Major sources of finance and funding for smes

Introduction

Small and medium-sized enterprises (SMEs) are the backbone of all economies and are a key source of economic growth, dynamism and flexibility in advanced industrialised countries, as well as in emerging and developing economies. SMEs constitute the dominant form of business organisation, accounting for over 95% and up to 99% of enterprises depending on the country (OECD 2006). While not every small business turns into a multinational, they all face the same issue in their early days – finding the funds to enable them to start and build up the business and test their product or service. This essay will be looking at the major sources of finance for SMEs and start ups, also will be looking at the advantages and disadvantages of this various sources. Furthermore I will be drawing from the lectures notes, seminars with different enterprise and other sources to identify these sources and their advantages and disadvantages. Funds are difficult to source for especially in this present period of recession. However, funds can be sources through various means each of which have it merit and demerits. The decision as to what source of finance will be the best will depend on, the cost of borrowing, the length of time the money will be need, what is the money for and ultimately whether the firm can payback. Burns (2007)

The most important consideration in deciding the source of finance for SMEs is to strike a balance equity and debt and to make sure the source of finance suits the business. What differentiate (money borrowed) debt and equity are that financial institutions demand interest and capital repayments, but debts is usually held up against a business assets or personal properties of the owners. The sources of finance for start-ups and SMEs can be divided into two: internal which includes (personal savings, family and friends) and external includes (trade credit, venture capitals, business angle, hiring and leasing, bank loans, Factoring and invoice discounting, grant, bank overdraft).

Internal sources:

Personal savings, family and friends: this is often the starting point for most SMEs where the owner uses his/her savings to start up the business, may be later in the business others may be prepared help you out example the case of Amazon that was shown in class where his parents and friends helped at some point, also is the same for most of the entrepreneur brought on in the seminar. It should be noted that for family and friends the reason for funding should be known as some may give in turn to have share of the business which might not be explicit, in other to avoid these a written agreements would be a better option stating the basis of such funding. An advantage is that this shows that the owner has some level of confidence and commitment to the business enterprise and might make it easier to gain money from others. It costless form of finance, but there is higher risk of the money being lost since the entrepreneur idea might not be fully developed.

External sources:

Grants: Grants are often available from councils, local authorities, and other Government agencies for specific reasons. For example there may be plans by the government or council to revive or encourage the development of a sector or an area. Alternatively there are some institutions that helps entrepreneur to lunch new business. One disadvantage is that assess to grants can be competitive as some businesses are classified more important than others and it can be very difficult to locate an individual or organizations who will be willing to give funds for small business. An advantage is that most grants don’t require payback and has no interest.

Bank Overdraft: An overdraft is agreed sums which a customer can overdraw form his current account. Bank overdraft can be a good source of short-term finance to help a business with seasonal shortage of funds that does not require long-term solution. The charges varies and are linked to the bank rate. The advantage of overdraft is that it is always there when it is need and it is at no cost (however small fee are charged) it helps to maintain a good cash flow. Also it is quick to set-up when compared to a loan. Overdraft disadvantages. The interest rate on an overdraft can be quite high, especially for small firms where the risk to the bank that they might not get their money back is greater. In addition, the business is not allowed to exceed their overdraft limit. If they do, the bank might refuse to pay cheques to creditors and may hit the business with a hefty charge for exceeding the limit. Overdraft facilities can be re-negotiated but if this is tried too many times, it may be a signal to the bank that a business has not got control over its finances.

Venture capitals (VCs): It is also known as private equity finance. This source is often most times used in the early stages (or a later stage depending on the type of VCs) of developing a new business, where the risk of failure is high but the possible earnings may well also be high. Venture capital dealings are, just about £500, 000 to £10 million, or above. Venture capital most time provides second round financing after Business angels. Venture capitalists invest large sums of money in return for a share in the firm's equity and also expect a good return on their investment. It should be noted that venture capitalists most times are firm or representative of a parent firm. One advantages of getting a VC are they provide large sum of finance and the significant expertise, contacts and experiences they have acquire while running other businesses. Furthermore successfully attracting a venture capital makes it sometimes easier to get others for further funding. Example of theses is the Dragon's Den. On the other hand disadvantage getting a deal with a venture capitalist may be a long and difficult process. As it will require drawing up a well detailed plan, financial projections which may require professional help or friends who have such knowledge, legal requirement may be needed on getting to the negotiation stage all of these services will have to be paid for whether or not the fund was secured. Also there is tendency for VCs to influence or take control of the business.

Business Angels: Business angels (BAs) are also know as angle investors, they are rich individuals who invest in a potential high growth businesses in return for a share in the ownership of the business. They are typically involved at an early stage of the business. Some BAs invest as an individual, while others do as part of a group, or investment club. BAs often make their own skills, experience and contacts available to the company. BAs in general invest in businesses between £10, 000 and £750, 000 as individual and up to £1, 000, 000 or more as a group. One advantage of BAs is that they often make an quick investment decisions, without complex assessments. (i. e. when it appeals to them or an area of interest) However, a professional and well prepared business plan will be needed to get their attention. Most BAs bring relevant experience, skill, time, and contacts they have built up overtime. Most BAs are committed and do everything within their power to make the business work.

The disadvantage of BAs is that they are difficult to find and don't make investments very regularly, more time will be spent with the BAs rather with the business giving information, The entrepreneur may loss some level of control over the business, locating the right investors may be difficult, also there is tendencies for the BAs to want to stay in the business therefore becoming a " devil". The British Business Angels Association (BBAA) is a good source of locating BA networks also they help in preparing and presentation of business proposals.

