OTC Document

Financing Your Business

Small and Medium Enterprises Development Authority
4th Floor, Building No. 3, Aiwan-e-Iqbal Complex, Egerton Road,Lahore
Tel: (92 42) 111 111 456, Fax: (92 42) 36304926-7
wwww.smeda.org.pk ,helpdesk@smeda.org.pk

TABLE OF CONTENTS

1 Disclaimer

This information memorandum is to introduce the subject matter and provide a general idea and information on the said matter. Although, the material included in this document is based on data/information gathered from various reliable sources; however, it is based upon certain assumptions, which may differ from case to case. The information has been provided on as is where is basis without any warranties or assertions as to the correctness or soundness thereof. Although, due care and diligence has been taken to compile this document, the contained information may vary due to any change in any of the concerned factors, and the actual results may differ substantially from the presented information. SMEDA, its employees or agents do not assume any liability for any finance al or other loss resulting from this memorandum in consequence of undertaking this activity. The contained information does not preclude any further professional advice. The prospective user of this memorandum is encouraged to carry out additional diligence and gather any information, which is necessary for making an informed decision, including taking professional advice from a qualified consultant/technical expert before taking any decision to act upon the information.

For more information on services offered by SMEDA, please visit www.smeda.org.pk

2 Introduction to SMEDA

Small and Medium Enterprises Development Authority (SMEDA) is an apex SME development agency working under the Ministry of Industries and Production (MoI&P), Government of Pakistan. In pursuit of its mission, SMEDA has adopted an integrated strategy that comprises SME sectors & clusters development, Business Development Services (BDS), and Policy advocacy to protect and promote SME interests.

SMEDA offers a broad spectrum of business development services to SMEs, which include prefeasibility studies, identification of experts, and consultants, delivery of need based capacity-building programs in addition to business guidance through help desk services.

3 Purpose of the Guide

This document will guide new entrepreneurs and existing business owners/managers regarding financing their businesses particularly Small & Medium Enterprises (SMEs). This will also help in understanding the important factors regarding business financing, assessing financial requirements and financing options available for SMEs in Pakistan.

4 Financial Requirements of a Business

Businesses require finances to run their operations. These finances include owner's money, also called Equity or borrowed money, known as Debt. To operate successfully a business needs to be financially strong and manage its funds efficiently.

Most businesses spend more than they earn in the beginning or startup phase, however, long-term health of the business depends on eventually earning more money than total expenditures i.e. they must manage their cash flows effectively to avoid draining finances and carry enough funds, on hand, to cover requisite expenses.

Financing:

The act of raising or providing funds for business activities, making purchases or investments, utilizing consumers and investors to help them achieve their goals and objectives.

4.1 New Business Startups

New businesses require financing for setting up, starting from idea testing and concept finalization to the actual start of operations. As the business grows, there is inevitably a greater need of financing for expansion. Depending upon the nature of the business, it may require financing for purchase of assets, materials and employing people; including pre-operational costs such as purchase and installation of machinery and equipment, etc.

Business Life Cycle:

Business life cycle includes idea formation and testing, business start-up, initial growth and operations, expansion into new markets, mature operation stage, and its eventual decline as market and consumer dynamics change.

4.2 Existing Businesses

Adequate financing is necessary at all stages of the business life cycle. Your business may need money for operations, manufacturing, expansion, product development, marketing, technology advancement etc.

5 Types of Financing Requirements

Business-financing requirements are broadly categorized as follows:

Working Capital:

Working capital consists of current assets including cash, bank A/C, cash equivalents, prepayments, receivables and stocks. While net working capital is the difference between current assets and current liabilities

5.1 Working Capital Requirement

Working capital is required for short-term utilization of funds for:

- Operating expenses; purchase of raw materials, paying salaries & utilities etc.

- Paying short-term debts, creditors and interest payments on long term debt

5.2 Capital / Long Term Financing Requirements

Capital / long term financing requirements arise from utilization of funds for fixed and long-term assets such as:

- Purchase and installation of plant, machinery and equipment
- Purchase / Construction of land and building
- Business acquisition, mergers, buyouts etc. – a less common use for a SME business

6 Do you Really Need to Borrow?

A number of questions arise while financing your business; whether to utilize owner's equity in your business or partially utilize debt money as an option? If you are interested in utilizing debt money, you need to be certain about your financial requirements and ascertain the stage of development your business in.

