

CHAPTER SIX

Business Financing

6.1 INTRODUCTION

6.2 Financial Requirements

- All businesses need money to finance a host of different requirements.
- In looking at the types and adequacy of funds available, it is important to match the use of the funds with appropriate funding methods.

1. Permanent Capital

- The permanent capital base of a small firm usually comes from equity investment in shares in a limited company or share company, or personal loans to form partners or to invest in sole proprietorship.
- It is used to finance the start - up costs of an enterprise, or major developments and expansions in its life - cycle.

- Ideally, permanent capital is only serviced when the firm can afford it; investment in equity is rewarded by dividends from profits, or a capital gain when shares are sold.
- It is not therefore a continual drain from the cash flow of a company, such as a loan, which needs interest and capital repayments on a regular basis.
- Equity capital usually provides a stake in the ownership of the business, and therefore the investor accepts some element of risk in that returns are not automatic, but only made when the small firm has generated surpluses.

2. Working Capital

- It is short-term finance. Most small firms need working capital to bridge the gap between when they get paid, and when they have to pay their suppliers and their overhead costs.
- Requirements for this kind of short-term finance will vary considerably by business type. For example, a manufacturer or small firm selling to other businesses will have to offer credit terms, and the resulting debtors will need to be financed; the faster the growth, the more the debtors, and the larger the financial requirement.

3. Asset Finance

- It is medium to long term finance. The purchase of tangible assets is usually financed on a longer-term basis, from 3 to 10 years, or more depending on the useful life of the asset. Plant, machinery, equipment, fixtures, and fittings, company vehicles and buildings may all be financed by medium or long-term loans from a variety of lending bodies.

6.3 Sources of Financing

- To get financing for a new business, **entrepreneurs must explore every option available.**
- **Four basic questions must be answered during initial financial planning.**
 - What types of capital do I need in my new business?
 - How can I estimate the amounts needed?
 - Where can I obtain the required funds?
 - What should my financing proposal include?
- Broadly speaking there are two main sources of finance
 - ✓ Equity, i.e., ownership capital
 - ✓ Borrowed capital (debt)

6.3.1 Internal Sources (Equity capital)

- Equity capital is money given for a share of ownership of the company.
- The investor shares in the profits of the venture, as well as any disposition of assets on a prorated basis.
- Key factors favoring the use of one type of financing over another are:
 - Availability of funds
 - The assets of the venture and
 - The prevailing interest rates.
- Equity capital is not therefore a continual drain from the cash flow of a company, such as a loan, which needs interest payment.

1. Source of equity financing

- **1. *Personal saving:*** The entrepreneur should contribute at least 50% of the starting up capital.
- **If an entrepreneur is not willing to risk his own money potential investors are not likely to risk their money in the business either.**
- **2. *Friends and relatives:*** After emptying their own pockets, entrepreneurs should turn to friends and relatives who might be willing to invest in the business. The entrepreneur is expected to describe the opportunities and threats of the business.
- Friends and relatives who believe in you are more likely to invest in your business than are strangers.
- **3. *Partners:*** An entrepreneur can choose to take on a partner to expand the capital formation of the proposed business.
- **4. *Public stock sale (going public):*** In some case, entrepreneurs can go public by selling share of stock in their corporation to outsiders. This is an effective method of raising large amounts of capital.
- **5. *Angels:*** These are private investors (or angles) who are wealthy individuals, often entrepreneurs, who invest in the startup business in exchange for equity stake in these businesses.
- **6. *Venture capital companies:*** Are private, for profit organizations that purchase equity positions in young business expecting high return and high growth potential opportunity.
- They provide start -up capital, development funds or expansion funds

- **6.3.2 External Sources (Debt capital)**

- Debt financing is a financing method involving an interest-bearing instrument, usually a loan.
- The payment of which is only indirectly related to the sales and profits of the venture.
- Debt financing (also called asset-based financing) requires that some asset (such as car, house, plant, machine, or land) be used as collateral.
- requires the entrepreneurs to pay back the amount of funds borrowed, plus a fee expressed in terms of the interest rate.
- The entrepreneur needs to be careful that the debt is not so large.

❑ Sources of debt financing

I. Commercial banks

- Are by far the most frequently used source for short term debt by the entrepreneur.
- Banks focus on a company's capacity to create positive cash flow because they know that's where the money to repay their loan will come from.
- **Bank Lending Decision:-** The small business owner needs to be aware of the criteria bankers use in evaluating the credit worthiness of loan applications. Most bankers refer to the five C's of credit in making lending decision. The five C's are capital, capacity, collateral, character, and conditions.
 1. **Capital:** A small business must have a stable capital base before a bank will grant a loan.
 2. **Capacity:** The bank must be convinced of the firm's ability to meet its regular financial obligations and to repay the bank loan.
 - 3.
 4. **Collateral:** The collateral includes any assets the owner pledges to the bank as security for repayment of the loan.
 5. **Character:** Before approving a loan to a small business, the banker must be satisfied with the owner's character. The evaluation of character frequently is based on intangible factors such as honesty, competence, willingness to negotiate with the bank.
 6. **Conditions:** The conditions surrounding a loan request also affect the owner's chance of receiving funds. Banks consider the factors relating to the business operation such as potential growth in the market, competition, location, and loan purpose.

