Chapter 8 Raising finance

Key terms

Capital expenditure Money spent on purchasing fixed assets (buildings, machinery, and so on).

Equity Money generated through the sale of shares; another term for share capital.

Overdraft An agreement with a bank to allow a business to exceed the balance in the account. Interest is charged on the amount overdrawn only.

Revenue expenditure Money used to help generate sales (stock purchases, wages, and so on).

Share capital Finance raised through the issue of shares; a part ownership in a company.

Venture capital Specialist finance providers who are prepared to invest in risky business ideas with little or no requirement for security. Venture capitalists will expect to have a share in the ownership of the business.

In this chapter you will learn about the different ways in which a business can raise finance to start up. All businesses will need money to start a business in the first place and when they have set up will also need to raise money to expand. You will learn that there are different means of doing so depending on the time period involved and the type of business organisation.

Sources of finance available to start businesses

A significant practical problem for a new business is raising sufficient initial finance to successfully launch the business. Even with a convincing business plan, the risk attached to new business start-ups make potential investors very wary of committing their funds. This can make it especially difficult for a new business to get the funds needed to get started.

A new business requires finance for two main purposes:

- Purchase of premises and equipment. Any business, whatever its size, will need to have some equipment and a base to begin trading. There has to be money available for acquiring these things.
- Working capital – the cash needed to keep the business working day to day, pay bills, and so on, in its early months of trading. Many new businesses underestimate the importance of having sufficient cash for working capital and quickly find themselves short of cash when revenues are slow to come in. In some cases, it might be many months from the original set-up to the time when cash in the form of revenue starts to come into the business from sales.

A new business might be an individual having an idea and wanting to set up as a sole trader. Equally, it might be an existing business looking to set up a new business idea. In this case the amount of finance needed may be much greater but the principle and the difficulties are similar.

We can broadly classify the way in which a business will use finance it manages to raise in two ways:

- **Capital expenditure** – money spent on purchasing fixed assets such as buildings, machinery and vehicles. Capital expenditure adds to the value of the company.
- **Revenue expenditure** – money used to help generate sales such as stock purchases, wages, and so on. Revenue expenditure does not add fixed value to the company.

We will look at the main ways in which a business can raise money and give an example in each case to highlight the advantages and disadvantages.

Ordinary share capital

Private and public limited companies are able to raise finance through the sale of shares in the business. A share is a legal right to part ownership of the business. For a private limited company, there might be only two shareholders, a husband and wife, for example, who hold the shares in the business, but it can be more. Note from Chapter 7 the limitations on the sale and transfer of shares in this form of business ownership.

Public limited companies can issue shares to the general public. This allows them to be able to raise large sums of money – **share capital**. If a member of the general public owns shares in a plc then they are able to trade them on the Stock Exchange, which provides the facility for the purchase and sale of shares. When share ownership is transferred through the Stock Exchange, the company whose shares are being traded are not directly affected – the role of the Stock Exchange is to bring together those who wish to sell shares and those who wish to buy shares.

Whilst raising finance in this way does give access to greater amounts of money, there are some drawbacks. The cost of planning and implementing a share issue can be expensive and time-consuming. Specialist organisations such as merchant banks might handle such a share issue on behalf of the company but using their specialist services does not come cheap. There are a number of legal requirements to be fulfilled and this can make such a method difficult.

Guru's views

'A bank is a place that will lend you money if you can prove that you don't need it.'

–Bob Hope, American comedian

For example...

