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**IS THERE A WAY OUT? (A CASE STUDY ON DEBT TRAP)**

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**ABSTRACT**

*The purpose of this case study is to create an insight into causes and consequences of debt trap in business. This case study outlines the journey of Mr. Surinder Agarwal\*\*, an entrepreneur who leaves the job to start on own and was forced to move back to job due to various circumstances. The desperation and hope at various stages of his journey were reflected through his actions. Mr. Agarwal acquired the ability to manage day-to-day operations but lacked the ability to manage funds and mitigate risks. Finance sense is very important for an entrepreneur and lack of understanding of the same results in sub optimal decisions. One such decision is to borrow more debt to meet the present financial obligations. This has lead the entrepreneur in to a debt trap. So, the challenge is to identify the ways in which entrepreneur may get released from this trap. Further research is needed to explore in detail the causes for this kind of behaviour in entrepreneurs.*

\* Real life case study of a client who sought advise from the author.

\*\*Name altered to protect the identity of the client.

**JEL CODE**

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**KEYWORDS**

debt trap, entrepreneur, finance sense, risk.

**CASE STUDY**

(\*This case study was developed for academic discussion only and not for criticizing effective or ineffective handling of a situation by an entrepreneur. The case study was developed through interview method using open ended questions)

Mr. Agarwal did his Diploma in Leather Working before joining a shoe factory in Agra. He enjoyed working in the first job. He was appreciated by his manager for his excellent communication and people skills. He took interest in whatever he did. He gained knowledge of the production process and quality aspects in his organization. In 1990, the managing director of the company where he worked decided to promote him to executive position in business development. He travelled to Maharashtra and Gujarat frequently to understand the markets and to promote products manufactured by his company. Here he understood the marketing aspect of the business very well. He felt a deep desire to be on his own. He understood the market demand and found an opportunity to establish his own business. So he quit the job in 1993 and with his savings did a fashion designing course for 6 months from Mumbai while staying with his uncle. After completion of this course, he opened a boutique in Mumbai. He ran this boutique very well in Mumbai for next 6 months.

As fate would have it, Mr. Agarwal's father met with an accident in Agra. He became paralyzed and Mr. Agarwal was forced to quit his boutique business in Mumbai. In 1994 he came to Agra and opened a boutique near home and also served his father for the next 7 years till his death. During this period, he also started driving a van for transporting school children and also started selling water filters on commission basis. His wife helped him in the evenings with the boutique business. Mr. Agarwal continued these activities till 2005. Then in 2005, the shop owner asked Mr. Agarwal to vacate the shop as he was trying to sell the property. On searching Mr. Agarwal found a shop in the main market. This was like a golden opportunity for realizing his dream of starting a big boutique and Mr. Agarwal immediately decided to shift to the new location.

Mr. Agarwal did not enter into any leasing agreement as he trusted the elderly new owner. The monthly rent of Rs. 3,000/- (\$60) is affordable and the location is perfect. He spent Rs. 30,000 (\$600) on the renovation and purchased Rs. 2,00,000 (\$4000) worth of material by taking a loan. His shop was briskly selling bags, kurtas, pajamas, quilts etc. He employed 3 helpers so that he could continue to drive the school van and also sell the water filters. The business was good for the next 6 months and then suddenly the shop owner asked Mr. Agarwal to increase the rent to Rs. 4,500/-(\$90) as the rentals have suddenly increased in that market. As Mr. Agarwal was earning well and making profits, he was able to pay the increased rent. Looking at the demand in the shop, he decided to focus more on shop so purchased a new van on loan and appointed a driver for running it. He started using old van for his business & personal needs. It appeared he will realize his dream of becoming one of the biggest boutiques in the area soon.

Looking at the success of Mr. Agarwal, another tailor also opened a boutique next to Mr. Agarwal's boutique. He was paying a monthly rent of Rs. 6,500/-. This resulted in Mr. Agarwal's shop owner increasing the rent again to Rs. 6,500/-. Due to competition, Mr. Agarwal's sale declined. Initially Mr. Agarwal met shop expenses with the income generated from the new van. But his new van met with a serious accident due to the negligence of the driver. He was forced to sell the van and clear the loan on the new van. As sales declined, unable to meet expenses, Mr. Agarwal was forced to borrow money to meet his expenses. At the peak festive season, in anticipation of better sales, he borrowed Rs. 50,000/- at an interest of Rs. 500/- per day (1% per day). Interest burden and increased debt led to Mr. Agarwal selling his old van. In 2008 Mr. Agarwal closed his business at Agra and took a job at Surat. He was earning Rs. 25,000/- with a garment exporter and decided to repay all his loans gradually by working there.

As fate would have it, in 2009 Mr. Agarwal's mother was diagnosed with cancer. So he was forced to comeback to Agra again and this time he took up a job in the local boutique. In the new job he was promised Rs. 10,000 per month. After working for few months he realized that the new owner was taking advantage of his situation. He was getting paid only Rs. 7,000/- far less than what he was promised. Failing health of mother coupled with long hours of employment (9am to 11pm) at the local boutique and also the low salary put tremendous pressure on Mr. Agarwal. After his mother's death in 2011, Mr. Agarwal left the job and started on his own again from home.