- **II) Trade Credit:** It is credit given by suppliers who sell goods on account. This credit is reflected on the entrepreneur's balance sheet as account payable and in most cases it must be paid in 30 to 90 or more days.
- **III) Equipment Suppliers:** Most equipment vendors encourage business owners to purchase their equipment by offering to finance the purchase.
- **IV) Account receivable financing:** It is a short term financing that involves either the pledge of receivables as collateral for a loan.
- **V) Credit unions:** Credit unions are non-profit cooperatives that promote savings and provide credit to their members. But credit unions do not make loans to just any one; to qualify for a loan an entrepreneur must be a member.
- **VI) Bonds:** A bond is a long term contract in which the issuer, who is the borrower, agrees to make principal and interest payments on specific date to the holder of the bond. Bonds have always been a popular source of debt financing for large companies in the western world.

6.4 Lease Financing

- **6.4 Lease Financing**
- Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee. The periodical payment made by the lessee to the lessor is known as lease rental. Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

- **6.4.1 Types of Lease**

- Depending upon the transfer of risk and rewards to the lessee, the period of lease and the number of parties to the transaction, lease financing can be classified into two categories. Finance lease and operating lease.

1) Finance Lease

- It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals.

- The following features can be derived for finance lease:
 - A finance lease is a device that gives the lessee a right to use an asset.
 - The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.
 - The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.
 - Lessee is responsible for the maintenance of asset.
 - No asset-based risk and rewards are taken by lessor.
 - Such type of lease is non-cancellable; the lessor's investment is assured.

2) Operating Lease

- Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee. The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why this type of lease is also known as service lease. Operating lease has the following features:
 - The lease term is much lower than the economic life of the asset.
 - The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.
 - The lessor provides the technical knowhow of the leased asset to the lessee.
 - Risks and rewards incidental to the ownership of asset are borne by the lessor.
 - Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.

Advantages and Disadvantages of Lease Financing

At present leasing activity shows an increasing trend. Leasing appears to be a cost -effective alternative for using an asset. However, it has certain advantages as well as disadvantages.

The advantages of lease financing from the point of view of lessor are summarized below:

Assured Regular Income: Lessor gets lease rental by leasing an asset during the period of lease which is an assured and regular income.

- **Preservation of Ownership:** In case of finance lease, the lessor transfers all the risk and rewards incidental to ownership to the lessee without the transfer of ownership of asset. Hence the ownership lies with the lessor.
- **Benefit of Tax:** As ownership lies with the lessor, tax benefit is enjoyed by the lessor by way of depreciation in respect of leased asset.
- **High Profitability:** The business of leasing is highly profitable since the rate of return based on lease rental, is much higher than the interest payable on financing the asset.
- **High Potentiality of Growth:** The demand for leasing is steadily increasing because it is one of the cost efficient forms of financing. Economic growth can be maintained even during the period of depression. Thus, the growth potentiality of leasing is much higher as compared to other forms of business.
- **Recovery of Investment:** In case of finance lease, the lessor can recover the total investment through lease rentals.
- Lessor suffers from certain limitations which are discussed below:

Unprofitable in Case of Inflation: Lessor gets fixed amount of lease rental every year and they cannot increase this even if the cost of asset goes up.

Double Taxation: Sales tax may be charged twice. First at the time of purchase of asset and second at the time of leasing the asset.

Greater Chance of Damage of Asset: As ownership is not transferred, the lessee uses the asset carelessly and there is a great chance that asset cannot be useable after the expiry of primary period of lease.

6.5 Traditional Financing in Ethiopian (Equib/Idir, Etc.)

(Reading Assignment)

- **6.6 Crowd Funding**

- Crowd funding is a method of raising capital through the collective effort of friends, family, customers, and individual investors or even from the general public.
- This approach taps into the collective efforts of a large pool of individuals primarily online via social media and crowd funding platforms and leverages their networks for greater reach and exposure.

6.6.1 How is Crowd Funding Different?

- Crowd funding is essentially the opposite of the mainstream approach to business finance. Traditionally, if you want to raise capital to start a business or launch a new product, you would need to pack up your business plan, market research, and prototypes, and then shop your idea around to a limited pool of wealthy individuals or institutions. These funding sources included banks, angel investors, and venture capital firms, really limiting your options to a few key players.
- Crowd funding platforms, on the other hand, turn that funnel on its end. By giving you, the entrepreneur, a single platform to build, showcase, and share your pitch resources, this approach dramatically streamlines the traditional model. Traditionally, you'd spend months sifting through your personal network, vetting potential investors, and spending your own time and money to get in front of them.

