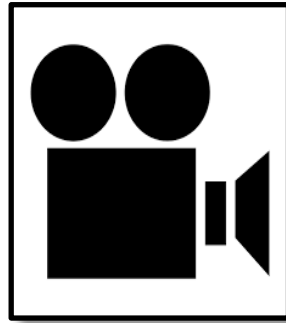


PowerPoint Guide



The **news icon** is hyperlinked to a related article or website. Simply click to access



The **film icon** is hyperlinked to a related clip. Simply click to access



The **discuss icon** indicates suggested points to discuss



The **writing icon** indicates a written activity or question time

Finance

5.2 Sources of finance



Key elements to this topic

**Methods
businesses use to
raise finance**

**Appropriateness
of sources of
finance**

Why does a business need finance?

A start-up or existing small business will need finance to fund **start-up costs** and **running costs**.

As a business grows, it will need to raise finance to fund **expansion**, **replace worn out assets**, to **improve efficiency** and to **fund new product development**.

There are **short-term** and **long-term** sources of finance available.

A business will need to choose the source of finance that is most appropriate to meet its specific needs.

Factors affecting the choice of finance

The source chosen by a business will depend on:

- the **amount needed**
- the **reason why the finance is required**
- the **circumstances of the business**
- the **legal status** the business has



Businesses, large and small, will need to consider the following questions when looking to raise finance:

- 1. How much** finance is required?
- 2. When** is the finance needed?
- 3. How long** is the finance needed for ?
4. What **security** (if any) can be provided?
5. Is the entrepreneur prepared to give up any **ownership and control** of the business?

Internal v External Sources of Finance

Internal	External
<p>Involves raising funds from within the business. Often internal sources may be limited; using them, however, means that a business can keep full control of its operations and does not need to pay high interest.</p>	<p>Involves raising funds from outside the business. This allows businesses to raise larger amounts of funds compared to internal sources of finance, although there are clear disadvantages of using external sources.</p>
<p>Examples:</p>	<p>Examples:</p>
<ul style="list-style-type: none"><input checked="" type="checkbox"/> Owners' capital<input checked="" type="checkbox"/> Retained profit<input checked="" type="checkbox"/> Selling unwanted assets	<ul style="list-style-type: none"><input checked="" type="checkbox"/> Bank overdraft<input checked="" type="checkbox"/> Hire purchase<input checked="" type="checkbox"/> Trade credit<input checked="" type="checkbox"/> Loans – friends/family, banks<input checked="" type="checkbox"/> Mortgage<input checked="" type="checkbox"/> New share issue<input checked="" type="checkbox"/> Crowdfunding

Internal – Owners' capital

An entrepreneur will often invest personal savings, redundancy or inheritance money into a start-up. This can also be in the form of providing assets for the business, for example an entrepreneur using his/her own car.

Benefits	Drawbacks
<ul style="list-style-type: none">• Provides a strong signal to other potential investors and the bank of the entrepreneur's commitment to the business• It is interest free• Readily available and maximises the control the entrepreneur keeps over the business	<ul style="list-style-type: none">• The amount that is available may be limited, resulting in the entrepreneur having to use other sources of finance to fund the business

Internal – Retained profit

When a business has worked out its profits, the owners or shareholders can decide whether to take the profits for themselves or reinvest the profits back into the business.

Benefits	Drawbacks
<ul style="list-style-type: none">• A cheap form of finance, as no interest has to be paid• Flexible – business owners have complete control over how any profits are reinvested and the proportion that is kept in the business, rather than paid out as dividends• Retained profits do not dilute or reduce the ownership of the organisation. For companies, there is no risk of a takeover	<ul style="list-style-type: none">• If a business needs some temporary finance because it is facing difficulties, then it is unlikely to have any profits that it can use• Growth may be slow if it is dependent on retained profits, as profits may not be high enough to finance the growth quickly• Using too many profits in the business, may upset shareholders who may feel that their dividend payments are too low

Internal – Selling unwanted assets

Selling spare or unwanted **non-current assets**, such as spare land, buildings, machinery or equipment that are no longer needed by the business, can result in extra finance being generated on an one off basis.

