34 Sources of finance

he need for funds

irms need money to get started, i.e. to buy equipment, raw aterials and obtain premises. Once this initial expenditure has een met, the business can get under way. If successful, it will arn money from sales. However, business is a continuous ctivity and money flowing in will be used to buy more raw aterials and settle other trading debts.

If the owner wants to expand, extra money will be needed ver and above that from sales. Expansion may mean larger remises, more equipment and extra workers. Throughout the fe of a business there will almost certainly be times when oney has to be raised from outside.

The items of expenditure above fall into two categories – APITAL EXPENDITURE or REVENUE EXPENDITURE. apital expenditure is spending on items which may be used ver and over again. A company vehicle, a cutting machine and new factory all fall into this category. Capital expenditure will e shown in a firm's balance sheet because it includes the urchase of fixed assets. It also includes the maintenance and pair of buildings and machines.

Revenue expenditure refers to payments for goods and rvices which have either already been consumed or will be ery soon. Wages, raw materials and fuel are all examples. It also cludes the maintenance and repair of buildings and machines. evenue expenditure will be shown in a firm's profit and loss count or income statement because it represents business costs expenses.

Internal sources of finance

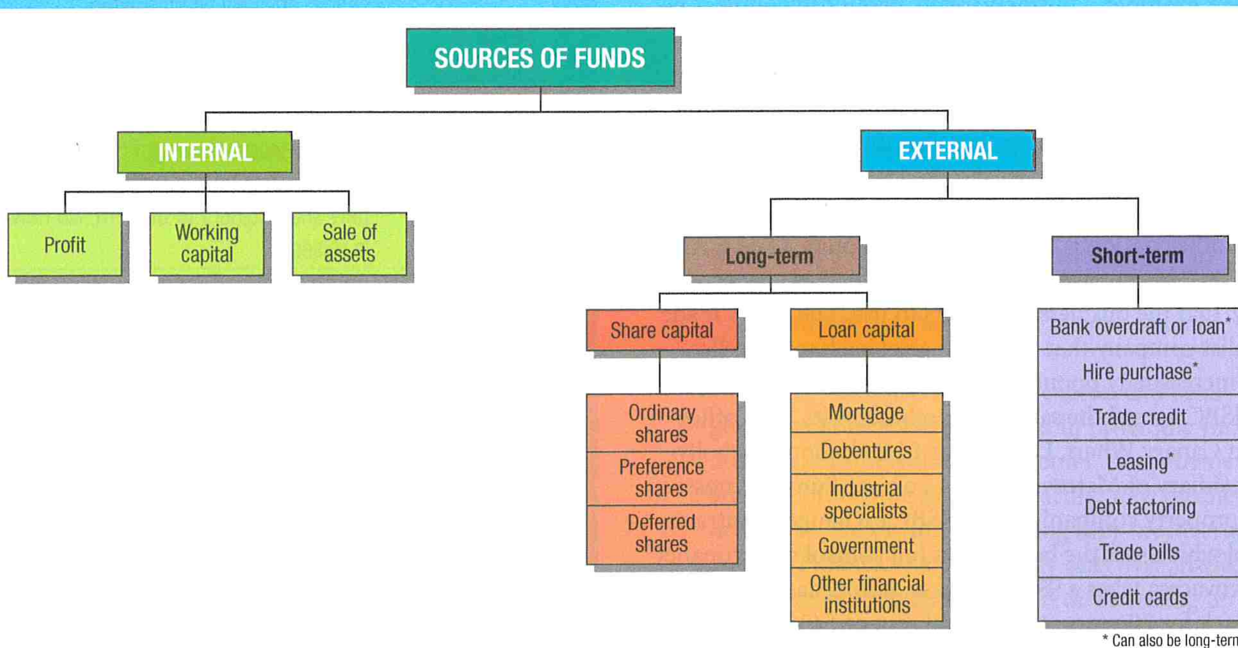
Figure 1 shows how sources of finance are either internal or external. Internal sources can only be used when a business is established because money cannot be taken out of a business until revenue has been generated by trading activities. Although most of this unit focuses on external sources of finance, internal sources are very important. This is because internal sources are cheap. A business does not have to pay interest, for example, if it uses its own money to fund activities.

There are three important internal sources of finance.

