



**ENTREPRENEURIAL
BUSINESS LAWYERS**

FINANCING A BUSINESS

INTRODUCTION

Businesses are either net generators or net expenders of cash. Any business which expends cash long enough will not survive. Many profitable businesses which generate cash from their operations will at some point find that they need to seek cash from sources other than the core business to finance working capital or to develop the business.

The range of options available will depend on external economic influences and the particular commercial position of the company.

INTERNAL FINANCE

No business owner should consider raising external finance until he has reviewed his internal business practices and controls. There are always costs or conditions attached to any form of external finance and, before considering such sources, it is crucial to look at the various ways in which it might be possible to release cash within the business. This is an important discipline in any event and, as well as giving a business the best chance of survival, it will make the business more investor friendly as and when the stakeholders do seek external finance.

The various techniques detailed below may appear obvious, but are often overlooked by those running the business as they can be too close to the business to objectively assess the options.

Possibilities to explore include:-

- Improving debtor control. For example, if the business has outstanding debtors of £300,000, it could generate £100,000 by cutting its debtor days from 90 to 60;
- Negotiating lower prices or better payment terms with suppliers;
- Carrying out a detailed review of all costs to reduce them wherever possible;
- Reviewing all outstanding standing orders and direct debit mandates at the bank to ensure there are no extraneous outgoings;
- Disposing of surplus assets;
- Turning obsolete stock into cash;
- Increasing prices;
- Improving margins by improving quality control;
- Increasing sales volumes;
- Review tax efficiencies such as R&D tax credits.

Of course, some of these measures will be easier to implement than others; but being able to demonstrate the business is professionally managed will make external finance quicker to obtain, and on better terms.

EXTERNAL FINANCE

The best source of external finance is of course revenue from business operations but, for various reasons, this may not be sufficient to allow those running the business to implement growth strategies.

Ideally, external finance should be sought as part of a detailed, carefully considered business plan. The argument in favour of funding will have been rehearsed and the sources of that funding targeted precisely. This should make funding easier to secure, and on terms more favourable to the business. The type of funding will be appropriate to the stage the business is at, and thought will have been given as to whether it is scalable in the event that the business needs to raise further external finance in the future.

GRANT ASSISTANCE

It is important to recognise that grant assistance should not be regarded as “free” money. Obtaining grant assistance can be a costly, time consuming and frustrating process as many of those who have tried will testify. However, grants are an important source of external funding, particularly for pre-revenue businesses in the early stages of product development.

There are an enormous number of grants available for young, innovative companies. Many are restricted sectorally or geographically, so it is important to research the area carefully before spending valuable time applying.

The four main bodies who offer grant assistance in the UK are:-

- the Government;
- the European Union;
- Regional Development Agencies in England, Scottish Enterprise, the

Welsh Development Agency and Invest Northern Ireland; and

- local authorities, local councils and local development agencies.

Many of these bodies can offer other important services, such as business mentoring, which can be as valuable as cash to many businesses.

In order to check on the availability of grant assistance and other support in your area, you should speak to your local development or enterprise agency, which should be able to make you aware of the full range of grants available.

FACTORING/INVOICE DISCOUNTING

Many fast growing businesses require additional working capital to finance increasing levels of business. Young companies may find it difficult to persuade the bank to extend the level of credit they require on overdraft. For such companies, debt factoring or invoice discounting may be an option.

The principle of debt factoring is very simple:-

- As soon as goods are shipped and invoiced to the customer, the company assigns the invoice to the factor;
- The factor pays a percentage of the value of the invoice, usually between 70% and 80%;
- The factor is then responsible for collecting payment from the customer;
- When payment is received, the factor remits the balance to the company under deduction of its charges.

Factoring may either be “with recourse”, which means that the company carries the risk of bad debts or “without recourse”,

meaning that the factor effectively provides bad debt insurance. Whilst there is a cost associated with the latter, it may be the more attractive option if bad debts are a significant concern.

Factoring was once regarded as “borrowing of last resort” and a sign of a company in trouble. There is no doubt that factoring normally costs more than an overdraft. In addition, companies may be reluctant to pass control of their sales ledger and debtors to a third party. However, a factor will normally advance against a higher percentage of debtors than a bank. The growth of the factoring industry in recent years is witness to the fact that this form of finance is now becoming increasingly popular, particularly with new and fast growing companies. In the current climate, it may be the only option for companies struggling to extend their overdraft with the bank.

