Top tips - how to secure business funding

Introduction

Finding credit in the current economic climate is hard, especially for small businesses. In many cases banks are withdrawing established credit lines and, as a result, businesses are short on working capital and the finance required for continued growth. In recent years, the availability of cheap debt finance has been attractive, but is now set to become an expensive burden to companies.

The net result is that the future success of many businesses hangs in the balance. However, while established businesses and those in the early stages of development are finding it particularly difficult, there are sources of funding available and this Guide will help steer a safe path through this tangled maze.

The Funding Challenge

The rules of funding have changed radically since the credit crunch erupted on the global economic scene. The old paradigm that ruled the roost during the boom years could be summed up with the two words: 'debt financed'. This was typified by private equity firms which got carried away and concentrated upon leveraging with debt at the expense of hands-on management and operating performance. For larger companies, debt was perceived as the way to maximise returns to a small group of investors, while smaller and early stage companies preferred it as a way to keep the lion's share of their business to themselves and ensure that they remained in control.

Those days are behind us, at least for the time-being. This is because traditional debt funding usually requires security. However, the ability to secure debt against equity in the housing market has fallen drastically, leaving businesses with the challenge of seeking alternative ways to gain cash in a turbulent landscape.

However, as all businesses need to be adequately funded, a company cannot trade if it is insolvent without the directors risking becoming responsible for debts, the need to be able to secure lines of funding remains. This is especially critical given that the main reason for failure for businesses is not lack of profits but poor cash flow as a result of working capital shortfalls.

The Options

There are several funding options available depending on the stage a business is at in its evolution:

1. Friends & family: The first £100,000 of funding for a business is usually regarded as the friends and family round and demonstrates the commitment of the entrepreneur.

Pros: you retain control.
Cons: provides insufficient funding to take the business beyond initial start-up.

2. Bank debt: While bank debt will be available within certain restrictions, it is unlikely to be a cheap alternative for many years to come, despite base rate cuts. This is due to banks needing to increase their lending margins and, as a result, the pendulum is likely to swing towards them requiring greater levels of security as they become less risk adverse. Some borrowers have seen their interest rates increase from a bank rate of +2% to as much as +7%, despite no apparent increase in risk.

Pros: you retain control; perceived to be less complicated to obtain.
Cons: banks have recently made this form of funding much more expensive; you may have to provide security over the company's or your own personal assets.

3. Debt factoring and invoice discounting: These are methods of securing funds against an invoice as soon as it is raised rather than waiting the long period until the customer pays. Using this facility can dramatically improve a business's cash flow by releasing money as early as possible in the process, after the order has been completed. Invoice finance is linked to sales and, as such, can be ideal for funding growth by providing immediate working capital.

Pros: improves cash flow.
Cons: tends to be expensive and requires relatively stable sales invoicing to Customers.

4. Trade finance: This is the provision of finance to enable goods to be purchased to satisfy a specific order and is provided by the financier to bridge the funding gap between purchase and sale.

Pros: can fund 80% to 100% of the cost of goods plus duty and VAT funding gap between purchase and sale.
Cons: has become harder to obtain since advent of credit crunch.

5. Venture capital: Many entrepreneurs have been put off from other forms of funding, such as venture capital, as they took the view that shareholders in their business would be more demanding than banks and that sharing control was to be avoided. A few venture capital houses earned the reputation for demanding quick returns, combined with sometimes unrealistic performance requirements and followed by an exit within three years.

However, if seeking funds in excess of £5 million, the venture capital houses are a serious and valuable option. In balance to those entrepreneurs who avoid sharing control at all costs, many view sharing or even losing control as an inevitability of expanding their business, owning a smaller slice of a very large pie is better than owning the whole of a very small pie.

Pros: large sums of money available.
Cons: loss of control; potentially aggressive repayment timelines; sale of companies often takes place at most advantageous moment for the venture capitalist which may or may not be the most advantageous moment for the entrepreneur; usually only for funding in excess of £3-5 million.

6. The Enterprise Finance Guarantee scheme: A further funding option emerged in January 2009, when the UK Government launched the Enterprise Finance Guarantee (EFG) scheme to help small businesses struggling with finances. Under the scheme, the government aims to provide viable businesses – which lack collateral and, in some cases, the track record, with the working capital and investment that they need.

The EFG provides loans up to £1 million for businesses with a turnover of up to £25 million, which can also be used to convert existing overdrafts. The launch of the EFG means that viable businesses which can no longer secure bank lending as a result of the financial crisis can gain access to additional funds. However, like its predecessor the Small Firms Loan Guarantee, these secured loans can be difficult to get, with only a few banking business managers being aware of the terms or availability.

