Studying New, Innovative Finance Methods

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Abstract

Development and growing complexity of financial issues in addition to new international tools in financial affairs have caused financial systems to require introducing new tools so that meet their macro goals. Using financial instruments and providing credit services to businesses activists across country are considered as a fundamental strategy to develop industrial-commercial capacities. Duty of financial managements to optimize financial procedures and utilizing innovative financing methods are substantially more important since introducing economic collective endeavor and cruel sanctions against Iran oppressed people. The structured financing as a new, innovative financing instrument is a developed area of industrial financing which provide the financial needs of investors through designing relatively complex financing methods and applying special financial instruments and securities. The present study, initially viewed the conventional financing methods; then, advantages of innovative financing methods as well as structures are clarified; finally, some new financing methods will be illustrated.

Keywords: *economic collective endeavor- financing methods- structured financing- debt-based financing- asset-based financing*

1. Introduction

In the past, financing process was mostly focused on providing cash resources in purchasing commercial goods, whereas the complexity of business processes and companies' activities have changed the cash needs. Hence, conventional financing methods were no longer able to meet the new requirements. Some conventional financing methods are initially analyzed in this study, next,

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new financing methods are provided, advantages and drawbacks are considered; finally, some methods are explained.

1.1. Some Conventional Financing Methods

As it was mentioned, conventional financing methods were mostly used in purchasing commercial goods. There are four proposed methods in conventional financing methods. (Parvizian and Azarakhsh, 2010)

1.1.1. Cash Pay

In this method, the issuer may avoid any credit risks as the payments are received preceding goods ownership transfer. Payment through draft or credit cards is regarded as the most common payment instruments of this method. Since the aforementioned method requires cash, it causes some problems on cash flows to buyers, hence is considered as the least interesting methods for buyers. Cash payment may be determined as a precondition, to foreign buyers, in shipping. Therefore, those exporters merely recommend this payment; consequently lose a large portion of the competitive market.

1.1.2. Letters Of Credit

It is regarded as a safe payment instrument in international trade. In this method, the buyer's bank accepts to pay seller in cash provided that the seller follow all requirements and documentations. In return, the buyer will pay the mentioned price to his bank. So, the buyer receives the goods in terms of the requested quality and quantity, and the seller would receive that amount in delivering his goods to shipping company. Letter of credit is useful whenever getting reliable credit information about the behavior and credit history of the outsider buyer is not possible, whereas the credit capacity of buyer exterior bank is established. This method certifies the buyer that payment is in accordance to conditions if the goods are shipped or delivered.

