Unit IV

Subject Name	Subject Code	Semester	Prepared By
Financial Services	18BBA51C	V	Dr.K.Karthikai, Assistant Professor in BBA

VENTURE CAPITAL

The term 'Venture Capital' is understood in many ways. In a narrow sense, if refers to, investment in new and tried enterprises that are lacking a stable record of growth. In a broader sense, venture capital refers to the commitment of capita} as shareholding, for the formulation and setting up of small firms specialising in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

Meaning of Venture Capital

Venture capital is long term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

Definition of a Venture Capital Company

A venture capital company is defined as "a financing institution which joins an entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprise."

Features of Venture Capital

Some of the features of venture capital financing are as under :

1, Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.

2. Investment is made not only in high risk but also in high growth potential projects.

3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.

4, Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.

5. There is continuous involvement in business after making an investment by the investor.
6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.
7. Venture capital is not just injection of money but also an input needed to setup the firm, design its marketing strategy and organise and manage it.
8. Investment is usually enterprises.

Scope of Venture Capital

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project viz. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale-and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance
even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

(1) **Development of an Idea - Seed Finance** : In the initial stage venture capitalists provide see capital for translating an idea into business proposition. At this stage investigation is made indepth which normally takes a year or more.

(2) **Implementation Stage Start - up Finance** : When the firm is set up to manufacture a-product or provide a service, start-up finance is provided by the venture capitalists. The first and second stage capital is, used for full scale manufacturing and further business growth.

(3) **Fledging Stage Additional Finance** : In the third stage, the, firm has made some headway and entered the stage of manufacturing j product but faces teething problems. It may not be able to generate, adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

(4) **Establishment Stage Establishment Finance**: At this stage, the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that they can reap economics of scale and attain stability. At the end of the establishment stage, the firm is listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exist routes. Before investing in small, new or young hi-tech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems. After assessing the viability of projects, the investors decide for what stage they should

provide venture capital so that it leads to greater capital appreciation. All the above stages of finance involve varying degrees of risks and venture capital industry, only after analysing such risks, invest in one or more. Hence they specialize in one or more but rarely all.

IMPORTANCE OF VENTURE CAPITAL

Venture capital is of great practical value to every corporate enterprise in modern times.

1. Advantages to Investing Public

a. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop 'malpractices by management.

b. Investors have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyse the prospects of the business.

c. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

II. Advantages to Promoters

a. The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors obtain venture capital assistance, he will be required to sell his idea ¢, Justify the officials of the venture fund.

b. Public issue of equity shares has to be preceeded by a lot of effort, Viz. necessary statutory sanctions, underwriting and brokers arrangement publicity of issue etc. The new entrepreneurs find it very difficult to make, underwriting arrangements and require a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon activities of business.

c. Costs of public issues of equity share often range between 10 percent to 15 percent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above to incur recurring costs for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

Ill.General

a. A developed venture capital institutional set up reduces the time lag between a technological innovation and its commercial exploitation.

b. It helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.

c. Venture capital acts as a cushion to support business borrowings. as bankers and investors will not lend money with inadequate margin of equity capital.

d. Once venture capital funds start earning profits, it will be very easv for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business will take-off will the help of finance from venture funds and this would help in increase productivity, better capacity utilisation etc.

e. The economy with well-developed venture capital network induces the entry of large number of technocrats in industry, helps in stablising industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.

f. A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start-ups.

g. It also paves the way for private sector to share the responsibility with public sector.

Methods of Venture Financing Venture capital is available in four forms in India.

1. Equity Participation 2. Conventional Loan 3. Conditional Loan 4.Income Notes.

1. **Equity Participation**: Venture Capital Firms participate in equity through direct purchase of shares but their stake does not exceed 49 percent. These shares are retained by them till the assisted projects making profit. These shares are sold either to the promoter at negotiated price under buy back agreement or to the public in the secondary market at a profit.

2. **Conventional Loan:** Under this form of assistance, a lower fixed rate of interest is charged till the assisted units become commercially operational, after which the loan carries normal or higher rate of interest. The loan has to be repaid according to a predetermined schedule of repayment as per terms of loan agreement.

