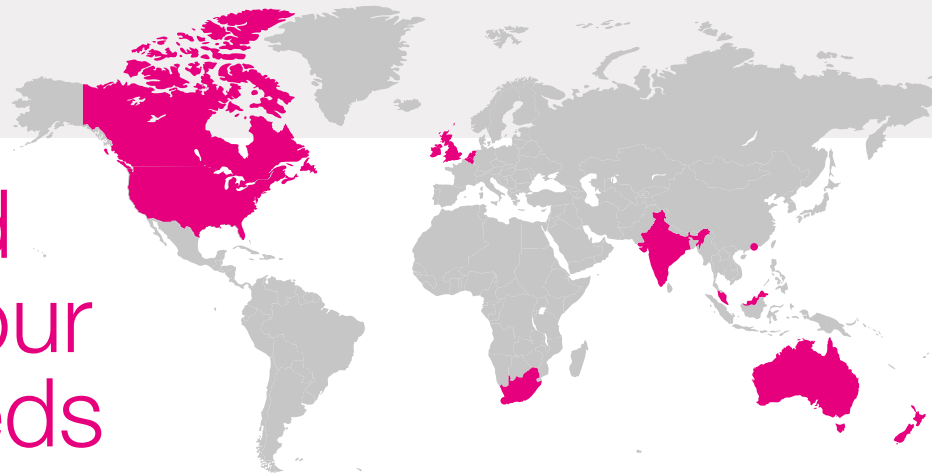




STRATEGIC FUNDING

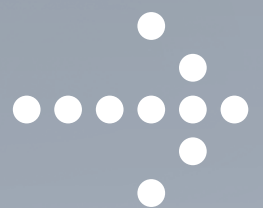
Where to find
the capital your
business needs



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Funding growing businesses is one of the major challenges any entrepreneur and business owner will face and whilst there is an increasingly vast array of options available, figuring out how to access these funds can be a very time consuming frustrating experience, even for the most seasoned business owner.



Executive summary

Whether you need working capital to support your growth, raise funds for a push into a new market, introduce a new product range or even have a requirement to raise funds for a new business venture, figuring out what you need to do and where to go can be difficult.

With the advantage of “doing this for a living” this report summarises the process and points you in the right direction in terms of funding providers and where to go to get the independent specialist advice you are likely to need.

Highlights

- Which type of funding will suit your needs?
- Sources of funding (including advantages and disadvantages of each one).
- Where to get independent specialist advice on your funding options and presenting your case for the best chance of success.



Introduction

Whether you need £1,000 or £10 million there are only two kinds of finance. Equity, whereby you are raising money to be traded for ownership of the company, and Debt which is borrowed money. The first step to raising finance is to decide between Equity or Debt. In the SME world, the choice usually depends on the preference of the business owner.

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If you want to maintain total control then you are typically going to prefer a Debt driven funding route, however if you are less worried about control, bringing in equity funds can often mean you grow faster. This can be a good route, particularly where you have a very clear exit in mind and that this exit lines up with other equity providers.

In most SMEs the entrepreneur or business owner is the person who looks for funding the business needs. When raising debt finance, our experience is that banks are still the most frequent form of funding used, but increasingly owners are hearing about and starting to use new forms of finance outside of traditional banks. This so called alternative funding market is growing rapidly, and has more than doubled in size year on year from £267 million in 2012 to £666 million in 2013 to £1.74 billion in 2014, according to the 'UK Alternative Finance Industry Report'.¹

Equity financing can come from individuals, so called angel investors and traditional venture capital firms. Depending on your ambitions, there is also the option to combine both Debt and Equity in a funding mix to provide the capital base for long term growth and the cash to support working capital requirements in the business.

Whilst there has been much advice for those businesses seeking to raise funds for Start-Ups, this report focuses particularly on the challenges facing mid sized companies who are past start up and need funds to continue to grow (those with annual revenues between £2M and £50M, or employing staff between 10 and 250 employees).