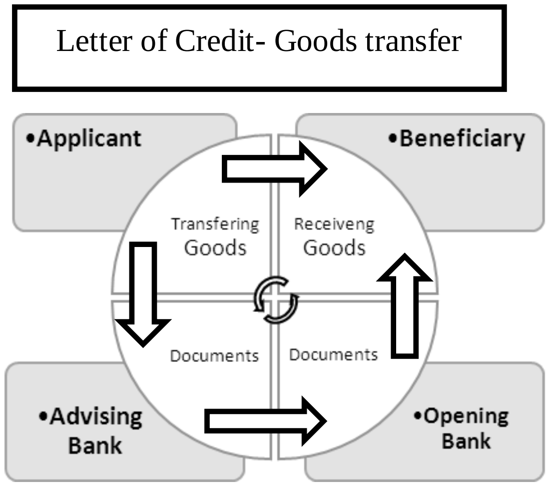

Figure1. Financing process of Letter of Credit in opening stage in Export

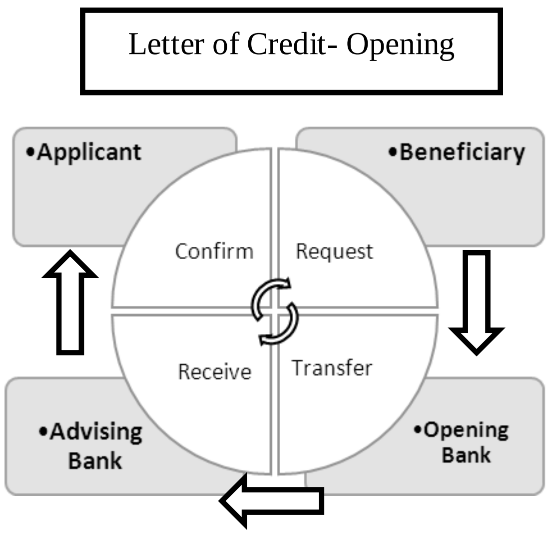

Figure2. Letter of Credit financing process in terms of goods shipping in export

1.1.3. Collection Draft

A transaction thereby the issuer assigned payment receipt to the issuing bank. Then, the assignor bank transfer (send) the documents to the reciting bank along with payment order. The funds being received from buyer are presented through mediator banks to the issuers in exchange of receiving intended documents. This method requires utilizing a draft to persuade the importer paying the initial amount in cash or in a particular time in the future. Draft listed guidelines require documentations to transfer goods. However, banks function as process facilitators in receiving to their customers, still collecting documents may not necessarily cause any improvement and limited reference during payment failure; moreover, it is less cheaper than letter of credit.

1.1.4. Open Account

An open account transaction means that goods are being delivered to the buyer preceding the due within 30 to 90 days. Hence, it is regarded as the most attractive way to a foreign buyer in terms of managing cash flows and associated expenditures, carrying high risks to the seller. The buyers due to the high competitiveness in the export market make the sellers provide an open account, as offering credit conditions to the buyer is customarily common abroad. Therefore, those exporters who fail to provide the required credential to the buyer may loss in the competitive market. The exporter, utilizing commercial financing techniques including export credit insurance, will be able to manage the risk of the foreign buyer nonpayment in the world competition market

2. Innovative Financing Methods

The growing importance of business and industry development has caused countries not only establish specialized institutions and organizations necessary to develop financing instruments, but also consider applying those instruments and innovative financing mechanisms through banking network in their industrial agenda. Structured financing is referred as a developed financing domain which meets the investors' financial needs by designing relative complex financing methods as well as applying securities and certain financial instruments. Innovative financing methods are classified in to two main debt-based and capital- based methods (Abde Tabrizi, 2010)

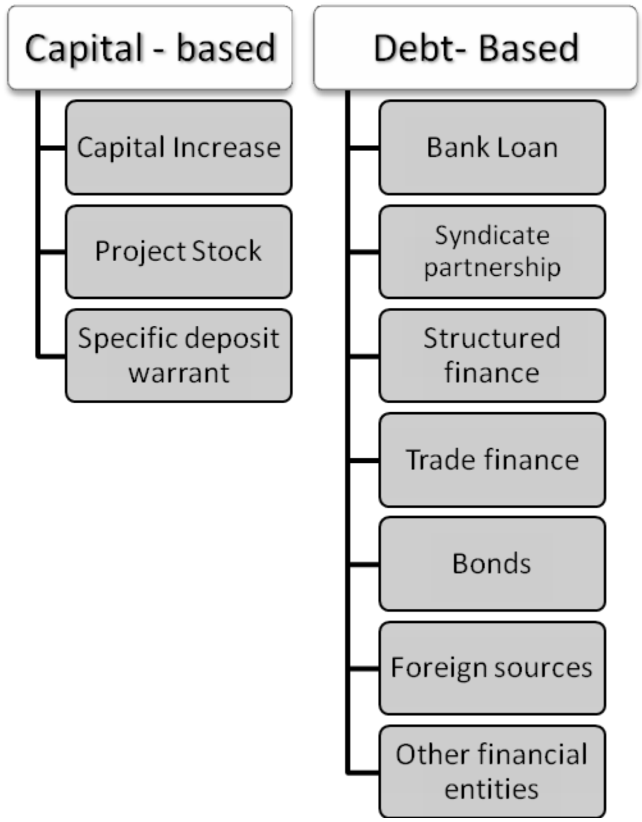

Figure3. New finance methods

2.1. Debt-Based Methods

Debt-based method indicates borrowing from an outside source in agreement with the company owners, hoping that the profit obtained from exploiting the sources be more than returning interest to lenders.

2.1.1 Advantages

The employer is not obliged to lose its ownership and subsequently its future profits. Indeed, investor(capital provider) , in this financing method, has no control over how to implement the project; just request the owner to timely pay back the profit and original loan.

Using borrowed capital to provide project funds allow the profit to be maintained in the company or to be paid to its owners.

Loan interest rate is paid before taxes so that tax rate would be less.

