Types of finance required

For starting any business enterprise you require two types of finances. Viz; medium/long-term finance and short-term finance. The medium and long-term finance is also called fixed capital whereas short-term finance is called working capital or operating capital. Fixed capital is used for creating fixed assets like land, building, plant and machinery, patents etc. Whereas working capital is used to finance current assets like purchase of raw material, payment of wages and other costs, and credit provided to customers etc. Fixed capital is required while starting any new business or expanding an existing business whereas working capital is required for running a business.

Fixed capital needs will have to be met by long-term financial sources whereas working capital needs will have to be met through short-term financial sources to have smooth operations over the project life cycle.

Exhibit 1 shows your various ways of raising long-term (fixed capital) and short-term finances (working capital).

Exhibit-1

- Finance/ Capital Required for Business
  - Medium/Long Term finance (Fixed capital)
    - Equity
      - Personal Savings
      - Funds from Relatives & friends
      - Internal accruals (in case of existing enterprise)
      - Subsidies & Grants
      - Seed capital
    - Others
      - Lease & Hire purchase
      - Venture Capital
    - Debt
      - Term loans
      - Soft loans
      - Debentures
      - Unsecured loans
  - Short-term finance (working capital)
    - Equity
      - Personal
      - Funds from Relatives and friends
      - Operational Cash accruals (existing enterprise)
    - Debt
      - Cash credit/Overdraft
      - Short term
      - Factoring
      - Unsecured loans

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Sources of raising finance

We will now try to understand various sources and ways of raising necessary finance for starting and running your business enterprise.

A) Long –term Finance Sources.

1. **Equity**: Equity refers to your own investment and does not carry any interest. When you are starting any new project and are a first generation entrepreneur, it is always advisable to use maximum of your equity because then you need not have to pay any interest and there is no burden on your head to repay it within a stipulated time. This helps you smoothen in the initial days of your business. Some entrepreneurs try to bring minimum equity even when they are capable of raising more and tend to depend on borrowed funds. This is not advisable especially if you are a first generation entrepreneur. The various ways of bringing equity are as follows.

- Personal Savings: This is one of the most common sources of raising finance when you are starting a small business.
- Funds from friends and relatives without interest burden.
- Internal accruals: If yours is an existing business then the profit generated in previous years is one of the sources of your equity.
- Subsidies and grants: Under certain schemes you get subsidies from the government or financial institutions like SIDBI (Small Industries Development Bank of India). Some state governments also provide subsidies if you set up your business enterprise in a priority specified area/sector. This also forms part of your equity.
- Seed Capital: Under certain schemes seed capital is provided particularly for first generation entrepreneurs by the state government. Seed capital though is to be repaid, forms a part of equity. Seed capital generally carries only transaction and administrative cost, ranging from 1% to 5% p.a and no real interest.

2. Others

- Lease and Hire purchase: Lease represents a contractual arrangement whereby the lessor grants the lessee the right to use the asset in return for periodic lease rental payments, whereas in hire purchase the (the counter part of lessor) purchases the asset and gives it on hire to the hirer (counter part of lessee). The hirer pays regular hire installments over a specified period of time. This installment covers interest as well as principal repayment. When the hirer pays the last installment, the title of the asset is transferred from the hiree to the hirer. In case of lease the lessee not being the owner of the asset, cannot sell or enjoy the salvage value of the asset, whereas in case of hire purchase the hirer being the owner of the asset can sell assets and also enjoy the salvage value of the asset. State industrial development corporations e.g. GIDC in Gujarat, MIDC in Maharashtra etc., provide you land and building on lease whereas National Small Industries Corporation (NSIC) provides plant and machinery on hire purchase.

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- Venture capital: Today the term "Venture Capital" has two distinct meanings. In its pure meaning it means, "Funds made available for the financing of a new business". It involves the process of building and financing successful self-sustaining companies, very often from scratch. The definition thus incorporates all high risk, high potential investments. To put it briefly, it can be called as the early stage financing of new and young companies who want to grow fast. In broad terms, however, it covers a wider range of activities than just start – up situations, which are financed by venture capital funds. Here, the term refers to long-term equity or semi-equity investments for the setting up of firms, specializing in new ideas or new technologies, involving high risk but having potential for significant growth and financial returns. (Venture capital is separately covered in detail in unit no.11.)