¹ 'Understanding Alternative Finance: The UK Alternative Industry Report 2014', Baeck, Peter; Collins, Liam; Zhang, Bryan, Nesta & The University of Cambridge, November 2014

Sources of funding for mid-sized business

Bank overdraft

For many businesses the bank overdraft remains the traditional form of funding, with relationships formed over many years. In more recent times banks have shyed increasingly away from overdrafts, steering their clients to other forms of debt which have better security for the bank.

Whilst overdrafts can be quick to set up the biggest drawback is that they can be called in by the bank on demand. So when things aren't going well and you need the facility, that's just the time when the bank might call in the overdraft, particularly if you haven't built a strong relationship with the bank, so they understand what's going on in your business.

If you are seeking to raise funds for working capital or business growth these days the bank overdraft is one of the less likely options to be successful.

Loans

A bank loan is normally for a set term, and you borrow a specific amount of money with repayments over a fixed period of time. Typically 2 – 5 years. As long as you payback the money per the terms of the loan, the advantage is that the bank can't call back the money on demand, although typically the business and usually the owner will need to offer strong security for the loan, usually secured on the assets of the business and indeed the owners personal assets, by way of a personal guarantee. As with overdrafts the irony is that the more profitable and cash generative your business is, the less likely the banks requirements for security.

The principle is straightforward: if your business has performed well over the years and the bank has

confidence that performance will be continued, then the easier it is to borrow money against security, or in some cases simply the cashflows of the business.

Invoice Discounting

Invoice Discounting has grown in popularity in recent years as the banks have moved away from the traditional Bank overdrafts. Banks and other specialist Invoice Discounting firms lend money which is secured by your debtor book, so if the company fails the bank or specialist firm has more security than in the case of a normal overdraft.

With invoice discounting, you effectively sell your outstanding business invoices to a third party. You get the cash flow benefit by receiving a percentage of the money immediately (usually around 80%) and the rest when the money is collected. Invoice financing can be really beneficial for growing businesses and can help you to bridge the gap between the delivery of goods or services and the payment from your customer.

+ Advantages

- Invoice discounting gives you improved liquidity.
- It's easier to obtain than overdrafts, loans and lines of credit.
- It's more flexible than other types of financing.
- You can obtain it quite quickly (sometimes in weeks).
- There are usually fewer covenants than conventional lines of credit.
- It can help you to establish and improve your track record with a lender.
- The costs are lower compared with some other alternative funding solutions.

— Disadvantages

- > The frequency of reporting to lenders can become burdensome.
- > Can be costly compared to overdrafts.

Asset Financing

A normal and important form of financing in the overall mix of funding a company uses. Used for funding fixed assets such as Plant and Machinery, Equipment, Computers and Vehicles. All the main banks have their Asset Financing arms and there are also many specialist companies in this space. Hire Purchase or Leasing (including contract hire) are the main forms of Asset Finance. The bank or finance company takes security of the asset as their protection. This form of financing has the benefit that it is pretty easy to organise, assuming the assets you are buying are standard, although the finance company will still need to be happy to extend a line of credit to you, as although the asset is secured, no finance company really wants to recover these assets if the company defaults on payments.

Alternative Financing

Alternative finance is a general term to describe a variety of financing models that sit next to traditional banking systems and 'whole turnover' factoring and invoice discounting products.

The alternative finance market includes a wide variety of new financing models including peer to peer lending, crowdfunding and specialist finance providers offering products such as selective invoice finance and invoice trading platforms.

Specialist providers have greater flexibility than the traditional sources and can often offer a faster turnaround on the right deals. Crowdfunding, peer to peer lending and invoice trading platforms greatly depend on online platforms bringing many investors and borrowers together.

The section below looks at the main options for the different and emerging Alternative Financing options:

Selective Invoice Financing

Unlike "whole turnover" invoice financing or invoice discounting, selective invoice finance allows businesses to choose which invoices or debtors should be put forward for funding. The business owner can choose when and how much they wish to draw from the selected invoices. The provider agrees an ongoing facility for the business – similar to an overdraft. On presentation of a valid invoice money can be accessed from the facility as soon as the validity of the invoice has been confirmed. For each invoice, an agreed percentage of the value becomes available to draw – typically 70% to 85%.