Typical plc is planning on setting up a new business venture in a related but different market from its existing one. The business plan and market research have all been carried out, and the sum needed to finance the new venture is £150 million. The company has decided to raise the funds through a new share issue. It has offered existing ordinary shareholders the opportunity of buying additional shares and it will also be offering the shares on the Stock Exchange. They have hired an investment bank, to organise the share sale for them. In addition, the company's solicitors have been working hard drafting the agreements, contracts and attending to the regulations that govern new share issues. Typical had to produce a prospectus to outline details of the share offer to give information to prospective investors and have had to give notice in the national press. The whole project has taken two years to plan and has cost the firm over £1 million. However, Typical is confident that it will be able to sell all the shares it is planning to issue. Even if it does not, the advantage in hiring an investment company is that they will underwrite the issue. That means that they will agree to buy any unsold shares. This makes it pretty certain that Typical will be able to raise the money it needs on time to get the business started as planned.

Loan capital

Businesses, large and small, will borrow money from banks in order to finance a start-up. In many cases, the loan will form part of the finance raised, but not all of it. The reason for this will become clearer later. We will look at two main types of loan capital: bank loans and **overdrafts**.

Bank loans

A bank loan is a common form of start-up business finance. Most of the main high-street banks, such as HSBC, Lloyds TSB, NatWest, and The Royal Bank of Scotland, will have a team of people working specifically on supporting businesses and managing business accounts.

The size of a bank loan will be dependent on a variety of factors. The bank will want to consider the risk involved. This will involve the likelihood that the borrower will be able to pay it back, the type of business venture the loan is for, the quality of the planning that has gone into the application and the client's banking history.

A bank loan is usually repaid on a monthly basis over a number of years. It can be medium- or long-term and incurs interest charges. The interest payable can be either fixed or variable. With a variable rate loan, the interest rate may change in line with decisions made by the Monetary Policy Committee of the Bank of England. If they change the rate at which they are prepared to lend to the banking system, it affects the structure of interest rates throughout the system.

This might mean that if the Bank of England raises interest rates, a business's interest payments will also rise – usually about a month after the announcement by the Bank. If rates are rising steadily over a period of time, this can make a significant difference to the costs of a business. This is something it will have to consider when taking out the loan. In the same way, the business might find its costs falling if there is a period where the Bank is reducing interest rates.

For businesses who negotiate fixed interest loans, there is usually a period of time which the rate is fixed for. This helps businesses plan more effectively and they will have a greater degree of certainty about their on-going costs. However, it might also be that when the fixed rate ceases and reverts to a new interest rate, it could be quite a different rate from that which the business has been experiencing. This could be a major shock to the cash flow of the business.

Bank loans are relatively popular and easy to access. However, banks usually require some form of security on the loan. This is some asset which shows the bank that the borrower is serious about the loan and

understands the consequences. Assets which might be put up as security against the loan might be a building or, in the case of a sole trader, a personal asset such as a house. If the business is unable to repay the loan, the bank will seize this asset to cover its loan. This means that sole traders, who have unlimited liability, do have to think very carefully before committing themselves. Now can you see why Bob Hope made the comment he did (see 'Guru's views' on page 69)?

Overdraft

An overdraft is effectively a short-term bank loan. A bank will allow a business to withdraw from its account more money than it has deposited. Overdrafts are often used to cover cash shortages, so a business may be overdrawn only for a matter of days. Interest is paid only when the account is overdrawn. An overdraft is a flexible way for businesses to borrow small sums of money as and when required. The bank will usually agree a limit for the overdraft above which the business should not go. Businesses that do breach this limit are not penalised immediately (they are likely to be charged a hefty fee and also higher interest on the excess), but over a period of time if the business cannot show that it can control its cash flow and keep within the overdraft, the bank may well withdraw the facility or, at the very least, want to have some serious discussions with the business.

Both loans and overdrafts tend to attract higher rates of interest. In many cases, small businesses might face very high rates of interest for loans and overdrafts. The more risky the business proposition is in the eyes of the bank, the higher the interest rate is likely to be.

For example...