Profit Retained profit is profit after tax that has not been returned to the owners. It is the single most important source of finance for a business. Around 65 per cent of all business funding comes from retained profit. It is the cheapest source of finance, with no financial charges such as interest, dividends and administration. However, there is an opportunity cost. If retained profit is used by the business it cannot be returned to the owners. This may lead to conflict if the shareholders of a public limited company, for example, see that dividend payments have been frozen because the directors have used the profit in the business.

Working capital It may be possible to 'squeeze' working capital to provide extra finance for the business. One way of doing this is to operate a 'tighter' credit policy. For example, a business might reduce the trade credit period, so that money is received

Figure 1: Sources of funds



Question 1.

Godwin's Ice Cream is located in Weston-on-the-Green, Oxfordshire. The business has an ice cream factory and shop attached to a working farm. The business's activities include ice cream manufacture from the farm's own milk, sale of ice cream on-site and sale through a limited number of shops and restaurants. The aim of the business was to replace lost income from falling product prices, through adding value to the existing product. Before setting up the owners wrote a business plan and made an application for a Rural Enterprise Scheme (RES) grant. There were initial problems with the grant due to different interpretations by DEFRA staff of which aspects of the business were eligible for the RES grant. However, it was felt this was probably a teething problem with the scheme as they were one of the first applicants and the forms and guidance are now clearer. The grant was eventually awarded to Godwin's. The other main source of finance for the business is a bank overdraft.

Source: adapted from www.southeast-ra.gov.uk.

(a) What is the advantage to Godwin's Ice Cream of obtaining a grant to help fund the business?
(b) Why do you think it is important to write a business plan when applying for funds?
(c) One of Godwin's main sources of finance is a bank overdraft. Explain (i) why this is an external source of finance and (ii) why this will be a flexible source of finance to Godwin's.

from customers more quickly. Or a business might collect long-standing debts by applying more pressure to customers. Both these options might result in a loss of orders and damage customer relations. Another approach is to reduce stock holding. Money tied up in stocks is unproductive. If a business can reduce stock, money is released and can be used for more productive activities. But having too little stock can be a problem. For example, a business might find it difficult to cope with a surge in demand if stocks are too low.

Sale of assets An established business may be able to sell some unwanted assets to raise finance. For example, machinery, land and buildings that are no longer required could be sold off. Large companies can sell parts of their organisation to raise finance. Another option is to raise money through a SALE AND LEASEBACK. This involves selling an asset, such as property or machinery, that the business still wants to use. The sale is made to a specialist company that leases the asset back to the seller. This is an increasingly popular source of finance. For example, in 2007, HSBC agreed the sale and leaseback of its head office building in Canary Wharf, London for £1.09 billion. A wholly-owned subsidiary of Metrovacesa, S.A., one of Europe's most respected property companies, and HSBC exchanged contracts on the deal which sees the bank retain full control of occupancy while Metrovacesa takes a 998-year lease. HSBC has leased the building back for 20 years at an annual rent of £43.5 million with an option to extend for a further five years.

External long-term sources of finance

External long-term capital can be in the form of share capital or loan capital.

Share capital For a limited company SHARE CAPITAL is likely to be the most important source of finance. The sale of shares can raise very large amounts of money. ISSUED SHARE CAPITAL is the money raised from the sale of shares. AUTHORISED SHARE CAPITAL is the maximum amount shareholders want to raise. Share capital is often referred to as PERMANENT CAPITAL. This is because it is not normally redeemed, i.e. it is not repaid by the business. Once the share has been sold, the buyer is entitled to a share in the profit of the

Table 1: Summary and explanation of the ways in which new shares can be made available to investors on the stock exchange

INITIAL PUBLIC OFFERING (IPO)	
Public issue	Potential investors might apply to an ISSUING HOUSE, such as a merchant bank, after reading the company prospectus. This is an expensive method, but suits big issues.
Offer for sale	Shares are issued to an issuing house, which then sells them at a fixed price. This is also expensive but suits small issues.
Sale by tender	The company states a minimum price which it will accept from investors and then allocates shares to the highest bidders.
PLACING	
Private placing	Unquoted companies (who do not sell on the Stock Exchange) or those with small share sales approach issuing houses to place the shares privately with investors.
Stock exchange placing	Less popular issues can be placed by the stock exchange with institutional investors, for example. This is relatively inexpensive.
AN INTRODUCTION	Existing shareholders get permission from the Stock Exchange to sell shares by attracting new shareholders to the firm. No new capital is raised.
RIGHTS ISSUE	Existing shareholders are given the 'right' to buy new shares at a discounted price. This is cheap and simple, and creates free publicity. Issues can be based on current holdings. A one for five issue means that 1 new share is issued for every five currently held.
BONUS ISSUE	New shares are issued to existing shareholders to capitalise on reserves which have built up over the years. No new capital is raised and shareholders end up with more shares, but at lower prices.

