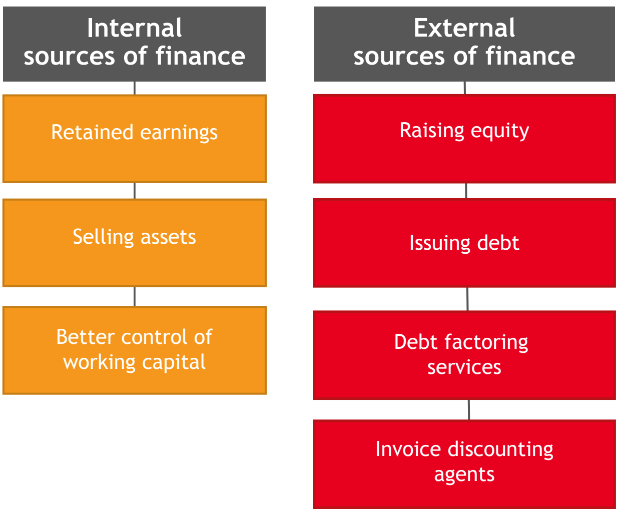
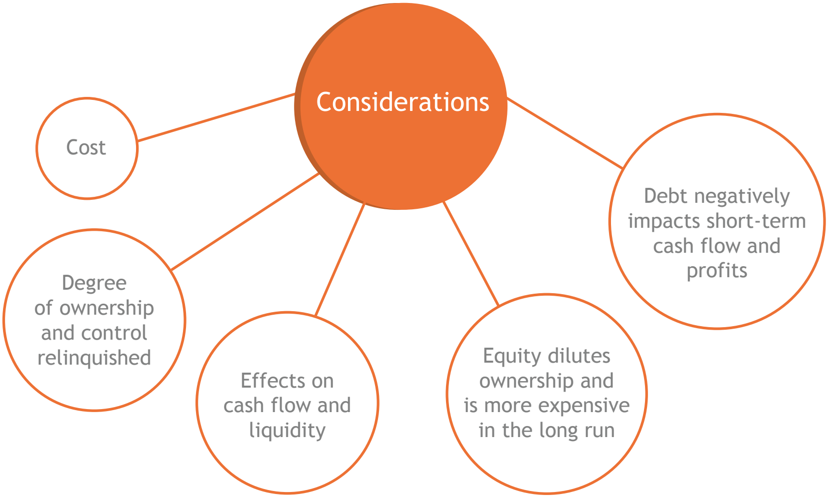
Chapter 19

Sources of Finance

What are the different sources of finance available to my organisation?

Organisations need finance when they start up, during periods of expansion, and simply to fund their everyday activities. They must decide whether they have sufficient cash available internally (perhaps from retained earnings, selling assets, or by releasing funds from the better control of working capital), or whether they need to seek external sources of finance, which could include raising more equity, issuing new debt, or using debt factoring services or invoice discounting agents. In making this decision, the business must consider the cost of the capital to be raised, the degree of ownership and control that its owners would have to relinquish, and the effects on its cash flow and liquidity. For example, a new share issue would dilute ownership and would be more expensive in the long run, but would not have the negative impact on short-term cash flow and profits that interest payments from debt would have.

