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BRIEFING NOTE

FINANCING A BUSINESS
CHOOSING THE RIGHT OPTION

Background

A small number of businesses are in the fortunate position of operating in a cash surplus with money in the bank. For the majority, however, life is very different with a constant balancing act to juggle debtors and creditors and to keep the business within its agreed banking limits. Some businesses find themselves fully extended at the bank with creditors clamouring and nowhere to turn.

Companies either generate cash or they haemorrhage cash and any company which haemorrhages cash long enough must ultimately go out of business. Profitable businesses should generate cash from their operations but sooner or later most businesses find that they need to generate cash from external sources either to finance working capital or the development of the business.

The wide range of different options available makes it difficult and confusing for the business owner to decide which option is best for his business and the purpose of this note is to look at the different options which are available from the perspective of the business owner.

Internal Finance

There are always costs or conditions attaching to any form of external finance and, before looking at external sources of finance, it is prudent to look at the various ways in which it might be possible to raise cash within the business. The ways in which this may be done may be obvious to an outsider but are often not considered in sufficient detail by those running the business as they are often too close to the running of the business to make an objective assessment of what might be possible. Some of the measures which might be possible are:-

- Better control of debtors. For example, if the company has outstanding debtors of £300,000, it would generate £100,000 cash by cutting its debtor days from 90 days to 60 days;
- Negotiating better payment terms with suppliers;
- Carrying out a detailed review of all costs and reducing costs wherever possible. Every business is able to trim some “fat”;
- Reviewing all outstanding standing orders and direct debit mandates at the bank;
- Disposing of surplus assets;
- Turning obsolete stock into cash;
- Increasing prices;
- Improving margins by improving quality control;
- Increasing sales volumes.

Many people regard these basic measures as part and parcel of good business practice but it is surprising how many look for financial support from external sources without having addressed any of these issues in any significant detail.

It is essential that these issues should be properly addressed before looking for external support for two reasons. Firstly, the company will be a much more viable “target” for external financing if the directors can show that they have taken all reasonable steps to get their house in order and secondly, they will be able to obtain external finance much more quickly and on much better terms if they can demonstrate that the business is well managed and run in a professional way.

Having taken all reasonable steps to generate cash from internal sources, the directors may then look at the various external financing options.

Grant Assistance

Everyone is attracted to the idea of "free" money. However, obtaining grant assistance can be a costly, time consuming and frustrating process as many of those who have tried will testify. In order to check on the availability of grant assistance in your area, you should speak to your local contact at Scottish Enterprise, who should be able to make you aware of the full range of grants available.

Factoring/Invoice Discounting

Many fast growing companies need additional working capital to finance increased levels of business and young companies in particular may find it difficult to persuade the bank to extend the level of credit which they require on overdraft. For such companies, the answer may be debt factoring or invoice discounting.
The principle of debt factoring is very simple and works along the following lines:-

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

Factoring may either be "with recourse", which means that the factor has recourse to the company in respect of bad debts or "without recourse", which means that the factor effectively provides bad debt insurance although there is a cost associated with this.

Factoring used to be regarded as "lending of last resort" and a sign of a company in trouble and it normally costs more than an overdraft. Some companies are also reluctant to pass control of their sales ledger to a third party. However, a factor will normally advance a much higher percentage of debtors than a bank and the enormous growth in 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.

Invoice discounting is similar to factoring but, in this case, 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, therefore, has less security and this option is therefore usually only available to larger, more mature companies.

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, title passes to the company after the final payment is made. In the case of a leasing contract, however, title does not pass to the company and 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 advantages of this type of finance are that it offers fixed monthly or quarterly costs, usually spread over the useful working life of the asset. Under no circumstances, however, should the finance period exceed the anticipated working life of the asset.

The supplier of the goods frequently also supplies the finance under a hire purchase or leasing agreement. However, it should be noted that the contract with the finance company is a different contract from the contract for the supply of the goods and, even if the goods are defective the liability to make regular repayments to the finance company will continue. Wherever possible, this issue should be raised with the supplier of the goods to try and avoid the situation arising where the company has an ongoing liability for payment notwithstanding a defect in the goods.

Bank

For the majority of private companies, the major form of external finance is still provided by way of a bank overdraft, usually secured by way of a Bond and Floating Charge over the company's assets, frequently supported by a personal guarantee from the directors and a second charge over their houses. The overdraft has been a popular form of finance over the years, both because of its flexibility, ease and speed of creation and relatively modest cost.