The present financial situation is as given below:

<b>i) Outstanding loans</b>		Rs.
	Private lender (5% per month)	69,000
	Rich friend (Interest free)	60,000
	NBFC (settlement amount)	65,000
	<b>Total loans outstanding</b>	<b>1,94,000</b>
<b>ii) Cash inflows:</b>		
	Income from boutique at home	
	after deducting expenses)	12,000
	Salary received by wife as a school teacher	4,000
	<b>Total earnings</b>	<b>16,000</b>
<b>iii) Cash outflows</b>		
	House rent	3,000
	other expenses	5,000
	<b>Total expenses</b>	<b>8,000</b>
<b>iv) Financial out flows</b>		
	Monthly interest on loan taken from private lender	3,450
	principal paid to the rich friend	4,000
	Principal paid to the NBFC	4,000
	<b>Total monthly outflows</b>	<b>11,450</b>
Net Cash Flows	Cash inflows - cash out flows - financial flows	16,000-8,000-11,450
		<b>= (3450)</b>

Interest is not being charged by the NBFC and Rich friend as Mr. Agarwal agreed to pay the principal regularly. He is planning to meet the short fall of Rs. 3,450 by borrowing from another lender at 2% per month. He feels that as and when the situation improves, he will be able to repay all the loans. Is this a wise decision?

## TEACHING NOTES

### 1. CASE SYNOPSIS

This case study highlights the importance of financial management in any business. Finance at micro level involves financing, investment, returns and financial flows. If excess debt is used in financing business operations, financial flows (interest and principal payments here) will exceed the returns. Continuously running business with negative cash flow situation leads to capital erosion and increased borrowing, which further increases outstanding debt. This is a negative spiral. Thus Mr. Agarwal is entering a debt trap.

### 2. PEDAGOGICAL OBJECTIVES

- Understand the concept of a debt trap
- Identify factors leading to a debt trap and
- Generate various options for dealing with a debt trap.

### 3. SUGGESTED QUESTIONS

- Identify various factors that impact the financial performance of a small business.
- Identify the risks faced by the entrepreneur and possible methods that could have been adapted to deal with the risk.
- How can we identify if a business is entering a debt trap ?
- Generate options for Mr. Agarwal so that he may come out of the debt trap.

### 4. OPPORTUNITIES FOR STUDENT ANALYSIS

- Students may be formed in to teams. Each team may first brainstorm. A team representative may present group views and other team representatives may join the discussion.
- Faculty can ask questions and lead the student interactions. Focus can be on identification of issues and generation of alternatives.

### 5. SUGGESTED ANSWERS FOR QUESTIONS

#### A. FACTORS THAT LED TO PRESENT FINANCIAL SITUATION

- Mr. Agarwal expanded the business without having sufficient funds. Every business should first focus on its sustainable growth rate. Sustainable growth rate is obtained by reinvesting the returns from the business and there is no external financing.
- The borrowed funds have high cost associated with them. In case a business has to borrow, first it should do a feasibility study to see whether it can payback the debts in time.
- In this case, the return from the business was not sufficient to cover the expenses. Also expenses like shop rent were increasing regularly. Increase in fixed expenses led to a higher operating leverage. The only way to meet expenses is to increase sale. Higher sales need higher inventory and again investment in current assets through borrowed funds. Thus it became a negative spiral. Finance sense is a must for any entrepreneur. Finance sense is the knowledge and ability to take correct financial decisions that add value to a business.
- A business has to enter into a regular contract with the stakeholders. Absence of stable contracts result in business failure when suddenly the cost of inputs go up.

#### B. RISKS FACED AND METHODS TO MITIGATE RISKS

Debt financing, Competition, rising cost of inputs, entrepreneurial mind set, are some of the risk factors faced by the business here. Mitigation of risks mentioned above could have been possible by taking the following steps:

Prior analysis of the move to shift from job to business. Entering in to a lease agreement after the first shop owner asked him to leave. Gradual expansion by reinvesting returns in to business. Replacing private loan by a bank loan or interest free loan to come out of debt trap. While keeping expenses low, strive for value addition and to differentiate services from the competitors.

#### C. OPTIONS FOR DEALING WITH THE PRESENT SITUATION

- May promote existing business. (But this is a long term option with uncertainty involved.)
- May request rich friend that the payment will be delayed by few months. (Need lot of persuasion as already he is not charging any interest)
- May do a part time job to increase earnings along with the business. (Need to find one and also need to ensure that he gets enough time to devote to his business also.)
- Reduce expenses. (bare minimum expenses to be incurred. Curtailing and convincing the family is important).
- May also look for a job with better salary. (Need to find one and looking at the gap in service, will prove to be a tougher option).
- May also try for financial restructuring i.e., replace high cost private loans with bank loans. (Need a collateral and guarantor for this purpose)



**D. PASSION OR NECESSITY DRIVING THE CAREER CHANGE OPTIONS**

Initially it was passion when he changed from job to business. But subsequently it was a necessity as family circumstances as well as exploitation of the employer forced him to start on his own again.

**6. SUGGESTED CLASSROOM TEACHING PLAN**

Q1	10 min
Q2	15 min
Q3	10 min
Q4	10 min
Summing up	5 minutes
<b>Total</b>	<b>50 minutes</b>



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I am sure that your feedback and deliberations would make future issues better – a result of our joint effort.

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Thanking you profoundly

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Sd/-

**Co-ordinator**

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In this age of Commerce, Economics, Computer, I.T. & Management and cut throat competition, a group of intellectuals felt the need to have some platform, where young and budding managers and academicians could express their views and discuss the problems among their peers. This journal was conceived with this noble intention in view. This journal has been introduced to give an opportunity for expressing refined and innovative ideas in this field. It is our humble endeavour to provide a springboard to the upcoming specialists and give a chance to know about the latest in the sphere of research and knowledge. We have taken a small step and we hope that with the active co-operation of like-minded scholars, we shall be able to serve the society with our humble efforts.

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