UNIT 14 OTHER MODES OF FINANCING

Objectives

The objectives of this unit are to:

- provide an understanding of non-traditional sources of long-term financing,
- focus on non-traditional sources of short-term financing.

Structure

14.1 Introduction

14.2 Non Traditional of Sources Long-term Financing

14.2.1 Leasing and Hire-Purchase

14.2.2 Suppliers' Credit

14.2.3 Asset Securitization

14.2.4 Venture Capital

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14.4 Summary

14.5 Self-Assessment Questions

14.6 Further Readings

14.1 INTRODUCTION

Raising funds is an important activity of finance managers. Business units require funds for two reasons - to acquire fixed assets and to run the operations of the units. Several factors influence the need for funds and typically a growing firm needs more funds year after year. In the previous units, we discussed how a firm can raise money from capital market and institutions. In this unit, we will look into other alternative sources of funds. Before we discuss these sources, let us quickly review the financing options available before a firm and what is the need for additional non-conventional sources of finance.

It was noted earlier that firms typically raise money in the form of equity or debt. Equity is risk capital and brought by owners, who want to take risk while investing money. Debt holders are typically risk-averse investors, and hence want safety but willing to provide funds at a lower rate of return. Debt holders are less interested on the future prospects of the company but they are interested to know whether the company would be liquid enough to pay interest and principal on the due date. In between the equity and debt, firms also raise money through preference capital and convertible debt instruments. Also, firms retain substantial part of the profit to meet their requirement. Fixing a broad mix and then choosing different sources of capital is an important job of financial managers. You would by now know why financial managers spend lot of time on this issue particularly, when we also say finance mix is irrelevant in valuation of firm (Modigliani and Miller Theory).

While equity capital is raised not so frequently, firms take additional debt from institutions and other sources regularly. In fact, debt is found to be important source of capital next to retained earnings. While retained earning provide convenience (easy to tap), debt is often believed cost effective particularly for tax reasons. In terms of convenience also, debt scores over fresh equity issue since banks and financial institutions are easily approachable than approaching

capital market for equity issue. Equity issue involves considerable amount of legal and other formalities and also there is no assurance that investors will be interested in putting their money in the company. Finance managers choose a particular source of capital after considering the following issues:

a) Whether the duration for funds required and funds available match?

b) What is the size of funds requirement?

c) What is the risk involved in the investments for which funds are demanded?

d) Whether the funds are required urgently?

e) What is the current and future financial markets scenario?

Finance managers look for constantly alternative sources of funding and depending on the demand and nature of funds, a particular source of funds is tapped. Often, the finance managers tap non-conventional source of funds. We will discuss some of the non-conventional source of funds in this unit.

14.2 NON-TRADITIONAL SOURCES OF LONG-TERM FINANCING

Long-term finance is raised when the need for funds is for more than one year. Typically, long-term finance is required for acquisition of fixed assets having a life more than one year or investments, which have long-term impact on the earnings of the company. For instance, if a firm wants to buy a patent or brand, which in turn contributes to the sales of the firm for a long-term, it requires long-term funds for such acquisition. While equity and debt are conventional source of finance, such source of finance is not available for many investments. Some time, the investment needs may not be large enough for the financial managers to approach banks or financial institutions. They look for alternative source of finance under these circumstances. In the following sections, we will discuss four such sources of alternative long-term finance available for the firms. They are (a) Leasing and Hire-purchase (b) Suppliers' Credit (c) Asset Securitization and (d) Venture capital.