Benefits	Drawbacks
<ul style="list-style-type: none">Using this method will mean that no finance needs to be repaid and the business owners keep full control of the organisation	<ul style="list-style-type: none">It is unlikely to be a long-term solution for most businesses that need to raise finance, as money will be raised on an one-off basisIt reduces the value of the business, as the business will no longer own these assetsWhen selling the asset, it is unlikely that the business will gain the value that it originally paid for it, due to depreciation

Rather than selling an asset outright, businesses can sell assets and have an agreement with the buyer to lease or rent the asset back. This means that the business will gain a large injection of cash, whilst still being able to use the asset, although the business's overheads will increase. This may affect the firm's long term profits .

Sale of assets at Mothercare, UK



Mothercare UK is hoping to move into profit in 2018. In 2017, UK losses narrowed to £4.4m from £6.4m in 2016.

Discuss how Mothercare would benefit from the sale of these stores

Mark Newton-Jones, Mothercare chief executive, said it would look to close up to 70 of its 152 UK stores as it adapts to a digital age where 41% of sales are rung up online.

“We are taking a fresh look at our estate and asking how many do we really need?” said Newton-Jones. “We’ve got six stores in Bristol – we don’t need six stores in Bristol. In Sheffield we’ve got five within a 20-minute drive time when we only need one or two. To cover all the major conurbations you only need 80 to 100 stores.”

External – Trade credit

Trade credit is provided by a firm's suppliers, allowing the business to have the goods now and pay for them at a later date.

Benefits	Drawbacks
<ul style="list-style-type: none">• This can allow the business to use the goods in the manufacturing process and/or sell the goods before it pays the suppliers, which will improve its cash-flow position	<ul style="list-style-type: none">• Danger of bad reputation and losing future credit arrangements with the supplier if bills are not paid on time• Difficult for new start-up businesses to negotiate trade credit with suppliers, as there is a risk that the business will fail and suppliers may end up not getting paid

External – Bank overdraft

A **short-term** source of finance that is available to help fund the day-to-day payments required by a business. It allows the business to withdraw funds from its account that are not there, up to an agreed maximum limit, and is only used when the business requires additional, temporary amounts of money.

Benefits	Drawbacks
<ul style="list-style-type: none">• Offers flexibility• Important source of finance for a business if it has a short-term shortage of cash or unexpected cost to pay• Interest is only paid on the amount used	<ul style="list-style-type: none">• Repayable to the bank at any time• A bank may lower or even withdraw the overdraft facility at any time• Usually has high levels of interest; using overdrafts is therefore an expensive form of finance



Concept links

Sentence starter - One benefit of using a bank overdraft is...

Bank overdraft

Short-term

Cash flow

Survival

Can you link these concepts?



Concept links

Sentence starter - One benefit of using a bank overdraft is...

Bank overdraft

Short-term
that it is a short-term source of finance, where the business can draw beyond its current funds.

Cash flow
As a result, cash flow problems can be prevented.

Survival
This will mean businesses can continue trading and survive through difficult times, which is particularly useful for seasonal businesses.

External – Loan (friends and family)

Friends and family, who are supportive of the business idea, may be willing to provide money either directly to the entrepreneur or into the business.

Benefits	Drawbacks
<ul style="list-style-type: none">• This can be quick and cheap to arrange (certainly compared with a bank loan)• The interest and repayment terms may be more flexible than a bank loan	<ul style="list-style-type: none">• Increased stress for the entrepreneur, particularly if the business gets into difficulties, as it can cause family/friend disagreements• The amount available may be limited, resulting in this source of finance having to be combined with other sources of finance

External – Loan (banks)

A bank loan is an amount of money borrowed for a set period with an agreed repayment schedule. The repayment amount will depend on the size and duration of the loan, as well as the **rate of interest**.

Benefits	Drawbacks
<ul style="list-style-type: none">• Guaranteed the money for a certain period - generally three to ten years• No need to provide the bank with a share in the business, so no control is lost• Interest rates may be fixed for the term, making it easier for an entrepreneur to forecast interest payments and cash flow• Repayments are made in instalments meaning the business can access substantial amounts of cash that does not need to be paid back in one-go	<ul style="list-style-type: none">• Time consuming - a new business would need to produce a detailed business plan in order to gain a bank loan• Security - normally has to be given to the bank on some of the assets of the business/entrepreneur's personal assets; the bank will have control over these assets if the business fails• Lack of flexibility - a small business might take a loan out for £50,000, but finds it only needed £30,000; interest must be paid on the full loan amount, which increases the costs of the business

Alternative Business Funding (ABF)



ABF is a government-backed scheme launched at the end of 2016 which has seen small businesses gain better access to loan finance.

