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Fund Raising Strategies for Companies

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Financials markets are fundamental in the economic development of a country. They provide financial resources required by the entrepreneurs for the long term sustainable growth. Developing well-functioning financial markets is the central focus of Government of India and Reserve Bank of India and various reforms have been introduced to liberalize, regulate and enhance the financial markets which has streamlined various sources from which entrepreneurs can raise funds.

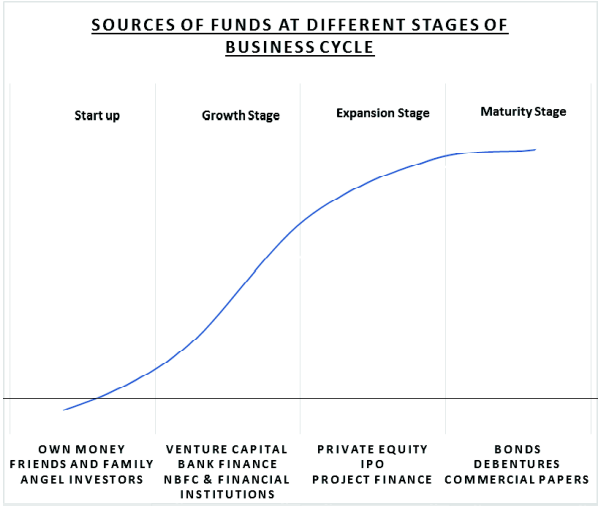
Financial markets can be used to raise long term debt, short term debt or equity to fund a business. The combination of debt and equity that a company uses to finance its business is known as capital structure of the company.

Debt comprises of short term and long-term instruments like bank loans and debentures. Debt is advantageous from tax purpose as interest payments offer tax shield. Raising debt also allows company or business to retain control of business. Debt is generally considered a cheaper source of capital. Equity on the other hand is an expensive instrument considering that the owner parts with the ownership stake in the company. Equity holders have a claim on future earning and value of the company.

For capital structure the Modigliani–Miller (M&M) theorem is considered prominent theoretical framework. M&M model advocates that in perfect market with no taxes, no transaction costs and with perfect information, the capital structure is irrelevant. However, in real world with imperfections and by relaxing the perfect market assumptions it can be demonstrated that the capital structure is relevant in maximizing the value of business. Due to taxes, agency costs, bankruptcy costs and information asymmetry in the real world the capital structure of the company is critical for valuation of the company.

Here we, as Chartered Accountants, can help entrepreneurs by maximizing the value of their business.A C.A. can guide the client in the way that the business can achieve optimal capital structure and generate maximum value.

Following are the different instruments that can be used for fund raising considering the life cycle of business.



Start-up Stage:

Start-up stage is the first and riskiest stage of business cycle. Providing proof of product, raising money, hiring staff, establishing market presence are some of the challenges faced by entrepreneurs at this stage. The decisions made at this stage can impact the company for many years to come.

Own Money & Friends and family: A venture can be initially funded by Entrepreneur's own resources, also called bootstrapping. Entrepreneur can also raise funds from 3Fs (friends, family and fools) at minimum cost of capital. The business survives through internal cash flows and reinvestmentof profits.This is one of the most popular approach for small businesses as owners

can maintain the control of their business. This approach also ensures that the expenditure is controlled cautiously. Bootstrapping also allows entrepreneurs to focus on customers instead of investors, thereby increasing focus on business and eventually profitability. No outside investors on board also leaves entrepreneurs with flexibility in deciding exit options.

Angel Investors: Angel investor is someone who lends funds to the owner of the business in lieu of convertible debt or ownership equity. They may be high net worth individuals who invest in early stage startups to help them take off or support them in early stages of operations. Investments by angel investors are generally risky and comprise a very small percentage of angel investor's portfolio. Also meaning that angel investors have well diversified portfolios. Angel investors provide fund to startups when others fear to lend. Indian Angel investors, CIIE, ISB Angels are some examples of angel investors.

Growth Stage: During growth stage the entrepreneur has already established the proof of product. In this stage the businesses experience sales growth and the cash flows begin to improve. Revenues start covering ongoing expenses and the business may see profitability. Streamlining operational efficiencies, dealing with market competition and increasing the profit volume are some challenges faced at this stage by businesses.

