be used to raise **long-term finance**, e.g. 25 years.
  - + No **collateral** is required, just the **trustworthiness** of a big company.
  - - Must be **repaid** with **interest**.
- **Factoring of debts:** Some businesses (**debt factors**) "buy" **debts** of a firm's **debtors** (e.g. customers) and pay the firm cash in return. The firm now does not worry about worrying about whether their customers will pay or not and 100% of all the debts goes to the factor. Factoring debt is very difficult for me to understand and explain, so explore http://business-debt.cleardebts.co.uk/factoring.html for more information.
  - + **Immediate cash** is obtained.
  - + **Risk** of collecting debt becomes the factor's.
  - - The firm does **not receive 100%** value of the debt.
- **Grants and subsidies:** can be obtained from outside agencies like the**government**.
  - + Do **not** have to be **repaid**.
  - - They have **conditions** that you have to fulfill (e.g. locating in poor areas).

Short-term finance:

This is **working capital** required to pay **current liabilities** that is needed up to three years. There are three main ways of acquiring short-term finance:

- **Overdrafts:** Allows you do draw more from your bank account than you have.
  - + Overdrafts can **vary** every month, making it **flexible**.
  - + **Interest** only needs to be paid only to the **amount overdrawn**.
  - + They can turn out **cheaper** than loans.
  - - **Interest rates** are **variable**, and often **higher** than loans.
  - - The bank can ask for the **overdraft** back immediately **anytime**.
- **Trade credits:** Delaying payment to your creditors, which leaves the company with better cash flow for that month.
  - + It is almost a short-term **interest free** loan.
  - - The supplier could **refuse** to give **discounts** or to **supply**you at all if your payments are delayed too much.
- **Factoring of debts**

Medium-term finance:

Finance available for 3 to 10 years that is used to buy fixed assets such as machinery and vehicles.

- **Bank loans**
- **Hire purchase:** This allows firm to pay for assets over time in monthly payments which has interest.
  - + The firm does **not** have to come up with **a lot of cash**quickly.
  - - A **deposit** has to be paid at the start of the period of payment.
  - - **Interest** paid can be **very high**.
- **Leasing:** Hiring something. Businesses could use the asset but will have to pay monthly. The business my choose to buy the asset at the end of the leasing period. Some businesses sell their fixed assets to a leasing company who lease them back so that they could obtain cash. This is called **sale and leaseback**.
  - + The firm does **not** have to come up with **a lot of cash** quickly.
  - + The leasing firm **takes care** of the assets.
  - - The total leasing costs will be **higher** than if the business has purchased it.

Long-term finance:

This kind of finance is available for more than 10 years. The money is used for long-term fixed assets or the takeover of another company.

- **Issue of shares:** Shares are sometimes called **equities**, therefore issuing shares is called **equity finance**. **New issues**, or shares sold by public limited companies can raise near limitless finance. However, a business will want to give the **right issue** of shares so that the amount bought by shareholders will not upset the balance of ownership.
  - + A **permanent** source of capital that does not have to be **repaid**.
  - + **No interests** paid.

- - **Dividends** will have to be paid. And they have to be paid after **tax** (so taxes become higher), while interest on loans are paid before taxes.
- - **Ownership** of the company could change hands to the **majority shareholder**.

- **Long-term loans or debt finance:** Loans from a bank, and this is how they are different from issuing shares:
  - Interest is paid before taxes, it is counted as an **expense**.
  - Interest has to be **paid every year** but dividends only need to be paid if the firm has maid **profit**.
  - They are **not permanent** capital.
  - They need **collateral**.
- **Debentures**

How the choice of finance is made in a business

These are the factors that managers consider when choosing the type of finance they need.

- **Purpose and time period:** Managers need to **match** the source of finance to its purpose. It is quite simple, **short-term** finance is used to buy **current assets** and things like that, while **long-term** finance for**fixed assets** and similar things.
- **Amount needed:** Different types of finance depends on how much is needed.
- **Status and size:** Bigger companies have **more choices** of finance. They pay **less interest** to banks.
- **Control:** owners lose control if they own less than **51%** of **shares** in their company.
- **Risk and gearing:** loans raise the **gearing** of a business, meaning that their **risk** is increased. Gearing is can be obtained by calculating the **percentage** of **long-term loans** compared to **total capital**. If long-term loans take up more than 50% of total capital, then the business would be called **highly geared**. This is very **risky** because the business will have to pay back a lot of its loans and has to succeed to do so. Banks are less willing to lend to these businesses, so they will have to find other types of finance.

Will banks lend and will shareholders invest?

Loans will be available to businesses but information about the business is required:

- The firms's **trading records**.
- **Forecasts** about the future.
- **Forecasts** have to show that the firms are **solvent**, i.e. able to repay the loan and the interest back.

Banks will also consider:

- **Experience** of the people running a business.
- **Gearing ratio** of a business.

This is what shareholders will consider if they want to invest:

- The **future prospects** of the company.
- How much **dividends** are given out compared to other companies.
- **Trend** of **share prices**.

- **Gearing ratio**.

Business plans

Banks will want to see a business plan if they are to lend to most businesses, especially a newly created one. A business plan contains:

- **Objectives**.
- How the business will be **operated**.
- How the business will be **financed**.

By creating a business plan owners will have to think carefully ahead about their business to ensure the best plan possible. These are things they will need to consider:

- **Target market** and **consumers**.
- **Profits**, **costs** and **break-even point**.
- **Location** of the business.
- **Machinery** and **workers** required.

Without a **detailed** plan which **works**, bank managers will be reluctant to lend any money to businesses because their owners have not shown that they are serious enough about their business.

Here is an example of a business plan from the book, it shows the things you need to put in a business plan:

Case study example

Business plan for Pizza Place Ltd
(Outline only – other, more detailed information, would be given in an actual plan.)

Name of business	Pizza Place Ltd
Type of organisation	Private limited company
Business aim	To provide a high-class takeaway pizza service including home delivery
Product	High quality home-cooked pizzas
Price	Average price of $5 with $1 delivery charge
Market aimed for	Young people and families
Market research undertaken and the results	Research in the area conducted using questionnaires. Also, research into national trends in takeaway sales and local competitors (See results of all research in the appendix to this plan.)
Human Resources plan	Two staff (the business owners) to be the only staff to be employed initially
Details of senior staff/business owners	Peter Yang – chef of 15 years' experience Sabrina Hsui – deputy manager of restaurant for three years
Production details and business costs	Main suppliers – P & P Wholesalers Fixed costs of business – $50,000 per year Variable costs – approximately $1 per unit sold
Location of business	Site in shopping street (Brunei Avenue) just away from the town centre. Leasehold site (10 years)
Main equipment required	Second-hand kitchen equipment – $4,000 Second-hand motorbike – $1,000
Forecast profit	(See financial appendix to this plan.) Summary: In the first year of operations the total costs are forecast to be $55,000 with revenue of $85,000. Predicted profit = $30,000 Break-even point – 12,500 units per year
Cash flow	(See financial appendix to this plan.) Due to the high set-up and promotion costs there will be negative cash flow in the first year
Finance	$10,000 invested by each of the owners Request to bank for a further $10,000 plus an overdraft arrangement of $5,000 per month

As a little reminder, this business plan is not mine, and all credit goes to the book and its author. Thank you