Chapter 9
Business finance

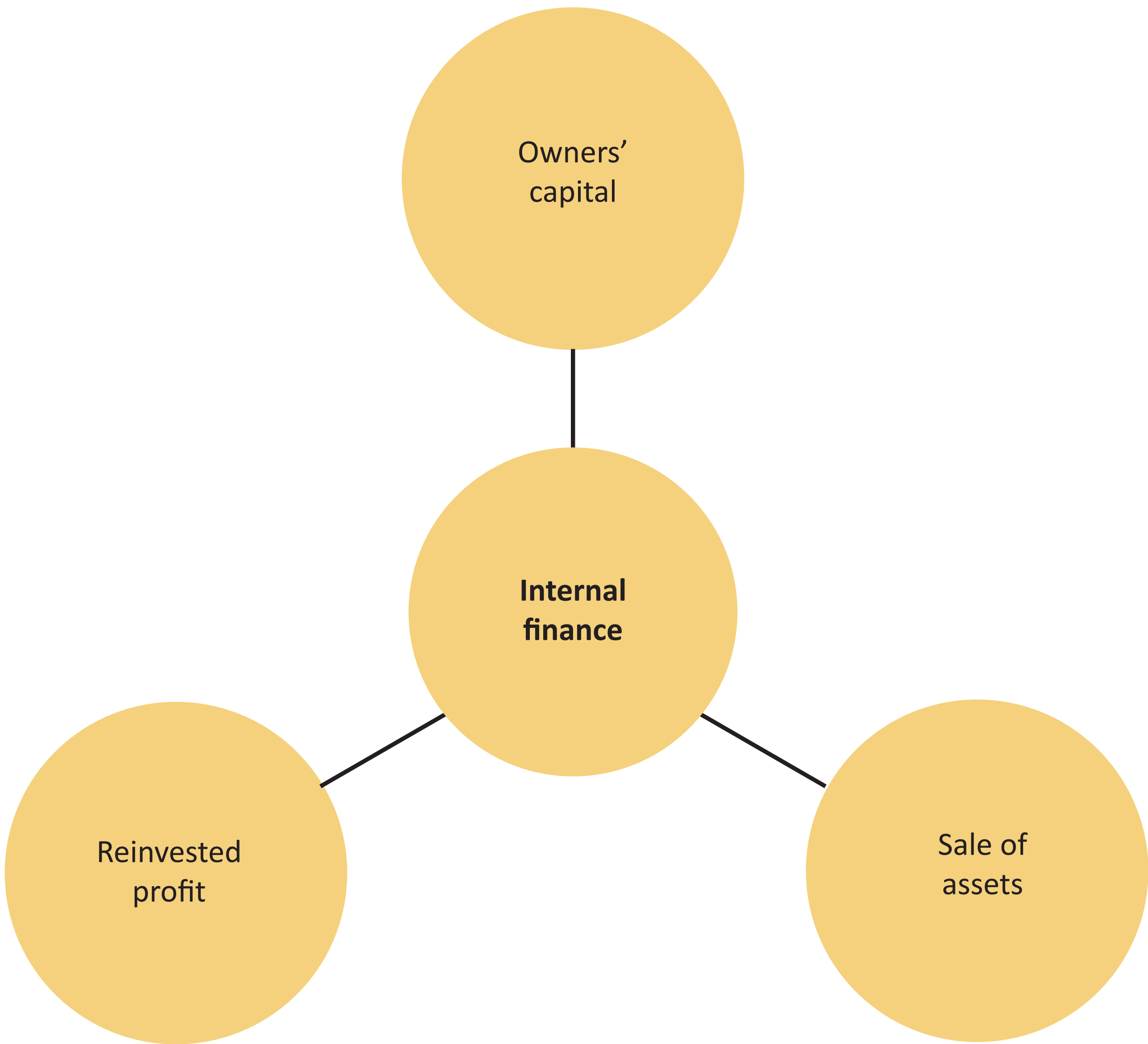
For many businesses there are potentially a wide range of ways of raising funds. These are needed to help set up the business, to keep the business going when cash is short and to help the business expand and grow.