company, i.e. a dividend. Dividends are not always declared. Sometimes a business makes a loss or needs to retain profit to help fund future business activities. A shareholder can make a CAPITAL GAIN by selling the share at a higher price than it was originally bought for. Shares are not normally sold back to the business. The shares of public limited companies are sold in a special share market called the STOCK MARKET or STOCK EXCHANGE, dealt with later in this unit. Shares in private limited companies are transferred privately. Shareholders, because they are part owners of the business, are entitled to a vote. One vote is allowed for each share owned. Voting takes place annually and shareholders vote either to re-elect the existing board of directors or replace them. Different types of shares can be issued.

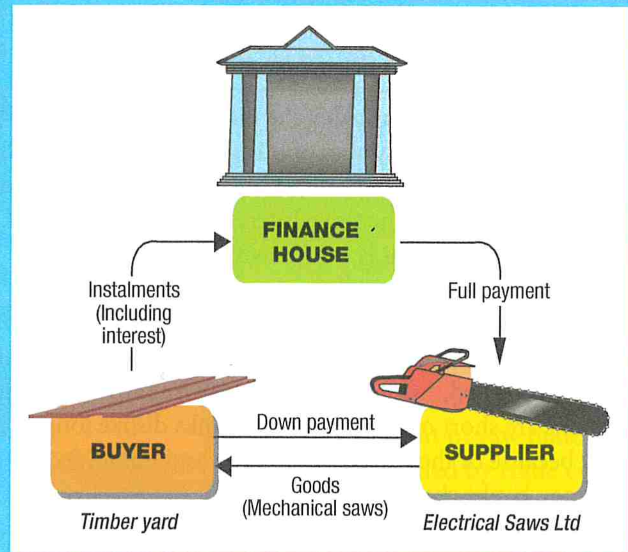
- **Ordinary shares.** These are also called EQUITIES and are the most common type of share issued. They are also the riskiest type of share since there is no guaranteed dividend. The size of the dividend depends on how much profit is made and how much the directors decide to retain in the business. All ordinary shareholders have voting rights. When a share is first sold it has a nominal value shown on it - its original value. Share prices will change as they are bought and sold again and again.
- **Preference shares.** The owners of these shares receive a fixed rate of return when a dividend is declared. They carry less risk because shareholders are entitled to their dividend before the holders of ordinary shares. Preference shareholders are not strictly owners of the company. If the company is sold, their rights to dividends and capital repayments are limited to fixed amounts. Some preference shares are cumulative, entitling the holder to dividend arrears from years when dividends were not declared. Some are also redeemable, which means that they can be bought back by the company.
- **Deferred shares.** These are not used often. They are usually held by the founders of the company. Deferred shareholders only receive a dividend after the ordinary shareholders have been paid a minimum amount.

When a company issues shares there is a variety of ways in which they can be made available to potential investors as shown in Table 1.

Loan capital Loan capital may come from a number of sources.

- **Debentures.** The holder of a debenture is a creditor of the company, not an owner. This means that holders are entitled to an agreed fixed rate of return, but have no voting rights. The amount borrowed must be repaid by the expiry date.
- **Mortgages.** Only limited companies can raise money from the sale of shares and debentures. Smaller enterprises often need long-term funding, to buy premises for example. They may choose to take out a mortgage. A mortgage is usually a long-term loan, from, say, a bank or other financial institution. The lender must use land or property as security on the loan.