Invoice Discounting and Invoice Factoring: This involves a company outsourcing its invoicing activities to an external organisation. It makes funds available in few days to the business base on the values of the outstanding invoices. Then process, It begins by the firm making sales, sending the invoice to the customer, sending a copy of the invoice to the factoring institution where necessary negotiations and investigations is carried out on the customer after which an agreed percentage of the invoice is paid by the factoring company, usually 70-80% within 24 hours. This service comes with a cost which include administration charges, interest, credit protection charges, etc. the major advantage of this source of finance is the quick availability of funds which can be channel into another aspect of the business, also with presence of many factoring companies, this makes prices competitive, further it makes preparation of financial planning and cash flow easier and smoother, it can be an efficient and cost effective was of sub contracting that area of the business which reduces the time spent chasing payment. It is also an opportunity to know the credit standing of your customers which can help in negotiating a better deal with your suppliers and customer. The down side is that the charges will imply a reduction in the profit margin, in addition it may limit the way business is done as the factoring company may want to vet your consumers. It may reduce the extent of borrowing as the invoice is not available as security, also some customer may prefer to deal directly with their suppliers. In the situation where the customer default the business has to pay also an additional fees may be charged.

Trade credit: some businesses depend on the purchase of a product from other companies (suppliers) to run their enterprise. Trade credit is a case where a supplier gives out his product to a customer on credit expecting to pay at a later date. Most trade creditors allow for a period of 30 days or longer before payment are made, this can allow the business to use the funds in the short term to finance other things. This should be done with caution so as not to risk upsetting the supplier and put at risk the future working relationship of business. Advantages of Trade credit: By setting up trade credit it will require less money to start up a business, this can be really important to those who have little capital in starting up a business, also the ability to buy now and pay later, the business can purchase the item and sell them at a profit before payment are made. With this the business time to focus on other areas of the business like marketing etc rather than worry about paying their supplier. It also makes for improved cash flow and smooth operation for the business. Example of all these is the case of QPC as discussed in the seminar. The downside to trade credit is if the business fails to meet the deadline it may leads to poor credit history which might limit the business chances of securing funds elsewhere. Also it can be difficult to get trade credit as only firms with good credit history are given, however these can be difficult to build as a new business.

Hire Purchase and Leasing: Hire purchase and leasing allows a business to acquire an asset without paying the full-price. The business will have the right to use the equipment for a period of time after which they can buy it at a reduced price or return it. These means is mostly used in the purchase of heavy equipment. Leasing an asset makes available some working capital that can be use in other areas of the business. In a lease, the business is paying for the use of an equipment or machinery but do not own it. A lease agreement on an equipment or machinery, for example, might mean that the firm pays out £250 or more per month for a 3-4 year lease. At the end of the years, the equipment or machinery is returned to the owner. Some advantages of leasing equipment include, having and using an asset without having to pay the full cost up front, so cash can be diverted for other purpose. it gives the business access to a modern standard of equipment, which might be too costly to buy upfront payments are spread over a long period of time., leases can be helpful to business which carries out short projects or needs equipment for short time as they don’t have to buy such equipments out-rightly. With the payment based on the fixed period of time the equipment will be use and fixed monthly rental costs, this helps the business to budget for the future, forecast cash flow and plan effectively. It also reduces the cost of maintenance, as the leasing company will be responsible for that and carries the risk of the equipment if it breaks down. Capital allowance can be claim on the equipment. The asset can be purchased as a reduced price. Some disadvantages of leasing equipment: it can work out to be more expensive than if you buy the assets outright, Capital allowances may not be claimed on lease equipment less than five years in some cases seven years. Business can be stocked into inflexible medium or long-term agreements, which may be difficult to terminate. In the case of Adrian Lauchlan who got a big warehouse and later discovers it was too big but could not break the contract due to the length of time. Leasing contract can be complex to manage and can add to the management operation, businesses has to be VAT-registered to take out a leasing contract, the asset are not owned despite paying monthly for it.

Bank Loans: Bank loans can be a couple of thousand to hundred thousands of pounds depending on the security and business prospects. A loan is an amount of money borrowed for a set period with aim of paying back at an agreed date. The repayment will depend on the size, length of the loan and the rate of interest. The terms and conditions of loan vary with providers and may be negotiable. Loan periods varies between 1 to 10 years, with some going up to 20 years, though each lender have a number of loan packages to suit various business needs. The riskier the business, the less likely to be able to borrow, and the higher the interest rate charged. This helps the bank to ensure that they are covered even if the risk does not pay off. Advantages of loans: Banks loan are reliable because the money is guaranteed throughout the agreed period generally three to ten years – unless there is a breach of the loan conditions. If the loan will be use in the purchase of equipment it can be tied to the lifetime of the equipment or other assets you're borrowing the money to pay for. Loans do not require giving up part of the business as of the case of an investor but the interest which serve as the cost must be paid. Some loans have fixed interest rates which are easy to calculate. Disadvantages of loans: Most loans are not flexible once the payment date are fixed also they have strict terms and conditions, there might be difficulty in making monthly repayment when customers done pay on time therefore causing cash flow problem. Most loans are secured against the business owner's property or the asset of the business, but these properties will be at risk if the business defaults. Adrian Lauchlan almost lost his house due to low cash flow. Businesses are charged if the loans are paid before the end of the agreed period. In situation where more funds are borrowed than needed interest will be paid on fund not used. The bank will not be willing to increase the loan without an increase in security.

In conclusion, the essay has discussed some of the major sources of finance and also discusses their advantages and the disadvantages of this various sources, it should be noted that each firm or business should choose the most appropriate sources of finance that suits it mode of operation and kind of business.

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