SOURCES OF FINANCE

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- Euro Corporate Services Pvt Ltd

Why do we need to study FINANCE?

Almost half of all ventures fail because of poor financial management

-Dun & Bradstreet

Case Study

S Ltd.			(Amt in Crs.)	
Particulars	**PRE STRUCTURING**		**POST STRUCTURING**	
Equity and Liabilities:				
Share Capital		6.31		6.31
Reserves & Surplus		22.9		34.69
Non- Current Liabilities		27.14		38.29
		56.35		**79.29**
Current Liabilities:				
WC from Banks	13.59		0.68	
other current liabilities	41.28	54.87	39.47	40.15
Total		111.22		119.44
Assets:				
Fixed Assets		66.33		62.64
Investments		6.17		4.64
		72.50		**67.28**
Current Assets:				
Inventory	6.96		8.40	
Other current Assets	31.76	38.72	43.76	52.16
Total		111.22		119.44
Gross Turnover		131.22		156.6
EBIDT		17.38		28.91
PAT		6.32		12.52
Ratios:				
Current Ratio		0.71		1.29
Acid Test Ratio		0.58		1.08
Debt Equity Ratio		0.93		0.81
TOL/TNW		2.87		1.91
Rating		BB-		BBB-

Parameters for choosing the right Source of Finance

- Amount of Money required
- Cost of Fund
- Tenure
- Security cover available
- Risk Profile of Borrower
- Prevalent Economic Conditions

Sources of Finance

- **Short Term**

- **Long Term**

Sources of Short Term Finance

- Working Capital by Banks
- Factoring
- Commercial Paper
- Inter Corporate Deposits

Working Capital Finance by Banks

- Options:-

- ➢ Cash Credit / Overdraft / WCDL
- ➢ Purchase/ Sale Bill Discounting
- ➢ Letter of credit
- ➢ Bank Guarantee
- ➢ Buyer's Credit

Cash Credit/ OD / WCDL

- Borrower is allowed to borrow up to certain limits against the security of Current assets.
- Interest is charged on the amount actually utilised .

  (Base rate + 1 % - 4 % spread)
- Security Margin :

  Stock - 25 - 30 %

  Book Debts - 25 – 40 %
- Current Assets Levels :

  RM - 1 to 3 m

  WIP – Process Cycle

  FG – 1 to 2 m

  Book Debts – 3 to 4 m

- **Ratios** :
  Current Ratio – Min - 1.25 , Desired – 1.33
  TOL /(Adj) TNW – Max - 3 , Desired - 2
  Interest Coverage - Min – 2
- **Rating** :
  External - Min – BB+ Or Equivalent
  Internal - Min – 4 & above (40 %)
  CIBIL – Clean for Co. & Directors
- **Collateral** : 10% onwards
- **Forms / Reports :**
  Annual – CMA & AR
  Monthly – Stock & Book Debts Stat
  Qtrly - Production & Performance Data
  Hly – Budget & Performance Data
- **Inspection & Audit :** At least once a year

Purchase/ Sale Bill Discounting

- Under this Bank takes the Bill drawn by borrower on his (borrower's) customer.
- Bank pays after deducting discount/ Interest & commission.
- The Bank presents the Bill to the borrower‘s customer on the due date and collects the total amount.
- If the bill is delayed, the borrower or his customer pays the Bank a overdue interest.

Bills Discounting

- Constitutes a vital part of the working capital finance and is a major Trade Finance activity.

- Bills can be clean or backed by L/C.

- Liability in case of dishonor of the bill shifts, depends on recourse terms .

