Obtaining Finance

The challenge of raising money

Often the hardest part of starting a business is raising the money to get going.

An entrepreneur might have a great business idea and clear plan for how to exploit a market opportunity. However, unless sufficient finance can be raised, the entrepreneur will struggle to make the most of the opportunity.

Raising finance for a start-up requires careful planning. The entrepreneur needs to decide:

- **How much finance is required**? Raising finance is hard work and expensive – the start-up should avoid having to go through the process too often!
- **When and for how long the finance is needed?** A useful distinction can be made between long-term, medium-term and short-term finance
- **What security (if any) can be provided**? This will affect the ability of the business to raise a bank or other loan where the lender requires some security (or "collateral")
- **Whether the entrepreneur is prepared to give up some control** (ownership) of the start-up in return for investment?
- **Whether the cost of the finance** (e.g. interest charged) is justified

The finance needs of a start-up should also take account of these key areas:

- **Set-up costs** -the costs that are incurred before the business starts to trade
- **Getting ready to produce** - the fixed assets that the business needs before it can begin to trade
- **Working capital** (the stocks needed by the business –e.g. raw materials + allowance for amounts that will be owed by customers once sales begin)
- **Growth and development** (e.g. extra investment in capacity)

Finance to cover different periods

An important consideration when obtaining finance for a business is when and for how long the finance is needed. A useful distinction can be made between long-term, medium-term and short-term finance. The table below summarises the main examples and uses of each category:

Long-term	Medium-term	Short-term
Finances the whole business over many years	Finances major projects or assets with a long-life	Finances day-to-day trading of the business
Examples:	**Examples:**	**Examples:**
Retained profits Share capital Venture capital Mortgages Long-term bank loans	Bank loans Leasing Hire purchase Government grants	Bank overdraft Trade creditors Short-term bank loans Factoring

Share capital

Share capital is the **money invested in a company by the shareholders**. Share capital is a **long-term source of finance**. In return for their investment, shareholders gain a share of the ownership of the company. An illustration of an example company share ownership structure is shown below:

Shareholder	Number of Shares	Shareholding
Angela	300	15%
Nicolas	400	20%
Gordon	600	30%
Barack	700	35%
Total	**2,000**	**100%**

Shareholders benefit from the protection offered by **limited liability** – they are only liable for the amount they invest in share capital rather than the overall debts of the company.

The founding entrepreneur is very likely to invest in the share capital of the start-up. This is a common method of financing a start-up. Ideally the founder will try to provide all the share capital of the company, retaining 100% control over the business.

A key point to note is that the entrepreneur may use a variety of personal sources (e.g. cash, personal investments) to finance the purchase of shares.

Once the investment has been made, it is the company that owns the money provided.

The shareholder obtains a return on this investment through **dividends** (payments out of profits) and/or increases in the value of the company when it is eventually sold.

A start-up company can also raise finance by selling shares to **external investors** – this is typically to a business angel or venture capitalist.

Retained profits

Retained profit is the profit kept in the company rather than paid out to shareholders as a dividend. Retained profit is widely regarded as the most important long-term source of finance for a business.

Retained profits are a very cheap form of finance. They are also very flexible. They can be left in the business as cash in the bank. They can be invested in more fixed assets, extra stocks and so on.

Retained profits are also under the control of the business. It is up to the business owners to decide what to do with them, not the bank manager.

Bank loan

A bank loan is the most common example of **loan capital** for a business.

A bank loan provides medium or long-term finance. The bank sets the **fixed period** over which the loan is provided (e.g. 3, 5 or 10 years), the rate of interest and the timing and amount of repayments.

The bank will usually require that the business provides some security ("collateral) for the loan, although in the case of a start-up this security often comes in the form of personal guarantees provided by the entrepreneur.

Bank loans are good for financing investment in fixed assets (such as plant & machinery, land and buildings). They are generally charged at a lower rate of interest that a bank overdraft. The interest rate can be either fixed (e.g. 8% per year on the amount outstanding) or variable (where the interest rate varies depending on the Bank of England base rate).

However, a bank loan provides less flexibility than a bank overdraft. The business commits to meeting the bank loan repayments and interest – which it needs to do whether or not the cash flow position is good. A failure to meet the terms of the bank loan may lead to the bank putting the business into insolvency.

Bank loans tend not to be offered to start-ups or businesses with a track record of poor profitability and cash flow. Such businesses are perceived as being high-risk by banks that, as a result of the credit crunch, are more cautious about the kind of lending they offer.

Trade credit

When a business buys raw materials, components, services or other goods from another business it will often look to pay for those at a later date. If it is allowed to do so, then that supplier is said to offer "trade credit" to the business. The supplier becomes a trade creditor – someone to whom the business owes money.

Trade credit is a short-term source of finance. It has several important advantages to a business:

- It is flexible – the amount of credit reflects the value of business done with a supplier
- It is low cost – trade creditors don't charge interest on the amount outstanding (unless payment is delayed well beyond the settlement date)
- It matches the purchase of goods and services – e.g. stocks can be bought and held for a period, with the finance provided by trade credit rather than cash

A common complain amongst small businesses is the time it takes for their (larger) customers to settle bills. By delaying payment to a trade creditor, a business holds onto its cash balances for longer. However, by delaying payment, a business has to be careful not to damage its credit reputation.