14.2.1 Leasing and Hire-Purchase

Firms need finance to acquire assets. Instead of borrowing and acquiring assets, it is possible for firms to acquire the assets on lease. There are two types of leasing - operational lease and financial lease. Operational lease is used when the assets are used for temporary period and the asset is returned at the end of the short period. Suppose a firm gets an extra order for which it requires some additional equipment. Such additional equipment can be taken on lease for few days, say three weeks and at the end of the three weeks, the equipment is returned to the owner. Some of the assets that are normally acquired under operational lease arrangement are computers, vehicles, generators, small movable equipment, etc. While operational lease is not considered a source of finance, financial lease is used when the assets are required permanently or for a long period. Normally, the assets are ultimately purchased by the firm from the lessor at a nominal value. During the period of lease, the firm which acquired the assets on lease (called lessee) can use the assets but it is not the owner of the asset. The ownership rests with the company which provided the assets on lease. During the period of lease, the lessee has to pay lease rent to the lessor. Lessee is not entitled for any depreciation whereas lessor can claim depreciation for the assets for tax purpose. Hire-purchase is similar to financial lease. A hire-purchase transaction

is usually defined as one where the hirer (user) has, at the end of the fixed term of hire, an option to buy the asset at a token value. In other words, financial leases with an option to buy the asset at the end of the lease term can be called a hire-purchase transaction.

So the basic question is why firms acquire assets on financial lease and why someone wants to buy an asset and then lease the same to another firm. There are several reasons given below:

a) **Easy Procedure:** Acquiring an asset through a lease transaction is much simpler than borrowing money from a bank or financial institution for acquiring the same asset. Leasing companies have developed fairly simple procedure to process lease application. The level of legal documentation is also fairly simple. In other words, you can acquire the asset in a very short period of time through lease transaction. Suppose, a firm wants to buy 10 lorries, it can be done with in two or three days through lease transaction. Acquisition of computers and other such electronics items like Air-conditioning can be done within a day. Since the ownership of the asset rests with the lessor, the leasing companies are willing to take additional risk while processing the lease application. If the assets leased are special type assets, whose re-sale value is low, leasing companies will take longer time to process such lease application since the risk involved in funding such assets is fairly high. Typically, in borrowing the end use of the funds will not differentiate the loan application processing. Hence, firms use lease for acquiring certain type of assets.

b) **Size of Loan:** Many banks and financial institutions fix certain minimum loan amount. If the need of firm is much lower, it doesn't make sense to borrow more and keep the cash idle. Leasing company funds assets of any value. If the requirement of funds is large, a consortium of leasing companies funds such acquisition.

c) **Cost:** It is difficult to say whether lease cost will be lower than borrowing cost but it is possible in certain cases due to tax impact. When a firm borrows money and then acquires the assets, it pays interest and also claims depreciation. Both interest and depreciation can be claimed as deduction under income tax. The net outflow will be thus much lower. On the other hand, when a firm acquires an asset on lease, it pays lease rent, which qualifies for income tax deduction but there is no depreciation benefit. However, depreciation benefit is claimed by the lessor and in all probability, the lessor will pass on the impact of the tax shield to the lessee by fixing lower lease rent. In other words, it is possible to fix a lease rental such that it is equal to borrowing to both lessor (borrower) and lessee (lender). The following example explains the issue further.

Illustration: Suppose a firm requires an asset worth of Rs. 1,00,000 and it can raise the funds at 10% for five years from a bank. The bank requires the firm to repay the loan with interest in 60 equated monthly installment (EMI) at the rate of Rs. 2124.70. Present value of annuity of Rs. 2174.20 at an interest rate of 0.83% per month for 60 months is equal to Rs. 1,00,000. It means by paying Rs. 2174.20 every month for the next 60 months, you can wind up Rs. 1 lakh loan you have taken today with an interest rate of 10%.
Since each installment consists of interest as well as principal, the interest and principal paid over the five years are to be separated. While interest is eligible for tax deduction, the amount paid towards principal will not qualify for income tax deduction.

