DRAFT TRAINING MANUAL

FOR

GENERAL ENTREPRENEURSHIP COURSES IN UNIVERSITIES

COURSE 2: BUSINESS CREATION AND GROWTH

MODULE 3: SOURCES OF FUNDS

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MODULE 3: SOURCES OF FUNDS

TIME: 3 Hours

Learning outcome

Upon the completion of this module, students will have:

- Discussed the sources of funds for new and entrepreneurial ventures
- Understood the importance of formal and informal sources of funds for new ventures
- Explored the concept, method, and types of finances provided by venture capital
- Discussed the various government initiatives in funding new ventures and small and medium enterprises in Nigeria.

Content

1. Sources of funds for new and entrepreneurial ventures
2. Internal and external sources of funds; formal and informal sources of funds and their importance to new ventures
3. Concept, method, and types of finances provided by venture capital
4. Government initiatives in funding new ventures and Small and Medium Enterprises (SMEs) in Nigeria.

RATIONALE

Finance has long been considered by Small and Medium Enterprises (SMEs) operators as an important issue. Obtaining financial resources assistance in the amount required and when they are needed can be more difficult for small scale entrepreneurial ventures than for established organizations. The critical issue is to ensure that sufficient cash is available for current operations and growth of the business. The owner must also ensure that money is available to settle current liabilities when due; these may include inventory, rent, telephone bills, office supplies etc. Other reasons for sourcing business finance include the following:

i. upgrading facilities to comply with stricter environmental regulations
ii. financing production in cases where there is significant lag between when costs are incurred and when payments are received;
iii. purchasing of new equipment or facilities;
iv. purchasing of business vehicles; and
v. building up inventory in advance of a busy season.

Irrespective of the reason(s) for which funds are required, it is the sole responsibility of the business owner to ensure that funding is obtained at the right time, at the right cost and from the right source. Before raising the required funds, the business owner must estimate the actual funds needed in order to avoid encountering unnecessary high cost of capital or excess capital.

The US Small Business Administration advices business owners to address the following questions when taking decisions on their need for funds:

(i) Why do I need the fund?
(ii) How much do I need?
(iii) When do I need it?
(iv) How long will I need it?
(v) Where can I obtain it?
(vi) How can I repay it?

Providing answers to these questions will help him or her to ensure that the needed fund is obtained from the right source and well utilized. This means that there are several sources of funds available to the small business owners.

ACTIVITIES

1. Explain to students the different sources of funds for new and entrepreneurial ventures which include**:**
   (i) Equity sources of funds
   (ii) Short-term sources of funds
   (iii) Medium-term sources of funds
   (iv) Long-term sources of funds
2. Have students read Handout 2 and discuss the following questions:

   (i) What are the differences between internal and external sources of funds?
   (ii) What are the differences between formal and informal sources of funds?
   (iii) What is the importance of internal and external sources of funds to new ventures?
   (iv) What are the advantages and disadvantages of internal and external financing?

3. Have students read Handout 3 and discuss the following:

(i) What is the concept of venture capital?
(ii) What are the financing stages in venture capital?
(iii) What are the different types of venture capital?
(v) What are the businesses that are attractive to venture capitalists?
(vi) What are the sources of financing in venture capital?
(vii) What are the methods of valuation in venture capital?

4. Have students read Handout 4 and discuss the following questions:

(i) The Small and Medium Industries Equity Investment Scheme (SMIEIS)

(ii) Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB)

(iii) The Bank of Industry (BOI)

(v) Refinancing and Rediscounting Facility (vi Small Scale Industries Credit Scheme (SSICS)

(vi) World Bank Facility for Small and Medium Scale Enterprises Loan (SMEX Loan)

(vii) Nigerian Export and Import Bank (NEXIM)

5. Have students read Handout 5 and discuss the Case Study at the end of this module.

RESOURCE GUIDE

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HANDOUT 1

SOURCES OF FUNDS FOR NEW AND ENTREPRENEURIAL VENTURES

There are several sources of finance for both new and old entrepreneurial ventures. These sources are:

(i) Personal Savings
(ii) Borrowing from Friends and Relations
(iii) Trade Credit
(iv) Accrual Accounts
(v) Retained Earnings
(vi) Equity Financing
(vii) Bank Loans
(viii) Project Financing
(ix) Venture Capital
(x) Debt Financing
(xi) Commercial Draft
(xii) Banker’s Acceptance
(xiii) Bills Discounting
(xiv) Commercial Paper
(xv) Inventory Financing
(xvi) Bank Overdraft
(xvii) Loans from Corporative Societies
(xviii) Hire Purchase
(xix) Leasing
(xx) Factoring
(xxi) Microfinance Bank
(xxii) Public Offerings
(xxiii) Small Business Investment Organizations

(i) Personal Savings

Personal savings is the most common source of financing for small business enterprises. It has to do with the personal money which the entrepreneur has been able to set aside for an intended business venture. This includes cash and any personal assets convertible into cash or to business use, for example, cash from family/friends which is an informal form of financing falls into this category. This may also be from past savings, trust accounts or some other form of personal equity of the business owner. This is the least expensive method of financing and also the easiest as the decision to lend is made by the same persons wishing to borrow the fund.