Venture Capital(VC): Venture capital provided by VC funds to small emerging businesses that are in the early stage and have high growth potential. Venture capital funds are made up from funds of high net worth individuals, investment banks and any other financial institutions.Venture capital funds invest in equity in exchange for an ownership stake in early-stage companies.Business looking for venture capital has to submit a business plan to a venture capital fund, which will perform due diligence and then may invest as per fund requirement. VC funding is widespread in new technology firms like Uber and Facebook.

Start-ups that are based on an innovative technology or business model may resort to VC funding. These funds can be used by start-ups to take off business and to support operations. VCs also give valuable guidance, consultation and business connections to startup. VC funding is also beneficial as it can be attracted without any security cover and can give good visibility to start up. On the other hand, VC funds look for high returns and may put pressure to perform in short time frame. This can interfere with the management of the business.

Bank Financing: Commercial banksare financial institutions which perform the functions of accepting deposits from public and giving loans and earning interest.Banks charge higher rate of interest from the borrowers compared to depositors to make profits. Commercial banks provide funds to businesses for long-term as well as short term. Banks provide long term loans in form of term loans, loan against property, equipment financing, vehicle loans, etc. and short term loans in form of cash credit, letter of credit, export finance, overdraft, bank guarantee, working capital demand loans, etc.Indian banks are regulated by Reserve Bank of India.

Companies can use bank funds as per the conditions prescribed by the bank. Long term loans are generally given for Capital expenditures and short-term loans can be utilized for working capital.Banks require borrowers to pay only the principal and interest amount on a loan unlike equity capital, where companies pay share in profits to shareholders. Bank loans are generally easier to attain due to large number of schedule banks and are one of the cheapest source of funds.However, the borrowers must make periodic payments to their banks and there is very low flexibility. Failure to service the debt may classify the account as NPA and may lead to seizure of company's assets and punitive actions by bank.

NBFCs and other Financial Institutions: Non-Banking Financial Company(NBFC) is a company registered under Companies Act engaged in the business of loans and advances and acquisition of securities.Their activities are similar to banks however they can't raise money through CASA (Current Account Savings Account) deposits and are subject to lenient regulatory norms by RBI compared to banks. NBFCs can raise funds from foreign

investments and up to 100% foreign investment is permitted.Theygenerally offer loans for equipment lease finance, hire purchase finance, personal loans, vehicle financing, working capital loans, housing loans, loans against shares and investment, etc.

NBFCs can fund transactions which banks can't do, for example funding against shares. SMEs can avail business loans with or without offering a collateral security on business loans.NBFC and other financial institution can provide loans for variety of purposes and can be quite useful for growing businesses. Moreover, loans from NBFCs can be availed within lesser time than from banks and are generally more flexible in conditions on usage. However, NBFCs funding is more expensive than the bank loans with higher rate of interest and businesses may prefer that only when bank funding is not easily available.

Expansion Stage: Business at this stage will see slower rate of growth compared to growth phase usually due to entry of new competitors and market saturation. Companywill now require topenetrate the market further or expand to new consumer base or new geographies to grow the business further.

Private Equity (PE): Private equity funds are capital pools that are to be invested in companies having potential for growth.Institutional funds and accredited investors generallyprovide capital to private equity funds forsubstantial durations and look for high internal rate of return. PE funds once formed will generally be sector specific, have ticket size preference and invest in the company for a period of usually 4 to 5 years.PE funds look for suitable exit from the company at the end of investment time frame. PE fund can exit by way of IPO of the company, secondary sale, merger and acquisition, repurchase by promoter or liquidation.

Companies that avail funds through private equity can utilize the funds to finance new technology, make acquisitions, expand working capital, repay debt, strengthen balance sheet etc. PE finance allows companies access to funds without conventional financial mechanisms where they may need to offer collateral or get favorable credit rating. PE funds also offer fund managers expertise and connections to business. In general PE backed IPOs also outperform market returns. However attracting PE fund is a lengthy exercise and takes considerable effort and time. Also, PE firms have a say in the important decisions of business which may lead to their interference with the management. Black Stone, Softbank, Sequoia, Saif partners are some examples of PE firms.