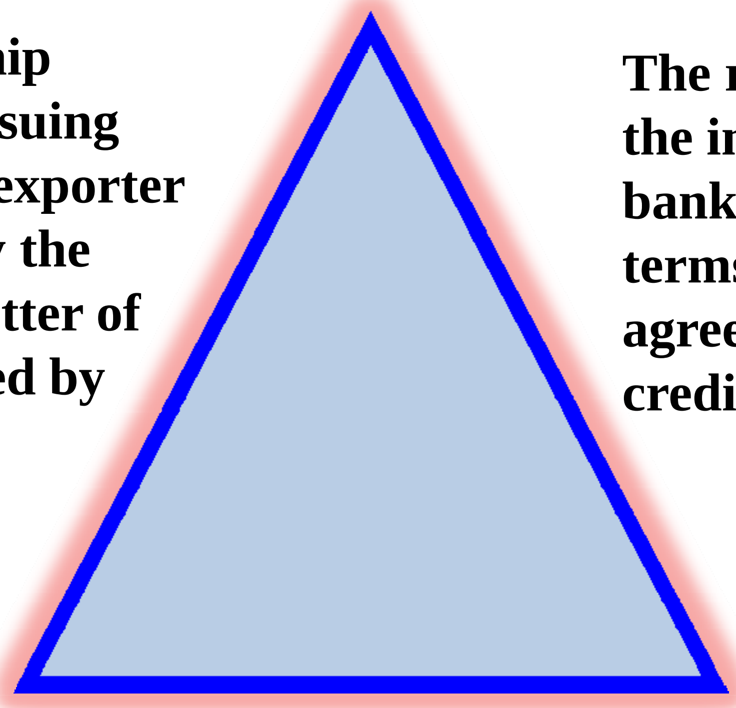
Letter of Credit (L/C)

- Issued by a bank at the request of an importer/ Purchaser.
- The bank promises to pay an exporter/Seller, upon presentation of documents specified in the L/C.
- An L/C reduces the risk of non fulfillment because the bank agrees to pay against documents.
- The L/C can be sight or Usance (30 -180 days).
- The L/C must contain a specified validity date and stated maximum amount .

Issuing Bank

The relationship between the issuing bank and the exporter is governed by the terms of the letter of credit, as issued by that bank.

The relationship between the importer and the issuing bank is governed by the terms of the application and agreement for the letter of credit (L/C).



Beneficiary
(exporter)

Applicant
(importer)

The relationship between the importer and the exporter is governed by the sales contract.

Bank Guarantee

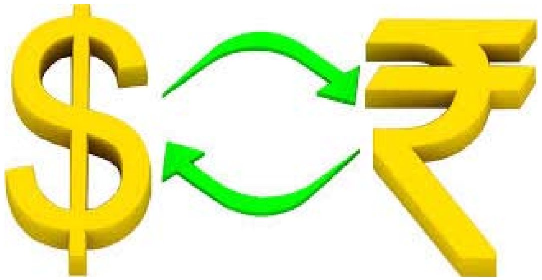
- Type of Guarantees :

  Advance Payment BG

  Performance BG

  Others – to Govt. Dept.

- Tenure – 3 to 36 Months
- Margins – 5 to 100 %



Buyer's Credit

- Short term credit availed by an importer(buyer).
- Availed from overseas lenders - banks and financial institutions.
- Helps importers gain access to cheaper foreign funds closer to LIBOR rates.
- Normally it is quoted as "3M Libor + 100 bps"

Buyer’s Credit

Steps Involved:-

Customer will import the goods either under LC, or Direct document.

Requests the Credit Arranger to grant the credit.

Overseas bank branches to provide a buyer's credit offer letter.

On receipt of LOU / LOC Overseas bank to fund Importer's bank Account or pays the supplier’s bank directly.

Importer's bank will recover and remit the same to overseas bank on due date.

Buyer’s Credit

- In India, buyer's credit tenure is :