2.1.2. Disadvantages

The Company as the project owner must own sufficient liquidity to refund loan in due.
Often, loans are refunded through project profit. Therefore, if the loan amount is much, even if it is profitable; there is no positive cash flow to show its profit.
Conceiving lenders to grant loans is costly and time consuming.
The loan may have high interest rate affecting capital return on investment (ROI).
To guarantee loan refund, it is required to hypothecate adequate pledges.
Some of debt-based methods are as follows:

2.2 Bank Loans

Commercial banks offer the greatest number and the most variety loans to the small businesses. Business owners regard the banks as the first lenders. Banks are often conservative in granting loans; mostly prefer assign the loans to those operating, old companies rather than new ones. If a bank goes wrong in lending, it prefers to be sufficient cash flows to refund loan. Short term loans less than one year, accounted as the most common commercial loans to small enterprises typically to provide working capital accounts to finance purchasing more inventories, increasing (product) output, financing credit sale or utilizing discount cash. This loan is refunded whenever the inventory converted to cash. Mid-term and long-term loans are presented for one or more years which usually used in increasing fixed capitals. Loans are granted to establish and launch businesses, build a plant, purchase properties and equipments, finance other long-term investments as well. In general, the refunds are monthly or quarterly. (Bigdeli, 2010)

2.3 Syndicate Partnership

Syndication of multiple financers to provide the necessary resources is a common way in large projects financing often carried out by investment banks. These banks are committed to introduce the projects to multiple financers, and arrange memorandum of understanding and partnership between lender and borrower. Financing group may include some banks, some financing banks and leasing companies or a combination of all.

2.3.1 Trade Finance Facility

The widespread use of trade financing (commercial financing) is as one of the influencing factors which have helped, in recent decades, to the massive growth of international trade. Trade finance facilities, referring as supporting and financing international trade and transactions, are considered as a common used method in importing and exporting different goods. The most well-known methods are commercial Usance and refinance. (Investopedia "Trade Finance, 2013)

2.3.2 Facilities Of Other Financial Entities

Investment companies, non-banking credit institutions as well as retirement and interest free loan funds, in addition to bank, can play as loan lender financial institutions. However, each follows its own different rules and regulations, still share a decision making process based upon borrower credential risk, its financial analysis as well as the project economical analysis.

2.3.3 Using Foreign Sources

In addition to interior banking sources and Iranian credit and financial institutes, foreign banking and non banking facilities can be similarly used. However, it is unlikely as the political conditions, sanctions and capital risks in Iran.

2.3.4 Bonds

Bonds are anonymous or registered securities issued in a specified nominal price for a particular period, to provide some part of the required funds in government profit-construction projects or to provide the necessary funds to create, complement and develop profitable manufacturing, construction and servicing projects in the private companies; and transferred publicly to those investors seeking participate in abovementioned projects. Bonds are transferable to other and the holder is known as the owner. The holders are granted on account profit, in given periods, proportionate to the nominal value per each bond, in terms of bonds' investment income. The rate of bonds' on account profit and payment periods is interpolated in the issuance terms, being paid, to holders, according to the attached coupons to the bonds in the seller branches. The payable realized profit is calculated following due. If the given realized profit was higher than payable on account profit, then they will get difference, in compliance to the regulations, will be paid to the holders of partnership final settlement. Moreover, if the project incurred any losses, the issuer is committed to compensate the costs with no burden on the holder.

2.3.5 Structured Finance

A developed area of financing industry meeting financers(investors) financial needs through Planning(drawing) relatively complicated financing methods and applying particular financial instruments and securities in the market formation framework. These classes of methods have no definite clarification and borders. This method depends on project and mutual terms, types of needs and types of agreements; recommended for those firms with special (particular) financial needs not being response through conventional financing like loan.

3. Characteristics Of Structured Finance

- In general, these contracts are more appropriate in longer term periods.
- A set of assets is collected in a portfolio.
- Most risks are covered in the form of contracts and structured guarantee.
- The possibility of using debt leverage with high debt to capital ratios.
- Contracts, privileges, ownership interest and or project natural resource property rights are accepted as collaterals. The accruals supported through assets are defined in classified various investment categorizations.
- Establishing a special purpose legal entity with limited life span, tee total assets credit risk is separated from the initial warrantor of credit risk and concentrated on the range of the defined financial activity.