(ii) Borrowing from Friends and Relations

Funds can be raised for entrepreneurial ventures through borrowing from friends and relations. The amount to be raised through this source however, depends on the financial capabilities of the friends and relations and the relationship that exists between the business owner and his friends or relations. The repayment period and the interest payable are a function of the terms of borrowing which are usually determined by the lender.

(iii) Trade Credit

Trade credit as a source of fund occurs when a buyer makes an arrangement with the seller to buy goods on credit and pay later. However, this arrangement depends on the customer's good reputation and it often requires a pre-arrangement between the buyer and the seller. Trade credit is one of the most widely used short term sources of funds and the term normally falls within the range of thirty to ninety days which can still be extended after the expiration period, depending on the relationship between the parties involved.

(iv) Accrual Accounts

Accrual accounts can also be called account payable. It represents the continually occurring current liability of a particular business. These include wages, interest, taxes and other expenses that are payable in arrears. They are due but yet to be paid. Their repayment period is usually within a period of one year.

(v) Retained Earnings

Funds can also be obtained through undistributed profits. A business owner may decide to reinvest part of his or her profit back to business for efficient operations of the business. This is also called plough-back profit and it shows the naira value of ownership rights that result from the business retention of its past income. In business, retained earnings are usually considered as an additional fund for financing the future growth of the business. Retained earnings are helpful as a last resort in business finance. The inability of the business owners in meeting up with the stringent conditions of the financial institutions usually makes the business owner come to fall back to their business reserves for funds raising.

(vi) Equity Financing

Equity finance is a form of business finance in which funds borrowed to operate a business venture are not taken as loan but converted to equity (stake in ownership) which now makes the lender a part owner of the business venture, risk and profit are shared together. The amount of equity finance in a particular business may be substantial subject to factors such as the nature of the business, the total amount of capital required and the interest of the investor. The advantage of equity financing is that its infusion of capital does not have to be repaid like a loan.

(vii) Bank Loan

A small business entrepreneur can approach bank for a loan. This is a common practice among established small business enterprises with good reputation doing business with a particular bank. Banks usually charge their borrowers a prime rate and an additional charge usually called handling charge. The actual interest rate charged depends on the creditworthiness of the customers. Banks usually charge a higher interest rate to borrowers whom they perceive as having a higher risk of default. The bank interest rate also depends on the type of loan involved whether is fixed or variable. If the loan is fixed rate loan, the interest rate will be the same for the amount of money over the number of years involved. But if the loan is variable rate loan, the interest payable will vary periodically over the terms of the loan subject to the fluctuation of the market interest rates.

Bank loan can be given either on short term or long term basis. Short term bank loan usually covers between one month and less than one year, while long term bank loan covers a period that is more than year one. Short term loans are used to replenish the working capital account, such as purchase of inventory, supply of consumables in an organization, finance of credit sales or taking of advantage of cash/bulk discounts etc. This is repaid after converting inventory or receivables into cash. The relationship of the borrower with the bank matters a lot. The reason for this is that banks are more likely to give loans to business owners they know very well and whom they have their business and personal records. The amount of money that banks are willing to give per time depends on the nature of business, the size of business, the repayment period and the creditworthiness of the business owner.

(viii) **Project Financing**

Project financing is the funding of a particular project by a financial institution. This can be a source of funds only when the proceeds from the project are sufficient to repay the capital sum usually known as the principal which is the amount of money borrowed for the execution of the project with interest accrued. The project will be used as the security for such loan and the advance is self–liquidating. In this case, the borrower‘s financial standing or position is less important because the institution must ascertain the value of the project and ensure that the value is high enough to settle the amount of money borrowed by the contractor.

(ix) Venture Capital

Venture capital is the money invested by individuals or venture capital firms in small and high – risk business enterprises. Venture capitalists are investors that invest in other people's businesses for the sole aim of profit. They receive equity participation i.e. the equity ownership right of some proportion in the business enterprises they have invested their money in. They participate substantially in the management of the enterprises in which they have invested, holding board positions and working in close liaison with the enterprise's management team.

The venture capital industry may consist of:

(a) wealthy individuals

(b) foreign investors
(c) private investment funds
(d) pension funds or
(e) major corporations.

(x) Debt Financing

These are funds that the business owner borrows and must repay with interest. Borrowed capital maintains ownership of the business (unlike equity financing, which dilutes ownership) but is carried as a liability on Balance Sheet. In general, small businesses are required to pay more interest than large businesses because of perceived higher risks, that is, few percent above prime rate. Entrepreneurs seeking debt capital can have access to a range of credit options varying in Complexity, availability and flexibility, both from commercial and government sponsored lenders.

(xi) Commercial Draft

Commercial draft is a short term financing source credit. It is an unconditional order in writing made by one party. The drawer addressed to a second party, the drawee ordering the drawee to pay a specified sum of money to a third party called the payee. Commercial draft may be a sight or time draft. The type depends on the negotiation terms.