  3-12 months for RM imports

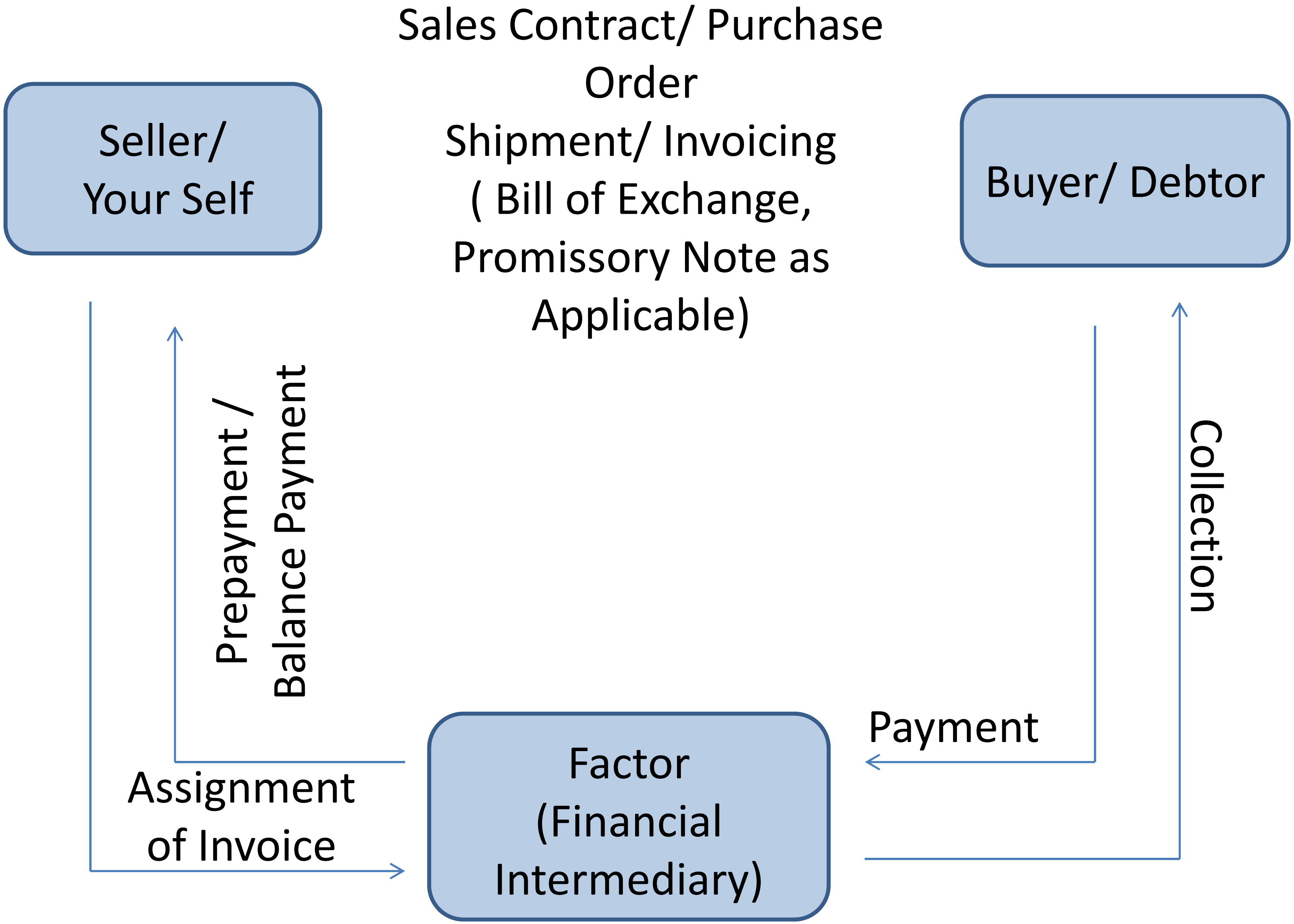
  1-3 Yrs for Capital Goods
- Every 3/6 months, the interest on buyer's credit may get reset.
- The exporter gets paid on due date.
- The currency of imports can be different from the funding currency.

Factoring

An agreement in which receivable arising out of sale are sold by borrower (client) to the factor(financial intermediary) at discount.

Factor usually make advances upto 80-90% of value of accounts receivable.

Factor is more concerned with the creditworthiness of the invoiced party than client's financial status.


Seller/
Your Self
Sales Contract/ Purchase Order
Shipment/ Invoicing (Bill of Exchange, Promissory Note as Applicable)
Buyer/ Debtor
Prepayment / Balance Payment
Collection
Payment
Assignment of Invoice
Factor (Financial Intermediary)

Factoring

Advantages

- Clean credit
- Focus on Core Areas
- It is the **quickest** way to get cash after sale.
- **Cost effective** with the cut in invoice processing and collection activities.
- Factoring helps in **eliminating the risks** of bad debts.
- It gives an opportunity to offer **credit to customers.**
- It helps in building **credit history** and no long-term obligation.

Disadvantages

- Not available for Small Customers
- May harm customer relationship.

Commercial Paper

- An unsecured money market instrument issued in the form of a promissory note.

- Corporates , Primary dealers and All India Financial Institutions are eligible to issue CP.

- Maturities between Min 7 days & Max 1 year

- Denomination of Rs 5 Lakhs or multiple thereof.