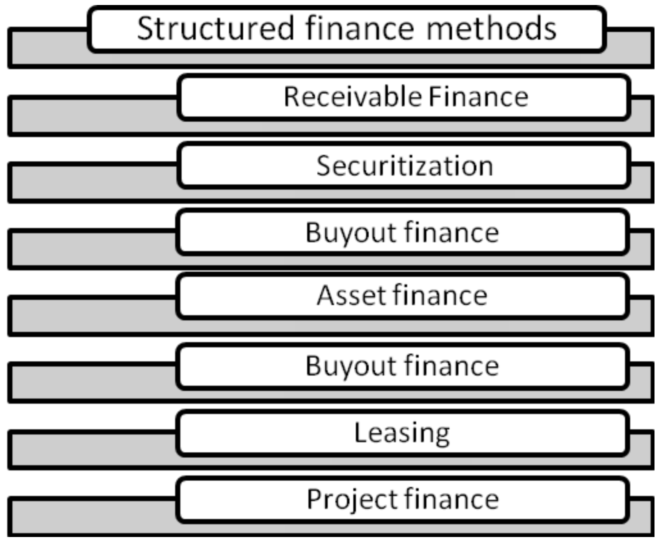

Figure4. Some various structured finance methods

4. Structured Financing Methods

4.1 Receivable Finance

The loan is granted versus cash flow resulted from a business activity income (such as chain hotels) through centralized payment in a mediating entity.

4.2 Securitization

Some receivable documents (such as credit facilities portfolio) financing method of in the capital market through securities issuance.

4.3 Buyout Finance

Company buyout finance is carried out by its employees and or a group of outsider investors in debt leverage high ratios. Cash flow obtained from firm's activity integration to its assets value is considered as collaterals in getting a loan.

4.4 Acquisition Finance

Acquisition of company B by company A. It is financed similar to the aforementioned finance except the combination of cash flow and assets values of both firms is determined as the loan collateral.

4.5 Asset Finance

Loan is granted in term of commercial asset value (like aircraft or commercial tenement).

4.6 Leasing

A type of asset financing which asset ownership remains to lessor (financer).

4.7 Project Finance

A financing method through financial engineer providing required sources in large projects by long-term loans. Loan process (borrowing process) versus the created cash flow is assessed and operated in this method.

There are some project financing methods as follows:

- Build- Operate- Transfer (BOT)
- Build- Ownership- Operate (BOO)
- Build- Ownership- Operate- Transfer (BOOT)
- Build- Lease- Transfer (BLT)

“Build- Operate- Transfer” method was first prevailed in 1980s, when some power plants were bid by the Turkish government. Project building and operation were done, in this method, by a company called “Project Company”, in a given period; then, plan transfer to the employer realized following a certain time and acquiring the necessary income. These methods necessarily require relevant government agencies (such as Ministry of Finance and Economic) adequately warranty the employer non-payment to the Project Company. In addition, identifying and utilizing abroad reliable, authorities financiers (namely, European banks) are counted as the other prerequisites to carry out these projects. (Project finance; Iran Commercial Center Site, 2012) As it can be seen, there exist great varieties in how to use these various tools as well as high designing and offering complexities. Designing a proper instrument (tool) for specific purpose must be done by financial engineers. Sometimes, designing a structured financing instrument considerably costs so that financing a project may reach to 5% of the initial investing. (Parvizian and Azarakhsh, 2010).

5. Capital- Based Methods

Capital-based financing requires submitting a part of project profit in exchange of capital. In fact, the required investment is provided, in this method, by using shareholders' cash and non-cash inventories and increasing the rights of stakeholders at the firm or project. Shareholders' inventory is being consumed in developing project activities and all its profits are later distributed within shareholders.

Persuasion and motivating investors to participate in the project considered as the most critical stage of the method. Nonetheless, investors association (participation) in a project more depends on the project owner willingness to share project management and control rather than investors interest to investment. Indeed, it must be regarded that selling per share of project in this financing method, may eliminate some managerial rights, decision making independence as well.

5.1 Advantages

- There is no need to reimbursement the obtained capital, if the project fails.
- The method necessitates no to mortgage company or project assets.
- Projects possessing adequate capital are more appealing to investors and lenders.
- Since there is no need to repay debts, then liquidation may increase if this method is applied.