The values of interest and principal are as follows:

Year	Interest	Principal	Total
1	9269.644	16226.76	25496.40
2	7570.491	17925.91	25496.40
3	5693.414	19802.99	25496.40
4	3619.782	21876.62	25496.40
5	1329.015	24167.39	25496.40
Total	**27482.35**	**99999.65**	**127482.00**

If the life of the asset is also 5 years and the asset qualifies a depreciation rate of 25%, the depreciation schedule is as follows:

Year	Opening Balance	Depreciation	Closing Balance
1	100000	20000	80000
2	80000	16000	64000
3	64000	12800	51200
4	51200	10240	40960
5	40960	8192	32768

Let us assume that the asset is sold at the end of 5 years at Rs. 32768. If the firm pays income tax at the rate of 35%, the after tax cost of the asset is as follows:

Year	Interest	Depreciation	Total	Tax Shield @ 35%	Cost net of Tax Shield
1	9269.644	20000	29269.64	10244.38	19025.27
2	7570.491	16000	23570.49	8249.672	15320.82
3	5693.414	12800	18493.41	6472.695	12020.72
4	3619.782	10240	13859.78	4850.924	9008.859
5	1329.015	8192	9521.01	3332.355	6188.66

The present value of cost net of tax shield at a discount rate of 10% is equal to Rs. 48985. Suppose a leasing company is willing to provide the asset on lease at a lease rental of Rs. 7561 per month for five years and at the end is willing to transfer the asset to you at a nominal cost of Re. 1, the present value of lease rent net of tax is as follows:

Year	Lease Rent	Tax Shield	Lease Rent Net of Tax	Present value of Lease Rent
1	90732	31756.2	58975.8	33486.91
2	90732	31756.2	58975.8	10669.96
3	90732	31756.2	58975.8	3399.77
4	90732	31756.2	58975.8	1083.27
5	90732	31756.2	58975.8	345.16
Total	**453660**	**158781.0**	**294879.0**	**48985.09**

In other words, both lease and borrowing leads to same effect. However, the actual lease rent may be higher or lower depending on the cost of funds to the lessor and tax shield the lessor get on leasing the asset. Further, if the lessee firm is not tax paying entity, then there is no actual tax benefit from

depreciation and in that process, the cost of owning the asset will go up. Thus, in a situation where the tax rates of lessor and lessee are different and the cost of funds to lessor and lessee are different, then lease may be cost effective. Since lease transactions also attract some additional taxes like sales tax, one has to consider such additional costs in evaluating lease vs. borrow decision. Students desiring to know more on this may refer some specialized book on Lease Finance (Vinod Kothari, Lease Financing and Hire Purchase, Wadhwa and Company, Nagpur).

Though leasing is not a major source of finance, Indian companies today acquire assets through lease finance. The following table shows the value of leased assets and lease rent (including operating lease rent) paid by BSE-100 index companies during the last five years.

The table values show an increasing trend in the value of leased assets over the years and also more than three time increase in the value of lease rent. Some of the prominent companies that use leasing extensively are ONGC, Shipping Corporation of India, IPCL, Larsen & Toubro, Reliance Industries, etc. Companies like ONGC hire most of the drilling equipment on lease and hence the lease amount is significant. Transport companies like shipping companies, air-lines also acquire their assets through lease transactions. Companies that prominently use leased assets, whose percentage on total assets is significant are Reliance Capital, Asian Paints, IPCL, Siemens, and BHEL. Today, there are several types of leasing. There are also mega international lease transactions called cross-broader leasing. Lease finance is likely to grow in the future due to its flexibility and convenience.

Table 14.1: Value of Lease Rent and Leased Assets of BSE-100 Index Companies
(Rupees in Crores)

Year	1998-99	1999-00	2000-01	2001-02	2002-03
Lease Rent	593.52	778.72	798.31	1433.00	1950.99
Value of Leased Assets	5428.86	4819.34	5428.57	6940.09	7300.52

Activity 1

"Leasing is nothing but borrowing and acquiring the asset" - Do you agree with this statement?