- Actively traded in secondary market.

Issue of Commercial Paper

C.P. can be issued by company whose

- Tangible net worth is not less than Rs 4 Crs.
- Working capital limits are sanctioned by bank/s or FIs.
- Borrowal account is classified as a Standard Asset by the financing bank.
- Specified Credit rating from SEBI registered CRAs. Minimum rating shall be ‘A3(As per SEBI)’ .
- Current ratio is 1.33:1 .

Commercial Paper

Advantages

- Flexibility
- Low Cost alternative to borrowing from bank
- It is unsecured so no lein is created on assets

Disadvantages

- Available only to select blue chip with good rating
- Low credit limits from bank
- Very closely regulated by RBI
- Only for short tenure

Inter Corporate Deposits(ICD)

- A deposit made by one company to another.
- Generally for tiding short term fund mismatch.
- Borrowing under ICD is restricted to 50% of the Net owned funds .
- Tenure - 7 to 365 days.
- ICD's are of 2 types:

  Fixed Rate ICD : Interest rate is fixed

  Floating Rate ICD : They are linked to NSEs MIBOR.

Inter Corporate Deposits

Advantages

- More flexible
- Can raise money at short notice
- Very Less documentation except letter and PDC'S

Disadvantages

- Interest rates are higher than those in the other markets.
- ICD market is not well organised with very little information available publicly about transaction details.

Sources of Long Term Finance

- Term Loans
- LAP & LRD
- Lease & HP Financing
- Debentures
- Venture Capital/Private Equity
- External Commercial Borrowing
- Retained earnings
- Others – IPO, FPO, GDR, ADR, Public Deposits

Term Loans

- Long term debt with a maturity of more than 3 years.
- Obtained from Banks and FI's.
- Mainly to finance company's capital expenditure.
- Credit is extended under a formal loan agreement.

Steps for Term Loan

Preparation of Detailed Project Report

↓

In-Principle Approval of Project

↓

TEV Study by Independent Consultants

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Detailed Appraisal

↓

Final Sanction

↓

Legal & Other Compliances

↓

Disbursal of Loan

Term Loans

Advantages

- Can be tailored to meet specific needs through negotiation with lender
- More readily available
- No dilution of control
- Flexibility
- Repayment holidays

Disadvantages

- Payment of interest and principal is mandatory . It's default may threaten existence of firm.
- Only creditworthy firm with good collateral can raise Debt.
- Usually fixed maturity date

LOAN AGAINST PROPERTY

LAP is similar to other long term loans like Corporate loan, home loan, Equipment Loan etc.

- **Quantum of Loan** : Depends on type of property & income of the borrower (LTVs at 65- 80% of PMV)
- **Tenure** : Flexible for 3 -12 years
- **Interest Rates** : 11%-14% p.a.
- **Security** : Charge on Property

LEASE RENTAL DISCOUNTING

LRD is a type of Term Loan offered against rental receivables derived from long term lease contracts with corporate tenants

- **Quantum**:
  - Based on the discounted value of the future rentals .
  - 60% to 80% of underlying property value.
- **Tenure**: 7-15 years (Linked with lease period, lock in period, quality of tenant etc.)
- **Repayment Mode**: Generally Rentals are payable by the tenant directly to an escrow account with lending bank.
- **Security:** The underlying leased property taken as prime security.
- **ROI** - @ 11-13%

Lease Financing

- It is a contract in which the asset is purchased initially by the lessor (leasing company) and thereafter leased to the user(lessee company) who pays specified rent at periodic intervals.

- Types of leases
  - Financial lease
  - Operating lease – Aviation & Heavy Machines(Oil Rigs) & Construction Equipments
  - Sale and lease back

Lease Financing

Advantages	Disadvantages
• Fixed rate	• More costly than purchase
• Holder pays only for use	• High fixed cost per month + Liability of VAT
• Better liquidity	• Commitment for entire lease period

Hire Purchase

- Transaction in which goods are let out on hire with option to the hirer to purchase with following conditions:

➢ Payment made in installment over specified period

➢ Possession given to hirer at start of contract

➢ Title of the assets passes to the hirer on payment of last installment

➢ Each installment is treated as hire charges (if default in any installment seller entitled to take away the goods).