Invoice discounting is similar to factoring but the invoices are not assigned to the finance house. The company retains control of its sales ledger and the finance company advances a percentage of the invoice value to the company. The finance house has less security. This option may be more suitable for larger, more mature companies. In both cases, it is important to review all banking covenants to ensure that employing these methods would not put the company in breach of its covenants.

HIRE PURCHASE AND LEASING AGREEMENTS

This type of finance is appropriate for the acquisition of fixed assets with a reasonably short working life.

In the case of a hire purchase contract, the company will own the asset only after the final payment is made. With a leasing contract, the company never owns the asset. The lease will normally move into a secondary period at a much reduced rent once the primary period

has passed.

There is a distinction between “operating” leases which are appropriate for financing minor pieces of equipment such as photocopiers and “finance” leases which are used to purchase more important items of capital equipment. In the case of an operating lease, the payments are simply debited against the profit and loss account, whereas in the case of a finance lease, the capital value of the asset is shown on the balance sheet with the corresponding liability for repayments.

The advantage of this type of finance is that it offers fixed monthly or quarterly costs, usually spread over the useful working life of the asset. Under no circumstances should the finance period exceed the anticipated working life of the asset.

It is not uncommon for the hire purchase or leasing arrangement to be provided in a contract with a finance company. This contract is different from the underlying contract for the supply of the asset. This can lead to a situation where the company may have a continuing obligation to make regular repayments to the finance company, even where the asset proves to be defective. This should be guarded against through careful scrutiny for and negotiation of conflicting clauses in the separate contracts.

BANK

The most common (and sometimes only) form of external finance is a bank overdraft. These are usually secured by way of a Bond and Floating Charge over the company's assets, although banks often insist on personal guarantees from the owners and second charges over their houses. Despite this unusually onerous obligation, the overdraft has been a popular form of finance over the years because of its flexibility, ease and speed of creation and relatively modest cost.

A core feature of all overdraft agreements is that the bank may demand repayment of the full amount at any time. Any company which operates with an extended overdraft facility is therefore permanently in an exposed position. There is increasing recognition both by the banks and by borrowers that this is not a satisfactory position and it is worth considering more structured finance arrangements, which may be broadly categorised as follows:-

- Short-term loan. 0-5 years, suitable for the purchase of assets with a short working life;
- Medium-term loan. 5-10 years, suitable for the purchase of assets with a medium-term working life; and
- Long-term loan. Over 10 years, suitable for the purchase of assets with a long-term working life, typically land and buildings.
- Banks may accept flexible repayment structures including:-
- Stepped repayments. Fixed repayment of capital over the life of the loan with the interest liability decreasing as the capital balance falls;
- Annuity repayments. Similar to a building society mortgage with the payments fixed over the term of the loan;
- Interest only loan. Interest is payable for the duration of the loan with a "bullet" repayment of capital at the end of the loan;
- Moratorium. Banks may be willing to agree to a moratorium on the capital element of repayments in the early years of the loan when cash flow is normally at its tightest.

Many loans are negotiated on the basis of a

fluctuating interest rate tied in to the bank base rate or LIBOR (London Inter- Bank Offer Rate) but many companies are becoming more aware of the need to protect themselves against adverse movements in interest rates and this may be achieved in one of the following ways:-

- Fixed interest rate loans. The interest rate is fixed, normally at a rate which is slightly in excess of prevailing market rates;
- Capped rate. The borrower pays an initial payment to the bank to purchase an interest rate cap. This is effectively an insurance policy which protects the borrower against increased rates above a pre-determined level; or
- Zero cost cap and collar. This is a narrow band within which the interest rate will fluctuate and is offered at no cost to the borrower. The borrower may lose out on any further decline in interest rates but will be protected against any significant increases.

As with overdrafts, security normally takes the form of a Bond and Floating Charge over all the assets of the company. Banks will also expect a first-ranked Standard Security over any heritable property. Again, banks typically expect personal guarantees and second charges over the directors' houses.

There are several important points to bear in mind in relation to personal guarantees:-

- Lenders will not normally accept a personal guarantee without an assurance that the guarantors have taken legal advice on its implications;
- Where the guarantee involves the family home, the guarantors should ensure that the terms of the guarantees do not breach the

guarantors' obligations under their personal mortgages;

- Where the family home is involved, spouses must seek independent legal advice;
- Whilst the advice received will highlight the onerous nature of the guarantees, it is highly unlikely that the terms of the guarantees will be negotiable.

ENTERPRISE FINANCE GUARANTEE

The Government-backed Small Firms Loan Guarantee Scheme (SFLG) was suspended on 1 January 2009 and was replaced by the Enterprise Finance Guarantee (EFG) on 14 January 2009.

