SHORTS

Could additional finance unlock the potential in your business?

A guide to business funding

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Over the years, we have been involved in the decision-making process for many clients considering obtaining additional finance for their business and have supported a large number through the funding process. We often use our knowledge of the funding market to make appropriate introductions and then assist in preparing and providing information to funders and comparing the offers received.

Drawing on this experience, we have put together a guide to highlight a few of the key types of funders available in today's marketplace and the differing forms of funding they could offer.

1 Risk

Levels of actual or perceived risk play a fundamental part in attracting funding whether this be the risk to the lender, the business seeking the money, the price of a facility or why funding may or may not be available. It is therefore essential that you understand the risks involved and how this impacts on a lenders perception of your business or your perception of a funding proposal.

Personal risk

You need to consider what the risk of any funding is to you personally. Is there any recourse to you should the business fail to meet its obligations to a lender? If you are a sole trader or non-limited partnership, there is no clear distinction between the liabilities of the business and personal liabilities, as such the risk is likely to be the same. If the funding is for a limited company, then your personal risk is limited, unless a personal guarantee is signed which means a funder can claim against you personally for any shortfall from the business.

Business risk (of the proposal)

What is the risk of taking on the additional funding to the business? Can the business afford the repayments when they fall due? What targets (covenants) do you need to meet to keep the funders happy? It is important that company forecasts incorporate proposed funding to ensure that it does not put the company under undue financial pressure.

Business risk (to the funder)

How safe is the business for the funder? Does it have a strong history of profit generation, is it newly established, are the income streams secure, is there any security available etc. A traditional funder will need to get the proposal through a credit team and therefore what are the key risks of the business and how can these be mitigated? The greater the perceived business risk, the greater the cost (in most cases). If a business appears too risky some funders may not have an appetite to lend. (see risk appetite below)

Funders risk appetite

Each funder and type of funder will have a different risk appetite; the perceived risk they are prepared to take before they are no longer willing to invest. It is important to understand what the perceived business risk is of your business first and then assess which lenders would be prepared to invest at this risk level. For example there is likely to be little point approaching high street banks with a highly speculative, risky proposition. However, an equity funder may find the same proposal highly attractive if it comes with the possibility of high reward Understanding which funders operate at the different risk levels is therefore essential.

2 Debt or Equity?

You may have heard of the above terms which represent the two main types of funding. It is important to be clear about the differences between them which are significant.

Debt

Debt is probably the most common form of funding. It relates to an amount of money which is loaned and which, at a certain date, will need repaying (almost certainly with interest).

Repayment terms can vary significantly, but are commonly done via monthly repayments, quarterly repayments etc. There are however, specialist loans, only repayable at the end via a 'bullet' repayment and 'revolving facilities' whereby the capital is not specifically scheduled to be repaid but interest is charged.

Covenants (or financial targets) can be set on a business utilising debt funding to ensure the business maintains its profitability or cash generation, but, assuming that repayments are made on time and there are no covenant breaches there is likely to be little other impact on the business of having a debt funder.

Equity

Equity funding involves an amount of money being provided to a business in exchange for shares. Whilst still common, it is significantly more complex than debt funding. Careful consideration should be given, as you will be bringing someone into the business who will expect an element of influence.

An equity funder is taking a greater risk. There is therefore likely to be a greater level of involvement in the business. Whilst it does vary between differing investors, they would probably like to appoint a member to the board, hold regular board meetings and receive full company information. Some may look to contribute more to the business and offer support and advice. Selecting the right investor therefore is of great importance as a shared vision and strategy should be established from the start. Personal chemistry is also key for a successful relationship with an equity investor.

A shareholders agreement is also a must and this should include relevant clauses to ensure that it is clear at the outset to both parties who has control of key decisions.

3 Funders

Business owners, friends and family

Probably the first port of call for many newly established businesses with personal funds, friends and families being the most common form of finance to get a business off the ground.

Assuming this is an option, it is often quick to obtain, often interest free and can have more lenient repayment terms. Be warned however, relations can sometimes quickly become strained should either expectations or repayment terms not be met. We have, unfortunately, seen many disagreements between previously good friends and/or family due to loans being made without clear terms being agreed.