➢ Hirer is free to return the goods without being required to pay any further installments falling due after the return

Hire Purchase

Advantages

- Get possession without having fully paid for it.
- Hirer can terminate it at will without payment of further installment.
- No burden since payments in installments over a period of time.

Disadvantages

- Buyer usually has to pay extra
- One does not get title to the goods until final payment is made.
- Creditor's harassment
- Liability of VAT in certain states

Debentures

- Debentures are debt securities
- Issued for Fixed Coupon Rate
- Undertaking to repay the debt at a specified date
- Debenture holders have no right to vote
- Minimum Rating of A & Above is preferred
- Only secured debentures are allowed

Debentures

Advantages

- No dilution of control
- Long term source
- Low rate of interest as compared to dividend
- Can be redeemed anytime

Disadvantages

- Charge on assets
- Fixed Interest
- Rating is must
- Not for all. Eg: Co. with unstable earnings, insufficient FA .

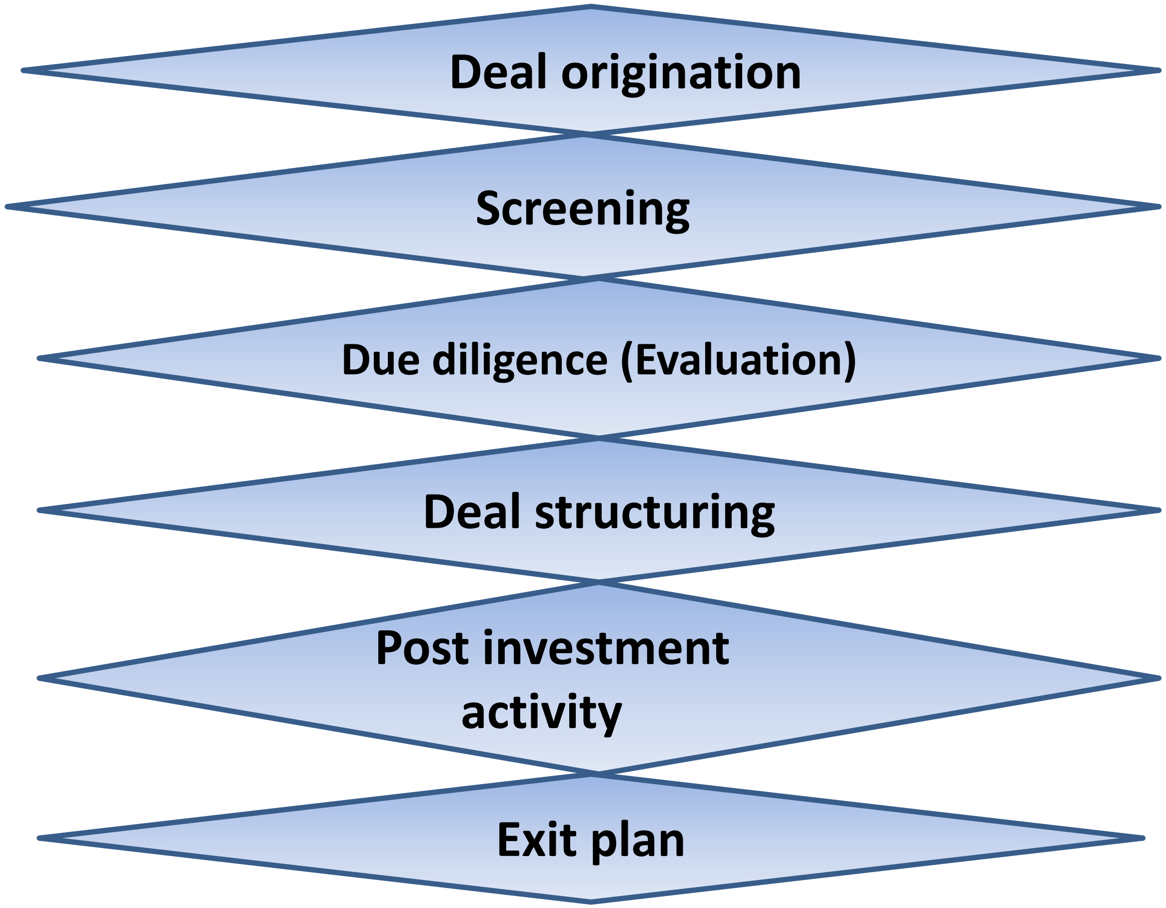
Venture Capital

- It is money for new, young and / Or small businesses that typically have little or no access to capital markets.
- Features
  - Equity participation
  - Participation in management
  - Long term Investment
  - High risk
  - Lack of liquidity