3. **Conditional Loan**: Under this form of finance, an interest free loan is provided during the implementation period but it has to pay royalty on sales. The loan has to be repaid according to a pre-determined schedule as soon as the company is able to generate sales and income.

4. **Income Notes**: It is a combination of conventional and conditional loans. Both interest and royalty are payable at much lower rates than in case of conditional loans.

DISCOUNTING

Generally, a trade bill arises out of a genuine credit trade transaction. The supplier of goods draws a bill on the purchaser for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months and in some cases for 9 months. The buyer of goods accepts the same and binds himself liable to pay the amount on the due date. In such a case, the supplier of goods has to wait for the expiry of the bill to get back the cost of the goods sold. It involves locking up of his working capital which is very much needed for the smooth running of the business or for carrying on the normal production process. It is where the commercial banks enter into as a financier. The commercial banks provide immediate cash by discounting genuine trade bills. They deduct a certain charge as discount charges from the amount of the bill and the balance is credited to the customer's account and thus, the customer is able to enjoy credit facilities against the discounting of bills, Of course, this discount charges include interest for the unexpired period of the bill plus some services charges, Bill financing is the most liquid one from the banker's point of view since, in time of emergency, they can take those bills to the Reserve Bank of India for rediscounting purpose In fact, it was viewed primarily as a scheme of accommodation for banks, Now, the situation is completely changed, Today it is viewed an a kind of loan backed by the security of bills. Bill financing is superior to the conventional and traditional system of cash credit in many ways.

(i) First of all, it offers high liquidity, in the sense, funds could be recycled promptly and quickly through rediscounting.

(ii) It offers quick and high yield, The banker gets income in the form of discount charges at the time of discounting the bills.

(iii) Again, there is every opportunity to earn the spread between the rates of discount and rediscount.

(iv) Moreover, bills drawn by business people would never be dishonoured and they are not subject to any fluctuations in their values.

(v) Cumbersome procedures to create the security and the positive obligations to maintain it are comparatively very fewer.

(vi) Even if the bill is dishonoured, there is a simple legal remedy. The banker has to simply note and protest the bill and debit the customer’s account. Bills are always drawn with recourse and hence, all the parties on the instrument are liable till the bill is finally discharged.

(vii) Above all, these bills would be very much useful as a base for the maintenance of reserve requirements like CRR and SLR.

FACTORING

As stated earlier, a lot of working capital is tied up in the form of trade debts. Collection of debts, especially for the small-scale and medium scale companies is the biggest problem. The average collection period, been on the increase. Delays in collection process in turn lead to liquid, problems and consequently to delay in production and supplies. To overcome this situation, the factoring service has been conceived.

MEANING

'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables. Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. Hence a factor is an agent who collects the dues of his client for a certain fee.

DEFINITION

Robert W Johnson in his book 'Financial Management' states "factoring is a service involving the purchase by a financial organisation, called a factor of receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities".

According to V.A.Avadhani, " Factoring is a service of financial nature involving the conversion of credit bills into cash",

MODUS OPERANDI

A factor provides finance to his client upto a certain percentage of the unpaid invoices which represent the sale of goods or services to approved customers. The modus operandi of the factoring scheme is as follows:

(i) There should be a factoring arrangement (invoice purchasing arrangement) between the client (which sells goods and services to trade customers on credit) and the factor, which is the financing organisation.

(ji) Whenever the client sells goods to trade customers on credit, he prepares invoices in the usual way.

(iii) The goods are sent to the buyers without raising a bill of exchange but accompanied by.an invoice.

(iv) The debt due by the purchaser to the client is assigned to the factor by advising the trade customers, to pay the amount due to the client, to the factor.

(v) The client hands over the invoices to the factor under cover of a ' schedule of offer along with the copies of invoices and receipted delivery challans or copies of R/R or L/R.

(vi) The factor makes an immediate payment upto 80% of the assigned invoices and the balance 20% will be paid on realisation of the debt.