If the business is a start-up, it may not be qualified for commercial financing options such as bank loans. However, a business with some years of experience (generally 2 – 3 years) in operations may be more qualified for external financing.

Further, the key tool to assess your financial requirements is development of a business plan. If you do not have a compelling business-plan, then make it a priority to write it. All lenders will want to see a solid, well thought out business plan for the start-up and growth of your business. For further assistance, please refer to OTC document "How to Make a Business Plan" available at SMEDA website.

7 Sources of Financing

There are various options of debt financing available for your SME business through banks and leasing companies. You may fund your business with leasing, business credit cards, overdraft limits, business lines of credit or business loans. However, debt financing must be carefully managed to ensure that you make smart choices about financing options and make payments on schedule to avoid any losses.

The box given below highlights definitions of some of the most commonly used formal financing options available to businesses:

Leasing: A lease contract enables the business / entrepreneur to purchase land, machinery, equipment, vehicles, etc. on installments, for a specified period of time. Installment amount also includes a portion of interest charge. Once all payments are cleared, ownership of the leased asset is transferred to the business / entrepreneur.

Credit Card: A card, generally issued by a bank, is used to make purchases without cash payment. The card generates a bill, mostly, on a monthly basis. If bill payment is delayed beyond the due date, the bank charges an interest fees.

Overdraft Limit: Overdraft limit is a flexible borrowing facility offered by banks against current accounts. Interest rates for such facilities are usually high.

Business Loan / Line of Credit: Banks offer loan facilities in various forms. A business loan also known as term loan provides the business with a specified amount of money, to be repaid after a stated time period with a predefined interest rate. Whereas a line of credit facility allows the entrepreneur to draw up a financing limit with the bank, however, repayments are based upon the amount of money utilized, allowing the entrepreneur the flexibility of a lower net interest rate.

For new enterprises, it is important to establish a good estimation on costs and benefits. Consideration on appropriate amount & tenure of financing and sources of financing can help businesses avoid cash flow problems.

Some of the most commonly available options of formal financing for SMEs are through banks in the form of long term and short term loans. Loans are paid through installments either on a monthly, quarterly or biannual basis. The installment amount comprises of principal repayment and interest charge. In addition, the bank also charges processing fees to cover operational expenses, incurred during evaluation and appraisal of the loan proposal.

The initial amount of money borrowed is called the principal amount, and is to be paid by the SME. In addition to the principal amount, the bank charges an interest rate. Interest rate covers the bank for risk taken by extending loan to the business. Therefore, the evaluation process of a loan proposal is a critical process for both bank and the loan applicant. Key areas of evaluation by the bank include; description of services / products of the business, management capacity, business viability and financial forecasts.

Please visit SMEDA official website at www.smeda.org.pk to view Banking Products Database which provides information of financing products available through banks to SMEs in a user-friendly format.

7.1 Internal Sources of Financing

Prior to deciding upon external sources of funding, it is advised to review your business for internal sources of financing. Internal sources of financing a business include managing your cash flows and / or inducting owner's equity. Thoroughly assess your current financial situation; manage business cash requirements by managing the following aspects of your business:

7.1.1 Personal Assets

Including your personal assets into the business by making addition to your business capital directly, is the easiest way to fulfill you current need of financing without diluting your ownership or taking the burden of a loan. For example, you may temporarily use your personal vehicle or cash for business operations, if the need arises.

7.1.2 Cash Conversion Cycle

Cash Conversion Cycle (CCC) indicates the time period during which current assets of a business, which are stuck in operations, will be converted into cash. This is done mainly by managing your working capital and operating cash flow in a way that it creates enough cash to pay current expenses and liabilities. CCC can be easily understood by the following formula:

CCC	=	Inventory Conversion Period	+	Receivables Conversion Period	–	Payables Conversion Period

Time taken by the cash conversion cycle can be reduced by quick turnover of inventory, encashment of receivables and easing payment terms with your creditors (to give you more time for repayment).

For Example:

Mr. Ali is a retailer who sells computer accessories and allied equipment. Ali buys inventory from different suppliers on credit of 12 days in order to get a purchase discount. Ali's inventory lasts for 15 days. He sells his finish product to the customers on 10 days' credit. CCC for his business model is:

Inventory Conversion Period is 15 Days, Receivable Conversion Period is 10 Days and Payable Conversion Period is 12 Days.

