Financing your business

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A solid financial base is essential when you are starting up a new business.

The right financing package will carry you through any temporary difficulties yet still allow you to make the most of growth opportunities when they arise.

This briefing focuses on four areas:

- Deciding how much money you need.
- Investment finance.
- Different forms of borrowing.
- Other sources of help.

1 How much do you need?

1.1 Draw up a **budget** based on your business plan (see Writing a business plan).

- The budget shows your forecast sales, expenditure and, most importantly, cash position for each month.
- The forecasts must be realistic. Inexperienced business people invariably make over-optimistic forecasts.
  Sales turn out to be lower and later than expected, getting paid takes longer and costs are higher.

1.2 Identify **how much** financing you require and when you will need it.

- A start-up business may spend more than it earns for two or three years. The amount of financing needed may continue to go up through this time.
- Many businesses have seasonal sales patterns that lead to predictable cashflow peaks and troughs.
  For example, a toy manufacturer faces heavy raw material costs in the summer producing a large stock of toys — but may not receive cash from sales until after Christmas.

1.3 Allow for some **contingency funding**. How much extra finance might you need?

- Consider worst-case scenarios to help you decide how much finance you should have available.
  What if a product launch is delayed, you lose your best customer, costs overrun or interest rates go up?
- How accurate is your forecast? If you are unsure, you may need to set up substantial contingency funding.

1.4 **Plan** to arrange all your financing. Even if you don't need all the money at once, don't wait until your need for the extra finance becomes urgent.

- For example, borrowing £20,000 in January and then asking for £20,000 more in April may alarm your bank manager.
  Let the bank know the total amount in the first place — even if you ask to borrow it in stages.

2 Investment finance

It will be difficult to borrow money from a bank unless you can point to an adequate financial base of money invested in the business.

2.1 Some will usually be your **own capital**.

- You may have cash you have saved or investments you can sell.

- Taking a mortgage on personal property, then lending the money to the business, can pay off.
  Mortgage rates are below business lending rates, there are no arrangement fees and some lenders will advance up to 95 per cent of a personal property's value.
  Some mortgages have flexible repayment arrangements that can help reduce the risk of defaulting.

2.2 You may be relying on **family and friends** who are willing to invest in your business.

- Make it clear that they should only invest amounts they can afford to lose.
- Show them your business plan and give them time to think it over.
- Discuss several what-if scenarios.
  For example, what if you go bust or want to pay yourself a big salary or expand or relocate or take risks or hire staff?
- Put the terms of any agreement in writing.

2.3 Your business may attract **outside investors**.

Valuing your business' assets

Banks will value your assets conservatively when you use them as security for borrowing.

A A bank will usually lend only 50 to 60 per cent of the value of a **business property**.

- Short leaseholds offer little security.

B **Equipment** will only be valued at its resale price — usually its price at auction.

- Specialised equipment that is difficult to sell and equipment which becomes obsolete quickly (such as a computer) will provide little security.

C A bank may lend up to 60 per cent of the value of your trade **debtors** (see also **3.3**).

- Small debts which are difficult to collect, old debts and any other doubtful debts will have no value.

Any existing financing arrangements — eg other loans, factoring services or leasing arrangements — will reduce the amount of security you can offer the bank.

- You are unlikely to interest outside investors unless you can show a strong track record and a credible business plan.
- Investors — who purchase an equity stake in the business — will expect to be offered high potential returns to compensate for the risk they are taking on.
  The British Private Equity and Venture Capital Association (BVCA) offers useful free publications that contain advice on finding private investors and venture capital companies (www.bvca.co.uk).
  Another good source of information on venture capital funding is the British Business Angels Association (020 7089 2305 or www.bbaa.org.uk).
- If you use a broker to find private investors you should expect to pay £50 to £350 in fees plus a percentage of any money raised.
- Government-backed regional venture capital funds will invest up to £500,000 in English companies. Check with your local regional development agency for details of their scheme.
- Most venture capital companies will not invest less than £1 million because of the high cost of investigating investment opportunities.

An outside investor whose personal investment in a business qualifies under the Enterprise Investment Scheme enjoys special tax treatment.

> "If you are hoping to raise external equity finance (venture or investment capital), get good professional advisers involved early on."
> **Frank Thaxton, Thames Valley Partners business advisers**

3 Bank finance

After your own family, the most likely source of borrowing is the bank.

3.1 Many businesses need **overdraft finance** from time to time. Overdrafts are useful for financing temporary — or fluctuating — cash shortages.

- You pay interest only on the amount you are overdrawn each day.
- Exceeding your overdraft limit is costly.
  The bank may bounce your cheques, damaging your credit with suppliers. You can also incur material bank charges and higher interest rates.
- The bank could, in principle, demand repayment in full at any time, usually at 24 hours' notice.
- Your overdraft limit is usually agreed for six to 12 months, after which it must be extended by negotiation. However, the limit can be reduced if the bank decides this is necessary.