TERMS AND CONDITIONS

The existence of an agreement between the factor and the client is central to the function of factoring. The main terms and conditions generally included in a factoring agreement are the following:

(i) Assignment of debt in favour of the factor,

(ii) Selling limits for the client,

(iii) Conditions within which the factor will have recourse to the client in case of non-payment by the trade customer,

(iv) Circumstances under which the factor will have recourse in case of non-payment,

(v) Details regarding the payment to the factor for his services, say for instance, as a certain percentage on turnover,

(vi) Interest to be allowed to the factor on the account where credit has been sanctioned to the supplier, and

(vii) Limit of any overdraft facility and the rate of interest to be charged by the factor.

FUNCTIONS

The term 'factoring' simply refers to the process of selling trade debts of a company to a financial institution. But in practice, it is more than that. Factoring involves the following functions:

(i) Purchase and collection of debts.

(ii) Sales ledger management

(iii) Credit investigation and undertaking of credit risk.

(iv) Provision of finance against debts

(v) Rendering consultancy services.

Purchase and Collection of Debts

Factoring envisages the sale of trade debts to the factor by the company, i.e., the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client. He does so as an agent of the client. But, under factoring, the factor purchases the entire trade debts and thus, he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

Credit Investigation and Undertaking of Credit Risk

Sales ledger management function is a very important one in factoring. Once the factoring relationship is established, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers, etc. Thus, the factor takes up the work of monthly sales analysis, overdue invoice analysis and credit analysis.

Credit Investigation and Undertaking of Credit Risk

The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financ:al inability to pay. This assumption of credit risk is one of the most important functions which the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world etc. For this purpose, the factor also undertakes credit investigation work.

Provision of Finance

After the finalisation of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption. This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

Rendering Consultancy Services

Apart from the above, the factor also provides management services to the client. He informs the client about the additional business opportunities available, the changing business and

financial profiles of the customers, the likelihood of coming recession etc.

TYPES OF FACTORING

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

(i) Full service factoring or without recourse factoring

(ii) With Recourse Factoring

(iii) Maturity Factoring

(iv) Bulk Factoring

(v) Invoice Factoring

(vi) Agency Factoring

(vii) International Factoring

(i) Full service Factoring - Under this type, a factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factor since he assumes the credit risk also. He cannot pass on this responsibility to his client and, hence, this type of Factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring - As the very name suggests, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself.

(iii) Maturity Factoring - Under this type, the factor does not provide immediate cash payment, to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire amount collected less factoring fees is paid to the client immediately. Hence it is also called 'collection Factoring'. In fact, under this type, no financing is, involved. But all other services are available.

(iv) Bulk Factoring - Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring ig resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc., has to be done by the client

himself. Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as “Disclosed Factoring” or “Notified Factoring”.

(v) Invoice Factoring - Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues etc have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called ‘Confidential Invoice Discounting’ or ‘Undisclosed Factoring’.

(vi) Agency Factoring - The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows: (i) The client has to look after the sales ledger administration an¢ collection work and (ii) The factor has to provide finance and assume the credit risk.

(vii) International Factoring - Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely the basis of the invoice prepared by the exporter. Thus, the exporter is able able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

(vii) Suppliers Guarantee Factoring- This type of factoring is suitable for business establishments which sell goods through middlemen. Generally, goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(ix)Limited Factoring - Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(x) Buyer Based Factoring - In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers’ end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets

ready cash. This facility is available only to reputed credit worthy buyers and hence it is also called selected Buyer Based Factoring.

(xi) Seller Based Factoring - Under this type, the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller's job is over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and credit worthy sellers and hence it is also called 'Selected Seller Based Factoring'.

FACTORING VS DISCOUNTING

Factoring differs from discounting in many respects. They are :
(i) Factoring is a broader term covering the entire trade debts of a client whereas discounting covers only those trade debts which are backed by Accounts receivables.
(ii) Under factoring, the factor purchases the trade debt and thus becomes a holder for value. But, under discounting the financier acts simply as an agent of his customer and he does not become the owner. In other words, discounting is a kind of advance against bills whereas factoring is an outright purchase of trade debts.