Figure 2: A hire purchase agreement and the parties involved in the three way transaction



- **Industrial loan specialists.** A number of organisations provide funds especially for business and commercial uses. These specialists tend to cater for businesses which have difficulty in raising funds from conventional sources. In recent years there has been a significant growth in the number of VENTURE CAPITALISTS. These provide funds for small and medium sized companies that appear to have some potential, but are considered too risky by other investors. Venture capitalists often use their own funds, but also attract money from financial institutions and 'Business Angels'. Business Angels are individuals who invest between £10,000 and £100,000, often in exchange for an equity stake. A typical Angel might make one or two investments in a three year period, either individually or together with a small group of friends, relatives or business associates. Most investments are in start-ups or early stage expansions. There are several reasons why people become Business Angels. Many like the excitement of the gamble involved, or being part of a new or developing business. Others are attracted by the tax relief offered by the government. Some are looking for investment opportunities for their unused income, such as retired business people.
- **Government assistance.** Both central and local government have been involved in providing finance for business. Business start up schemes can provide a small amount of income for those starting new businesses for a limited period of time, providing they meet certain criteria. Financial help is usually selective. Smaller businesses tend to benefit, as do those setting up in regions which suffer from heavy unemployment.
- **Other financial institutions.** Banks, for example might under certain conditions give a business a long-term loan

which will be repaid over a number of years. The bank may require some form of collateral on the loan, and a business may need to present a business plan to secure the loan.

External short-term sources of finance

Bank overdraft This is probably the most important source of finance for a very large number of businesses. Bank overdrafts are flexible. The amount by which a business goes overdrawn depends on its needs at the time. Interest is only paid by the business when its account is overdrawn.

Bank loan A loan requires a rigid agreement between the borrower and the bank. The amount borrowed must be repaid over a clearly stated time period, in regular instalments. Most bank loans are short or medium term. Banks dislike long term lending because of their need for security and liquidity. Sometimes, banks change persistent overdrafts into loans, so that firms are forced to repay at regular intervals.

Hire purchase This is often used by small businesses to buy plant and machinery. Sometimes, a hire purchase agreement requires a down payment by the borrower, who agrees to repay the remainder in instalments over a period of time. FINANCE HOUSES specialise in providing funds for such agreements. Figure 2 illustrates the working of an agreement and the parties involved. The buyer may place a down payment on a machine with the supplier and receives delivery. The finance house pays the supplier the amount outstanding and collects instalments (including interest) from the buyer. The goods bought do not legally belong to the buyer until the very last instalment has been paid to the finance house. If the buyer falls behind with the repayments the finance house can legally repossess the item. Finance houses are less selective than banks when granting loans. Hence their interest rates are higher. They add a servicing charge for paying in instalments which also leads to higher rates. Hire purchase agreements can sometimes be for longer periods.

Trade credit It is common for businesses to buy raw materials, components and fuel and pay for them at a later date, usually within 30-90 days. Paying for goods and services using trade credit seems to be an interest free way of raising finance. It is particularly profitable during periods of inflation. However, many companies encourage early payment by offering discounts. The cost of goods is often higher if the firm does not pay early. Delaying the payment of bills can also result in poor business relations with suppliers.

Leasing A LEASE is a contract in which a business acquires the use of resources such as, property, machinery or equipment, in return for regular payments. In this type of finance, the ownership never passes to the business that is using the resource. With a finance lease, the arrangement is often for three years or longer and, at the end of the period, the business is given the option of then buying the resource. In accounting, the payments are treated as capital expenditure. With an operating lease, the arrangement is generally for a shorter period of time, and the payments are treated as revenue expenditure.

There are some advantages of leasing.
- No large sums of money are needed to buy the use of equipment.
- Maintenance and repair costs are not the responsibility of the user.
- Hire companies can offer the most up to date equipment.
- Leasing is useful when equipment is only required occasionally.
- A leasing agreement is generally easier for a new company to obtain than other forms of loan finance. This is because the assets remain the property of the leasing company.

However:
- over a long period of time leasing is more expensive than the outright purchase of plant and machinery;
- loans cannot be secured on assets which are leased.

Factoring When companies sell their products they send invoices stating the amount due. The invoice provides evidence

Question 2.

A mobile phone-based information service, 82Ask, launched by one of Britain's top rising female entrepreneurs, is aiming to float on the stock market early next year after raising £1.3 million in funds. The company, which is changing its name to Texperts, is led by Sarah McVittie, a former UBS investment banker. Texperts allows users to text a question to a team of research experts who promise to provide an answer within five minutes. Users are charged £1 per question only if the inquiry is fully completed. The service, which has close to 400,000 users, has a network of 220 experts answering questions on anything from trivia and entertainment to recommending restaurants, providing travel information and sending maps to people's mobile phones.