(xii) Banker's Acceptance

This is credit facility that involves a bank and its customer. It is a time draft payable at a stipulated date. It is an arrangement between the businessmen who produce goods for sale. The businessman customer then draws the acceptance credit paper requiring his banker to accept the responsibility of settling the bills pending when the goods will be sold. By placing its acceptance on the bill (acceptance credit) the bank has accepted a contingent liability as well as giving an indication that it will honour the bill upon presentation at maturity in case the customer defaults. A discount house usually evaluates the creditworthiness and reputation of the accepting bank. The maturity date is usually less than six months and it is mainly used in international trade.

(xii) Bills Discounting

Bills discounting is a source of finance where the supplier of goods (creditor) writes a bill of exchange for the customer for acceptance. Immediate cash may be obtained by the supplier for his goods after the goods have been dispatched to the customer by discounting the bill with the bank or discount house after the bill has been accepted by the debtor (customer). Other aspects of bill discounting involves Government securities such as Treasury Bills and certificates which can be surrendered before their maturity dates to banks or discount houses for purchase. The amount paid to the bill owner is less than face value.

(xiii) **Commercial Paper**

This is an instrument of the money market (commercial Bank) that is usually used by many organisations to raise short- term funds. Under this source of funds, an issuing house issues it on behalf of a company. The issuing house only finds investors to buy the commercial paper, the investors deal directly with the company issuing the note. The issuing house does not even guarantee the note. The issuing house charges commission for the service through a coupon rate which is usually stated on the commercial paper. The maturity date of a commercial paper ranges between 90 and 180 days and it is usually written out to contain details such as the date of issue, the maturity date, the amount per coupon, etc. The coupon rate and the issuing house commission make up the cost of commercial paper.

(xiv) Bank Overdraft

Another financial facility is an overdraft facility, which banks give to its business clients. Bank overdraft is an overdrawn bank current account and a short-term financial facility which is renegotiated every year depending on the performance of the business. It may be secured or unsecured depending on the amount of money involved. Bank overdraft is usually covered by personal guarantee of SME owners and carries a higher interest rate than a normal loan. Often this interest rate is higher than profit margin percentages, which makes it a very short-term loan for covering cash flow problems rather than to finance acquisitions or buy stocks. Before banks grant overdraft, the following factors are considered:

(i) The purpose for which the fund is required;
(ii) The character of the entrepreneur;
(iii) The management and financial position of the business;
(iv) The capacity of the business and
(v) Collateral security (this depends on the amount of money involved).

(xv) **Inventory Financing**

Inventory financing is the use of inventory or stocks as collateral security for borrowing of fund. The stocks are usually placed under the control of the lender pending when the loan will be repaid. Note that not all stocks are qualified for such transaction. The marketability, durability and the price stability of the stocks must be considered before such stocks will be used for inventory financing.

(xvi) **Borrowing from Cooperative Societies**

A cooperative society is an association established by group of individuals who pooled their resources together to engage in a business transaction for profit making but mainly for the benefit of members. Depending on the financial capability of the cooperative society, it can provide funds for its members to start business or finance their business transactions. The amount that can be raised from cooperative society is subject to the financial commitment of the members. The repayment period is not usually beyond two years since the fund is provided on short-term sources of finance. The interest charged is also considerable low compared with commercial bank interest rates.

(xvii) Hire Purchase

Hire purchase is used when purchasing assets such as plant, equipment, machinery and vehicles. An initial deposit may be required followed by a series of installment payment with an attached interest. The interest rate is usually controlled by the prevailing bank rate (e.g. 4 percent above bank lending rate when regulated by government). Under hire purchase, agreement periods can range between 1 to 3 years depending on life span of the asset. Hire purchase is quick and easy to arrange, the security for agreement being the asset itself. Upon the payment of the initial deposit, the customer enjoys immediate use of the asset. The asset legally belongs to the owner of the asset and if the buyer defaults, the owner of the assets automatically repossesses his or her asset.

(xviii) Leasing

A lease is an agreement whereby the owner-manager (lessee) undertakes to make regular monthly payments to the financial institution (lessor) in return for the use of equipment belonging legally to the latter. The leasing instrument is used by SMEs to finance equipment (including vehicles) acquisitions. Operating leases function in such a way that the leasing company retains ownership and risks associated with the equipment (although insurance is mandatory). The lessor is therefore both the financier and the legal owner of the equipment. When the tenure of the lease ends, the lessee can decide to elect to purchase the equipment for a sum which must represent at 10% of the cost of the equipment. In lease financing, the following points are important and worth noting by any entrepreneur that wants to enter into lease agreement.

(i) Ownership of the asset does not rest with the business until the asset is sold at residual value at end of contract.
(ii) Capital allowances may be claimed by leasing institution but not by the business.
(iii) Lease payments are tax deductible that is, passed as expenses in Profit and Loss.
(iv) Leasing does not normally affect borrowing capacity unless financial legislation requires balance sheets to reflect leasing finance.
(v) Period of repayment matches expected life of asset.
(vi) Immediate use of asset.

