

## 3 Sources of Finance

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### Introduction

In this chapter we will examine the options available to a person who needs to borrow money to start or to operate a small business.

### Sources of Finance

The money that is used to start or operate a business is known as finance.

A person can borrow money from a number of different sources. These sources include:

- 1 a loan from a family member or from a friend
- 2 a credit card
- 3 a bank overdraft
- 4 a term loan from a bank
- 5 lease finance, and
- 6 factoring.

A person may use a combination of these sources of finance.

#### ***Loans from Family or Friends***

A prospective business owner may be able to borrow money from other family members or from a friend. The length of the loan, the interest rate, if any, to be paid on the loan and any other terms of the loan, must be negotiated between the parties.

#### ***A Credit Card***

A credit card can be used as a **short term** source of finance for a business. A short term source of finance is a loan that should be paid back within a period of a few months, such as, two or three months.

Credit card interest rates can be 17% per annum or higher, as compared to about 10% per annum for a bank overdraft. A credit card is a very expensive form of short term borrowings unless it is paid off within the interest free days period, that is, within about 30 days.

#### ***A Bank Overdraft***

A bank overdraft is a loan made by a bank in which the customer can withdraw more money from his or her bank account than has been deposited in the account.

There is a limit on the overdraft amount. This limit may be, for example, \$10,000. Interest is paid on a monthly basis on the overdrawn amount.

A bank overdraft is a **short term** source of finance, that is, it should only be used for a few months at one time.

## **A Term Loan**

A term loan is a **long term** source of finance obtained from a bank. A term loan will be paid back over a number of years, for example, 1 to 10 years.

A bank will consider a number of factors when it is deciding whether or not to make a loan to a prospective small business owner. These factors are:

- 1 the quality of the business plan
- 2 the collateral available to secure the loan
- 3 the capacity of the business to repay the loan.

As Tiki Papaioannou, Senior Product Manager, Small Business Banking Products, Australian and New Zealand Banking Group Ltd, stated:

“Small business customers need to be ‘finance ready’. You should approach a financier with a well thought out business plan that includes realistic cash flow projections. You need to demonstrate a good understanding of your business (or proposed business), an ability to keep accurate financial records and of course the capacity to repay any loan.” [1]

## **A Business Plan**

A bank will want to see that the prospective business owner has a well thought out business plan. A business plan sets out, in detail, how the future business will be run, identifies the market for the products or services of the business and describe how the business will gain an acceptable share of this market.

The bank will also want to see the projected cash flows (the expected cash inflows and cash outflows) of the business for a period of two or three years.

## **Collateral**

Collateral is the security that a prospective business owner can provide to repay a loan in the event that the business fails.

A common form of security required by a bank is land.

A bank also expects that a future business owner is going to invest a large amount of his or her own money in the business.

## **Capacity**

A bank will examine the ability of a small business to meet the regular loan repayments. The bank will review the expected cash inflows and cash outflows of the business to see if they are reasonable, considering the type of business that is being started.

## Lease Finance

A lease is an agreement to rent an item of plant and equipment for a fixed number of months or years.

There are two different types of leases. A **finance lease** means that the business has the right to purchase the item of plant and equipment at the end of the lease agreement. An **operating lease** means that the plant and equipment must be returned to the financier at the end of the lease agreement.

## Factoring

Factoring is the selling of the amounts owing from the debtors of a business for a fee.

## Example

A Business has \$100,000 in debtors who are expected to pay in about 30 to 60 days. A Business sells these debtors to a factoring company for \$80,000 and receives this money within two days.



## Questions

### Question 1

Set out below is an extract of an ABC Radio National program [1]. The speakers are ABC radio presenter Joe Gelonesi and Maria Doolan, a District Manager with the ANZ Bank.

**Joe Gelonesi:** “The first contact small business has with a bank is when they approach them for their business loan. Many get knocked back because they haven't done a business plan.”

**Maria Doolan:** “One of the worst examples I had was someone years ago now, but they came in and they started the conversation by telling me about how they wanted to go into a small business because they were really very tired of working so hard for a boss and it was going to be so much better in a small business that they'd open and they wouldn't have to work so hard and be able to reduce their hours.

And they had a vague idea of what this business was, but they had absolutely no preparation. I mean they didn't know what the business was doing now, they had no financial projections, had no cash flows, didn't understand anything about revenue or costs (expenses) or anything else. And they wanted a certain amount of money and they didn't really want to offer security, in this case, because they didn't really have faith in whether it (the business) was going to make money or not, so they didn't want to put their house up. I thought like this is really going downhill fast. We obviously weren't going to lend the person the money in that case, nor was anyone else for that matter.”