(iii) The factors may extend credit without any recourse to the client in the event of non-payment by customers. But, discounting is always made with recourse to the client.
(iv) Accounts receivables under discount are subject to rediscounting whereas it is not possible under factoring.

(v) Factoring involves purchase and collection of debts, management of sales ledger, assumption of credit risk, provision of finance and rendering of consultancy services. But, discounting involves simply the provision of finance alone.

(vi) Bill discounting finance is a specific one in the sense that it is based on an individual bill arising out of an individual transaction only. On the other hand, factoring is based on the 'whole turnover' ,that is, a bulk finance is provided against a number of unpaid invoices.

(vii) Under discounting, the drawee is always aware of the bank's charge on receivables. But, under undisclosed factoring everything is kept highly confidential.
(viii) Bill financing through discounting requires registration of charges with the Registrar of Companies. Infact, factoring does not require such registration.

(ix) Discounting is always a kind of "in-balance sheet financing". That is, both the amount of receivables and bank credit are shown in the balance sheet itself due to its "with recourse' nature. But, factoring is always "off balance sheet financing."

BENEFITS OF FACTORING

Factoring offers a number of benefits to the clients. Some of the important benefits are : (i) **Financial Service**

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for 3 months to 9 months to realise their debts. In the meantime, the business may suffer due to want of funds. Infact, many business concerns fail more as a result of inadequate cash flow than anything else. The kev to successful working capital management lies in the ability of an enterprise to convert sales into cash flow and the speed at which it is done. The major benefit of the factoring service is that the clients will be able to convert their trade debts into cash upto 80% immediately as soon as the credit sales are over. They need not wait for months together to get cash for recycling. Another major advantage is that there are no constrains by way of fixed limits as in the case of cash credit or O.D. As sales grow, the financial assistance also grows and both are directly proportional to each other.The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus, he can avail of cash discount facilities also.

(ii) Collection Service

Collection of debts is another problematic area for many concerns. It is found that over 60% of the total sales of the SSI sector and over 50% of total sales of the medium and large scale sector are made on "On Account Terms of Payment" i.e. credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this

collection work is completely taken up by the factoring organisation, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(ii) ‘Credit risk’ Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the client is assured of complete realisation of his book debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client, It is the greatest advantage of factoring.

(iv) Provision of Expertised ‘Sales Ledger Management’ Service

Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. Infact, the success of any organisation depends upon the efficiency with which the sales ledger is managed. It requires a specialised knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it becomes the factor’s responsibility to take care of all the functions relating to the maintenance of sales ledger. Thus, factoring offers an excellent credit control for the client.

(v) Consultancy Service

Factors are professionals in offering management services like consultancy. They collect information regarding the credit worthiness of the customers of their clients, ascertain their track record, quality of portfolio turnover, average size of inventory etc., and pass on the same to their clients. It helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters. Generally, no time is available to the client for investigating his customer’s credit standing. Now, the factor takes up this work on behalf of his client.

(vi) Economy in Servicing

Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover, their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say, for instance, 80% of his total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

(vii) Off-Balance Sheet Financing

Factoring is an off-balance sheet means of financing. When the factor purchases the book debts of the client, these debts no longer exist on the current asset side of the balance sheet. It leads to reduction in debts and less collection problems. The client can utilise the money so received to reduce his current liabilities: It means an improved current ratio.

(viii) Trade Benefits

Availability of ready cash against bills enables the supplier to negotiate better prices for the inputs and also offer finer terms to customers. It ensures a steady flow of inputs on the one hand and better market prospects on the other. Again, factoring enables the supplier to concentrate on production ana materials management without bothering about the financial management. Factoring enables clients to offer longer credit facilities to their customers and thus to attract more business. Thus many trade benefits are available under factoring.

(ix) Miscellaneous Service

Generally, factors are able to computerise their operations fully. So they are able to render prompt service at reasonable rates. They spend more on MIS analysis. They also build bigger credit library of debtors by means of collecting information about new debtors. Thus, improved cash flow through realisation of trade debts by factoring, efficient follow up of collections, computerised sales ledger maintenance and the competitive rates are the main benefits of factoring.