As with any bank loan, EFG loans are only granted to commercially viable businesses. However, since the government only secures 75% of the loan and banks take the full risk on balance, the commerciality of extending an EFG loan tends to be under tighter scrutiny. For the banks, this becomes a less attractive option as typically they would look for full security in the current climate.

When a company is unable to offer security, as is required with the other funding options, the EFG is often one of the few options up to the £3 million mark. Beyond that is the realm of the venture capitalists.

Pros: provides credit for businesses where security is otherwise unavailable.
Cons: very hard to obtain as banks have to take risk on 25% unsecured element.

7. Angel investment: Backing from an individual investor, commonly referred to as angel investment, is where an individual provides capital in return for a stake in the company. There are at least four types of businesses that are well-suited for this category:

- Start-ups/early stage companies who having developed their prototype or Intellectual Property Rights need funding to take the product to market or finalise development.
- Established businesses that need investment for additional working capital to fund growth or to launch a new product line in order to expand.
- Companies that require bridging finance, often because they have had to defer an Initial Public Offering, such as on AIM or PLUS Markets, due to the present economic climate.
- Companies that need funding to replace credit lines withdrawn by banks as a result of the economic climate.

Pros: fills the funding gap between £100,000 and £3m; brings in valuable expertise. Angels' aims tend to be closely aligned to those of the entrepreneur, particularly when compared to any other source of funding.
Cons: perceived loss of control and equity.

<u>Summary</u>

The simple fact is that traditional funding lines from banks, trade finance and even the Government, despite its claims to the contrary, are extremely hard to come by and increasingly expensive for the business. When looking at the alternative investment options, many businesses simply do not require the sums of investment that are attractive to venture capitalists and few businesspeople have the sort of friends and family members who are able to collectively lend above the £100,000 mark. For the time being at least, this leaves angel investment as the optimum financing route for the vast majority of UK small businesses. This Guide will explain how to secure that funding.

<u>Business Angel Investment</u>

Unlike many other forms of investment, angel investment extends beyond financial commitment to include hands-on involvement from the investor in a start-up or early stage business. The vast majority of angel investors have previously founded and owned a small business so are well-positioned to add considerable value. In addition, 40% of them consider the investment of their general management expertise and experience equally as important as their money.

However, investors usually stop short of becoming involved as part of a management team or Board. Instead, investors take a structured approach to spending time with the investee, often meeting on a regular basis rather than confining their involvement to crisis situations. While the investor is clearly motivated by financial considerations, other factors feature highly. Approximately 70% invest in an industry where they have not necessarily had previous experience, indicating that they often enjoy their involvement in ventures away from full-time work pressures.

Furthermore, external parties regard this type of investment in one or more rounds of funding very positively. When dealing with this type of investment, sometimes the returns for investors may seem too high. However, unfortunately many companies do not survive, which means investors sometimes lose their money. Therefore, they have to make high returns on winning investments to cover the losses on those that fail, which is often as high as 60% compared with 10-20% that achieve success.

Individual business investors tend to invest on a longer-term timescale than venture capitalists. For the large part, they invest as share capital which, unlike bank debt, cannot be withdrawn at short notice. Perhaps more importantly, they can often help businesses build by accessing their wide experience, contacts and know-how. In seeking such alternatives to bank debt and venture capital, small businesses must put in place certain measures to ensure success.

Ten steps to successfully obtain funding

Whatever bracket of investment the business falls into, there are certain criteria that an investor or lender will consider in order to establish the viability of making an investment or loan. To assist with this process, here are ten steps to successfully securing funding:

1) Decide level of funding required

The level of funding required is largely dictated by what stage of evolution the business is at. Established companies with revenues, profits and an order book, and that are seeking working capital or replacement of bank debt will typically fall in the £350,000 to £1.5 million bracket. Broadly speaking, start-ups or early stage businesses seeking funding for final product development/take product to market will tend to require £150,000 to £450,000. In both cases, the amount must be sufficient to fund the delivery of the planned stage or end result.

When considering the amount of funding required, businesses must take the long term view. It is important that the level of funding is sufficient to see the business through all of the identified stage of development. Otherwise they risk not achieving the desired goal and having to halt progress part way due to cash running out.

Top tips:

- Take the long term view.
- Identify your end goal and ensure the funding is sufficient to get you there.

2) Put in place a strong management team

Few early stage businesses have complete management teams and very few can claim to hold all the skills required to maximise the potential of a business. These skills include general management, finance, marketing, sales, production and licensing, to name a few. Entrepreneurs who can recognise their weaknesses as well as their strengths and plan accordingly are well placed to raise investment. Many of the complementary skills required are available on a freelance or part-time basis, sometimes on a sweat equity basis and can on occasion be provided by an investor. Sweat equity is where someone invests time and skills in exchange for a shareholding stake in a company instead of cash.