Odey Asset Management (an industrial loan specialist), is understood to have provided most of the new funding and now has a stake of around 14 per cent in Texperts. McVittie and co-founder Thomas Roberts, each have about a 15 per cent stake. Over the past four years, Texperts has raised £2.5 million, mainly from wealthy individuals in three fundraising rounds. About £1 million of the £1.3 million from the latest round of fund raising is earmarked for advertising and marketing. This is well above the £200,000 spent to date.

Source: adapted from the *Sunday Times*, 19.8.2007.

(a) Why is Texperts raising finance?
(b) How much of the business is owned by the original founders?
(c) Describe the two key sources of finance used by Texperts?
(d) Discuss the drawback to the founders of Texperts of using this type of finance.

Table 2: Advantages and disadvantages of being high geared and low geared

	Advantages	Disadvantages
Low geared	The burden of loan repayments is reduced. The need for regular interest payments is reduced. Volatile interest rates are less of a threat.	Dividend payments have to be met indefinitely. Ownership of the company will be diluted. Dividends are paid after tax.
High geared	The interest on loans can be offset against tax. Ownership is not diluted. Once loans have been repaid the company's debt is much reduced.	Interest payments must be met. Interest rates can change, which causes uncertainty. Loans must be repaid and may be a burden, increasing the risk of insolvency.

of the sale and the money owed to the company. Debt factoring involves a specialist company (the factor) providing finance against these unpaid invoices. A common arrangement is for a factor to pay 80 per cent of the value of invoices when they are issued. The balance of 20 per cent is paid by the 'factor' when the customer settles the bill. An administrative and service fee will be charged.

Trade bills This is not a common source of finance, but can play an important role, particularly in overseas trade and commodity markets. The purchaser of traded goods may sign a **bill of exchange** agreeing to pay for the goods at a specified later date. Ninety days is a common period. The seller of the goods will hold the bill until payment is due. However, the holder can sell it at a discount before the maturity date to a specialist financial institution. There is a well developed market for these bills and all holders will receive payment at the end of the period from the debtor.

Credit cards Businesses of all sizes have uses for credit cards. They can be used by executives to meet expenses such as hotel bills, petrol and meals when travelling on company business. They might also be used to purchase materials from suppliers who accept credit cards. Credit cards are popular because they are convenient, flexible, secure and avoid interest charges if monthly accounts are settled within the credit period. However, they tend to have a credit limit. This may make them unsuitable for certain purchases.

The choice of the source of finance

A number of factors are important when choosing between alternative sources of finance.

Cost Businesses obviously prefer sources which are less expensive, both in terms of interest payments and administration costs. For example, share issues can carry high administration costs while the interest payments on bank overdrafts tend to be relatively low.

Use of funds When a company undertakes heavy capital expenditure, it is usually funded by a long-term source of finance. For example, the building of a new plant may be financed by a share issue or a mortgage. Revenue expenditure tends to be financed by short-term sources. For example, the purchase of a large amount of raw materials may be funded by trade credit or a bank overdraft.

Status and size Sole traders, which tend to be small, are limited in their choices of finance. For example, long-term sources may be mortgages and perhaps the introduction of some personal capital. Public and private limited companies can usually obtain finance from many different sources. In addition, due to their size and added security, they can often demand lower interest rates from lenders. There are significant economies of scale in raising finance.

Financial situation The financial situation of businesses is constantly changing. When a business is in a poor financial situation, it finds that lenders are more reluctant to offer finance. At the same time, the cost of borrowing rises. Financial institutions are more willing to lend to secure businesses which have **collateral** (assets which provide security for loans). Third World countries which are desperate to borrow money to fund development are often forced to pay very high rates indeed.

Gearing GEARING is the relationship between the loan capital and share capital of a business. A company is said to be **high geared** if it has a large proportion of loan capital to share capital. A **low geared** company has a relatively small amount of loan capital. For example, two companies may each have total capital of £45 million. If the first has loan capital of £40 million and share capital of only £5 million it is high geared. The other company may have share capital of £30 million and loan capital of £15 million. It is relatively low geared.