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Activity 2

Collect the details of lease/hire-purchase instalment per Rs. 1 lakh from a local leasing company. Evaluate whether it is cheaper than borrowing Rs. 1 lakh at an interest rate of 10% and buying the asset. Summarise your findings below:

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14.2.2 Suppliers Credit

The concept of supplier credit is fairly simple and in existence for a long time. Under this, the equipment suppliers provide long-term credit and accept the payment for the supply of equipment over a longer period of time say 5 to 8 years. In that process, the company which acquires the assets neither take bank loan nor approach has leasing company for credit but directly takes the credit from the supplier of the equipment. In other words, the supplier of equipment acts as a lender or lessor. The question is how it is superior to other forms of acquiring the assets. First of all, the buyer need not approach any other agency for credit. Normally, suppliers provide short period of credit, and in this special case, the suppliers provide long-term credit. Since there is no intermediary to fund the acquisition between the seller and buyer, it reduces the cost. In addition, it is possible that the supplier may be a cash rich company or may get funds at a much lower rate than the buyer. For instance, the credit rating of the supplier is far above than the credit rating of buyer or seller may be in another country where the interest rates are low. There are specialised government agencies to provide funds to the suppliers in order to improve the export sales or to help a particular sector. Though suppliers provide long-term credit to the buyers, there is no need for the suppliers to stuck with such huge long-term receivables because they can get finance under certain specific scheme against such receivables. They can also sell such receivables through securitization.

14.2.3 Asset Securitization

Securitization is fairly a simple concept. It is the process through which an asset (fixed or current) is converted into financial claim. It other words, it brings liquidity to an illiquid asset. The concept is very popular in housing finance. Let us explain the concept with a simple example. Suppose a housing finance company has Rs. 100 cr. During the first six months, it accepts the loan proposals and lent Rs. 100 cr. at an average interest rate of 10% and the duration of the loan is 15 years. Suppose the housing finance company gets some more loan applications say for Rs. 20 cr. in seventh month. The company has to look for new source of finance to fund the new loan proposals since it has already invested the entire capital and converted them into illiquid long-term 15 years receivables. The growth of the housing finance company is thus restricted to its ability to raise additional funds. Securitization assumes importance in this context. Suppose a group of pension companies is willing to buy Rs. 100 cr. 15-years receivables from the housing finance company discounting the receivables at say 9%. With this new cash flow, the housing finance company can finance new loans without making any fresh borrowing. In other words, the housing finance company has sold its 15-year illiquid receivables and raised money against it. The process of selling makes the concept slightly different from simple bill discounting concept. Under securitization, an intermediary agency is created, which initially buys the illiquid asset and against that it issues securities, which are tradeable in the market through listing. Thus, it is also called asset-backed securities or mortgaged-backed securities. The value of the securities is improved by taking credit rating and often through insurance cover.

Securitization improves operating cycle of the capital in the sense the housing finance company can recycle the capital several times and finance more houses without borrowing on its book. Every time when the cycle is completed, the firm receives profit. You might wonder why pension funds or other companies prefer to buy housing loans instead of investing or lending to housing finance company. The logic is fairly simple. For instance, if the pension funds give loan to housing finance company, there is no guarantee that housing finance

company will lend money to quality loan proposals. The lender has no control on the business of borrower. On the other hand, in buying the existing loan, the pension company can ask a credit rating agency to assess the quality of loans. In this process, the risk is reduced considerably. In addition, lending will block the funds of pension funds for a long-term whereas an investment in securitized asset brings liquidity for the funds invested. So it is a rare case of win-win situation for both the housing finance company and pension fund investors. Like pension fund, there are many investors who are looking for such investments, which essentially creates liquidity for these kinds of securities. Though this concept is yet to become popular in India, already several securitization deals have taken place.

