

Chapter Six

Business Financing

Chapter Objectives:

- ☑ Definition of Finance
- ☑ sources of finance to start a business venture
- ☑ Understand lease financing
- ☑ Learn micro finances
- ☑ Understand crowd funding
- ☑ Learn about traditional financing in Ethiopia





The Concept of Financing

- ☑ 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?





Financial Requirements

- ☑ All businesses need money to finance a host of different requirements.
- ☑ **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.





Cont….

- **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.
- **Asset Finance:-** It is medium to long term finance. 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.





Sources of Financing

- ☑ **Internal Sources (Equity capital):-** Owner's capital or owner's equity represents the personal investment of the owner(s) in a business and it is sometimes called risk capital because these investors assume the primary risk of losing their funds if the business fails.
- ☑ **Internal Sources (Equity capital) are as follows;**

1. *Personal saving*
2. *Friends and relatives*
3. *Partners*
4. *Public stock sale (going public)*
5. *Angels*
6. *Venture capital companies*





Cont….

- ***Personal saving:*** Entrepreneurs should take for startup money is in their own pockets.
- ***Friends and relatives:*** After emptying their own pockets, entrepreneurs should turn to friends and relatives who willing to invest in the business.
- ***Partners:*** An entrepreneur can choose to take on a partner to expand the capital formation of the proposed business.
- ***Public stock sale (going public):*** In some case, entrepreneurs can go public by selling share of stock in their corporation to outsiders.





Cont….

- ***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.
- ***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.





Comparison of Angles and Venture Capitalist

Angels	Venture Capitalists (VCs)
• Individuals who wish to assist others in their business venture, • Usually found through networks, • Reasonable expectations on equity position and ROI, • Often passive, but realistic perspective about business venture, Exit strategy is important,	• Finance, small scale new technology and any risky idea. • Funds are more specialized versus homogeneous • High expectations of equity position and ROI,





External Sources (Debt capital)

- ☑ Borrowed capital or debt capital is the external financing that small business owner has borrowed and must repay with interest. There are different sources as discussed here below:
- ☑ **Commercial banks**: Commercial banks are by far the most frequently used source for short term debt by the entrepreneur.
- ☑ In most cases, commercial banks give short term loans (repayable within one year or less) and medium term loan (maturing in above one year but less than five years), long term loans (maturing in more than five years).





External Sources (Debt capital)…

- ☑ To secure a bank loan, an entrepreneur typically will have to answer a number of questions, together with descriptive commentaries.
  - ☑ What do you plan to do with the money?
  - ☑ When do you need it?
  - ☑ How much do you need?
  - ☑ For how long do you need it?
  - ☑ How will you repay the loan?





External Sources (Debt capital)

- ☑ **Bank Lending Decision:-**The small business owner needs to be aware of the criteria bankers use in evaluating the credit worthiness of loan applications. The five C's are capital, capacity, collateral, character, and conditions.
- ☑ ***Capital:*** A small business must have a stable capital base before a bank will grant a loan.
- ☑ ***Capacity:*** The bank must be convinced of the firm's ability to meet its regular financial obligations and to repay the bank loan.
- ☑ ***Collateral:*** includes any assets the owner pledges to the bank as security for repayment of the loan.
- ☑





External Sources (Debt capital)…

- ☑ ***Character:*** Before approving a loan to a small business, the banker must be satisfied with the owner's character.
- ☑ ***Conditions:*** The conditions surrounding a loan request also affect the owner's chance of receiving funds.
- ☑ **Micro Finances**: provide financial services mainly to the poor ,micro and small enterprises.
- ☑ **Trade Credit**: It is credit given by suppliers who sell goods on account.





External Sources (Debt capital)…

- ☑ **Equipment Suppliers**: Most equipment vendors encourage business owners to purchase their equipment by offering to finance the purchase.
- ☑ **Account receivable financing**: It is a short term financing that involves either the pledge of receivables as collateral for a loan.
- ☑ **Credit unions**: Credit unions are non-profit cooperatives that promote savings and provide credit to their members.
- ☑ **Bonds:** It 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.





External Sources (Debt capital)…

- ☑ Traditional Sources of Finance: “Idir”, “equib”
- ☑ **Lease Financing**:-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.
- ☑ lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract.





Types of Lease

- ☑ **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.
- ☑ **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.





Advantages and Disadvantages of Lease Financing

- ☑ **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.
- ☑ **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.





Advantages and Disadvantages of Lease Financing

- ☑ **High Potentiality of Growth:** The demand for leasing is steadily increasing because it is one of the cost efficient forms of financing.
- ☑ **Recovery of Investment:** In case of finance lease, the lessor can recover the total investment through lease rentals.
- ☑ Lessor suffers from certain limitations:
  - ☑ **Unprofitable in Case of Inflation**
  - ☑ **Double Taxation**
  - ☑ **Greater Chance of Damage of Asset**





Traditional Financing in Ethiopian (Equib/Edir…)

- ☑ Ethiopia has one of the least-developed formal financial sectors in the world, it possessed a rich tradition in indigenous, community-based groups such as savings and credit associations and insurance like societies.
- ☑ These "iqub" and "idir" groups provide a source of credit and insurance outside the formal sector but much rooted in Ethiopian society.





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.
- ☑ Crowd funding is essentially the opposite of the mainstream approach to business finance.





The Benefits of Crowd funding

- ☑ Reach: By using a crowd funding platform can access to thousands of accredited investors who can see, interact with, and share your fund raising campaign.
- ☑ Presentation: By creating a crowd funding campaign, go through the invaluable process of looking at your business from the top level its history, offerings, addressable market, value proposition, 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.





The Benefits of Crowd funding…

- ☑ Validation of Concept: Presenting your concept or business to the masses affords an excellent opportunity to validate and refine your offering.
- ☑ Efficiency: One of the best things about online crowd funding is its ability to centralize and streamline your fund raising efforts.





Types of Crowd Funding

- ☑ **Donation-BasedCrowd Funding:-**Common donation-based crowd funding initiatives include fund raising for disaster relief, charities, nonprofits medical bills.
- ☑ **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.
- ☑ **Equity-Based Crowd Funding:-**allows contributors to become part-owners of your company by trading capital for equity shares.





Micro Finances

- ☑ 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.





Some of the importance of MFIs

- ☑ it provides resources and access to capital to the financially underserved
- ☑ helps them invest in their businesses, and as a result, invest in themselves.
- ☑ serve as an important resource for those in the developing world.
- ☑ Decrease unemployment, increase earning power, and aid the financially marginalized
- ☑ Micro Finance in Ethiopia





End of chapter six