(xix) Factoring

Factoring is a financing source that allows a business owner to raise fund based on the value of his or her invoices yet to be paid. Under factoring arrangement, an entrepreneur can outsource their sales ledger operations and maximize the use of sophisticated credit rating systems for their funding. Factoring arrangement can be with or without recourse. It is with recourse if the factor company collects the amount due from other means upon the default of the debtor and without recourse, if the factor company bears the consequence upon default of the debtor.

In factoring arrangements, an agreed proportion of the invoice value (about 80%) will be paid within a pre-arranged time of say 24 hours. In return, the factor issues receipt on behalf the organization upon collection of the payments.

One of the advantages of factoring is that the business owner will receive the majority of the cash from debtors within 24 hours rather than a longer time. It also reduces the time and money an organization can spend on debt collection since the factor will usually run your sales ledger for the organization. On the other hand, factoring may impose constraints on the way business is being conducted thereby discouraging the customer for future business transactions with the customers.

(xx) Microfinance Banks

Microfinance bank was established in 2005 by the Central Bank of Nigeria according to the provisions of Section 28, sub-section (1) (b) of the *CBN Act 24 of 1991(*as amended) and in pursuance of the provisions of Sections 56-60(a) of the Banks and other Financial Institutions Act (BOFIA) 25 of 1991. This was mainly to promote monetary stability and a sound financial system in the country. The establishment of microfinance banks is meant to expand the financial infrastructure of the country so as to meet the financial requirements of the Micro, Small and Medium Enterprises (MSMEs). Three features distinguish microfinance from other formal financial products. These are: (i) the smallness of loans advanced and or savings collected, (ii) the absence of asset-based collateral, and (iii) simplicity of operations. The goals of microfinance banks include the following:

(i) to provide diversified, affordable and dependable financial services to the active poor, in a timely and competitive manner, that would enable them to undertake and develop long-term, sustainable entrepreneurial activities;

(ii) to mobilize savings for intermediation;

(iii) to create employment opportunities and increase the productivity of the active poor in the country, thereby increasing their individual household income and uplifting their standard of living;

(iv) to enhance organized, systematic and focused participation of the poor in the socio-economic development and resource allocation process;

(v) to provide veritable avenues for the administration of the micro credit programmes of government and high net worth individuals on a non-recourse case basis. In particular, this policy ensures that state governments shall dedicate an amount of not less than 1% of their annual budgets for the on-lending activities of microfinance banks in favour of their residents.

(xxi) Public Offerings

Public offering is a financing option that is only available to companies that are well established. Businesses with sustainable growth potentials in the course of expanding their businesses might decide to use public offerings by 'going public' to raise required funds for their business operations. However, before a company decides to use public offerings as financing means, certain factors need to be considered. These factors include; the cost of the security, other financial obligation of the business, the prospect of the money market, issues concerning the ownership and control of the business. Public offering usually starts with selling of equity holding to the public and this is called initial public offering (IPO) in which stock is registered with the Securities and Exchange Commission (SEC). This is usually offered to the public through a registered Brokerage firm or an investment Banker and this gives the organization the opportunity to trade its shares in the floor of the stock exchange market. To get firms' shares quoted in the stock exchange market, the firm needs to make provision for the associated expenses, filling requirements and other equity considerations. Many Small and Medium Scale Enterprises consider these requirements as stringent conditions and this affects their readiness to undertake IPO as a financing option.

Public offerings usually result in long term sources of funds which include the following:

(a) ordinary shares
(b) preference shares
(c) debentures

(a) **Ordinary Shares**: Ordinary shares represent the ownership position in an organization. Ordinary shares holders are also called shareholders and the risk bearers of the firm. Their rate of dividend is not fixed rather it depends on the discretion of the management. Ordinary shares can be issued at par, discount or premium. The rights of shareholders include:

(i) right to participate in the annual general meeting and vote;
(ii) right to appoint a proxy;
(iii) right to have access to the organization's books; and
(iv) right to contribute to the appointment of members of the board.

(b) **Preference Shares:** Preference shares as a long term source of funds are certificates of ownership in organizations that usually have a fixed rate of dividends which must be paid before ordinary share dividends. It is considered as a hybrid security because it has many features of both ordinary shares and debentures. The types of preference shares include: cumulative and non-cumulative preference shares, redeemable and non-redeemable preference shares, participating and non-participating preference shares. The following features make preference shares to be in the class of ordinary share:

(i) the non-payment of dividends when the company is insolvent;
(ii) dividends are not deductible for tax purposes; and
(iii) some preference shares have no fixed maturity date.

On the other hand, the following features make preference share to be in the class of debenture:

(i) fixed rate of dividends;
(ii) preference shares do not share in the residual earning of the firm; and
(iii) preference shareholders have claims on the income and assets of the business before the ordinary shareholders in the time of winding up.