It is essential to discuss and formalise the terms of any loan at the start to avoid the potential for disputes at a later date.

Venture Capitalists (VCs)

A VC is an investor that has raised funding through a variety of sources (maybe large institutions or High Net Worth individuals) and is responsible for investing the funds to generate a return. They focus on equity investments which are higher risk, earlier stage businesses. These are the businesses which have a large business risk, but have some track record. The business will have high anticipated growth in the coming years, but need support and funding in order to realise this. With the high risk, comes the potential for high reward, which compensates the investor for other investments in the VC's portfolio that fail.

Private Equity (PE)

PE is similar to VC investment but is for more established companies. There is a relatively reduced risk appetite with PE investment due to the more mature nature of the business and therefore the returns expected by a PE house are lower (compared to a VC) They do however still need the business to have clear growth plans and more often than not a clear route for the PE house to be able to sell their equity stake (and hence realise their investment) within a defined period, often not greater than 5 years.

Both VC and PE funders look to support the management team of the business in their growth plans, however some investment agreements may pass significant power to the funders if certain performance is not met in order to balance the risk the equity funder is taking. As a result, the investment agreement and the funder that is selected should be considered very carefully prior to entering into the agreement.

High Street Banks

The term high street banks refers mainly to the most common, well known banks such as HSBC, NatWest, RBS etc. Banks offer debt packages (as opposed to equity) and are large organisations with teams covering businesses which are split dependent on the size (turnover) of the business they are looking to support. Typically smaller companies fall into the business banking, medium into commercial banking and larger companies into corporate banking. These terms are however different at each bank along with the defining turnover levels.

High street banks have policies set by credit teams which state their general lending criteria and in the main are willing to take less of a risk than other funders. They generally prefer established businesses, secured lending which is comfortably serviced and as a result will charge you a lower rate of interest in return. These banks have now generally recovered their lending appetite and as a result, the competition amongst them is increasing. This has resulted in more creative lending proposals and unsecured lending (or cash-flow lending) becoming more freely available, for the most attractive businesses.

High Net Worths (HNWs) and Angel Funders

HNWs and Business Angels are individuals (sometimes they act in a group or consortium) who have cash available to invest in businesses. They quite often have earned this though businesses of their own or from previous investments and will often want to invest in something where they can add value (i.e. be involved in the business). If this is not something you are comfortable with then this type of funding may not work for you. They generally look to invest in earlier stage businesses and expect high returns as a result.

Crowd Funding and Peer to Peer lending

Whilst crowdfunding has been around a long time, it has only recently gained significant traction. The basic concept is that funding portals (websites set up to provide crowdfunding) attract a large number of different lenders all contributing relatively small amounts, these are then pooled into a larger investment.

For example, if an individual invested £1,000 into Crowdcube (a popular crowdfunding portal) this £1,000 may be spread over 4 investments of £250 and so on. However, Crowdcube's funding to each company may be £100,000 each. Each portal operates differently, however the premise is that the investors funds are spread or diversified over a larger portfolio meaning the lender's risk is reduced (to a degree).

Crowdfunding can raise both debt and equity. Crowdfunding portals often have a greater risk appetite than banks, or individual asset based lenders.

Grants

The grants landscape is constantly evolving and difficult to navigate for a non-expert. They are generally limited to capital expenditure and / or job creation although all schemes vary. Grants can be provided in specific areas or sectors so if you don't hit all the criteria, you don't qualify. You must also demonstrate that the project cannot progress without the grant and, generally, you must not pre-commit to expenditure. It is usually therefore worth seeking advice from a grant professional.

Challenger Banks

A challenger bank relates to a smaller bank that is not one of the (maybe 7) high street banks. Examples of which would be Metro Bank or Shawbrook Bank. These are generally less well established in the UK market and are looking to offer slightly different funding solutions to the traditional High Street Banks.