5.2 Disadvantages (Drawbacks)

- Complete ownership has been eliminated and profits are divided among investors.
- Other investors' attitudes contrasted to project owner's in terms of how to implement.
- The interest will be paid to the investors once taxes have been paid; hence, the taxes paid, in this financing method, are higher as compared to debt-based financing method.

Some capital-based methods include:

5.3 Capital Increase

Capital increase is the first coming to mind option among capital-based financing methods. Capital increase directly, with no theoretical constraints, provides sources to the executor. This method lacks risk refund with much shorter executive stages.

5.4 Project Stocks

Project Owner Company introduces the layout followed by analyzing, and then predicts its profitability. Next, a basic percent is being determined as the on-account profit, to attract investors; whereas, the final percentage is due to the project completion time. Therefore, the stocks are purchasable once announcing publicly through media or bank branches.

This financing method is to some extent similar to financing through bonds. However, there are some differences including:

Stocks in project stocks method are registered issuance, therefore second market and its buy and sell is not easily possible. But bonds are simply transferrable.
Bonds interests are assigned to the holders in the certain intervals, but project stock holders benefit investment profit once the project is completed. (Projects Finance instruments. Project Stocks, New Economy Bank (Bank Eghtesade Novin, 2012)

5.5 Specific Deposit Warrant

Time certified deposit for investment (specific) is referred to a deposit that bank opens to equip resources in financing new particular productive, constructional and servicing profitable plans; in return, issues time deposit warrant special to investment (specific). Specific deposit warrant commonly offered by a financial association, bank or a financial entity has higher interest rate as compared to a saving account. (U.S Securities and Exchange Commission (sec), 2013)

5.6 Specialized Funds

This sort of funds started up according to a particular goal and expertise including a broad spectrum of funds. Land and construction investment fund is a financial entity established under the license of Securities and Exchange Organization dealing with collecting investing applicants funds, investing on certain constructional projects, selling building units and consequently dividing the revenues obtained from this activity within funds investors. Financing company has created land and building funds namely Asman and building fund, Ardabil; and, Cheshmeh Funds, Tehran (Projects financing instruments. Specialized Funds, New Economic Bank Site, 2013), under the license of Securities and Exchange Organization. These funds are considered as the project-based funds including other projects in addition to construction. Finance company looks forward establishing non constructional projects funds as well. Another finance instrument designed and implemented in housing sector or generally in land and tenement sector of industrial countries is establishing finance entities named tenement and properties finance funds. These funds are a kind of common financing funds with fixed capital merely created for maintaining real property, property relevant to mortgage securities or both designed with specific purposes through financial engineering so that provide financing opportunities in real property and financing chance to small financers in tenement and land sector. Monopoly and bribery (Rent) avoidance in housing and finally specialized management in tenement and property sector are counted as the goals of such funds(Projects Finance Instruments. Specialized funds, New Economy Bank Site, 2013)

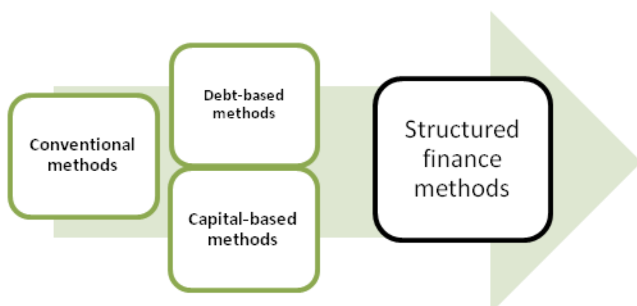

Figure5. Structured Finance Method As The Presecure Method In Innovative Financing

6. Conclusion

Considering the long-term strategic goals for the future economy, relying merely on the current convenient financing methods is not enough to support all the existed potentials. Certainly, realizing economiccollective endeavor and perspective statement in country economic development require applying new methods coupled with innovation, coordination to structure and financial properties. Of the new methods discussed in this study, different structured financing methods poses great potentials; also, are of great interest in international level. Structured finance is a developed industry finance meeting the needs of investors through designing relatively complex financing methods and applying specific financial instruments and securities. Moreover, is known as one of the best innovative finance methods. It is anticipated that finance managements and the other relevant authorities get more familiar to these methods; and by their application and providing an ideal atmosphere to realize the endeavor cause more economic prosperity and increasing development in the country.

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