There are different general management skills required to run a small business compared to those for required for larger firms. It may even be that the founder is not best placed to lead the company through all the stages of its growth and will at some point need to step aside.

Top tips:

- Consider what skills you and your existing team have and what needs to be brought in.
- Be broadminded about your relationships with employees, putting someone on the payroll is not the only option.

3) Create a business plan identifying the strategy

A solid business plan that identifies the strategy is crucial. The plan must contain a commercial idea which will provide an eventual profit for investors or, as a minimum, sufficient profit to repay the interest and the principal on a loan. However, not all plans need to be unique as many 'me-too' but better businesses are established to take advantage of a niche or to stake a claim for a share of an existing market.

The business plan must set out the key factors that determine success or otherwise of the business. In addition, the entrepreneur should be prepared to monitor these factors and not be afraid to set out the risks. If an entrepreneur does not recognize the risks, it may be either because they do not fully understand their own business or they are ill-prepared to manage these risks adequately.

Top tips:

- Always have a business plan.
- Only include as much within the business plan as is necessary to keep you on track and to give investors a clear idea of where you are taking the business and how you are going to get there.

4) Determine a sensible valuation of the business.

Early stage businesses are notoriously difficult to value. There are different ways to approach this. One rule of thumb is:

- A solid business idea alone - £10,000.
- A solid business idea with a reasonably presented business plan - £50,000.
- Both of the above, plus a good management team with relevant CVs - £250,000.
- All of the above, plus a sale - any figure upwards of £500,000.

A perhaps better approach is to apply the rule of thirds, with the valuation split between the inventor, the management team and the investment. As such, the level of funding sought determines the post-money valuation. This ensures that the management are sufficiently incentivised to drive the business forward. It also ensures that investors can retain an important stake after second and third round funding which is sufficient for them to make a respectable rate of return on final exit. However, the bottom line is that the valuation is essentially what a willing investee will accept and a willing investor will pay.

Top tips:

- Be realistic.
- Make sure you can justify the valuation.
- Don't be too greedy – remember that if you fail to secure any funds you may not have a business that can go forward

5) Define the unique selling points (USP)

Aside from coming up with a compelling business proposition, the entrepreneur must ensure that nobody else is offering exactly the same product or service or have a particular USP which makes it different and potentially more profitable than competitors. It is then necessary to consider how easy it would be for another business to replicate it, assuming that it is not patented.

For example, a new idea for a type of soft drink might taste good, be healthy and unique, and retailers have expressed an interest in stocking the product. However, as soon as another drinks manufacturer becomes aware of the product, how long will it take for them to replicate it?

If the entrepreneur is certain that any competitor, even one with unlimited resources, will take at least two years to come up with the same product, then they are in a strong position to claim that they have a chance to establish their brand. However, in this example, it could be a case of weeks or a few months. As a result, the market will be saturated by other similar products, some of which may be backed by known brands.

Another valid USP is a unique management team mix. However, this would have to be very specific as it could be replicated. Alternatively, a patent or other Intellectual Property Right by definition would fit the bill perfectly. There are many further examples, but the crucial point is to have a clearly defined view of how viable the business proposition is in the long term.

Top tips:

- Research the market.
- Research the competition and put yourself in the mind of the competition to figure out how they will react to you entering the market.

6) Protect your business

Depending on the business, there are times when protection is an absolute must have. An easily replicable product for example, if protected, can be a great investment. Entrepreneurs should also ensure they understand how patents and other forms of intellectual property work, which may require seeking professional advice.

Without replacing professional advice, it is worth remembering that once an idea is in the public domain, it is not possible to then apply for a patent. Therefore, it would be a mistake to assume it is possible to find the funding first and then look at a patent, if investors have been told people the idea, the business will not be able to apply. There are many forms of protection for different aspects of the business and products. Patents are just one, which is why professional advice is very worthwhile.

Top tip:

- Seek professional advice.

7) Prepare your business for due diligence

Due diligence is usually carried out when an investment or acquisition is going to be made and is the process of checking the facts of a business, including its market, key staff, directors, financials and legal position. Any investor and many banks who do not have a direct relationship with the entrepreneur will require a level of due diligence on their affairs before investing or loaning funds to the business.

However, there is a real danger that investment deals will fall through if factors are uncovered during the due diligence process that were not already apparent. It could be that the investee had failed to recognise the point as relevant.

Companies can save themselves a lot of time and energy when negotiating an investment by completing much of the groundwork and making it available to the bank or investor during negotiations. There are certain legal advisors or financial services professionals who work with business investment networks who can provide specific assistance around due diligence. This includes providing a pre-packed questionnaire which reduces the risk of deals falling through and minimises legal costs on completion.

Top tips:

- Always expect due diligence to take place so be prepared.
- Seek professional advice if you are unsure how to do this.

