OZA PATEL & DOSHI

CHARTERED ACCOUNTANTS

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Debt Financing for Start Ups

- Introduction
- Ways to obtain Debt for Private Companies
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Introduction to Debt Financing

- Debt funding means borrowing money to fund the business.
- A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date, usually with interest. Therefore, In case of Debt Interest portion can be considered as Cost of Debt.

Ways to Obtain Debt for Private Companies

- Largely, the Start ups going for fund raising are in the form of Private limited companies, Private limited companies can borrow money from Bank and Financial Institutions but there are strict restrictions over these companies to borrow money from Public at large.
- There are some restrictions on Private limited companies as to accept loans or deposit from public under section 73 to 76 of Companies Act, 2013. The said companies can borrow money or accept deposits form public provided it is in compliance with below mentioned conditions,
  1. Amount received from its director out of his own funds.
  2. Any amount received by a company from any other company.
  3. Amount received from relatives of a director out of his own funds.
  4. There are some relaxations under section 73 to 76 where Private limited company borrow money from members of the company. Members include both Equity Share holders and Preference Share Holders of the company ;

Ways to Obtain Debt for Private Companies

A. Where a private limited company being a Start Up Company*, can borrow without any limit

B. Where a private limited company is NOT a Start Up Company, there are three conditions which are required to be met (w/o any limit);

a) Which is not an associate or a subsidiary company of another company

b) The borrowings of such a company from banks or financial institutions or any body corporate is less than twice of its paid up share capital or fifty crore rupees, whichever is less

c) Such a company has not defaulted in the repayment of such borrowings subsisting at the time of accepting deposits under section 73

* **Start-up company means** a private company incorporated under the Companies Act 2013 or Companies Act 1956 and recognized as a start-up in accordance with the notification issued by the Department of Industrial Policy and Promotion.

Benefits of Debt over Equity

- Raising fund through Debt over Equity does not result into dilution of founders' valuable equity
- Cost of obtaining fund through Debt is usually lower than obtaining fund through Equity
- When company pays interest on the Debt, the same is allowable as deduction for Tax purposes, whereas dividend paid is not allowed as deduction.

Limitations of Debt

- In the event of Liquidation, debt being outside liability to the company, must be paid prior to the equity.
- Regardless profit or losses, it is imperative to service the interest on debt on due dates, whereas there is no compulsion for payment of Dividend.
- Debt being fixed liability is considered as fixed burden over the company which may not be suitable for the early stage Start Ups.

THANK YOU

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