Asset Based Lenders (ABLs)

There are a large number of ABLs in the market and these are debt funders who look to lend money against specific assets. Depending on the ABL the assets can be anything from debtors (monies due from customers), plant and equipment, stock, property etc. The banks mentioned earlier will also offer ABL products and asset based lenders are likely to be more expensive than a bank, however they compete in different ways, for example, funding greater levels against the asset, quicker response times, more complex assets or business propositions with a higher risk profile.

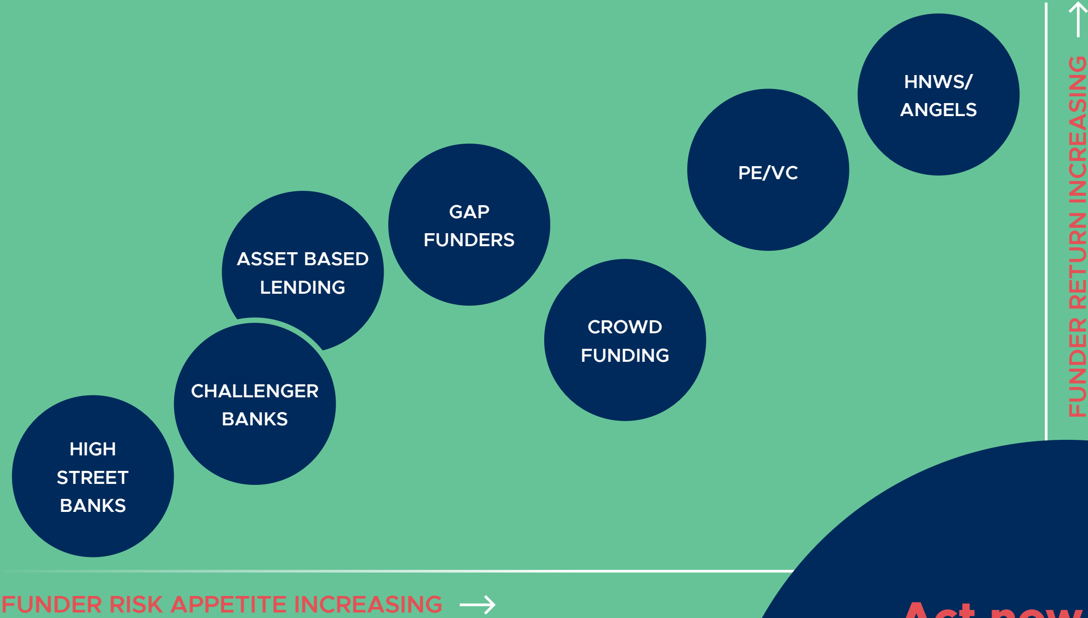
Gap Funders

Gap Funders are there to support a "gap" in the market. This could be where a bank can only fund 80% of the total requirement and there is no security or appetite from another funder to fund the rest. Gap funders can offer both debt and equity funding and depending on who it is can have certain geographical or performance restrictions on what business they lend too. UK Steel Enterprises is an example of a gap funder in this region along with the Northern Powerhouse Investment Fund (NPIF) which is supported by the British Business Bank. Gap funding by it's nature is likely to be unsecured (all the security will have been taken by the main lender) and as such is likely to be more expensive than a traditional debt funder.

Putting it all together

The graph below is designed to illustrate where key funders mentioned above fit in terms a risk and reward to try and illustrate how the price is likely to increase based on the type of funder.

There are of course exceptions to all rules, however if you look at your business and your funding requirement to determine the perceived risk, hopefully this guide will help you to determine which type of funder may be appropriate and therefore the expected return they would seek. With any type of funding requirement we would advise that you get a professional advisor to discuss and consider this with you. Shorts have worked with a vast number of businesses and funders and can help shape your proposal, focus your requirement and approach the right funders, to give you the best chance of succeeding in attracting the investment you need to take your business to the next level.



Act now
– we can help

Our team are on hand if you would like a free, confidential, no commitment discussion. Please click here to contact us.

LEARN MORE

Experience

Shorts in numbers

10

The number of nominations our team have received for local business awards in the past three years

£135m

The total value of transactions that our team have advised on

100%

Our team of professionals spends 100% of their time advising clients on Corporate Finance transactions

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