Many companies are refused loans on the basis that they cannot offer sufficient security to the bank. The EFG seeks to address this issue by guaranteeing up to 75% of the loan. There are a number of detailed rules and regulations regarding the types of company which qualify for this type of assistance, but the loan application is made in the normal way via an accredited bank. Further details can be obtained from the Department of Business, Innovation and Skills.

Whilst the intent of the EFG is similar to the SFLG, its scope is wider. More companies are eligible, and the EFG can cover loans of up to £1,000,000 as opposed to the SFLG's £250,000. There are drawbacks however, and banks can refuse a loan if the borrower is not prepared to offer a personal guarantee over his unsecured assets.

RISK FINANCE

In the current climate, banks have been more reluctant than ever to expose themselves to business risk. However, a prudent business owner should not automatically assume that a given bank has rejected a loan or overdraft simply because of the prevailing economic

situation. All good business owners should learn to review all aspects of their business with a critical eye.

Many business owners believe that banks exist only to lend and can find it hard to accept the bank's reluctance to lend. It should be remembered that, when banks lend money, they risk their shareholders' and their depositors' funds. Where a bank lends money, its primary concern is to ensure that it profits from that arrangement. Whilst this is currently a controversial view given that the banks' attitude to risk contributed to the recession, the fundamental principle remains true.

If a bank declines an application it may have, within its current strategy, good reason for doing so. If a lending proposition is declined by a bank, the proposition should be reassessed to determine whether there is something wrong with the proposition rather than something wrong with the bank.

NON-TRADITIONAL LOAN FINANCING

With banks being more risk averse than hitherto, some businesses are turning to alternative sources of loan financing.

Several business angel organisations have increasingly have offered loans to carefully selected companies.

It should be noted that this form of loan financing will not replace bank lending in the long term, as these organisations are not offering an easily accessible product. Indeed, they would be extremely unlikely to accept speculative applications from companies with whom they do not already have an established relationship.

At the lower end of the scale, individuals have shown an increasing willingness to lend money to fledgling companies. These can range from friends and family members to stakeholders in and directors of the company. All such loans

should be properly documented so that all parties have a record of the understanding amongst them. In addition, it is vital that all parties to such agreements take appropriate legal and taxation advice so that they understand all of the implications.

EQUITY FINANCING

This is where current or new investors subscribe for an equity stake in the business in the form of shares. For many business owners, this raises a number of concerns and considerations, all of which must be addressed to determine whether it is appropriate for the business to seek this form of finance.

Whilst a business founder may be unwilling to give up an equity stake in his business, the balancing arguments centre on what he and the business will gain from the relationship.

Equity finance may dilute the current stakeholders' percentage holding in the business, but it increases the equity base of the business. In short, they have a smaller piece of a bigger pie. The value of the individual shareholding may increase also, especially where a founder subscribed for his stake at nominal value and the funding round has established a market value for the shares. This is only a paper gain of course: the actual value of any stake will inevitably fluctuate.

The injection of working capital means, amongst other things, that a part of the business plan which was hitherto unfeasible can now be initiated. This can again increase the overall value of the business by, for example, increasing market share, gaining patent protection, moving to the next stage of development or launching a product.

In addition to this, the company can benefit from the relationship with its investors, whether they are business angels or institutional equity investors.

Founding money, expertise and contacts are

invaluable to the fledgling or developing business.

Equity investors will usually require some degree of control over the business. The terms of this control will be set out in an investment agreement and/or the Articles of the company. This can range from information rights or the right to appoint a director, to a list of restrictions on the activities of the company, which may only be lifted with the express permission of the investors.

A well-chosen external director can bring to the company:-

- the discipline of convening regular board meetings and monitoring the company's actual progress against its forecasts;
- a wealth of experience and contacts;
- a non-executive or chairman stewardship of board issues;
- the principal point of contact with lenders and external shareholders; and
- credibility in the marketplace which the company might not otherwise have.

Ideally the current stakeholders should work closely with the new investors to select a mutually acceptable candidate.

CONCLUSION

Although funding options may appear limited, all of the options should be considered carefully and revisited regularly to ensure that the most appropriate financial package for your business is accessible when required. The key to this is anticipating that completing a re-financing may take months (or even years) longer than an optimistic entrepreneur might expect.

While all reasonable care has been taken in the preparation of this guide, no responsibility is accepted by MBM Commercial LLP for any errors it may contain, whether caused by negligence or otherwise, or for any loss, howsoever caused, occasioned to any person by reliance on it. Individual advice should be sought before considering any of the matters detailed in this guide.

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