6.6.2 The Benefits of Crowd funding

- From tapping into a wider investor pool to enjoying more flexible fund raising options, there are a number of benefits to crowd funding over traditional methods. Here are just a few of the many possible advantages:
- **Reach:** By using a crowd funding platform like Fundable, you have access to thousands of accredited investors who can see, interact with, and share your fund raising campaign. **Presentation:** By creating a crowd funding campaign, you go through the invaluable process of looking at your business from the top level its history, traction, offerings, addressable market, value proposition, and more and boiling it down into a polished, easily digestible package.
- **PR & Marketing:** From launch to close, you can share and promote your campaign through social media, email newsletters, and other online marketing tactics. As you and other media outlets cover the progress of your fund raise, you can double down by steering traffic to your website and other company resources.
- **Validation of Concept:** Presenting your concept or business to the masses affords an excellent opportunity to validate and refine your offering. As potential investors begin to express interest and ask questions, you'll quickly see if there's something missing that would make them more likely to buy in.
- **Efficiency:** One of the best things about online crowd funding is its ability to centralize and streamline your fund raising efforts. By building a single, comprehensive profile to which you can funnel all your prospects and potential investors, you eliminate the need to pursue each of them individually. So instead of duplicating efforts by printing documents, compiling binders, and manually updating each one when there's an update, you can present everything on line in a much more accessible format, leaving you with more time to run your business instead of fundraising.

6.6.3 Types of Crowd Funding

- Just like there are many different kinds of capital round raises for businesses in all stages of growth, there are a variety of crowd funding types. Which crowd funding method you select depends on the type of product or service you offer and your goals for growth. The 3 primary types are donation-based, rewards-based, and equity crowd funding.

1) **Donation-Based Crowd Funding**

- Broadly speaking, you can think of any crowd funding campaign in which there is no financial return to the investors or contributors as donation-based crowd funding. Common donation-based crowd funding initiatives include fund raising for disaster relief, charities, nonprofits, and medical bills.

2) **Rewards-Based Crowd Funding**

- Rewards-based crowd funding involves individuals contributing to your business in exchange for a “reward,” typically a form of the product or service your company offers. Even though this method offers backers a reward, it’s still generally considered a subset of donation-based crowd funding since there is no financial or equity return.

3) **Equity-Based Crowd Funding**

- Unlike the donation-based and rewards-based methods, equity-based crowd funding allows contributors to become part-owners of your company by trading capital for equity shares. As equity owners, your contributors receive a financial return on their investment and ultimately receive a share of the profits in the form of a dividend or distribution.

6.7 Micro Finances

- **6.7.1 What is Micro Finance?**
- Microfinance is a term used to describe financial services, such as loans, savings, insurance and fund transfers to entrepreneurs, small businesses and individuals who lack access to banking services with high collateral requirements. Essentially, it is providing loans, credit, access to [savings accounts](#) – even insurance policies and money transfers to small business owners, entrepreneurs (many of whom live in the developing world), and those who would otherwise not have access to these resources.

6.7.2 Importance of MFIs

- Microfinance is important because it provides resources and access to capital to the financially underserved, such as those who are unable to get checking accounts, lines of credit, or loans from traditional banks. Without microfinance, these groups may have to resort to using loans or payday advances with extremely high interest rates or even borrow money from family and friends. Microfinance helps them invest in their businesses, and as a result, invest in themselves.

6.7.3 Micro Finances in Ethiopia

- Micro-finance in Ethiopia has its origin in traditional informal method used to accumulate saving and access credit by people who lacked access to formal financial institutions. Ethiopia has also more 38 MFIs (in 2018) and practice is one of the success stories in Africa even though there are certain limitations.
- The history of formal establishment of Ethiopia Micro finance institution is limited to about less than twenty years (since 2000). The first groups of few MFIs were established in early 1997 following the issuance of Proclamation No. 40/1996 in July 1996. The objective of the MFIs is basically poverty alleviation through the provision of sustainable financial services to the poor who actually do not have access to the financial support services of other formal financial institutions.
- The microfinance industry is growing in terms of number and size. The MFIs in Ethiopia have been able to serve the productive poor people mainly with savings, credit, money transfer, micro- insurance and other related services. Governmental and other developmental organizations have played a vital role for impressive performance the microfinance sector in the country.

- The known micro finance institutions in different regions of Ethiopia with more than 90%
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- market share are
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- 1. Amhara Credit and Savings Ins. (ACSI) S.C.
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- 2. Dedebit Credit and Savings Ins. (DECSI) S.C.
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- 3. Oromiya Credit and Savings Ins. S.C (OCSCO).
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- 4. Omo Credit and Savings Ins. S.C.
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- 5. Addis Credit and Savings Institution S.C.(ADCSI)