(c) **Debentures:** Debentures are certificates of debts and they are long term sources of funds that give the holders the opportunity to collect the principal amount at a fixed future date. Debentures have definite interest rate which is payable at annual basis until the capital sum of the amount borrowed is fully paid. They are issued in units of hundred and the interest rates depend on the prevailing interest rate in the money market and financial condition of the firm. The following are the features of debenture:

(i) debentures are negotiable instruments;
(ii) the interests on debenture are tax-deductible;
(iii) they have a fixed coupon rate;
(iv) debentures are redeemable at specific date;
(v) debenture holders do not participate in the control of the firm; and
(vi) debentures are secured either on floating or fixed assets.

(xxii) Small Business Investment Organizations

These can be government owned or private owned with debts being government guaranteed.
Small business investment organizations can be regular or specialized, for example, giving loans only to agro-business or manufacturing firms, business research, product research and development, business start-ups and minority/vulnerable groups. Unlike traditional venture capital companies, they use private funds or government funds to provide both for debt and equity financing to small businesses. Examples of institutions under this category are - Small and Medium Industries Equity Investment Scheme (SMIEIS), Central Bank of Nigeria (CBN, National Economic Reconstruction Fund (NERFUND), National Bank for Commerce and Industry (NBCI), Small Scale Industries Credit Scheme (SSICS).

<u>Questions</u>

Discuss the various sources of funds that are available for the Nigerian entrepreneurs in the following classification:

(i) Equity sources of funds
(ii) Short-term sources of funds
(iii) Medium-term sources of funds
(iv) Long-term sources of funds

HANDOUT 2

INTERNAL AND EXTERNAL SOURCES OF FUNDS

Internal financing is the term for a firm using its profits as a source of capital for new investment, rather than distributing them to firm's owners or other investors and obtaining capital elsewhere while external financing consists of new money from outside of the firm brought in for investment. External financing is the phrase used to describe funds that firms obtain from outside of the firm. It is contrasted to internal financing which consists mainly of profits retained by the firm for investment. There are many kinds of external financing. The two main ones are equity issue which is also considered as external financing are accounts payable, and taxes owed to the government. External financing is generally thought to be more expensive than internal financing, because the firm often has to pay a transaction cost to obtain it. Internal financing is generally thought to be less expensive for the firm than external financing because the firm does not have to incur transaction costs to obtain it, nor does it have to pay the taxes associated with paying dividends.

Advantages and Disadvantages of internal financing

Advantages of internal sources of finance include the following:

i. capital is immediately available;
ii there is no interest payable on such fund;
iii. there is no control procedures regarding the credit worthiness of the owners; and
iv there is no third party's influence.

Disadvantages of internally sourced funds

i. It is somehow expensive.
ii. It does not easily increase capital.
iii. It is not as flexible as external financing.
iv. It is not tax-deductible.
v . It is limited in volume because it is subject to the capability of the owner(s) to raise fund internally.

FORMAL AND INFORMAL SOURCES OF FUNDS

Formal sources of funds represent those institutions that are registered with appropriate authorities to transact the business of finance with entrepreneurs. Examples of formal sources of funds include loans from commercial banks, insurance company etc. Formal financial services are usually provided by financial institutions that are controlled by the government and subject to banking regulations and supervision. On the other hand, informal sources of funds are provided outside the structure of government regulations and supervision. Examples of informal sources of funds include those groups or individuals that are involved in loan disbursement with little or no formal regulations e.g. Esusu, thrift savings scheme, cooperative society etc.

Advantages of formal sources of finance

(i) Provides proper guidelines and documentation for loans.
(ii) Business advisory support from the banks that is lending.
(iii) Helps the entrepreneur to stay focused on the business because of interest rates.

Advantages of informal sources of finance

(i) It helps entrepreneurs to have easy access to funding.
(ii) Less documentation is involved in loan process.
(iii) Entrepreneurs do not stand the risk of loss of assets or business to the institution.

Questions

(i) Distinguish between internal and external sources of funds
(ii) What are the major differences between formal and informal sources of funds?
(iii) Why are internal sources of funds more important than external sources of funds?

HANDOUT 3

CONCEPT, METHOD AND TYPE OF FINANCES PROVIDED BY VENTURE CAPITAL

The Concept of Venture Capital

Venture capital originated in the late 18th century but it only became popular in the industry in the late 1970s and early 1980s when a number of venture capital firms were founded as entrepreneurs found wealthy individuals to back their projects on an ad hoc basis. Venture capital funds may be described as pools of capital constituted for investing in relatively high-risk opportunities. It provides long-term, committed share capital, to help unquoted companies grow and succeed. The venture capitalist makes money by owning equity in the companies they invest in. These companies usually have a novel technology such as biotechnology, IT, software, etc. The venture capital firm that puts in money in new entrepreneurial venture recognizes the risk inherent in the funding exercise. There is a serious risk of losing the entire investment, and if not loss of money invested, it might take a long time before any profit and returns materialize from such investment. However, where there is good management in place, there may be prospect of very high profits and a substantial return on such investment. That is why a venture capitalist will always require a high expected rate of returns on investments, as a compensation for the high risk inherent in the transaction.