While securitization as a concept was developed to help finance companies to covert their loans into liquid assets, it is now extensively used in several other business situations. It is possible for manufacturing or service firms to raise long-term funds through securitization. For example, many electricity boards, whose balance sheet is very weak and no financial institutions would be willing to lend money to such companies, have raised long-term funds at a cheaper interest rate by securitizing future receivables of some good clients. By securitizing, the company actually sells the receivables to the intermediary agency (called Special Purpose Vehicle or SPV), which collects the money and distributes to the holders of such securities. Figure 14.1 shows the structure of future flow securitization. There are several variation of this model but the essential principle is to protect the interest of investors. It is possible for companies producing commodities, where the demand is predictable, raise long-term resources by securitizing their future receivables. Companies like Reliance Petroleum have done such securitization. The amount thus raised can be used to strengthen long-term or permanent working capital needs of the firms or invest in fixed assets to expand the capacity.

Structure of a typical future flow securitization

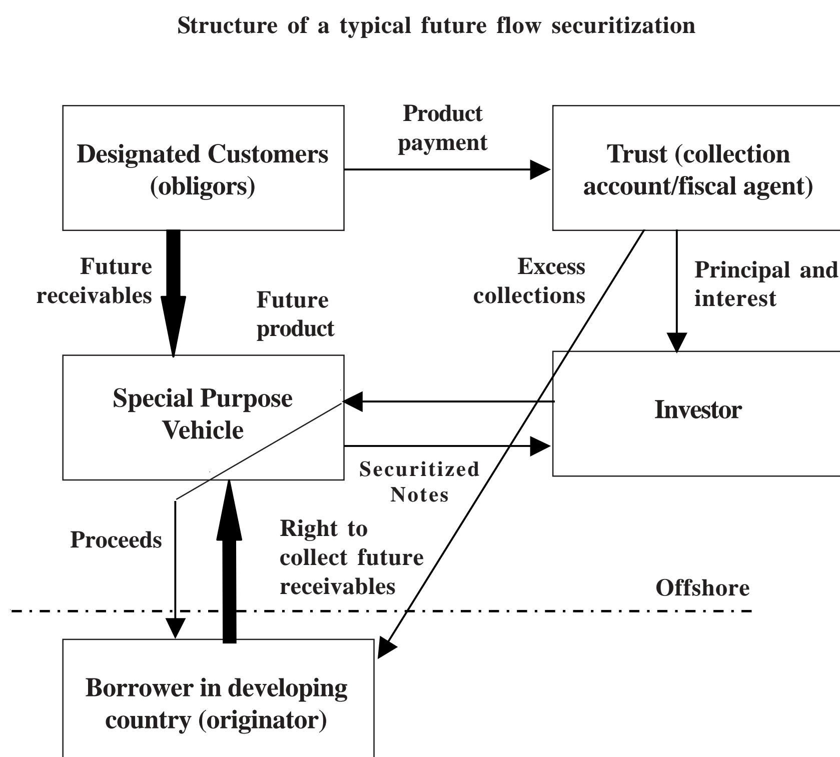

Figure 14.1: Structure of Future Flow Securitization

Source: *Suhas Ketkar and Dilip Ratha, "Securitization of Future Flow Receivables: A Useful Tool for Developing Countries", Finance & Development, March 2001*

Activity 3

Briefly discuss any one Securitization deal completed in India. You can get the details from business magazines and economic dailies which periodically report such details.

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Activity 4

Why securitization is not popular in India? Find the details from some of your friends working for financial services company or bank.

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14.2.4 Venture Capital

While leasing/hire-finance, suppliers' credit or securitization are debt financing, venture capital is a equity finance. Venture capital is investment in early-stage, high-growth projects, which are high-risk with the potential to give extraordinarily high returns over a period ranging from three to seven years. The risk factor being high, the probability of failure is also high. The returns to the venture capitalist are from the handful of the projects, which succeed. Venture capital investment is generally in equity or quasi-equity instruments in unlisted companies, often set up to commercialise a novel idea. The venture capitalist will, in the normal course of business, like to have a 20% to 50% stake in the company invested in. The returns to the venture capitalist are at the time of disinvestment from the venture backed unit. This could be in several ways, such as buy-back of the stake of the venture capitalist by the promoters, disinvestment of the investment at time of an IPO, or during a merger or acquisition transaction. Venture capital investment is "hands-on" investment, where the investor mentors and advises the promoters of the business in which the investment has been made. The venture capitalist is an investor who guides the project through its different stages of growth by identifying avoidable pitfalls and directs the business along possible avenues of growth. The venture capitalist is, therefore, a partner who brings much more than money to the project.