## Required

- 1 What mistakes did this person make when he or she applied for a business loan?
- 2 What factors will a bank consider in assessing a small business loan application?

**Question 2**

Peter is the owner of a second hand furniture store. He has just moved to a larger shop and needs to purchase more inventory. Peter is considering opening a second store in about 12 months and will need to purchase a second delivery vehicle costing \$30,000 and a new computer system costing \$4,000.

**Required**

- 1 What method of finance should Peter use to pay for the extra trading stock?
- 2 What method of finance should Peter use to pay for the new delivery vehicle and the computer system?

**Question 3**

Henry Battler has applied for a bank loan to help finance a business that he wants to start. Below is a transcript of Henry's meeting with the loans manager of a bank.

**Henry:** "I want to borrow \$310,000 to start a new business called Wonders of the West Tours. I will be offering tourists half-day tours around Perth."

**Bank Manager:** "Do you have any security for the loan?"

**Henry:** "I have a motor vehicle. Its 14 years old but it has got to be worth something." (a)

**Bank Manager:** "What will you use the loan for?"

**Henry:** "I want to use the loan to purchase the best tour bus in the world. I could get a standard bus for \$150,000 but I want a deluxe bus and that will cost \$310,000." (b)

**Bank Manager:** "What about the money that you will need to pay for the rent of an office, to pay wages, advertising and other expenses?"

**Henry:** "The money from the customers will pay for that." (c)

**Bank Manager:** "Do you have a business plan?"

**Henry:** "That is my business plan. I don't have anything in writing. But I have given this idea a lot of thought." (d)

**Bank Manager:** "Have you ever worked in the tourist industry?"

**Henry:** "No, but I have seen many tourists around the city and I have repaired tour buses." (e)

**Bank Manager:** "Have you ever operated a business before?"

**Henry:** "No. This will be my first time. Exciting isn't it?" (f)

**Question 3 continued**

**Bank Manager:** "Have you conducted any marketing research to see if your business idea will work?"

**Henry:** "Yes, of course. I counted the number of tourists coming off a tour bus the other day and multiplied the number by 365. The bus was full of tourists so my idea is definitely a winner." (g)

**Bank Manager:** "Have you had any training in accounting, management or marketing?"

**Henry:** "No. Do you reckon I need that sort of thing?" (h)

**Bank Manager:** "How much are you going to charge each tourist?"

**Henry:** "Well, this is where I am very smart. The other crowd is charging \$60 for a half-day tour of Perth. I intend to beat them by charging only \$30. The tourists will love it." (i)

**Bank Manager:** "How do you know that you can make a profit by charging each tourist only \$30?"

**Henry:** "Well, I haven't done any calculations but \$30 should be enough to cover my expenses, shouldn't it?" (j)

**Bank Manager:** "Do you have a cash flow forecast for the next three years?"

**Henry:** "Yes. I think that the cash will be flooding into my business." (k)

**Henry:** "Now. When can I have the money? Today?"

Set out below are a series of risk factors that a bank will consider when it is evaluating a business loan application. [2]

Factors		Yes	No	Comment
1	Lack of planning			
2	Poor presentation of how the operator is going to make the business happen			
3	Lack of understanding of the market place or pricing			
4	Lack of a realistic marketing plan			
5	Lack of a detailed financial plan to take into account working capital requirements			
6	Lack of financial management skills			
7	Lack of experience in operating a business			
8	Overspending on set up costs			
9	Focus on product rather than how to sell it.			



### Question 3 continued

#### Required

Assess the loan application of Henry Battler against the checklist of factors on the previous page. If Henry, in your opinion, has not satisfied, each factor in the checklist, place the letter that supports your decision in the relevant comment column of the table.

Would you approve the \$310,000 loan to Henry Battler?

### Question 4

Lucinda wants to open a shop that will sell bicycles. She estimates that this type of business will cost \$300,000 to establish.

Lucinda has the following personal assets:

- a motor vehicle           \$19,000
- cash in the bank       \$21,000
- a computer               \$2,500.

Lucinda believes that she can borrow \$279,000 from a bank.

#### Required

- 1 Do you think that Lucinda will be able to borrow \$279,000 from a bank?
- 2 What other sources of finance would you recommend that Lucinda use to establish this business?
- 3 Which of the following is a short term source of finance?
  - a A loan repayable over five years.
  - b A bank overdraft.
  - c A loan from a friend to be repaid in three years.
- 4 What would be a suitable source of finance to pay for inventory?

### Reference

- [1] "Show me the Money – A Woman's Guide through the Financial Maze", Department of Innovation Industry and Regional Development, page 20
- [2] "The Business Report" broadcast in December 1995