Initial Public Offering (IPO): Initial public offering (IPO) is a type of offering in which equity shares of a company are sold toretail (individual) investorsas well asinstitutional investors. An IPO transforms a company into a public listed company.Further issuance of shares by a public listed company is called FPO, follow on public offer. Securities and Exchange Board of India (SEBI) is the regulatory body for IPOs and companies have to comply with the SEBI Issue of Capital & Disclosure requirements Regulations, 2009 and the listing agreement.IPO is underwritten and managed by one or more merchant bankers who also arrange for the shares to be listed on stock exchange. IPOs pricing is done by book building process or fixed pricing and they are marketed by investment bankers by way of roadshows and advertising.

An IPO provides the company with access to funds for its growth and expansion. Companycan raise additional funds in the future through FPO. IPO can be exit option for PE or VC investors who can sell their stake to public. There is no servicing in IPO and the funds remain with the listed entity. IPO is also very beneficial for the promoters as their equity stake now gets publically valued. However, raising equity through IPO is very expensive and IPOs can only be planned when stock market is favorable. Also, certain business families do not favor IPOs as once public, a lot of informationhas to be shared and disclosures are to be made to public from time to time.

Project finance: Project finance involves funding of long term infrastructure and industrial projects.Special Purpose Vehicles (SPV) are created to obtain project finance by the promoters of parent company who seek funding. While the parent company or promotes bring equity into SPV, asingle bank or consortium of banks or financial institutions lend money for a

particular project to the SPV. Repayment is done from the cash flows generated by the project and project assets are held by lenders as collateral. Risk identification, allocation and financial modelling are key aspect of project finance.

Roads, Power Plants, Airports, SEZs are projects funded by way of project finance.Project finance enables the sponsors to raise debt over and above the capacity of the sponsor/parent andSPVs are created to shield the sponsor from project failure. Project finance an expensive instrument with complex structure. Careful risk allocation is critical to manage involvement of multiple parties and technical, economic and political risks associated with the project.

MaturityStage: Companies that reach maturity stage find that the markets have saturated and sale may become stagnant or slowly begin to decrease.The profit margins also get thinnerand reducing cost of finance and operations should be a major focus area.Businesses will still try to expand themselves by reinventing themselves or investing in new technologies or emerging markets.

Bond offering: A bond is a debt instrument used by a company or government to raise funds for a definite period. Individuals as well as institutions like banks, insurance companies, etc. can invest in bonds depending upon the type of bond. Bondsare usually rated bycredit rating agencies. These ratings are published and used by investors to assess the financial strength of issuer. Bonds are like a loan and carry an interest rate that has to be paid regularly at fixed intervals to the investor. Bonds have a specified maturity period upon completion of which the borrower/issuer has to return money to the lender/investor. Bonds are issued by companies, municipalities, states and sovereign governments.

Companies that raise capital through bonds can use the funds to run their business, buyother companies or to pay off older debts or loans. When acompany issues bonds it does not give investors any ownership stake in the company unlike shares. Company can therefore keep the control of the business. On the other hand government bonds are one of the most popular instrument of financing fiscal deficit used by countries across the world. However, the companies who do not enjoy good credit rating may find the bond offering an expensive instrument.

Debentures: Debentures are long term debt instruments that are used to raise additional capital from the general public. Individuals, banks, corporates and primary dealers invest in debentures. Debentures may be secured or unsecured and backed by the integrity and the creditworthiness of the issuer. Each debenture has fixed face value or par value and interest has to be paid on debentures at a predetermined rate of interest. They have to be redeemed after a fixed period of time and are issued by large corporations and government. Various types of debentures are secured, unsecured, redeemable, irredeemable, convertible and non-convertible debentures.

Funds raised through debentures are used by companies for a specific purpose or planned expansion. Companies who enjoy good credit rating may find debentures an excellent low cost source of funds. The payment of interest on debentures is obligatory even when the company incurs a loss and this may create stress on financials in tough times.

Commercial Paper(CP): Commercial Paper is an unsecured short-term debt instrument issued in the form of a promissory note for a period of minimum 7 days and maximum of up to one year. Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, non-resident Indians and foreign institutional investors etc. can invest in CPs. They are not secured by collateral and only large corporates with high credit rating can issue Commercial Papers. CPs are usually sold at a discount from face value and carry higher interest repayment rates than bonds. They are redeemed at par and can be issued in denomination of Rs.5 lacs or multiples thereof.

Large banks or corporations can issue CPs to cover short-term receivables and meet short-term financial obligations. Hence, companies need not keep large cash reserves on hand and can raise short term funds thru commercial paper. The companies who enjoy good ratings may find this source cost effective as well.

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