3.2 Loan finance is often the best way to finance a longer-term business need.

- Most loans are for a fixed period of one to ten years. Mortgages and some other loans may be for as long as 25 years.
- Repayments are agreed in advance. Paying equal monthly instalments of capital plus interest is a common choice. You may be able to arrange a repayment holiday to allow time for your cashflow to pick up before the first repayment is due.
- Loans are more suitable than overdrafts for longer-term finance. Both you and the bank make a commitment to the business, based on an understanding of your long-term plans and forecast cashflows. Your bank can advise you on what information is required and how figures should be presented when seeking a loan.

3.3 Bank-finance **costs** can vary widely.

- The interest rate for both overdrafts and loans is usually set at a margin over the bank base rate, which can vary. Margins on loans are usually two per cent to six per cent, depending on how risky the bank thinks the loan is. Alternatively, the interest rate may be fixed (eg a flat-rate ten per cent).
- An arrangement fee is usually levied when an overdraft facility or loan is set up. Typically the fee is one to 1.25 per cent of the facility requested.
- A renewal fee is sometimes charged when an overdraft facility is extended.
- You may incur costs arranging security (see **5**).

4 Other finance

Trade credit (paying your suppliers after 30 to 60 days) and bank finance may be all that a small business needs. Suppliers keen to enter a new market may offer extended credit. But other options are worth considering, especially for vehicle finance.

4.1 Leasing is used to finance equipment you do not need to own.

- Instead of buying the item, you rent it for a fixed period — usually three to five years.
- Payments are spread out over the period, helping your cashflow.
- You get full tax relief on lease payments, except for cars costing more than £12,000.
- Leasing can be an attractive way of financing a vehicle. In addition, there is the option to fix maintenance costs as part of the agreement (contract hire).

4.2 Hire purchase (HP) is used to finance the purchase of equipment.

- You buy the equipment, but payments of capital and interest are spread over a fixed period — usually three to five years.
- You can claim capital allowances on the equipment, and the interest payments receive full tax relief.

4.3 Factoring provides you with finance against invoices that customers have not yet paid.

- You can receive up to 90 per cent (typically 80 per cent) of the face value of each invoice immediately and the balance (less charges) when the invoice is paid by the customer.
- It may be difficult to extricate yourself and switch to normal bank finance later on when this might be more appropriate.

4.4 Stock finance, where cash is raised against the value of stock held by a manufacturing company, may also be a possibility.

4.5 Leasing, HP and factoring can all enable a business to raise more money than would be possible through traditional bank finance, although the costs may often be higher.

- Comparing the cost of different forms of finance is complicated. Key factors are fees, the period of the finance, interest rates and the tax position. Seek your accountant's advice.

  Focus on your cashflow first, as this is most important. Only if your cashflow is healthy and robust should you try to save money by relying on overdraft finance.

5 Security for borrowings

For any borrowing you need to show that you can afford the capital and interest payments. In addition, a bank usually wants security to ensure the loan is repaid if things go wrong. There are a number of different possibilities:

5.1 A **personal guarantee** is a guarantee from an individual.

- If supported by a legal charge over your personal assets, these assets (including your house) can be at risk if the guarantee is called upon.

➨ Your bank can advise you on what information is required and how figures should be presented when seeking a loan.

5.2 A guarantee from a **third party**, who will be liable to pay the debt if you default.

- Directors of limited companies are often asked to provide personal guarantees in case the company fails.
- Sole traders (and partners) are already personally liable for all business debts.

5.3 If your annual turnover is no more than £5.6 million, another source of security may be the **Small Firms Loan Guarantee**.

- The scheme focuses on start-up and younger businesses who have been trading for less than five years.
- It can be used to guarantee 75 per cent of loans of up to £250,000.
- Repayment terms and interest rates depend on the lending institution. You also pay the Small Business Service a premium of two per cent a year on the outstanding balance, payable quarterly by direct debit.
- The scheme is operated by Department for Business, Enterprise and Regulatory Reform (BERR) in partnership with a number of private sector financial institutions, including all the clearing banks.
- Ask your bank manager whether you are eligible.

For more details and a list of lenders, visit www.berr.gov.uk.

5.4 You may need to take out **insurance** that will pay out if you suffer an accident, sickness or death.

- This will also protect the bank if you are unable to work.

You should seriously consider how much you are prepared to risk on the business. Can you really afford to lose your home or savings?

6 Working with your bank

6.1 Before lending you any money the bank will want to see a viable **business plan**.

6.2 Once your business is operational, provide the bank with regular **management information** summarising sales, margins and costs.

- Draw up a table of figures comparing what you actually achieved with your budget and with the previous year.
- Add comments to explain any differences and mention key events you are expecting (eg an order you think you will win).

6.3 **Warn** the bank if you expect to run into any financial difficulties.

- Teach the bank to trust you, your data and your judgement. Avoid surprises.

7 Where to get help

There is a wide range of schemes providing help and finance for start-up and small businesses. The European Union, central and local government, Business Link, Enterprise Agencies, trade organisations and charities all offer assistance.

7.1 Check what is available **before** you start trading, or you may no longer be eligible.

- Areas such as exporting, technology and training are specially targeted for support.
- Some regions offer financial incentives to attract start-ups to particular areas.

7.2 **Visit** the Business Link website at www.businesslink.gov.uk or call 0845 600 9006.

Expert contributors

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Further help

There are other Start-up Briefing titles that can help you. These briefings are referred to in the text by name, such as Writing a business plan.

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