Venture capitalists receive several proposals for investment. Many projects, which find it difficult to raise funds from banks and other financial institutions, approach venture capitalists for assistance. Venture capitalists conduct a preliminary project appraisal. This includes verification of whether the project is in the area of their investment and a review of the promoters of the business. If the venture capitalists are interested in the project they offer a term sheet to the promoters. The term sheet is a summary of the proposed principal terms and conditions of a venture capital investment. It sets out the broad terms and conditions of investment and is signed by both the venture capitalist and the proposed venture capital investee. Signing of a term sheet by both parties is a statement of good faith and is not an obligation until an agreement is signed by the parties. It is normally subject to satisfactory completion of due diligence review and signing of legal documents such as an equity subscription agreement.

A venture capitalist will look for a project that has potential for great returns. The project should be feasible and though it may be risky, there must be a definite chance that it can be successful. The venture capitalist would like to maximize the upside potential in any project, and would like to exit from a project at a time when he can get a maximum return on his investment in the project. The venture capitalist will look at different aspects of the projects. Some of these aspects are the integrity and ability of the promoters and key management, the details of the project, the market potential and strategy for sale. A professional venture capitalist would validate all the data included in business plans. A venture capitalist is most concerned about the ability of the entrepreneurs to adapt to different circumstances, good and bad. The promoters must be committed and have a passion for their project. They must believe that they can do something different or differently. They must believe that they can succeed. The venture capitalist backs the promoter first and then the project. In fact sometimes, the project may be excellent, but if the venture capitalist feels that the promoters lack the required skills, the project may get rejected. This is not very surprising as venture investment is akin to a partnership, particularly in the initial stages of the project. If the partners in the project are not in agreement or have different ways of functioning, the entire project can be in jeopardy, despite having phenomenal potential.

A venture capitalist will also scan the project in great depth. The project must have the potential to be commercially viable. Ultimately the investor wants a financial return, so it is important that the investment makes commercial sense. It must have the potential for commercial success. The project must be feasible, it must be marketable, ie it must meet an existing requirement or fill a gap in the market or it must have the potential to create a market. Further, the venture capitalist would like to have higher than normal returns as compared to other financial investors in a project. This is not surprising, since the venture capitalist does not expect all investments to do well, he would like the few that do well to give above average returns. Professional venture capitalists mentor projects they invest in. They are closely involved in the operations of the investee. This does not stop at appointing a member to the Board of Directors of the company and attending Board meetings regularly. The venture capitalist often visits the project frequently. Some venture capitalists visit the projects every week, even spending half-a-day in each visit. This is one of the reasons why most venture capitalists do not invest in many projects at a time.

A venture capitalist does not take any collateral or guarantee (there have been cases of risk financiers who have asked for personal guarantees of the promoters, but that is not typical of venture capital financing). If the project does well, the venture capitalist would get good returns, if it fails, the entire investment would be written off. A venture capitalist looks for very great returns in say five years time. In many cases cash inflows in initial years are ploughed back into the business.

Activity 5

Collect the details of any one projects funded by venture capital company, which run successfully today?

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Activity 6

Do you have any idea that fits venture capital funding? If yes, briefly discuss the idea here. Later on you can prepare a detailed business plan.