Diane is thinking of starting a business providing manicures and nail art. She has found a small shop in a town centre that is available for rent and one which would provide the ideal accommodation for her business. She has prepared a business plan and has approached her bank's business manager for a loan of £40,000 to help pay for some of the fixtures and fittings she requires for the shop. She has also asked for an overdraft facility to be arranged for £5,000. The bank has looked closely at her business plan and especially her projected cash flow figures. They are a little concerned that she has been rather over-confident in her revenue projections, although they believe the basic business idea is sound. Diane knows that the normal interest rate on loans for things like cars is 7.5% and she has based her cost projections for the loan on this figure.

She had a bit of a shock when she had her meeting with the bank. They said that they would only be prepared to lend her £30,000 and that the interest rate would be 12.5%. In addition, they were only prepared to offer an overdraft of £2,500 and the interest rate on this would be 15%. That was very different from what she had expected. Diane had to go away and rethink and rework her projections as well as work out how to raise the additional £10,000 she needed. The bank had told her that if she could put up some form of security for at least £50,000 then they might be able to accommodate her original request. Having only just bought a ground floor flat, and getting sorted out in life, Diane was not keen to risk losing her home. Not only that, she was advised by the bank that she could also risk losing her business assets to the bank if she was not able to repay her debt. She had some hard thinking to do over the next few weeks!

Venture capital

Venture capitalists are specialist finance providers. If a business is unable to raise sufficient funds, **venture capital** is often used. Venture capitalists usually invest in smaller, risky ventures and do not ask for security. Rather, they will loan a business money in return for a share of business ownership or of any eventual profits.

Venture capital has become an increasingly important source of finance over the last 10 to 15 years. Venture capital can be defined as capital contributed at an early stage in the development of a new enterprise, which may have a significant chance of failure but also a significant chance of providing above-average returns and especially where the provider of the capital expects to have some influence over the direction of the enterprise. Venture capital can be a high-risk strategy.

With over 400 members, the British Venture Capital Association (BVCA) represents the majority of UK-based private **equity** and venture capital firms. Since 1983, additional private equity invested in UK industry has amounted to over £60 billion with a further £20 billion invested in the rest of Europe. Those funds have gone to assist 29,500 UK companies. In 2005 alone over £6.8 billion was invested in more than 1,300 companies in the UK.

Source of data: BVCA

Business angels

Business angels are informal investors who are wealthy and entrepreneurial individuals looking to invest in new and growing businesses in return for a share of the **equity**. They usually have considerable experience of running businesses that they can place at the disposal of the companies in which they invest. Business angels invest at all stages of business development, but predominantly in start-up and early-stage businesses. The majority of them tend to invest in businesses located within a reasonable distance from where they live.

The general profile of a business angel style of relationship is that:

- you are looking to raise between £10,000 and as much as £600,000
- you are prepared to give up some of the equity in your business and allow an investor to take a 'hands-on' role
- your business has the potential to grow sufficiently over the next few years to provide the business angel with a return on investment
- you can offer the business angel an 'exit' (for example, through a trade sale or the repurchase of their equity stake) at some future date.

Business angels, then, are small business-related investors who can have a major impact on the success of a start-up company.

For example...

Devon Adams had an idea for a new business. He had prepared a business plan and visited his bank to get a loan to help start-up. He was prepared to put in £40,000 of his own money but needed another £120,000. He thought he had everything planned out and had offered his three-bedroom house as security. He was therefore staggered when he read the bank's letter refusing to grant him a loan. The reason, they said, was that they felt the risk was too great that the business would not be a success. He tried three other banks but they all gave the same response.

His Business Link advisor explained that his idea was indeed risky but that he might try contacting the British Venture Capital Association. Through their website he identified a member and made an appointment to see them. The meeting was very productive. They pointed out that they were not a last resort of finance for a new business but simply a different way of securing finance. They identified a number of advantages. If an agreement was reached they did not always require security and therefore took on the same risk as he did.