So, Cash Conversion Cycle (CCC) of Ali will be CCC = 15 + 10 – 12 = 13 Days

Inventory Conversion Period:

Time required to obtain raw materials for a product leading to its manufacturing and sale. It is essentially the time-period during which a company must invest cash while it converts raw materials into sales.

Receivable Conversion Period:

Time between sale on credit of the finished product and receiving cash against accounts receivable.

Payables Conversion Period:

Time between purchases of raw material on credit and cash payments for accounts payables.

In other words, Ali's business requires 13 days to convert money used for raw material to receiving actual cash from the finished products' sale. Ali would have to compare his cycle to other businesses in his sector to see if the cycle is reasonable or needs to be shortened.

The following three ways may be helpful in improving Cash Conversion Cycle;

a) Not storing raw material and finished goods inventory for longer time,

b) Receiving payments against finished goods sold earlier than 10 days, and

c) Asking for a longer time to make his payments to the creditors.

Mr. Ali can also use a combination of above mentioned three strategies and shorten the duration of his business's cash conversion cycle, thereby, generate additional funds from his business operations.

7.1.3 Working Capital Management

Sound financial management ensures that your company is able to meet day-to-day expenses, having enough finished products on hand to meet customers' demand, having enough money in the bank to pay your staff on time and adequate capital ready when your business has the opportunity to grow. Working capital management involves keeping accurate checks on day-to-day expenses and income, have alternative sources of funding available in case of emergencies and ensure sound judgment to determine when to take advantage of these emergency funding options.

7.1.4 Determining Working Capital Requirements

Working capital requirements can be determined through budgeting. It is the process of deciding the best time to make a purchase based on the amount of money your business is currently earning and your expectations about how much it will earn in the future.

There are number of ways a business can reduce its immediate requirements of finances or generate enough finances to cover working capital requirements by controlling current assets and current liabilities. Some examples of such activities are as follows:

7.1.4.1 Inventory Management

Keeping an eye on your inventory turnover is an important aspect related with the cash conversion cycle. Inventory can be in the form of raw material, work in process or finished goods held for sale. If your cash is stuck in inventory, it can negatively affect the financial health of your business. You may be paying more for warehousing, insurance, shipping, and other services related to obtaining and maintaining inventory.

Commonly Used Inventory Management Techniques:

Last In First Out (LIFO): Finished good produced last is sold off first

First In First Out (FIFO): Finished good produced the earliest / first in sold off first

Most businesses use the FIFO method of inventory management. FIFO ensures that finished products are not stored for longer than necessary thereby reducing inventory maintenance expenses, chances of damage to inventory and ensuring that flow of costs correspond with the physical flow of finished goods.

If your inventory turnover period is less than required averages i.e. you maintain less than desired levels of inventory, you run the risk of business operations failure. Therefore, finding the best way for your business to buy, store and move inventory can make the difference between profits and losses. Maintain an optimum level of inventory such that you are neither shortening your stock nor piling it up.

7.1.4.2 Trade Credits

This is another way of catering to your current needs of financing. Your relationship with the vendor/supplier and good credit worthiness can earn you generous trade credits, easing up the burden of payment. There might be discount options available with your supplier on buying in bulk or paying total amount in cash. Another way of benefiting from trade credit cycle is to take time (reasonable time as per industry standards) when paying back. If you increase the payment period, it will give you time to recover money from your debtors and ease cash conversion cycle of your business.

7.1.4.3 Managing Current Assets

Unproductive Current Assets of a business can be reduced by:

- Reducing stock of raw materials, consumables or commodities
- Speeding up work-in-process
- Reducing stock of finished goods or inventories
- Reducing debtors and receivables
- Reducing prepaid expenses

7.1.4.4 Managing Current Liabilities

Current liabilities comprise of payments due by your business to your creditors; formal and informal both. It is recommended to make your payments on the due date in order to maintain payment integrity of the business. However, in some cases when internal cashflows are not sufficient and funds need to be generated, current liabilities of the business can be increased. In doing so, it is important to note that excessive delay in payments may hamper supplier relations, therefore payment terms must not exceed beyond market / industry norms. Two of the most frequently used methods of generating internal cash-flows in the short term are:

- Obtaining longer payment terms from suppliers
- Obtaining delay in loan repayment dates

7.2 External Sources of Financing

External sources of financing include involving a new business partner into your business who will invest capital, issuing equity shares or bonds to create long-term obligations, taking loans and debts or instruments such as bill discounting and promissory notes etc. for short-term debt.

