WORKING CAPITAL FINANCE

CA B.L. Maheshwari

WHY DO WE NEED TO STUDY FINANCE

Almost half of all ventures fail because of poor financial management

- *-Dun & Bradstreet*

Parameters to choose right Source of Finance

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

Working Capital Finance - Options

Fund Based

- Cash Credit
- Overdraft
- Bill Discounting
- Working capital demand loan

Non- fund Based

- Letter of credit
- Standby Letter of Credit
- Bank Guarantee

Structured Product

- Buyers / Suppliers Credit
- Factoring / Securitisation of Receivables.
- Commercial Paper

Mobilisation of Information

- Promoters / Directors Background
- Management / Executive Team
- Industry Scenario – Competitors, Demand & Supply, Trend
- Major Customers & Suppliers – Terms of Trade, WC Cycle
- Business Plans & Projections – CMA Data
- SWOT Analysis
- Ratings – External & Internal

CASH CREDIT / BANK OVERDRAFT / WCDL

- Borrower is allowed to borrow up to certain limits against the security of Current assets.
- Interest is charged on the amount actually utilized.
  (MCLR rate + 1 % - 4 % spread)
- Security Margin : On stock 25 % - 30 % and on Book debts 25 % - 40%.
- Ratios :-

Current Ratio	Min 1.25 ; Desired 1.33
TOL (Adjusted) / TNW	Max 3 ; Desired 2
Interest Coverage Ratio	Min 2

- Current Asset level :-

Raw material	1 month to 3 month
Work in progress	Depend upon process cycle
Finished Goods	1 month to 2 month
Book debts	3 - 4 months

- Credit Rating required from Authorised agency

External rating	Min BBB or Equivalent
Internal	Min 4 & Above (40%)
CIBIL	Clean for Company and Directors

- Security

Primary Security	Entire Current Assets
Collateral Security	10 % onwards of facility

- Forms / Reports

Monthly - Stock & Book Debts statement
Quarterly Production and Performance data
Half Yearly Budget and Performance data
Annually Audited financial statement.

- Inspection and Audit At least once in a year

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

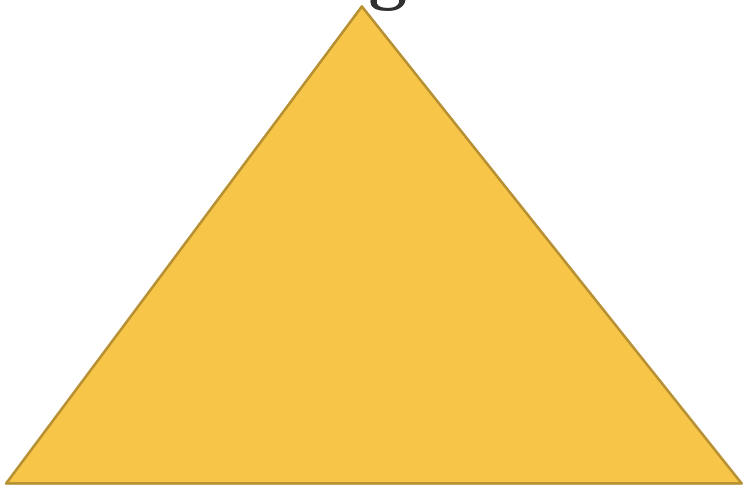
- A bill must be a usance bill
- The bank will normally discount only trade bills.
- Bills can be clean or backed by L/C
- Liability in case of dishonor of the bill shifts, depends on recourse terms .

LETTER OF CREDIT

- 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/supplier is governed by the terms of the letter of credit, as issued by that bank.



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

STANDBY LETTER OF CREDIT

- A SBLC is a financial instrument used mostly in international trade.
- The SBLC is issued by a bank on behalf of the buyer/obligator and guarantees that the seller/beneficiary will receive payment in the event the buyer fails to pay the beneficiary as per the terms of the contract.
- The SBLC assures the beneficiary of the performance of the customer's obligation.
- SBLC is issued by banks to stand behind monetary obligations, to insure the refund of advance payment, to support performance and bid obligations, and to insure the completion of a sales contract.

- Procedures required to execute a SBLC are less rigorous than other forms of guarantee.

- **<u>LC vs SBLC</u> :-**
  The LC is a method of paying for goods. The SBLC is a performance guarantee that the goods will be paid for in the event the buyer defaults.

- SBLC is open for a specified period usually no longer than 12 months.

- Security Margins is 10% - 25 % of SBLC amount.

BANK GUARANTEE

- Types of BG : -
  - Advance Payment BG
  - Tender Guarantee (Also called as Bid Bond)
  - Performance BG
  - Others BG – to Govt. Dept.
- BG is opened normally for 3 months – 36 months
- Cash Margins is 5% - 25 %.
- Collateral security - (case to case basis)

BUYERS CREDIT

- Short term credit availed by an importer(buyer).
- Availed from overseas lenders - banks and financial institutions.
- The overseas banks usually lend the importer (buyer) based on the letter of comfort (LOU) issued by the importer's bank.
- Helps importers to access cheaper foreign funds closer to LIBOR rates.
- Normally it is quoted as “3M Libor + 200 bps” .
- In India, buyer's credit tenure is : 3-12 months for RM imports and 1-3 years for Capital Goods.
- Every 3/6 months, the interest on buyer's credit may get reset.
- The exporter gets paid on due date.