They were in it for the long term – a bank's interest might be limited to the period of the loan. The return to the venture capitalist was not interest payments but the success and profitability of the business and therefore they had an interest in making sure Devon had all the support he needed. Devon did have to accept that the venture capitalist would expect to have some say in the running of the business. This did reduce the amount of independence he had but at the same time provided Devon with experience, skills and expertise that could be a real benefit to him in making sure the business was a success. Devon was also told that he would have to convince the venture capitalist that there would be some form of exit for them. This might be in the form of a future management buyout, the ability to sell shares to another investor or another business, or possibly a future stock market listing.

Devon was impressed with the quality of the advice he was given and the professionalism of the venture capitalist. This might be the ideal route for him!

Personal sources

Many people will start up a business using their own money as the source of finance or at least as part of the financing of the start-up. Such sources can range from the personal savings of an individual – it might be that someone has received a sum of money through an inheritance – through selling another business and even through redundancy.

Individuals might also ask friends and family if they wish to invest in the business. In such cases it is important that the individual makes it very clear to the investor what they are letting themselves in for, what the risks are and what the terms and conditions of the investment would be.

Guru's views

'Out of debt, out of danger.'

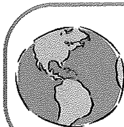
–Proverb

	Time frame	Possible usage
Short term	Under 1 year	Working capital
Medium term	1–5 years	Capital expenditure (vehicles, refurbishment, etc.)
Long term	Over 5 years	Major capital expenditure (buildings, land, etc.)

Figure 8.1 Borrowing money: time frames and possible uses

For example...

Mike had been working as a technical engineer for a motor manufacturer for 25 years. He had built up a considerable expertise in his field and was widely respected. However, when the business had to close due to the pressure of competition from China and Japan, Mike found himself redundant. Due to the number of years he had been with the company and the generous redundancy package they had offered, Mike had some time to be able to consider his next step. At 45, he knew that this was an important decision in his life. He looked around for jobs but many of them paid him less than he was earning before and did not fully make use of his skills. The more he looked, the more he felt that he could set himself up in business acting as a consultant for other engineering firms. He decided to use the £25,000 lump sum payment from his redundancy, which he had initially put into a savings account, as the main source of funds for the new venture. He was also able to get a further £15,000 backing from three contacts he had from his previous work. They knew how good Mike was at his job and believed he could make a success from his idea. The £40,000 was sufficient to be able to rent a small office and to equip himself to begin his new life.



Further material and resources relating to this section can be found at **www.collins.bized.co.uk**. Keep checking for updates.

Raising finance: Summary

- Start-up finance is required for two main reasons:
  - purchase of premises and equipment
  - for working capital.
- A start-up business can be a completely new business idea developed by an individual, a small group of individuals or an existing business moving into a new market.
- There are several main ways in which a start-up might raise finance – each has its own advantages and disadvantages and depends on the particular business context:
  - ordinary share capital
  - loan capital (loans and overdrafts)
  - venture capital
  - personal sources.

Summary questions

1. What are the two main reasons why a start-up business would require finance?
2. What is meant by the term 'working capital'? Give an example to illustrate your answer.
3. Distinguish between capital expenditure and revenue expenditure.
4. Explain why working capital is so important to a start-up business.
5. Identify two advantages and two disadvantages of the use of ordinary shares as a source of start-up finance.
6. Identify two advantages and two disadvantages of the use of using loans as a source of start-up finance.
7. Distinguish between a loan and an overdraft as a source of finance.
8. Identify two advantages and two disadvantages of the use of venture capital as a source of start-up finance.
9. Identify two advantages and two disadvantages of the use of personal sources of money as a source of start-up finance.
10. Why might a business prefer a bank overdraft to a bank loan?

Points for discussion

Investigate the activities of several venture capital companies. Using the Internet, research the following:

- what services are offered
- what recent loans have been made
- what criteria have to be met for a loan to be made.

The following websites might be useful:

- http://www.bvca.co.uk
- http://www.3i.com/

Up-to-date links to these websites can be found at **www.collins.bized.co.uk**.