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14.3 NON-TRADITIONAL SERVICES OF SHORT-TERM FINANCING

As in the case of long-term finance, firms can raise short-term finance from banks and other investors. However, in recent time, new methods of financing are also be used to raise funds for working capital. We will review briefly some of these new methods in this section.

a) **Commercial Paper:**

Companies with good credit rating can raise money directly from the market for working capital purpose by issuing commercial papers. Commercial papers are unsecured notes but negotiable and hence liquid. Why firms issue commercial paper and other invest in commercial paper? As discussed earlier, loan typically binds both lender and borrower for a period. The option for exit is difficult to exercise whereas instruments like commercial papers enable both lenders and borrowers to move out of the relationship in a short period of time. Since lender and borrower meet directly, the cost of commercial paper borrowing will be lesser than working capital loan. Many banks and cash rich companies participate in commercial papers, which are issued by high-quality companies. Since they are liquid, even banks are willing to invest money in commercial papers.

b) **Factoring Service:**

Factoring is essentially a management (financial) service designed to help firms better manage their receivables; it is, in fact, a way of off-loading a firm's receivables and credit management on to some one else - in this case, the factoring agency or the factor. Factoring involves an outright sale of the receivables of a firm by another firm specialising in the management of trade credit, called the factor. Under a typical factoring arrangement a factor collects the accounts on the due dates, effects payments to its client firm on these days (irrespective of whether or not it has received payment or not) and also assumes the credit risks associated with the collection of the accounts. For rendering these services, the factor charges a fee which is usually expressed as a percentage of the total value of the receivables factored. Factoring is, thus, an alternative to in-house management of receivables. The complete package of factoring services includes (1) sales ledger administration; (2) finance; and (3) risks control. Depending upon the inherent requirements of the clients, the terms of factoring contract vary, but broadly speaking, factoring service can be classified as (a) Non-recourse factoring; and (b) recourse factoring. In non recourse factoring, the factor assumes the risk of the debts going "bad". The factor cannot call upon its client-firm whose debts it has purchased to make good the loss in case of default in payment due to financial distress. However, the factor can insist on payment from its client if a part of the receivables turns bad for any reason other than financial insolvency. In recourse factoring, the factoring firm can insist upon the firm whose receivables were purchased to make good any of the receivables that prove to

be bad and unrealisable. However, the risk of bad debt is not transferred to the factor. Canbank Factor and SBI Factor, the two factoring companies, have done an annual turnover of nearly Rs. 2000 cr. and they are growing at an attractive rate. Many foreign and private banks have also started providing the factoring services.

Activity 7

Visit the branch office of Canbank Factor or SBI Factor in your city or their web site. Collect the details of factoring service schemes they provide for different types of companies.

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14.4 SUMMARY

Apart from traditional sources of finance like debt and equity from institutions and others, finance managers today look into several non-traditional sources of finance. The reasons for raising finance from such non-traditional sources are cost advantage and flexibility. In this unit, we discussed three such sources of long-term finance namely leasing/hire-purchase, asset securitization, and venture capital. Leasing definitely scores over others in terms of flexibility and in special cases, it may also be cheaper. Asset Securitization is suitable when a firm wants to raise funds against future receivables or against some existing illiquid assets. Venture capital is most suitable for high risk venture where venture capitalist is willing to put equity capital and assumes risk provided the project has a scope for high return. Commercial paper and factoring are two prominent sources through which firms can raise short-term funds in addition to traditional source of short-term finance like bank loan. While traditional source of finance contribute significant part of capital, these additional sources of finance are often used to leverage cost advantage and in some cases to gain flexibility. Finance managers have to bring innovative financial products that satisfy different segments of investors. The job is as challenging as selling products to consumers.

14.5 SELF-ASSESSMENT QUESTIONS

1. How is lease finance different from that of equity or debt finance?
2. In evaluating funding options, when do you chose lease finance?
3. Is lease finance cheaper than other sources of finance? If so, under what conditions will it be cheaper than other sources of finance?
4. Explain how Securitization is considered as a source of finance? Who are the typical investors for such papers?:
5. Suppose you are working for a venture capital company. What are the things you will look into a proposal that comes to you for venture capital funding?
6. Is it possible to get funds from venture capitalist for all kinds of projects? Explain.
7. How is factoring different from that of traditional bill discounting scheme?

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