However, an essential feature of all overdrafts is that the bank may demand repayment of the full amount at any time and 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 increasingly both the banks and borrowers are looking at 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;
- Long-term loan - over 10 years, suitable for the purchase of assets with a long-term working life, typically land and buildings.

The banks are willing to adopt 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 only is payable for the duration of the loan with a "bullet" repayment at the end of the loan;
- Moratorium - sometimes the bank 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 or other 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.
- Security normally takes the form of a Bond and Floating Charge over all the assets of the company and a Standard Security over any heritable property. The bank may also ask for a personal guarantee and a second charge over the directors' houses. However, nobody

should offer any personal security for the debts of their business without seeking detailed advice as to the consequences and directors who are married should invite their wives to take independent advice if the family home is involved.

Small Firms Loan Guarantee Scheme

Lack of security can be a problem, particularly for smaller companies, and the Small Firm's Loan Guarantee Scheme has therefore been designed to overcome this problem in the case of businesses which are believed to be viable but do not have sufficient security available to meet normal banking criteria. In such cases a SFLGS loan by the bank will be partly guaranteed by the Department of Trade and Industry under the Small Firm's Loan Guarantee Scheme. There are a number of detailed rules and regulations regarding the types of company which qualify for this type of assistance and you have to apply via the banks in the normal way rather than via the DTI.

Risk Finance

The bank may take the view that they are not providers of risk capital where, for example, the company has only a very small net asset position in relation to its present and proposed borrowings or where the additional funding is required for some form of product development which does not yet have guaranteed sales. Many small companies believe that the banks exist to give them money and often find it hard to accept the bank's reluctance to lend. However, if the banks lend money, they are putting their shareholders' and their depositors' funds at risk and their job is not only to lend money, it is also to ensure that they get it back.

The banks operate in a competitive market place with many banks chasing after good quality lending propositions. If they decline a project they usually have good reason for doing so and if a lending proposition is declined by a bank, it should be reassessed to determine whether there is something wrong with the proposition rather than something wrong with the bank. The banks are not in business to provide 100% finance and they will invariably insist that the company should have an adequate capital base before they put their money at risk.

Additional Equity

This means that the directors must consider whether they are willing to put more of their own money at risk to subscribe for additional share capital in the business, or whether they would be willing or indeed prefer to bring in outside shareholders. For many companies, this opens up a whole series of concerns and considerations, all of which must be addressed to determine whether it is appropriate for the company to seek additional finance from external shareholders. The type of issues which usually arise are:-

- **Why should I give up part of my equity?**

  This is one of the most frequently asked questions. However, the effect of bringing in additional share capital is to increase the equity base of the company, it does not decrease it. With an increased equity base, the company will in turn be able to borrow more money from the bank.

  What does happen is that the percentage of the equity held by the founder shareholders will decrease. However, the value of the founders' shareholdings will not decrease and may in fact increase, if the investment is made at a premium to the net asset value of the company. This is frequently the case with high tech companies which have a substantial "hidden" value in intellectual property rights which is not fully reflected on their balance sheet.

- **When will the investors want their money back?**

  Once the money goes into the company it becomes the company's money and not the investor's money and they are therefore not entitled to get it back unless some of their investment is made in redeemable shares. However, the investors will expect a return on their investment and this will come in the form of dividends and capital growth which will hopefully be achieved when the company is ultimately sold or the investor's shares are subsequently bought back by the founders of the company or by the company itself. It should be noted that even if shares are redeemable, they can only be redeemed out of the company's profits and if the company does not make profits the shares cannot be redeemed. This is in complete contrast to bank debt. The money always remains the bank's and they are entitled to repayment at any time, subject to the terms of their loan;

- **Will the investors be able to control my company?**

  The bank has a very strong hold over the company by virtue of its security. If the company is in default the bank has the ability to put the company into receivership, in which event the founders of the company will lose everything. However, while the investors may seek to influence the company, they are in reality in a much weaker position.

- **How do the investors influence the company?**

  Normally the investors will enter into an investment agreement with the company which provides that the company must agree annual budgets, convene regular board meetings and generally run the business in a proper and professional manner. This agreement will normally give the investors the right to appoint a nominee to the Board of Directors.