Traditionally, there have been two options available to new business startups and existing entrepreneurs looking to finance their businesses i.e. borrow funds (debt financing) or sell ownership interests in exchange for capital (equity financing). In turn financing is utilized either in capital expenditure of the project or to meet working capital requirements.

7.2.1 Equity Financing

Equity financing is the selling of an ownership interest to finance a new or existing business. Further, the business and its owner(s) will typically not repay the investors in the event that the business faces loss of money. The equity investor will be liable to bear both profit and loss of the business. Equity financing sources include friends, family, venture capitalists and angel investors etc.

7.2.2 Do You Have Sufficient Equity Capital?

Sufficient capital along with necessary understanding of managing the capital is essential for a successful business. Common mistakes by the business owners in securing finances include;

a) obtaining the wrong type of financing,

b) incorrect calculation of the amount of money required, or

c) failing in accurate estimation of the cost of borrowing money.

The owner should consider financial ratios to understand the sufficiency of existing amount of financing available for example; the debt-to-equity ratio is the relation between the money the business has borrowed and the money owners have invested in the business.

7.2.3 Debt Financing

Debt financing sources include conventional lenders like banks, leasing companies, government loan schemes, SBP loan schemes, micro-finance lenders, personal credit cards, etc. The primary difference between equity and debt financing is in the fact that interest is charged on the principal amount borrowed, i.e. the loan amount.

The duration of a business loan can vary from one month to five or more years, depending on the business requirement. Working capital loans generally last from 1 to 3 years and long term loans may last for more than 5 years. Conventional banking processes may take weeks or months before actual disbursement/utilization of funds is possible for the SME business.

Tip:

Effective management is an important element of business. Your lender will be looking for a strong managerial presence.

The lender will need to know your specific intentions for the money, to assure themselves that your business will succeed and repayment will be timely. Whether your industry is depressed, stable, or growing will have a distinct effect on the search for funding sources.

Businesses that prosper in tough economic times will generally receive better funding terms.

8 Advantages & Disadvantages of Borrowing

8.1 Advantages

Borrowing finances enables the entrepreneur to save on personal investments in the business, thereby providing the business with extra liquidity. Equity investment provides the entrepreneur with the opportunity to access external expertise from the investor in the form of business networking and technical acumen, considering that success of the business translates into monetary benefits to the equity investor.

The principal advantages of borrowing through debt for a new or existing business are that the lender will not have power in management & operations of the business and will not be entitled to any profits that the business generates.

8.2 Disadvantages

Disadvantages of equity financing include:

- By selling an ownership interest, the entrepreneur will dilute control over the business
- The investors are entitled to a share of business profits
- The investors must be informed of significant business events and the entrepreneur must act in the best interests of investors

Disadvantages of borrowing are mostly considered to be fixed and timely payments to be made by the borrower, however, additional points to consider include:

- Failure to make required loan payments will risk assets of the business (including personal assets of the business owners) that are pledged as security for the loan
- Credit approval process may result in not qualifying for financing or only qualifying for high interest loans that require the pledge of personal assets as collateral. The time required to obtain credit approval may be significant, depending upon the willingness of the bank to lend to SMEs
- Excessive debt may overwhelm the business and ultimately risk bankruptcy. A business that carries a heavy debt burden faces an increased risk of failure

9 Conclusive Remarks

For Small & Medium Enterprises (SMEs), getting the right kind of financing is often a challenge. SMEs seldom have the assets, track-record, or management background to qualify for conventional financing. Financial institutions, such as banks, prefer to finance large companies as they are considered to be safe investments. However, without external financing, few companies can grow.

Further to conventional sources of business financing, alternative financing sources of debt and equity have also emerged. Unless SMEs have collateral and can prove revenue, banks are hesitant to lend money. Often new startups and businesses operating for less than a year do not have collateral and private moneylenders or angel investors may be considered, as they are willing to take more risk than banks recognizing the potential upside. However, SMEs are advised to be wary of private moneylenders as they charge interest rates much higher than a commercial bank. SMEs should go for the source of finance, which costs them less than the intended benefit in choosing this option. The assistance of a financial advisor can also be very valuable in this process.

Relying on your own resources is always the better and more reliable option unless there is no alternative available or there is a problem of survival. You should choose an optimum solution for your business-financing requirement based upon your financial analysis of the business.