Stages in Venture Capital Financing

- Early Stage Financing
- Expansion Financing
- Acquisition / buyout financing

Venture Capital Investment Process



Venture Capital

Advantages

- Provides large sum of long term equity finance
- Venture capitalist bring expertise, provides advice and support.
- Future funding are easily secured
- Venture capitalist has network of contacts which may add value to company

Disadvantages

- Loss of control
- Loss of autonomy
- Lengthy and complex process

External Commercial Borrowing (ECB)

- Refers to foreign currency loan in the form of bank loans, securitized instruments availed by residents from non resident lenders with minimum average maturity of 3 years.

- Department of Economic Affairs, Ministry of Finance along with RBI monitors & regulates ECB guidelines & policies.

- FCCB, Preference Shares & FCEB are also governed by ECB Guidelines.

Forms of ECBs

- Bank loans;
- Securitized instruments (e.g. floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares/debentures);
- Buyers’ credit;
- Suppliers’ credit;
- Foreign Currency Convertible Bonds (FCCBs);
- Financial Lease; and

All the forms of borrowing can be availed of both under the automatic and approval routes

ECB Framework

Track I	**Medium term foreign currency denominated ECB with Minimum Average Maturity (MAM) of 3/5 years.**
Track II	**Long term foreign currency denominated ECB with MAM of 10 years.**
Track III	**Indian Rupee denominated ECB with MAM of 3/5 years.**

Amount and Maturity

The individual limits of ECB that can be raised by eligible entities under the automatic route per financial year for all the three tracks are :

Companies	Limit (in USD)
in infrastructure and manufacturing sectors	Upto 750 mio
in software development sector	Upto 200 mio
engaged in micro finance activities	Upto 100 mio
Others	Upto 500 mio

Minimum Average Maturity (MAM) Period

Track I	Track II	Track III
i. 3 yrs for ECB upto USD 50 mio.	10 yrs irrespective of the amount.	Same as under Track I.
ii. 5 yrs for ECB beyond USD 50 mio.		

Eligible Borrowers

Track I	Track II	Track III
i. Companies in mfg, and software development sectors.	i. All entities listed under Track I.	i. All entities listed under Track II.
ii. Shipping and airlines Cos.	ii. Companies in infra sector.	ii. All NBFCs.
iii. Units in SEZs.	iii. Holding companies.	iii. NBFCs-Micro Finance Institutions, NGOs engaged in micro finance activities.
	iv. Core Investment Companies (CICs).	iv. Cos engaged in R&D, training , infra, logistics services.
	v. Real Estate Investment Trusts (REITs) & Infrastructure Investment Trusts (INVITs)	v. Developers of SEZs

All-In-Cost Ceilings

Average Maturity Period	All in cost ceilings over 6 month LIBOR*
Track I	
3 yrs & upto 5 yrs	300 basis points
More than 5 yrs	450 basis points
Track II	
10 yrs	500 basis points
Track III	
3-5 yrs and >5 yrs	In line with Market conditions

*All in cost includes rate of interest, other fees and expenses in foreign currency except Commitment fee, Pre-payment fee, Withholding tax and fees payable in Indian Rupees

Permitted End Uses of ECB

Track I	Track II	Track III
1. ECB proceeds can be utilised for capital expenditure in the form of: i. Import of capital goods including import of services, technical know-how and license fees ii. Local sourcing of capital goods; iii. New Project; iv. Modernization /expansion v. Overseas direct investment in JV/ Wholly owned subsidiaries (WOS);	1. The ECB proceeds can be used for all purposes excluding the following: i. On-lending to other entities with any of the above objectives; ii. Investing in capital market iii. Using the proceeds for equity investment domestically; iv. Real estate activities v. Purchase of land.	NBFCs can use ECB proceeds for: a. On-lending to the infrastructure sector; b. providing hypothecated loans to domestic entities for acquisition of capital goods/equipments; and c. providing capital goods/equipment to domestic entities by way of lease and hire-purchases

Track I	Track II	Track III
vi. Acquisition of shares of PSUs on disinvestment; vii. Refinancing of existing ECB provided the residual maturity is not reduced.		
2. Units of SEZs can raise ECB only for their own requirements.	2. Holding companies can also use ECB proceeds for providing loans to their infrastructure SPVs.	2. Developers of SEZs/ NMIZs can raise ECB only for providing infrastructure facilities within SEZ/ NMIZ.
3. Shipping and airlines companies can raise ECB only for import of vessels and aircrafts respectively.		3. NBFCs-MFI, NGOs can raise ECB only for on-lending to self-help groups or for micro-credit.