STEPS INVOLVED IN BUYERS CREDIT

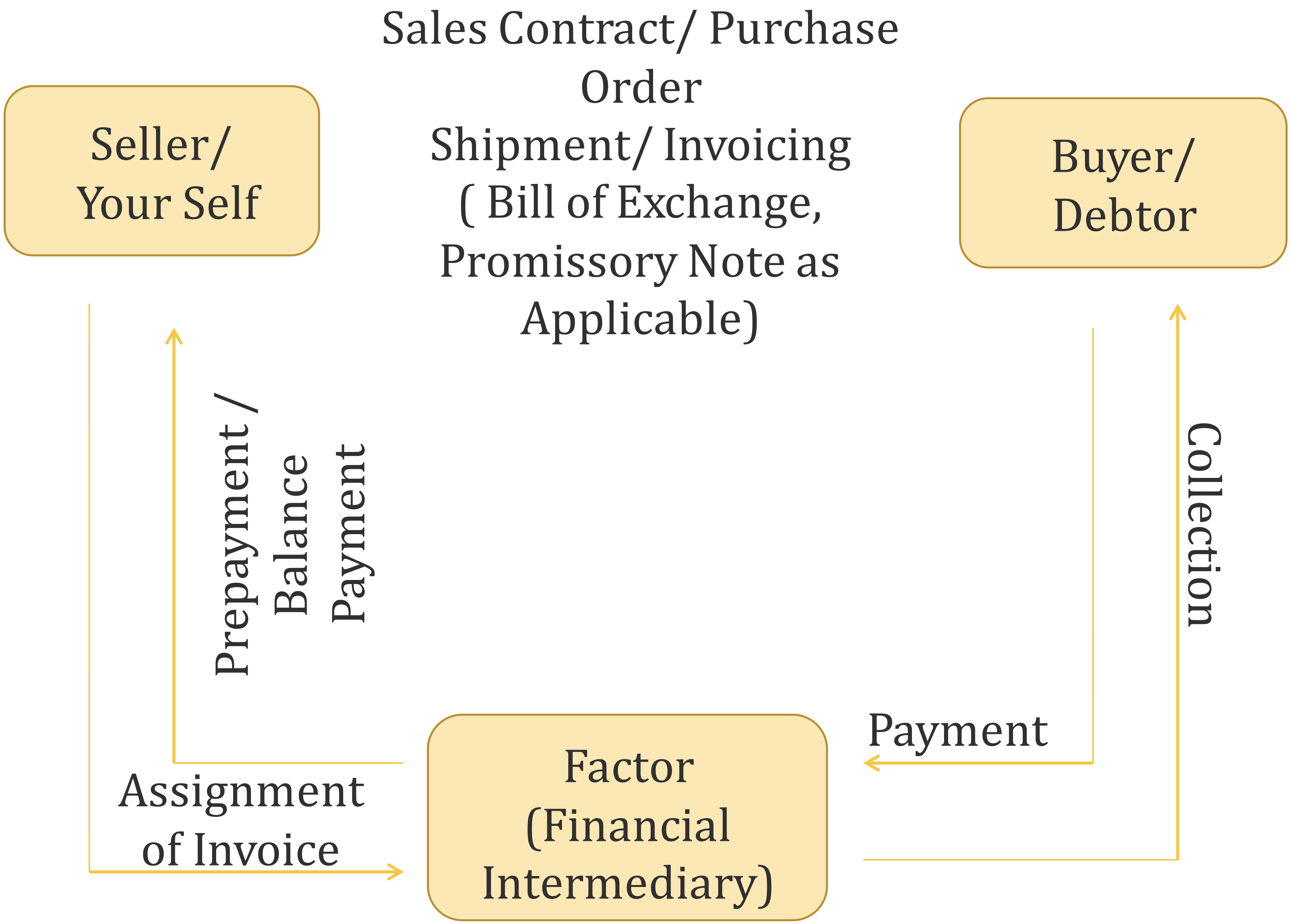
- Customer will import the goods either under LC, or Direct document.
- Requests the Credit Arranger to grant the credit.
- Overseas bank branch to provide a buyer's credit offer letter.
- On receipt of LOU / LOC Overseas bank to fund Importer's bank Account or pays the supplier’s bank directly.
- Importer's bank will recover and remit the same to overseas bank on due date.

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.


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

TIPS TO SAVE BORROWING COST

Some Common Situations & SUGGESTIONS

- **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 exports -** *Use PCFC/ FBN / FBP / FCNR(B) facilities. (Even SME's can take sub-limit with CC limit)*
- **Change of bank -** *Change from co-operative/small Pvt. banks to bigger PSU banks/foreign banks for better interest rates*

- **If you have imports -** *Always use buyer’s credit@Libor+2% i.e approx 4.50 % (If no exports, go for hedging also)*

- **If you have 100% collateral for your CC limit -** *Better convert your part CC to mortgage loan/ OD/ FCNR loan 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 & to 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 @ 11-12 % 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>

By CA B.L. Maheshwari