Venture Capital Funding

Obtaining venture capital is substantially different from raising debt or a loan from a lender. In capital venture, lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or otherwise of the business. As a shareholder, the venture capitalist's return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist sells his or her shareholdings to another owner. Venture capitalists are typically very selective in deciding where to invest in; as a rule of thumb, a fund may be invested in one of the hundred opportunities presented to it, looking for the extremely rare, yet sought after, qualities, such as innovative technology, potential for rapid growth, a well-developed business model, and an impressive management team. Of these qualities, funds are most interested in ventures with exceptionally high growth potential, as only such opportunities are likely capable of providing the financial returns and successful exit event within the required timeframe (typically 3–7 years) that venture capitalists expect.

Financing Stages in Venture Capital

Six stages are involved in venture capital financing and they are as listed below:

(i) **Seed Money:** This is a low level financing needed to prove a new idea, often provided by angel investors.
(ii) **Start-up:** This stage deals with firms that are in their early stage that need funding for expenses associated with marketing and product development.

(iii) **First-Round:** This stage covers early sales and manufacturing funds of firms.
(iv) **Second-Round:** It includes funds that are used for financing of the working capital for early stage companies that are selling products or services but make little or no profit from the business.
(v) **Third-Round:** Also called Mezzanine financing. This is expansion money for a newly profitable company.
(vi) **Fourth-Round:** Also called bridge financing. This is used in financing companies that want to "go public".

Types of Venture Capital

Venture Capital firms differ in their approaches, certain factors influence the venture capital decisions and these include:

(i) some venture capital firms tend to invest in new ideas, or fledgling companies. Others prefer investing in established companies that need support to go public or grow.
(ii) some invest solely in certain industries.
(iii) some prefer operating locally while others will operate nationwide or even globally.
(iv) some may want a quicker public sale of the company or expect fast growth. The amount of help a venture capital provides can vary from one firm to the next.

The Positions in Venture Capital Firms

The following positions are obtainable to venture capital firms:

(i) Venture Partners: Venture partners are expected to source potential investment opportunities and they are typically compensated only for those deals with which they are involved.

(ii) Principal: This is a mid-level investment professional position, and often considered a "partner-track" position. Principal venture capitalists are usually promoted from a senior associate position or who have commensurate experience in another field, such as investment banking or management consulting.

(iii) Associate: This is typically the most junior apprentice position within a venture capital firm. After a few successful years, an associate may move up to the "senior associate" position and potentially principal and beyond. Associates will often have worked for 1–2 years in another field, such as investment banking or management consulting.

(iv) Entrepreneur-in-residence (EIR): Entrepreneur in residence are experts in a particular domain and perform due diligence on potential deals. EIRs are engaged by venture capital firms temporarily (6 to 18 months) and are expected to develop and pitch startup ideas to their host firm although neither party is bound to work with each other. Some EIRs move on to executive positions within a portfolio company.

Businesses that are Attractive to Venture Capitalists

Venture capitalist prefers to invest in "entrepreneurial businesses". This does not necessarily mean small or new businesses rather; it is more about the investment's aspirations and potential for growth, rather than the size of the business. The growth potential of a business is a primary factor for attracting the interest of a venture capitalist who ensures that the business is managed by experienced and ambitious teams who are capable of turning their business plan into reality.

Sources of Finance for Venture Capital Firms

Venture capital firms raise their funds from several sources. To obtain these funds, venture capital firms have to demonstrate a good track record and the prospect of producing returns more than what is achievable through fixed interest or quoted equity investments. Most venture capital firms raise their funds for investment from external sources such as; pension funds scheme, insurance companies, mutual funds, public offerings from interested investors and private placements. Venture capital firms' investment preferences may be affected by the sources of their funds. The term of the investment is often linked to the growth profile of the business. Many funds raised from external sources are structured as 'limited partnerships' and usually have a fixed life of 10 years while they retain their investment in business for period of three and five years. That is the reason why venture capitalists prefer to invest in businesses with high effective performance where they are sure of maximizing their returns within the stipulated period of time of investment.

Before a venture capital firm can invest in any business, information on the following are important:

(i) Good business plan/feasibility report.
(ii) Technical know-how of the promoters of the business.
(iii) Product or service commercially viability.
(iv) Potential sustainability of growth for the business.
(v) Whether management have the ability to exploit this potential and control the company through the growth phases.
(vi) Forecasting techniques and accuracy of past forecasting.
(vii) Assumptions on which financial assumptions are based.
(viii) The latest available management accounts, including the company's cash/debtor positions
(ix) Bank facilities and leasing agreements.
(x) Pensions funding.
(xi) Employee contracts, etc.
(xii) Does the possible reward justify the risk?
(xiii) Does the potential financial return on the investment meet their investment criteria?

Methods of Valuation Used By Venture Capital

The following steps are mostly used as methods of valuation by venture capital firms:

(i) Identification of the amount of capital to be invested by the investor.

(ii) Identification of the target rate of return expected by the investor.

(iii) Estimation of the multiple of the original investment that will fetch the required rate of return over the anticipated holding period.

(iv) Projection of the market value of the firms based on performance projected during the proposed year of existence.

(v) Estimate the percentage of the projected value that the investor needs to claim in order to achieve his return objective.

