GUIDELINE ON OBTAINING FINANCING FOR MSME

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Types of financing

MSMEs often need external funding in order to expand their business or to cover their regular business operations. Basically, there are two types of financing that are available, i.e. debt financing (loan) and equity financing.

a. Debt financing (loan)

In debt financing, the MSME takes a loan from a financier (e.g. bank) and pledges to pay it back with interest. The financier has no control of the MSME's business, and they are only concerned about the timely repayment of the loan. Once the MSME pays back the loan, the relationship with the financier ends.

b. Equity financing

The main difference between equity financing and debt financing is that equity financing involves investors (usually venture capital). To gain this type of funding, MSMEs will have to give the investor a percentage of ownership in the MSME. The MSME will then have to share the profit and consult with the investor any time the MSME makes decisions affecting the business.

The benefit of debt financing is that the MSME does not have to give a portion of ownership to the lender, and the benefit of equity financing is the MSME does not have to make loan repayments although the MSME will have to share its profit with the investor and relinquish a portion of ownership in the MSME.

Financing products

Below are the financing products that are usually offered by financiers (usually banks) for MSMEs:

a. Term loan

A Term loan gives you an up-front lump sum of cash. The MSME pays back the loan, plus interest, over a length of time known as the term. Most term loans are usually for between one and five years.

b. Credit line/Revolving loan

A Credit line provides a form of revolving credit, so you can use only the money you need. As you repay what you use, plus interest, those funds become available for you to borrow again. You get a constant source of working capital, with no need to reapply. This makes lines of credit a great way to cover short-term cash flow problems and to anticipate future financial challenges.

c. Letter of Credit (L/C)

A Letter of Credit is actually not a loan but a guarantee (from a financial institution, usually a bank). A Letter of Credit (LC) is a document that guarantees the buyer's payment to the sellers. It is issued by a bank and ensures timely and full payment to the seller. If the buyer is unable to make such a payment, the bank covers the full or the remaining amount on behalf of the buyer. LC is especially important in cross-countries transactions, i.e. export-import, when usually there are different laws and regulations for each party involved (buyer/importer and seller/exporter).

The Five C's of Credit

It will be useful for MSMEs to understand the factors that financiers are usually looking at when conducting loan assessments so that each MSME can better prepare itself. It is common in the lending industry to use 5 C's concept when assessing a loan application.

a. Capacity

To evaluate the capacity, or the MSME's ability to repay a loan, lenders look at revenue, expenses, cash flow and repayment timing in the business plan. They would like to know how the MSME will be able to meet the repayment schedule. One ratio that lender commonly uses is the debt-to-income ratio (DTI), which describes your outstanding debt compared to how much you earn. The lower your DTI, the better your liquidity, and the more likely you'll keep up with timely payments.

b. Capital

Lenders also consider any capital that the borrower puts toward a potential investment i.e. the MSME's own money. This shows the level of seriousness and commitment to the project. The more of the MSME's money put in, the more the lender will see your level of commitment in the project and, hence, be more inclined to approve the loan application.

c. Collateral

Collateral can help a borrower secure a loan. It gives the lender the assurance that if the borrower defaults on the loan, the lender can get something back by repossessing the collateral.

d. Conditions

Lenders want to be sure there's a market for your business. Make sure your business plan proves that you will be successful based on economic conditions, competition, industry type and your history as an MSME owner.

e. Character

It mostly refers to credit history, which is a borrower's reputation or track record for repaying debts. It also helps if you have a good reputation in your industry.

Documents for financing assessment

Once you gain some understanding of the criteria/factors used by financiers to assess your loan application, then hopefully, it will help each MSME to better understand the loan assessment process and the documents usually required by financiers when you submit a loan application. The required documents are usually:

a. Business Plan

A business plan is an essential document that provides a description and overview of the MSME's future. The plan should explain the MSME business strategy and the key goals to get from where you are now to where you want to be in the future. Since your main objective in writing the business plan is to secure funding, you need to clearly show in the plan, for what purpose you are going to use the fund (for example, to purchase more equipment, to rent/buy more farmland, etc.) and especially important to the financier; how you are going to repay the loan.

The business plan should ideally include the items below:

- Enterprise description
  Detailed description of your enterprise (e.g. history/background of your enterprise, what are the products and/or services of your MSME, how long has it been in operation, what is your key market, etc.)

- Organization and management
  - Who owns the enterprise?
  - Who manages the enterprise?
  - Organization chart and experience of the manager/staff
  - The legal structure of the MSME

- Financial condition
  - Financial statements for the last three years

        - **Balance Sheet** (financial statement that reports an enterprise's assets, liabilities, and equity)
        - **Income Statement** (financial statement that shows an enterprise's revenues, expenses and profitability over a period of time)
        - **Statement of Cash Flow** (financial statement that summarizes the movement of cash that comes in and goes out of the MSME)

- The nature of the project that requires funding
    - A detailed explanation of the nature of the project
    - What are you planning to do with the loan?
    - Who is your buyer/client? Where are you going to sell the products of this project?
    - Are there competitors? How do you plan to overcome the competitors?
    - Do you have experience in running this business/project?

- Repayment of the loan
    - How do you plan to repay the loan, and by when? Please provide the projected cash flow to explain how you can repay the loan
    - Do you plan to repay the loan only from the project, or do you have other sources of income? If yes, please specify.

- Collateral
    - Do you have collateral that you can pledge for the loan? If yes, please specify.

b. Permit and licenses as required by existing regulations

c. Certification schemes, for example:

- Management quality certification (e.g. ISO 9001)
- Legality certification (e.g., Timber Legality Assurance System)
- Sustainability Certification for commodities (e.g., Forest Stewardship Council, Rainforest Alliance, Fair Trade, etc.)

d. Copy of bank statements (last six months)

This provides proof of your enterprise's cash flow movements.

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