The FD Centre helped me raise the funds to fully purchase the business from my brother and father. It all happened really quickly and everyone was delighted. That all happened eleven years ago and the business has gone from strength to strength. Colin (our FD Centre FD) continues to help the business grow and develop.

ADAM STARKEY, CEO – GREEN GOURMET



Main types of funding to support your business needs



Selective invoice finance is a great option if you're looking for flexibility as the business is not tied to any contract and can dip in and out of the facility as needed. Business owners have direct control over costs and the opportunity to repay early if additional funds become available from elsewhere.

Additional security is often required to support the facility. This could include a charge over business assets (debenture) and a personal guarantee from the directors or owners.

Invoice Trading Platforms

Invoice trading is a short-term finance option where the borrower signs up to an online platform and submits an invoice for sale.

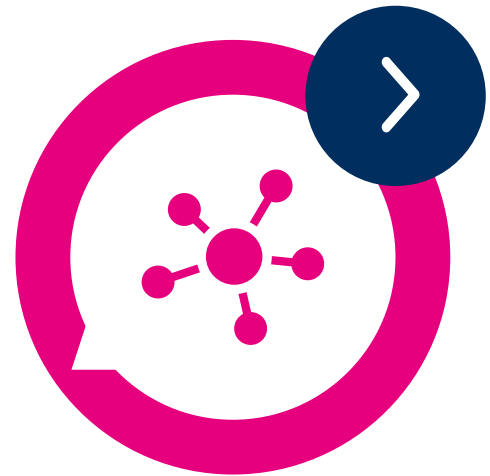
The invoice trading platform will pre-vet the invoice, looking to ensure the debtor is creditworthy. If satisfied with the quality of the debt, full details of the invoice will be posted on the platform and a bidding process begins.

Potential lenders start a reverse auction so the keener they are the lower the interest rate for the borrower. If there is insufficient appeal the trade will fail. It is exclusively web based due to the administration efficiencies involved.

When the invoice becomes due the debtor pays directly to the platform but the business remains responsible for making sure the invoice is paid.

On repayment the platform deducts its own charges and repays the capital and interest to the individual lenders. A shortfall in the repayment will mean the business will be asked to make up the difference.

Some trading platforms have now started to take additional security in the form of a charge on the business and a personal guarantee from the directors and/or shareholders.



Peer To Peer Lending

Peer to peer (P2P) lending enables numerous small investors to loan money directly to a business and could be a good solution for longer term funding. The length of the loan is agreed by all parties upfront and as per a normal commercial loan the business will have to pay interest, typically quarterly. In order to attract lenders the proposition needs to demonstrate a strong likelihood of both the interest and capital being repaid on agreed terms.

Failure to meet the repayments may result in penalties such as a demand for immediate repayment or an increased rate of interest if the loan remains in default. The platform provider acts as middleman between lender and borrower and will ultimately enforce whatever security has been taken on behalf of the individual lenders.

Provided a loan has been properly serviced and there is adequate security available, it is often possible to return to the P2P lender for a second or later round of borrowing but each new loan has to be separately posted to the platform and must justify why the new lending is required.

Security will need to be offered, normally in the form of a charge over company assets (a debenture) and a personal guarantee. Investor money is at risk if the loan is defaulted.

Crowdfunding

Crowdfunding involves a business plan being posted to a specialist website where sufficient small investors offer funding to generate the target amount required by the business.

Crowdfunding is a good option for businesses not wanting ongoing interest costs. However, on completion investors will own shares and have certain rights in the business. For example they may require input such as annual accounts and will need to be kept informed of how revenue is progressing. No personal security is needed from the current owners.

There are two main types of crowd funding and the expectations of investors vary according to which they are looking at: **Special Interest Funding:** Often used in the entertainment industry, for instance to pay a musician to produce a new album or to cover the production costs of a new show. In this case, the investor doesn't necessarily expect a commercial return on the investment but will have some special rights, such as pre-release copies of a CD or discounted tickets to see a show.

Equity Funding: Akin to angel funding where the investor expects an annual return in the form of a dividend and may look for a sale of the business in order to realise their profit on the investment. Investor money is at risk if the business collapses.