Investment Process of a Venture Capitalist

The investment process, from reviewing the business plan to actually investing in a proposition, can take a period between one month to one year except in some exceptional cases where it takes extremely long time frame due to the volume of information involved. The key stage of the investment process is the initial evaluation of a business plan. Most approaches to venture capitalists are rejected at this stage. Venture capital investments are often accompanied by additional financing at the point of investment. This is usually the case where the business in which the investment is being made is relatively well-established. In this case, it is appropriate for a business to have a financing structure that includes both equity and debt. To support an initial positive assessment of a business proposition, the venture capitalist will want to assess the technical and financial feasibility in detail.

The professionals that venture capital use to access a business may include: business consultants/analysts, lawyers, chartered accountants, engineers etc. External consultants are often used to assess market prospects and the technical feasibility of the proposition, unless the venture capital firm has the appropriately qualified people in-house. Chartered accountants are often called on to do much of the due diligence, such as to report on the financial projections and other financial aspects of the plan. These reports often follow a detailed study, or a one or two day overview may be all that is required by the venture capital firm.

How is Venture Capital (VC) different from banks?

Banks provide term loans and working capital limits to companies. The company has to make interest payments and pay back the principal within a stipulated timeframe. In comparison, VC subscribes to the equity shares of a company for a stake in the company at a negotiated valuation.

Questions

(i) What is venture capital?
(ii) What are the methods that can be used to value venture capital?
(iii) List and explain Venture Capital Financing Stages.
(iv) What are the factors that influence the venture capital decisions?
(v) Enumerate rewards to Venture Capital.
(vi) Explain alternative sources of funds to venture capital.
(vii) What are the information that are necessary for consideration of venture capital?

HANDOUT 4

GOVERNMENT INITIATIVES IN FUNDING SMALL AND MEDIUM ENTERPRISES (SMEs) IN NIGERIA

The importance of the SMEs to the economic development and growth of both developed and less developed economies had earned them a worldwide recognition. Several efforts from both government and international agencies have been directed towards enhancing the operations of SMEs especially in the area of financing. These schemes are making much impact to ensure that the objectives of SMEs are achieved in terms of job creation, poverty alleviation, skill supply, infrastructure provision etc. in the Nigerian economy. In order to make the SMEs sector more vibrant, the Central Bank of Nigeria evolved new initiatives, which are geared towards improving accessibility and availability of credit to the SMEs through the following schemes:

(i) The Small and Medium Industries Equity Investment Scheme (SMIEIS)

Bothered by the persistent decline in the performance of the industrial sector and with the realization of the fact that the Small and Medium Scale Industries hold the key to the survival of the manufacturing sector and other productive sectors of the economy, the Central Bank of Nigeria successfully persuaded the Bankers' Committee in 2000 to agree that each bank should set aside 10 percent of its annual profit before tax for equity investment in small and medium scale enterprises. To ensure the effectiveness of the programme, banks are expected to identify, guide and nurture enterprises to be financed under the scheme. The activities targeted under the scheme include agro-allied, information technology, telecommunications, manufacturing, educational establishments, services, tourism and leisure, solid minerals and construction. The scheme was formally launched in August 2001. With the introduction of the scheme, it is expected that improved funding of the SMEs will facilitate the achievement of higher economic growth. As at August 2002, the sum of N11.572 billion had been set aside by 77 banks. Out of this amount, N1.692 billion had been invested in the small and medium scale enterprises.

(ii) Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB)

Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB**)** was established in October, 2000 as an amalgamation of the Peoples Bank of Nigeria, Nigerian Agricultural and Cooperative Bank and the Family Economic Advancement Programme (FEAP). The primary aim for setting up this scheme is to finance agriculture as well as small and medium enterprises. It is structured to accept deposits and offer loans /advances in which the interest rates are usually in proportion to the reason for taking the loan, mainly for Nigerians and their business. Other services offered by the NACRDB include target savings: Loan for start – up ventures and smallholder loan schemes.

(iii) The Bank of Industry

The Bank of Industry (BOI) was establish in 2000 as an amalgamation of the former Nigerian Industrial Development Bank, the Nigerian Bank for Commerce and Industry and the National Economic Reconstruction Fund (NERFUND). The main objective for setting up BOI is to provide credit to the industrial sector, including the SMEs.

(iv) Refinancing and Rediscounting Facility (RRF)

This programme was introduced by the Central Bank of Nigeria in January 2002 to offer financial assistance at concessionary interest rate to support medium to long term bank lending to the real sectors of the economy. The primary objective of this programme is to provide liquidity to banks in support of their financing of the productive sector activities of Nigerian economy. This was meant to bridge the gap in financing projects that are mainly long term since banks mainly gives short term loans and loans for commerce and trade. The medium and long term business operators, who are involved in productive sectors of the economy, are to be encouraged through this facility. Banks that are facing liquidity problems as a result of having committed their resources to long term financing to the specified productive sectors are relieved through the activities of RRF. The following sectors are included for the RRF loan schemes: agricultural production, semi manufacturing and manufacturing, solid minerals and information technology. Under the facility, banks shall have access up to 60 percent of qualifying loans. Qualifying loans must have been held for not less than one year.