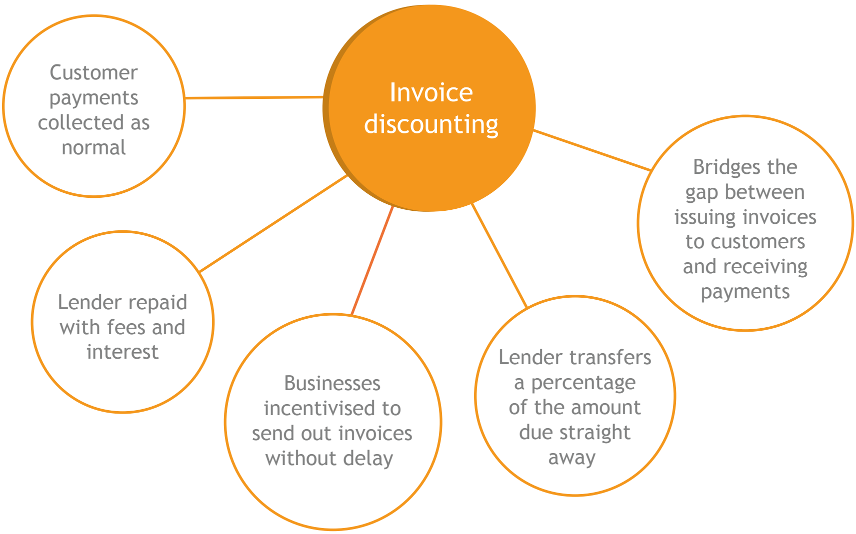




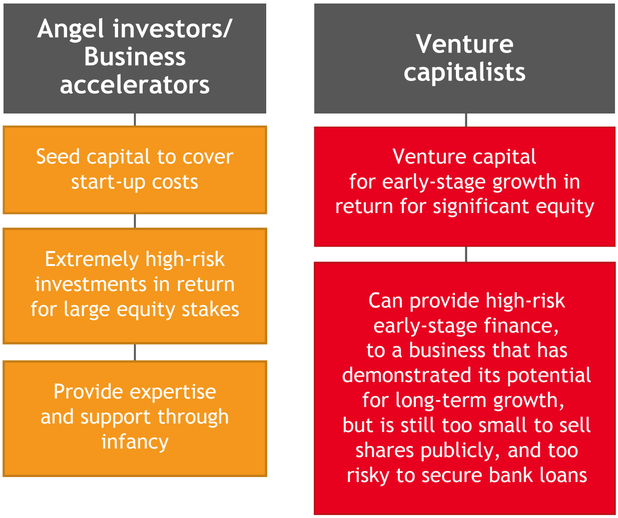
Careful consideration must also be given to match the source of finance to the time period for which the funds are needed. Long-term finance of more than five years may be needed to acquire fixed assets such as plant and machinery. These assets would be used over a similarly long period to generate revenues sufficient to cover the cost of the funding option chosen. Sources of long-term finance include: additional share capital; retained earnings; long-term loans; venture capital; mortgages; and debentures. In contrast, short-term finance of less than a year would be needed to fund the business' working capital requirements and pay for its net current assets, including its stock and debtors. These assets would generate cash within the year, and could therefore repay the finance used in the short-term. Sources of short-term finance include trade creditors, short-term loans, overdrafts, the sale of assets, grants, debt factoring and invoice discounting.

Long-term finance	Short-term finance
More than five years	Less than a year
Needed for fixed assets	Needed to fund working capital requirements
Use generates long-term repayment	Use generates cash in the short-term for repayment
Share capital	Trade creditors
Retained earnings	Short-term loans
Long-term loans	Overdrafts
Venture capital	Sales of assets
Mortgages	Grants
Debentures	Debt factoring
	Invoice discounting

To improve its cash flow in the short-term, an organisation may decide to take advantage of invoice discounting. Here, a lender provides finance to bridge the gap between when invoices are issued to customers, and when payments are received. Upon receipt of a copy of each invoice, the lender will transfer an agreed percentage of the amount due (typically between 80 and 90 percent), to the business straight away. The organisation then collects payments from its customers as normal, before repaying the lender along with its fees and interest charges. The desire to minimise interest payments, means that invoice discounting provides an incentive for businesses to send out invoices (and therefore receive the cash) without delay. Debt factoring also provides funds immediately, however, a factoring agency buys the invoices at a discount, and then, unlike with invoice discounting, takes complete responsibility for them, including the risk of non-payment. Customers are also aware that their debts have been sold on, which may affect their relationship with the firm if they are aggressively chased for payment.



At inception, before a business begins to earn revenue, it may need to secure seed capital from angel investors or business accelerators to cover its start-up costs. These extremely high-risk investments are usually made in return for large equity stakes in the business, but can have the added advantage of providing much-needed expertise and support through infancy. Again, in return for significant equity, venture capitalists can provide high-risk early-stage finance, to a business that has demonstrated its potential for long-term growth, but is still too small to sell shares publicly, and too risky to secure bank loans.


Angel investors/ Business accelerators
Seed capital to cover start-up costs
Extremely high-risk investments in return for large equity stakes
Provide expertise and support through infancy
Venture capitalists
Venture capital for early-stage growth in return for significant equity
Can provide high-risk early-stage finance, to a business that has demonstrated its potential for long-term growth, but is still too small to sell shares publicly, and too risky to secure bank loans

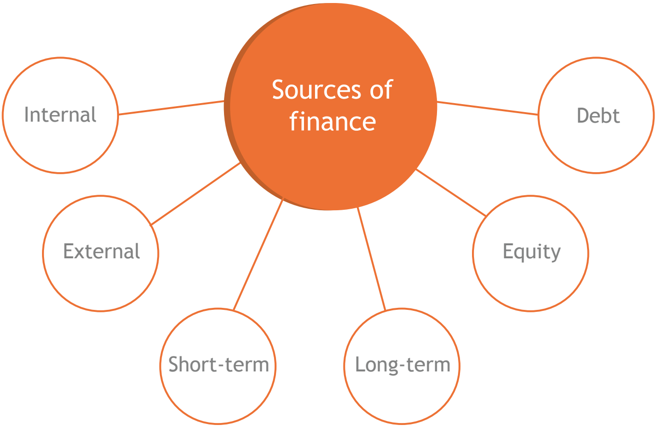

Debt factoring
Provides funds immediately
A factoring agency buys invoices at a discount
Total responsibility passed to agency
Risk of non-payment passed to agency
Customer relationships may be damaged

Rather than giving up large amounts of equity, a firm may prefer to issue debt. It could sell bonds to borrow the funds it needs, and then make interest payments at set intervals to the holders of these bonds. Some debt, such as a mortgage, is secured against a specific asset the business has, perhaps a factory. So if the business fails, the bank will be repaid by selling that asset. Where the bond has a debenture associated with it, the lender can claim what it is owed by selling all of the business' assets that are left, after its secured creditors have been paid. This means that debentures would be repaid before unsecured creditors, such as trade creditors or taxes owed to HMRC.

Debt

- **Bonds**
  - Sell bonds to borrow money
  - Must pay interest at set intervals to bondholders
- **Secured debt**
  - A specific asset is sold to repay the debt if the business fails
- **Debenture**
  - All assets left after secured creditors have have been paid are sold to repay the debt
  - Debentures are repaid before unsecured creditors, eg. trade creditors or HMRC

When choosing which sources of finance are most appropriate, the organisation must consider what the funds will be used for, so that it can match the assets it will acquire with these funds, to the length of the liabilities they entail. Businesses with the right mix of financing options, will find that they are not hit by significant demands for repayment at the same time.



The right mix, appropriate, circumstances