Angel Investment

An equity rather than a debt route to accessing finance. Funds are advanced by extremely high net worth individuals sometimes bringing useful experience as well as cash. Angels will typically expect rapid growth followed by an exit event (such as a sale), enabling them to make a return on their investment.

A photograph of a middle-aged man with short, light-colored hair, smiling broadly. He is wearing a dark blue V-neck sweater over a white collared shirt. The background is a soft-focus outdoor setting with greenery. The man's sweater has a small logo on the left chest that says "SANT" with a shield emblem below it.

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It really adds value to have a part-time Finance Director as part of your team from the standpoint of external partners such as banks or potential investors.

Pension Fund Lending

A loan made into the business from the owners' pension funds. The loan is repaid with interest typically over five years. It's worth noting that the loan cannot exceed 50 per cent of the pension fund's value and the interest rate has to be at least 1% above the base rate. The key risk is that if the business fails then it's the owners' pension pot that is at stake.

The Challenger Banks

Akin to the traditional banks but newer entrants into the market. Challenger banks try to be more flexible and faster than their more traditional counterparts and so may be less likely to turn down funding requests.

Trade Finance

Money is advanced to enable goods to be purchased (typically from abroad) before they are sold. The lenders security is the goods purchased so these must either be easily saleable or in response to a confirmed order. Generally available to established businesses with good credit. Minimum transaction values and margin on the contract will apply.

Supply Chain Finance

The funder takes control of the supply chain, generally making payments direct to the supplier. Security is taken over goods purchased. There is usually a high degree of involvement and control over the borrower's business and other security is invariably required.

Private Equity Firms

Private equity firms provide medium to long-term finance in return for an equity stake in unquoted companies with high-growth potential.

The investors' return is dependent on the growth and profitability of the business. As a result, most private equity investors will seek to work with you as a partner to grow the business. It is most suitable for firms looking for longer term capital to fund their expansion activities.

+ Advantages

- > Private equity investors usually boost the profitability of the business through operational improvements.²
- > They look to boost revenue by investment in new services or product lines or expansion into new territories.
- > They will provide access to established marketing or distribution channels.

- Disadvantages

- > Typically private equity investors manage their investments for between five and seven years. After that, they will look to sell their shares in the company.

IPO (Public Offering for Shares)

This is where your business is publically listed and shares can be bought and traded by the public. Typically this is only used for larger businesses. The main public equity market in the UK and Europe for growing businesses is the Alternative Investment Market (AIM) which is operated by the London Stock Exchange.

+ Advantages

- > You can offer a further issue or placing if you need more equity capital in the future.
- > You can raise money to fund growth opportunities; finance acquisitions; rebalance the balance sheet; and expand the company's shareholder base.

- Disadvantages

- > Preparation to list is time-consuming and expensive.
- > The company's actions will come under greater scrutiny from shareholders, customers, regulatory bodies and the media once it is listed.
- > Financial statements must be produced and corporate governance codes adopted.

²The Business Finance Guide: A Journey from Start-Up to Growth', Mullen, Mark, Petrie, David, ICAEW Corporate Finance Faculty & the British Business Bank, 2014

Conclusion

Funding is often the catalyst for taking your business to the next level.

It's your choice whether you want to take on an Equity partner or raise Debt to finance the growth of your business. When raising equity, if the right partner can be found, it can make a profound difference to your business. It may be that the investor provides not only funding but also adds significant value to your business in terms of experience, expertise, infrastructure, and channels to market. However, it does mean you will lose partial or complete control in running your business. Something that for many is not appropriate.

Raising Debt can be complex and frustrating, and the increasing array of alternative funding doesn't make that process any easier, but it does mean you keep control as your business grows. However, if you're like most business owners, you simply want the funds and are less interested in the detail of how to get hold of them!

That's fine if your company has a full-time Finance Director (FD) with substantial experience of raising funds, however, as an SME, you probably don't have a full-time FD, or if you have they probably don't have a vast range of fund raising experience, whether it be raising Debt or Equity. So what can you do?

You can hire a very experienced part-time FD to manage the entire process for you. He or she

will manage everything from determining your immediate and long-term objectives to finding the right kind of funding partner for the business.

Discover the funding options now

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