Other Government Financing Incentives which had one time functioned include:

(v) Small Scale Industries Credit Scheme (SSICS)

The Small Scale Industries Credit Scheme was introduced in 1971, as a revolving grant by the Federal and State Government, to assist in meeting the credit needs of small scale enterprises on relatively more liberal conditions than in private lending institutions as commercial banks.

(vi) Nigerian Bank for Commerce and Industry (NBCI)

The NBCI operates as the apex institutional body for financing SMEs in addition to its normal banking operations, the bank also administers the Federal Ministry of Industry (FMI) special fund for small scale enterprises to secure loan from the bank to finance a particular project, the applicant for such loan must fulfill the Bank's requirements to source at least 20 percent of the investment from his own personal resources to show commitment.

(vii) **National Economic Reconstruction Fund (NERFUND)**

The Federal Government in furtherance of its programme and commitment to boosting SMEs in it industrialization drive has set up a fund for the financing of SMEs. The fund known as

National Economic Reconstruction Fund (NERFUND) was established under decree number 2 of 1989.

According to the President, the fund is a "crucial policy instrument for stimulation of valid Small and Medium Scale Industries and Agro Allied Enterprises for economic development".

(viii) **World Bank Facility for Small and Medium Scale Enterprises (SMEX) Loan**

In order to further promote the growth of the SMEs, the Federal Government also negotiated further financial assistance with the World Bank to complement other sources of funding for the SMEs. This involves a loan of US$270 million of which US$265.7 million is to be made available for on lending to SMEs through eligible participating banks. The SMEX is managed directly by the SME Apex unit loan scheme located in the Central Bank of Nigeria (CBN).

(ix) Nigerian Export and Import Bank (NEXIM)

NEXIM was established in January 1990 to manage a number of credit facilities introduced specifically to boost Nigeria's non-oil export sector. The establishment of NEXIM was also intended to support farmers and other small scale exporters to have direct access to international markets. The facilities offered by NEXIM include the export stimulation loan (ESL), the foreign facility (FF) and the refinancing and rediscounting facility (RRF). Various financing methods of small scale business could be loan and bank overdraft.

<u>Questions</u>

Write short notes on the following:

(i) The Bank of Industry (BOI)

(ii) The Small and Medium Industries Equity Investment Scheme (SMIEIS)

(iii) Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB)

(iv) National Economic Reconstruction Fund (NERFUND)

(v) Small Scale Industries Credit Scheme (SSICS).

<u>HANDOUT</u> 5

CASE STUDY

Company J&J Nig. Ltd was incorporated in 1998 with a total sum of ₦200,000.00 equity funds and as part the firm's business activities, it deals with a wide variety of products for home and office use. The firm also sells picture frame and other related products. In addition, the firm also markets its products through some independent distributors or sales representatives who mak sales to variety and furniture stores and gift items. The firms accounts receivable range in size from ₦400,000.00 which represents the minimum order that it will accept to ₦ 25,000.00 to ₦30,000.00 for its five largest distributors and 10 to 15 of its major department store accounts. The Chief Executive of the firm is Mr. James John Oluwa. The company J&J Nig. Ltd is privately owned with the majority of the shares held by members of the James Oluwa's family as the employees of the firm. Mr. Jacob who is the first son of the chief executive of the firm and one of the directors follows the firm's traditional policy of, as his father used to say," a sound product line, and a sound balance sheet." By stressing new technology and complete product line, the firm has shown strong profits with minimum cyclical downturns. By emphasizing a sound balance sheet, the firm has avoided borrowing to finance capital purchases.

The company has retained a portion of its earnings each year to finance expansion and opening of new branches. In 2010, for example the firm retained ₦300, 000.00 after declaring its profit as part of the exercise to strengthen the business. The owner of J& J Company selects one area of the firm for detailed review. This year it has chosen the firm's credit policy and has begun to collect information so that it may be evaluated. The firm selling terms are 1/10 net 30 and he does not plan to change them because of competitive factors. But he does want to pay particular attention to bad losses, which typically run to some ₦150, 000.00 a year.

At the beginning of the review, one of the Directors Mr. Jacob who represents the firm at the SMEs meetings, called Mr. Tony the Accountant of the firm to arrange for the N625,000 bank note financing he used to help finance J&J company inventory. The total line of credit is N1, 200,000 and the firm ended the year with ₦625, 000.00 exercised against it. Mr. Jacob pointed out the bank's wishes that the line of credit be 'cleaned up' by the middle of the year and Mr. Tony indicated his willingness to work with Mr. Jacob on the review of the firm's credit policy.

Note: This case was adapted from Hampton, J. J. (1989).

<u>Questions</u>

(i) What are the benefits of using equity funds to run a family business?

(ii) What are the cost implications of using debt financing for a family business?

(iii) What are the consequences of going to a bank for financial assistance for a new business?

(iv) What type of credit policy can you advise the chief executive J&J Nig. Ltd to adopt for building a strong future for the business?