Whether any money for investment is actually available will depend upon a number of factors:

- how well established the business is;
- the amount of profit previously made;
- how much security the business can offer (like buildings or other assets);
- the type of business (sole trader, partnership, private limited companies, public limited companies).

Businesses can raise finance from internal sources and/or external sources.

Internal finance



Sale of assets

A business can sell some of the assets it owns to raise finance. Businesses may have assets they no longer need, such as an old factory site, which can be sold. Often the selling of assets only happens when other ways of raising money have failed. In some cases the business may lease back the asset, so that it still retains its use. Big businesses often do this – e.g. the sale and lease back of office blocks. Selling assets and leasing the asset back improves cash flow in the short term. If the cash raised from the sale of the asset is used effectively by the business, cash flow and profitability can also improve in the long term.

Owners' capital

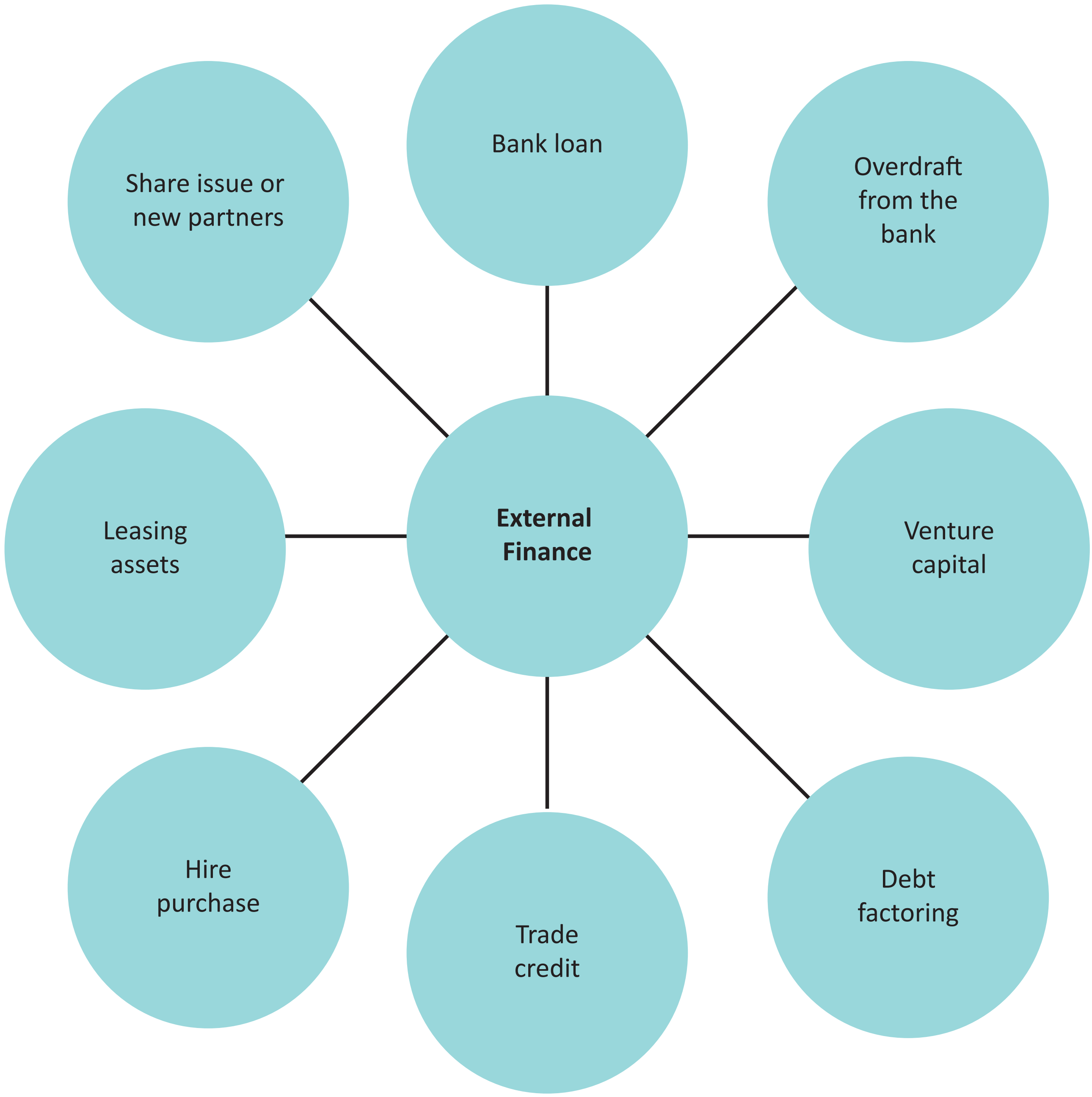
For small businesses, further investment of the sole trader's or partners' own capital (savings) may be the only method of raising money. Risk-taking entrepreneurs may sell their own assets (e.g. house) to raise money to invest.