The gearing of a company might influence its finance. If a business is high geared, it may be reluctant to raise even more finance by borrowing. It may choose to issue more shares instead, rather than increasing the interest to be paid on loans.

Table 2 shows the advantages and disadvantages of being low or high geared.

Capital and money markets

Businesses have to look to external sources for their finance. Financial intermediaries are the institutions responsible for matching the needs of savers, who want to loan funds, with those of investors, who need funds. These groups do not naturally communicate with each other. Intermediaries provide the link between them.

A number of financial institutions hold funds for savers, paying them interest. In addition, they make finance available to investors who, in turn, are charged interest. Some deal in capital, i.e. permanent and long-term finance, while others deal in money, i.e. short-term loans and bills of exchange. They offer a variety of commercial and financially related services.

The stock market The capital market is dominated by the London Stock Exchange, which deals in second-hand shares. The main function of a stock exchange is to provide a market where the owners of shares can sell them. If this market did not exist, selling shares would be difficult because buyers and sellers could not easily communicate with each other. Savers would be less inclined to buy shares and so companies would find it more difficult to raise finance through the issue of shares.

A stock exchange enables mergers and takeovers to take place smoothly. If the price of a company's shares begins to fall due to poor profitability, a predator may enter the market and begin to build up a stake in that company. Once the stake is large enough a predator can exert control over the company.

A stock exchange also provides a means of protection for shareholders. Companies which have a stock exchange listing have to obey a number of Stock Exchange rules and regulations, which are designed to safeguard shareholders from fraud.

Finally, it is also argued that the general movement in share prices reflects the health of the economy. However, there are times when share price movements could be very misleading. For example, they fell very sharply in 2003 just before the Iraq war when the UK economy was quite stable.

Insurance companies, pension funds, investment trusts, unit trusts and issuing houses (merchant banks) are some of the institutions which trade in shares.

Banks and other financial institutions The money market is dominated by the major commercial banks, such as NatWest or the HSBC. They allow payments to be made through the cheque system and deal in short-term loans. Savings banks and finance corporations also deal in short-term funds. Building societies also provide a source of finance. They have tended to specialise in long-term loans for the purchase of land and property.

At the heart of this highly complex market system is the **Bank of England.** This plays a role in controlling the amount of money loaned and interest rates.

In recent years many of the above institutions have changed in nature. Due to competition, changes in legislation and mergers there has been a great deal of diversification. In particular, there is now little real difference between the role of a building society and that of a bank.

The Alternative Investment Market and the PLUS Markets Group In June 1995 the Alternative Investment Market (AIM) was established. Its purpose was to give small, young and growing companies the chance to raise capital and trade their shares more widely, without the cost of a full stock market listing. In order to join the market, a nominated adviser must be appointed, such as a stockbroker, banker or lawyer. The adviser must supervise the admission procedure and be responsible for ensuring that the company complies with AIM regulations. The admission procedure takes three months. The cost of a listing is about £100,000. Another market, called the PLUS Market Group (previously called OFEX), was set up by J.P. Jenkins, the specialist market-maker in small company shares. It is not regulated by the stock exchange, but only stock exchange member firms can deal directly on the PLUS Market Group. It offers a market place for the shares of unlisted companies that have no interest in joining AIM. Two of Britain's biggest private companies, Rangers Football Club and Jessops, the camera retailer, both feature on the PLUS Market group. The market also acts as a 'feeder' to AIM because flotation and other costs are less at the initial stages.

Capital structure

The CAPITAL STRUCTURE of a business refers to the different sources of funds a business has used. Capital structures can vary considerably depending on the type of business. For example:

- sole traders will not have any share capital in their capital structure;
- firms which have funded expansion by reinvesting profits may not show any long-term loan capital in their capital structure;
- debt-laden companies may have large amounts of loan capital in their capital structure.

KNOWLEDGE

1. Why do businesses need to raise finance?
2. State the internal sources of finance.
3. State the main advantage of using internal finance.
4. What is the difference between ordinary, preference and deferred shares?
5. Why would someone want to become an Business Angel?
6. State the advantages to a business of a bank overdraft compared with a bank loan.
7. What is trade credit likely to be used for?
8. Which is likely to be more expensive, a bank loan or HP?
9. What is the difference between a finance lease and an operating lease?
10. What factors affect the choice of source of finance?