- **What about the investors' director?**

  Once a director is appointed to the company, his duty lies to the company rather than to the shareholder or group of shareholders who appointed him. It is very important to the success of an investor relationship that an appropriate director is chosen who is able to make a meaningful contribution to the affairs of the company. A well chosen external director will cover his costs many times over and will bring to the company:-

  A. the discipline of convening monthly board meetings and monitoring the company's actual progress against its forecasts;
  B. a wealth of experience and contacts;
  C. a calming influence over boardroom disagreements;
  D. the principal point of contact with lenders and outside shareholders; and
  E. a degree of credibility which the company might not otherwise have.

  Many companies resist the idea of any external influence over the management of their affairs. However, there is no shortage of evidence to demonstrate that a well chosen non-executive director can contribute an enormous amount to the success of a company.

- **Why do I need to bother with all this? My business provides me with a very comfortable lifestyle anyway?**

  There is no shortage of research material to demonstrate that there is a huge difference between a "lifestyle" business and a "growth" company. A typical lifestyle business is one where the proprietors take all of the profits out of the business to finance their lifestyle, they reinvest nothing in the business, they do not like to be challenged as they feel that any challenge represents a threat to their lifestyle and ultimately such businesses become moribund through the lack of new ideas and sooner or later are likely to fail.

  The owners of such companies generally feel very uncomfortable with the idea of outside shareholders and any external influence over the running of their business as it will threaten their comfortable lifestyle. Such companies do not make good investment "targets" as they offer very little opportunity for a return to investors.

  "Growth" companies, on the other

hand, are those whose owners have a clear vision of the future, they are determined to grow a successful business and their vision becomes an absorbing way of life as distinct from a job to finance a lifestyle.

The owners of such companies generally recognise that they will achieve their goals more quickly if they bring in outside share capital and they tend to be less concerned about owning all of their business than growth in shareholder value, which is the ultimate barometer of their own personal wealth.

Such individuals will see the value not only of the cash investment but of the contribution which experienced non-executive directors and external investors can make to the business. The owners of such companies will find the time to plan the future of their businesses, to write proper business plans and to consider all available forms of finance to ensure that they get the correct mix.

- **Is Venture Capital Appropriate?**

The established venture capital houses are normally the preferred source of external finance for investments of about £0.5m to £1.0m and above for established companies or management buy-outs/ins. However, venture capitalists generally do not find it economic to get involved in investments much below this level and in start-up companies because of the more intensive commitment of management time in undertaking due diligence and thereafter in monitoring the investment.

Start-up and early stage companies and those looking for smaller amounts of investment, therefore, usually find that it is more appropriate to seek backing from an informal investor or “business angel”.

- **What is Informal Investment**

Informal investors come in many guises but they all have capital available to invest in small private companies. Some are “passive” investors, who simply want to invest their cash and leave the management team to get on with it, others are “active” investors, who take a close interest in the companies which they invest in. Some prefer to invest on their own and others through small syndicates. Typically, they will be attracted to the tax relief available under the Enterprise Investment Scheme and reinvestment relief.

- **How do I find a Business Angel?**

A number of firms have contact with small numbers of informal investors in their local areas but LINC (Local Investment Networking Company) is the only nationally recognised body in Scotland with a database of investors throughout the country. They fulfil the role of a matchmaker, bringing together potential investors with those requiring investment. While they will offer help and guidance it remains up to the parties involved to make their own deal.

The business birth-rate enquiry carried out by Scottish Enterprise in 1992 and the commercialisation of the science base which has been carried out in 1996, and various initiatives which have arisen as a result of these major investigations have led to a much increased awareness of the importance of creating an enterprise culture in Scotland, an increase both in the quality and quantity of new businesses and an increase in the demand for appropriate types of investment.

This has been matched by an increase in the number of individuals with surplus capital expressing an interest in becoming involved in investment in private companies and informal investment is likely to play an increasingly important role in financing new and developing companies. This has been recognised by Scottish Enterprise in recent years who have investment funds that provide matched funding along side business angel investments.

Conclusion

There is a bewildering array of financing options available to the owners of new and developing businesses. It is important that all of the options should be checked out to ensure that you obtain the most appropriate financial package for your business. The implications of the different types of finance should be carefully considered, particularly the far-reaching implications of equity finance and in all cases, you should take appropriate professional advice.

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.

For further details, please contact:

Sandy Finlayson
Stuart Hendry
Mark Michie

Tel: **0845 408 5453**
Fax: **0131 225 9212**
E-Mail: sandy.finlayson@mbmcommercial.co.uk
stuart.hendry@mbmcommercial.co.uk
mark.michie@mbmcommercial.co.uk

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