8) Appoint a solicitor

It is essential to appoint a solicitor who has experience of similar forms of investment in small businesses. Just one example of where this is required is that, in line with the Financial Crime Prevention Procedures, the business and the solicitor will have to verify the identity of investors before accepting any investment. This will require a copy of an official photographic ID such as a passport, driving licence, services ID card or national ID card.

Top tips:

- Make sure the solicitor you choose has the relevant experience.
- Make sure legal charges are commensurate with size of investment and try to obtain fixed fee for the work.

9) Have an exit plan

Businesses that are a lifestyle plan for the entrepreneur often find it difficult to attract investors. One example is a business that will provide the entrepreneur with long term employment and remuneration but which they will want to continue with until retirement. However, in these instances, a secured loan may still be viable. Having a well thought through exit plan is therefore a key element of obtaining investment. Exit strategies can take several forms, the most common of which are:

- A trade sale, which is arguably the most common.
- A listing on a stock exchange, such as PLUS, AIM or London Stock exchange.
- A management buyout.

It may be difficult for an entrepreneur to imagine selling their business when they are just starting it. However, most investors are looking for capital gains rather than a dividend stream so will want to know how they will make their profit. In many ways, the actual form of exit is less important than the principal that there will be an exit at some point, generally within three to seven years.

Top tips:

- Always have an exit plan in mind.
- Ensure that the route to exit is clear when speaking to any potential investor.

10) Find an investor

Arranging investments is a category of regulated activity which can only be carried out by firms authorised to do so by the Financial Services Authority (FSA). This must also be done with information authorised by a FSA-approved firm. It amounts to acting for a business with the expectation that they will be introduced to an investor.

Direct approaches to potential investors by individuals can be a criminal act and result in the individual making the approach becoming personally liable for any losses incurred by an investor. This is unless the individual has received certain certifications from the investor before seeking investment.

The FSA aims to protect consumers; both companies and investors. It does this by regulating the way in which financial service providers operate, paying particular attention to the integrity, skill, care and diligence with which they are run and to the competence of those people delivering services.

Regulations under the FSA lay down, in some detail, the framework within which approaches to investors must operate in order to comply with the Financial Services and Markets Act (FiSMA) as well as subsequent UK and European modifications to it such as the EU's Markets in Financial Instruments Directive (MiFID). Obligations are placed upon all business angel networks, their Directors, employees and associates by the wider law, particularly by the Companies and Data Protection Acts.

Top tips:

- Take heed of the legal requirements when seeking investment.
- Find a reputable business angel network or corporate finance house that has a proven track record.
- Ask the right questions :

Questions a fund seeker should ask an angel network before proceeding:

Investors

1) How many investors are in your network?
2) Where did these investors come from?
3) What sort of information do you hold about your investors?
4) Do you know how many have expressed an interest in my sector and stage of business?
5) What is the typical profile of your investors?

The deal

1) Is there any exclusivity, or can I go to other networks?
2) What happens if I find the funding myself whilst working with you?

The process

1) Explain the process fully – including: how do you actually get my business in front of investors?
2) Do you produce any marketing materials for me?
3) Do you come to investor meetings?
4) Do you help with the negotiations/valuation etc?
5) How long does the whole process take?
6) What are the quickest and slowest deals you have done?
7) Is there a time limit on the help you give me? – when do you stop trying?

Track record

1) How many companies do you act for per annum?
2) How many completions do you achieve per annum?
3) What do you class as a completion?
4) What are your total funds raised per annum?
5) What is the average deal size?
6) What is the personal track record for the person representing you? – plus, all the above questions but for them as an individual, including seeking information on their personal background.
7) Of the companies you have raised money for, what is the breakdown by stage and sector?

Competition

1) Who would you say are your main competitors?
2) Why should I go with you rather than any of them?

Conclusion

The funding landscape has changed dramatically since the onset of the credit crunch and the subsequent financial crisis and the once popular options such as debt finance have suffered as a result. During the downturn, it is clear that sufficient funding is essential for business to grow or even just to survive and avoid cash flow crises. While initiatives such as the government's EFG scheme are a welcome aide, they only go part way to solving the problem.

Alternative business investment offers a number of advantages. Not only is it the only viable option in many cases, such as when a business is unable to offer security, but comes with the added bonus of knowledge and consultancy from the business expert.

To raise finances successfully, businesses must ensure they are well-prepared, follow certain best practice rules, and meet the strict criteria of investors. This includes having a clear economic and commercial plan that will provide returns to investors as well as to the entrepreneur, having a good management team or being prepared to strengthen the existing team, and being sensible about the business valuation.

With these principles in place and the support of experienced investment agencies and other professional advisors, small businesses will be in the strongest position to ride the wave of the recession and prepare for market recovery.