Reinvested profit

When a business makes a profit it can pay out the profit to owners or shareholders or it can reinvest the profit back in the business. Often both may occur, with some profits going to owners or shareholders and the rest reinvested in the business.

Reinvesting profit is a good idea as there is no interest to pay on the money invested (there would be interest to pay if all the profits had been given to the owners, and the money for investment had come from loans). Also the owners should be happy to reinvest profits as the growth of the business will increase the value of their share of the business, and hopefully lead to higher profits in the future. However, there is a short-term cost – less profit to be shared amongst owners and lower dividends for shareholders of private limited and public limited companies.

External finance



Share issue or new partners

For a sole trader, taking on a partner is a good way of helping fund investment. New partners not only bring in more capital (money) for investment, but can offer new skills which help a business grow. For existing partnerships new partners are also an effective way of funding growth. New partners 'buy in', and will be given part-ownership of the business. Their share of ownership, responsibilities and profits should be made clear in a new Partnership Agreement.

A share issue is the offering for sale of new shares in a business. For the largest businesses like BP, Vodafone and Tesco, there are literally billions of shares in issue, with some shareholders owning perhaps a few hundred shares and other big investors (like pension funds) owning millions. The money raised from share issues can be used for investment in the business or for expansion into new ventures. Shares can be sold by both Private Limited Companies (Ltd) and Public Limited Companies (PLC), and can be issued at any time in the life of the business, not just when the business is starting up. For the largest PLCs hundreds of millions of pounds can be raised through issuing shares. The major problem with share issues is that ownership is spread over a larger number of existing shareholders and new shareholders. If new shareholders have purchased enough shares they may try to change the way a business is run, or even attempt to take over the business.

Overdraft from the bank

An overdraft is a form of bank borrowing. A business becomes overdrawn when it withdraws more money out of its account than there is in it, so the business will end up with a negative bank balance. Once an overdraft limit (perhaps £5000) is agreed with the bank, the business can use as much of the overdraft as it needs at any time, up to the agreed overdraft limit. The bank will of course charge interest on the amount overdrawn, and will only allow an overdraft if they believe the business is creditworthy (capable of paying the money back). Interest rates on overdrafts tend to be very high.

Unfortunately a bank can demand the repayment of an overdraft at any time. Many businesses have been forced to cease trading because of the withdrawal of overdraft facilities by a bank. Even so, for short-term borrowing, an overdraft is often the ideal solution and many businesses often have a rolling (ongoing) overdraft agreement with the bank. An overdraft is often the best way of solving short-term cash flow problems, e.g. funding purchase of raw materials, whilst waiting for payment on goods produced.