Bank overdraft

A bank overdraft is flexible **borrowing facility** on a bank current account which is repayable on demand.

A bank overdraft does not actually result in cash flowing into a business. Instead the business is allowed to let its bank account become "overdrawn" – i.e. in the red, up to a maximum amount.

For example, a business may find that it expects to have a cash shortfall of £15,000 during a month as a result of paying wages and suppliers. If the bank allows it, the overdraft facility can be used to temporarily "borrow" the cash from the bank.

A good way to think about a bank overdraft is to imagine a bank current account which can have either a positive (i.e. cash in the bank) or negative (i.e. cash owed to the bank) status.

The maximum amount that the bank account can go into the red is known as the **overdraft facility**.

How much interest does a business pay on a bank overdraft? It depends on what the bank balance is day to day. Interest is calculated daily, usually at a high rate, on the overdrawn balance.

You can see that a bank overdraft is a flexible form of finance. A business only pays interest on the amount of the overdraft facility used.

However it is important to realise that a bank overdraft is essentially a short-term source of finance designed to cover temporary shortages of cash. If a business finds itself using the expensive overdraft month after month, then it ought to consider whether a cheaper, long-term bank loan would be a more suitable source of finance.

Leasing

Leasing is another word for renting assets (e.g. property) over a period of time. Leasing is a way of financing the use of such assets without actually having to buy them outright.

There are two main ways a business can pay for the resources and equipment it needs:

- Buy it outright (often referred to as "capital expenditure")

- Hire purchase or lease

Buying outright is a good option if a business has the funds available, or if it is essential that it owns the equipment. However, paying for resources and equipment means an up-front outflow of cash. This might not be the best option for cash flow.

Paying for goods on hire purchase or leasing equipment allows a business to:

- Use an asset over a fixed period in return for regular payments (i.e. the cash outflow is spread over a longer period)
- Lets the business choose the equipment it needs, with the finance company buying it on behalf of the business

Obtaining finance from outside investors

Should a start-up accept investment from outside investors?

You will have seen entrepreneurs making their pitches on Dragon's Den – this is a good example of how a start-up or small business tries to raise capital by encouraging people other than the entrepreneur to invest in the business idea.

For a start-up, the main source of outside (external) investor in the share capital of a company is **friends and family** of the entrepreneur. Opinions differ on whether friends and family should be encouraged to invest in a start-up company. They may be prepared to invest substantial amounts for a longer period of time; they may not want to get too involved in the day-to-day operation of the business. Both of these are positives for the entrepreneur. However, there are pitfalls. Almost inevitably, tensions develop with family and friends as fellow shareholders.

Business angels are the other main kind of external investor in a start-up company. Business angels are professional investors who typically invest £10k - £750k. They prefer to invest in businesses with high growth prospects. Angels tend to have made their money by setting up and selling their own business – in other words they have proven entrepreneurial expertise. In addition to their money, Angels often make their own skills, experience and contacts available to the company. Getting the backing of an Angel can be a significant advantage to a start-up, although the entrepreneur needs to accept a loss of control over the business.

Using an entrepreneur's personal sources of finance

In practice, most start-ups make use of the **personal financial sources of** the entrepreneur. This can be personal savings in the building society, a bank balance. It can be providing assets for the business (e.g. a car). It can also simply be **working for nothing!** The following notes explain these in a little more detail.

Savings and other "nest-eggs"

An entrepreneur will often invest personal cash balances into a start-up. This is a cheap form of finance and it is readily available. Often the decision to start a business is prompted by a change in the personal circumstances of the entrepreneur – e.g. redundancy or an inheritance. Investing personal savings maximises the **control** the entrepreneur keeps over the business. It is also a strong signal of commitment to other potential investors and banks.

Re-mortgaging is the most popular way of raising loan-related capital for a start-up. The way this works is simple. The entrepreneur takes out a second or larger mortgage on a private property and then invests some or all of this money into the business. The use of mortgaging like this provides access to relatively low-cost finance, although the risk is that, if the business fails, then the property will be lost too. However, the credit crunch falling house prices has made re-mortgaging harder.

Borrowing from friends and family

This is also common. Friends and family who are supportive of the business idea provide money either directly to the entrepreneur or into the business. This can be quicker and cheaper to arrange (certainly compared with a bank loan) and the interest and repayment terms may be more flexible than a bank loan. However, borrowing in this way can add to the stress faced by an entrepreneur, particularly if the business gets into difficulties.

Credit cards

This is a surprisingly popular way of financing a start-up. In fact, the use of credit cards is the **most common source of finance** amongst small businesses. It works like this. Each month, the entrepreneur pays for various business-related expenses on a credit card. 15 days later the credit card statement is sent in the post and the balance is paid by the business within the credit-free period. The effect is that the business gets access to a free credit period of around 30-45 days!

Working for nothing!

How can this be a source of finance? Simple - by working for nothing, an entrepreneur saves the business cash. By working long hours and multi-tasking, the entrepreneur reduces the need to employ others - and therefore saves cash that would otherwise have to be paid out in wages in salaries. In just about every start-up, the founders look to save cash (i.e. reduce the finance needed) by putting in the "hard yards"