Nine of the UK's biggest banks currently take part. The scheme ensures that small businesses, whose loan applications are denied by such banks, are helped to find finance elsewhere.

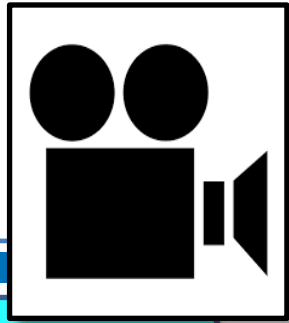


<http://startups.co.uk/small-businesses-finance-bank-referral-scheme/>

Give **THREE** reasons why a bank might reject a loan application from a small business



Long-term – Crowd funding



This is a way of raising money through a crowd funding platform, publicising a proposal seeking to attract a large number of worldwide small investors.

Benefits	Drawbacks
<ul style="list-style-type: none">• Provides cheap investment, when other sources of external finance may not be available• If the project is newsworthy, it might attract good publicity• Social media can be easily used to keep investors informed of the progress of the business venture, which might then provide ongoing finance• Investors may have experience or skills that they can offer the business	<ul style="list-style-type: none">• Investors will need to be offered a return; this might be free use of the good or service produced or a share in the profits. Some schemes will also provide shares, which dilutes the control of the original owners of the business• Risk that there will be a limit to the amount of money investors are willing to invest• The business idea may not be of interest and attract little finance; time and money spent organising the crowdfunding campaign will be lost

Examples of crowd funding sites

INDIEGOGO

JustGiving™

gofundme

KICKSTARTER

 **Crowdfunder**

Business example



Thomas Clipper, a men's grooming service, obtained £93,000 of Seedrs investment through crowd funding

External – New share issue

Small or new businesses that are set up as private limited companies can raise finance by **selling shares** in the company. Alternatively, large public limited companies can raise large amounts of funds by issuing **new shares** for sale.

Benefits	Drawbacks
<ul style="list-style-type: none">• Large sums of money can be raised• Capital does not have to be repaid• There is no interest – dividend payments can be missed if profits are low	<ul style="list-style-type: none">• Possible loss of control if the original owners sell more than 50% of the total shares• Need to satisfy shareholders expectations of dividends and share price growth

The *Teashed

The demand for tea and tea rooms has grown significantly over the past few years, partly due to the increase in demand for afternoon tea, which has been inspired by the success of shows such as the Great British Bake Off. Jules Quinn, a budding entrepreneur, decided to open a business called the*Teashed, as a private limited company to meet this growing demand.

Jules is planning to launch her first *Teashed tea room in Northumberland, targeting a young, urban, affluent crowd and intends to serve only the finest Sri Lankan tea. Jules requires £180,000 to fund her new tea room. Interest rates are very low at the moment, which could make it cheaper for Jules to raise the required amount of money.



www.The-TeaShed.co.uk

20 Berry Orange *Teabags –
Strawberry, Orange &
Lemongrass

£3.50



www.The-TeaShed.co.uk

Minty Tea – 20 Minty Jasmine
Green *Teabags

£3.50



www.The-TeaShed.co.uk

Redbush and Vanilla Tea – 20
*Teabags

£3.50

Decision time...



Jules needs to raise £180,000 to fund her new tea room. She is considering two ways of doing this:

- Selling shares in the business (share capital)
- Obtain a loan from the bank



Identify one benefit and one problem of each option



Selling shares

Will not incur interest charges



Loss of control, shareholders may want a say in how the business is run



Bank loan

No need to offer shares to the bank – no loss of ownership and control



Interest charges will increase Jules' cash outflows



Identify one benefit and one problem of each option



Selling shares

Bank loan

Apply these points specifically to Jules and the set up of the *Teashed.

Why are these important issues for Jules to consider?

Which option?

Advise Jules on the best option for her business, justify your answer

Checking your understanding



*Which of the following is an **internal** source of finance ?*

- A hire purchase*
- B retained profit*
- C trade credit*
- D loan from family and friends*

*Which of the following sources of finance incurs **interest** ?*

- A share capital*
- B retained profit*
- C government grant*
- D bank loan*

Checking your understanding



*Which two of the following are **external** sources of finance ?*

- A sale and leaseback*
- B retained profits*
- C government grant*
- D share issue*

*Which source of finance leads to a **loss of ownership** ?*

- A sale of unwanted assets*
- B share capital*
- C retained profit*
- D bank loan*

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