Bank loan

This is lending by a bank to a business. A fixed amount is lent for a fixed period of time and normally for a specific purpose. The bank will charge interest on the loan and the interest, plus part of the capital (the amount borrowed), will have to be paid back each month. The bank will only lend if the business is creditworthy, and it may require security. If security is required, this means the loan is secured against an asset of the borrower. If the loan is not repaid, then the bank can take possession of the asset and sell the asset to get its money back.

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Obtaining finance
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Trade credit

If a shoe retailer buys on credit from a shoe manufacturer, it may not have to pay the manufacturer for a month after delivery. This means it could sell the shoes at a profit and have the money at the end of the month ready to pay its bill to its creditor – the manufacturer.

Extending a credit period will help short-term cash flow. Credit could be extended by delaying paying bills for an extra 14 days, meaning there will be more cash in the bank for this period. Unfortunately if a business delays payment of money it owes to its suppliers it would be no surprise if the supplier becomes somewhat upset – after all they have their own cash flows to think of. Also the next time the business requests credit from a supplier, they may be turned down and asked to pay cash.

Leasing assets

When leasing, a business pays monthly for the use of an asset but will never own it. Think of a partnership setting up a business as a parcel delivery service. They could lease a van from a leasing company. They will have to pay a monthly leasing fee, say £250, which is very useful if they do not wish to spend £8000 on buying a van. This will free up other money the business has, which can now be used for other purposes.

A business looking to purchase equipment may decide to lease if it wishes to improve its immediate cash flow. In the example above, if the van had been purchased, the cash flow out of the business would have been £8000. When leasing, the cash flow out of the business over the first year would be only £3000, leaving a possible £5000 for other assets and investment in the business. Leasing also allows equipment to be updated on a regular basis. However, in the long run, it may well cost more than outright purchase and the business does not have the van as an asset on its balance sheet.

Hire purchase

This is similar to leasing, but at the end of the hire period the asset belongs to the business that hires it.

Venture capital

Venture capital is money invested in a business by professional investors (venture capitalists).

When venture capitalists invest, they expect a say in how the business will be run and they also expect to make a good profit on their investment within two to three years.

The normal method of investment is for the venture capitalists to take an 'equity stake' – this means that in exchange for their investment they will be given a shareholding in the business. The percentage share will depend upon the amount invested relative to the value of the business.

The amount invested can be relatively small – perhaps £100 000, or quite large – say £20m. Of course the amount invested depends upon the size of the business and what it is trying to achieve. The venture capitalist expects quick growth, and potentially large profits.

From the business's point of view this form of finance comes with no interest payments and ongoing professional advice, so it often makes a great deal of sense. However, it does mean the current owners can potentially lose control of the business they have built if the shares are sold on.

Debt factoring

Debt factors are finance companies that will pay the selling business part of the value of an invoice issued as soon as sale has been made. So if company X sells goods on 30 days credit to company Y for £5000, the debt factor will pay company X a percentage of this debt (say 90% – £4500). The debt factor will hold the invoice and will collect the full value of the invoice (£5000) from company Y after 30 days. Company X benefits because cash flow is improved and they can use the £4500 to purchase raw materials and pay wages straightaway. Also, some aspects of debt management are moved outside the company. Of course, the full amount received by company X will be £500 less than the original invoice value. Debt factoring is normally only available to well-established businesses and the factor will carefully examine how creditworthy the debtors are before making any payment.

External finance
http://bit.ly/23cspnb

Suitable sources of finance
http://bit.ly/1n7SK4C

Discussion themes
Are you a financially savvy small business owner? http://www.smallbusiness.co.uk/financing-a-business/alternative-business-finance/2475372/are-you-a-financially-savvy-small-business-owner.thtml
Finance guide for small businesses. This includes a short video guide http://www.simplybusiness.co.uk/knowledge/articles/2013/05/small-business-finance-guide/
Identify the main reasons why businesses may seek extra finance.
Describe methods of finance available to small business owners.
What are the advantages of internal forms of finance over external forms?
Discuss the following statement: 'Venture capitalists offer the best form of external finance for a business that wishes to expand.'