3. **Debt**

- Medium/Long term loans: Term loan represents a major source of debt finance. State financial corporations (SFCs), nationalized banks, Commercial banks etc. provide term loans for small business enterprises. Generally, term loans are refinanced by the Small Industries Development Bank of India (SIDBI) or National Bank for Agriculture Rural Development (NABARD). In selected cases, SIDBI provides direct assistance in the form of term loan.
- Soft loans: Soft loans are similar to term loans with very low rate of interest. Soft loans are provided under certain schemes like National Equity Fund Scheme, Mahila Udyam Nidhi etc.
- Unsecured loans: Loans taken from private sources, friends or relatives, which carry interest, are called unsecured loans. These are called unsecured loans because while taking the loan the entrepreneur does not provide any security for the loan.

B) Short-term finance Sources

Various sources for raising short-term finance can broadly be divided into two categories (1) Equity & (2) Debt

1. **Equity**: As discussed earlier, equity refers to your own investment; either your personal savings or the funds collected from your relatives without paying any interest. For an existing business enterprise, one of the common sources of equity financing is through operational cash accruals. The profit generated in the businesses is usually ploughed back and gets invested in current assets like inventories, debtors etc.
2. **Debt**: Working capital loan is usually provided by commercial banks. The common ways of financing working capital are as follows:

- Cash credit/ Overdraft: Under a cash credit or overdraft arrangement, a pre-determined limit for borrowing is specified by the bank. The borrower can draw as often as required, provided the outstanding does not exceed the cash/credit/overdraft limit. The borrower also enjoys the facility for repaying the amount, partially or fully, as and when he/she desires. Interest is charged only on the running balance, not on the limit sanctioned. A minimum charge is payable irrespective of the level of borrowing, for availing this facility.

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This form of advance is highly attractive from the borrower's point of view because when the borrower has the freedom of drawing the amount in installments as and when required, interest is payable only on the amount actually outstanding.

- Short –term Loans: These are advances of fixed amounts to the borrower. The borrower is charged with interest on the entire loan amount, irrespective of how much he/she draws. In this respect, this system differs markedly from the overdraft or cash credit arrangement wherein interest is payable only on the amount actually utilized. Loans are payable either on demand or in periodical installments. When payable on demand, loans are supported by a demand promissory note executed by the borrower. There is often a possibility of renewing the loan.

Factoring:

Factoring is a financial option for the management of receivables, In simple definition it is the conversion of credit sales into cash. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 80 %(rarely up to 90%) of the amount immediately on agreement. Factoring company pays the remaining amount (Balance 20%-finance cost-operating cost) to the client when the customer pays the debt. Collection of debt from the customer is done either by the factor or the client depending upon the type of factoring. The account receivable in factoring can either be for a product or service. Examples are factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt) in the stipulated period of factoring. Contractors submit invoices to get cash instantly), factoring against medical insurance etc.

Institutions providing Finance

Development Banks and State Financial Corporations (SFCs)

After attaining independence, the government had chalked out a course for achieving rapid industralisation in the country and hence an acute need was felt for setting up institutions which could offer long term finances to enterprises. This resulted in the emergence of term lending institutions both at the national as well the state level. These institutions are known as Development Banks.

For meeting the term finance requirements of small and medium scale industries, the Government of India passed an act in the Parliament called the State Financial Corporations Act, 1951 with the principle objective of assisting industries, especially when the traditional sources of finance for creation of fixed assets are either not adequately available or raising finance from capital markets is difficult.

Small Industries Development Bank of India (SIDBI)

Principal Development Financial Institution for SSI

SIDBI was established on April 2, 1990. The Charter establishing it, The Small Industries Development Bank of India Act, 1989 envisaged SIDBI to be "the principal financial institution for promotion, financing and development of industry in the small scale sector and coordinating the functions of the institutions engaged in the promotion, financing and

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