Track I	Track II	Track III
4. For general corporate purpose (including working capital) provided the ECB is raised from the direct / indirect equity holder or from a group company for a MAM of 5 years.		4. For other eligible entities under this track, the ECB proceeds can be used for all purposes excluding the following: i. Real estate activities ii. Investing in capital market iii. Using the proceeds for equity investment domestically; iv. On-lending to other entities with any of the above objectives; v. Purchase of land
5. ECBs for the following purposes will be considered under the approval route: i. Import of second hand goods as per the Director General of Foreign Trade (DGFT) guidelines; ii. On-lending by Exim Bank.		

Security for raising ECB

i. AD Cat I banks are permitted to allow creation of charge on immovable & movable assets, financial securities and issue of CG and/or PG in favour of overseas lender/security trustee, to secure the ECB to be raised / raised by the borrower during the currency of the ECB with security co-terminating with underlying ECB, subject to that:

a. the underlying ECB is in compliance with the extant ECB guidelines,

b. there exists a security clause in the Loan Agreement requiring the ECB borrower to create charge, in favour of overseas lender/ security trustee, on immovable assets/movable assets/financial securities/issuance of CG and/or PG, and

c. NOC from the existing lenders in India has been obtained.

External Commercial Borrowing

- Guarantee : Issue of BG, standby LC, LOU or LOC by banks, FI and NBFCs to secure ECB is not permitted.

- Prepayments : Prepayment of ECB up to USD 500 mln may be allowed under Automatic route whereas >USD 500 million under Approval route.

- Refinancing : The existing ECB may be refinanced by raising a fresh ECB subject to the condition that the fresh ECB is raised at a lower all-in-cost and the outstanding maturity of the original ECB is maintained.

ECB Liability Equity Ratio

- **<u>Automatic Route</u>**

The total ECB liability should not be more than four times of the equity Contributed.

- **<u>Approval Route</u>**

The total ECB liability should not be more than seven times of the equity Contributed.

Tips to save borrowing cost

Some Common Situations & SUGGETIONS

- **If you have imports**

  Always use buyer's credit@Libor+1.25% i.e approx 1.75% to 2 %

  (If no exports, go for hedging also)

- **If you have exports**

  Use PCFC/ FBN / FBP / FCNR(B) facilities.

  (Even SME's can take sub-limit with CC limit)

- **If you have good collateral**

  Always ask for best CC rates or convert part of CC in to WCDL / FCNR(B) Loan

- **Change of bank**

  Change from co-operative/small pvt. Banks to bigger PSU banks/foreign banks for better interest rates

- **If you are supplier to biggies like HUL, ITC, PFIZER, ONGC etc…..**

  Never take spot payment against cash discount. It costs you 18% to 24% p.a. instead take bill discounting from banks @ 10%-12% p.a

- **If you have 100% collateral for your CC limit**

  Better convert your part CC to mortgage loan/ OD at much better rates

- **If you want to increase negotiation power**

  Go for External Rating to take best interest rates benefit.

- **If you want better rating & avoid penal interest**

  Submit Monthly, Quarterly, Half yearly statements in time

- **If you are in a liquidity crunch for temporary reason**

  Go & explain your problem to bank and take Adhoc limits instead of spoiling track record of not paying creditors
- **If you are in good financial position**

  Always avail cash discount from your supplier say 2% p.m. and use bank limits of 12%-13% p.a.
- **If you are importer and exporter**

  Always deal with a forex branch of bank to avail better Rs. $ rates
- **If you have large limits say 50 Cr +**

  Always deal with more than one bank to negotiate better….

<u>Remember…you don't get what you have…but you get what you negotiate….</u>

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