PART TEN
Growth capital

Funding your business: where are we?

10.1

The fourth year of the downturn that started in autumn 2008 sees the financial markets facing the same global challenges that dominated 2011. At the sharp end, obtaining finance for growing businesses – never easy – is still not straightforward, but there are still available sources for those seeking to secure funding and actions to take to ensure survival, says Paul Beber at HW Fisher & Company

Both the government and the banks have committed themselves to ease the funding difficulties for SME businesses caused by the financial crisis in the banking industry. In practice, however, this is often no more than 'lip-service', businesses fighting for a share of the limited funds available. To add to the challenge, the cost of these funds has risen significantly.

With less credit available and lenders becoming more selective about whom they lend to, businesses have to start looking beyond the traditional routes to obtain funding. There is still money available, although there may be less of it overall, but with interest rates at historic lows, cash in the bank is earning pitiful returns. So just what are the options for established businesses that are finding it difficult to obtain bank loans and overdrafts?

Considering other types of finance

With banks still reluctant to lend to individuals and businesses, or demanding additional security which entrepreneurs either do not have or are reluctant to give, there are other options worth consideration and, fortunately, there are resources available to help businesses accomplish their goals and continue to grow, beyond the 'friends and family' financing. These include:

- Asset-based lending. Invoice finance is the foundation of asset-based lending (ABL), whereby money is advanced against a company's assets. In the case of factoring, the most popular form of asset-based finance, the financier can

collect debts on behalf of a business. Apart from invoices, other suitable assets can include stock, machinery and, of course, property.

- Peer-to-peer lending has recently emerged in the UK as a successful alternative, whereby private investors often lend directly, offering various types of loans from business to personal, without the requirement for a financial intermediary.
- Government grants have notoriously difficult application processes and can be complex to navigate, but there are genuine opportunities available for those who persevere.
- Tax incentives – Enterprise Investment Scheme (EIS) and Seed EIS for small early-stage companies – are designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies. Seed EIS in particular, due to commence in April 2012, can be extremely tax beneficial and reduce investors' risk at the cost of HMRC. With cash returns so low, this could be extremely attractive.
- Businesses of any size can use joint ventures to strengthen long-term relationships or to collaborate on short-term projects, while sharing the risk and costs with a like-minded partner. Even start-up businesses can sometimes get such backing to help get themselves established.
- Business angels can often provide substantial investment in return for equity in the business, offering a direct involvement with that investment for business owners. There are a number of business angel clubs that seek to serve this market.
- 'Private equity' – the more modern name for 'venture capital' – typically comes from institutional investors and high net worth individuals, and is pooled together by dedicated investment firms. Private equity in the UK is primarily aimed at already profitable companies with high potential growth. There is a wide array of types and styles of private equity, including leveraged buyouts, growth capital, distressed investments and mezzanine capital.
- Venture capital trusts (VCTs) aim to bridge the equity gap between banks, government grants and business angels on one side, and institutional venture capital on the other. They are often more geared towards the early-stage company than private equity.
- The lack of available bank finance has led some companies to consider getting a public quotation. Companies typically seek a public quotation because it offers profile, some liquidity for its shares, an audience receptive to growth and an environment where management can devote as much energy as possible to doing what their shareholders want them to do – run the business. Available markets include PLUS, AIM and even potentially the London Stock Exchange. Although new companies joining the public markets has been at a low point now for the past three years, this could well change if sentiment starts to turn during 2012.

The going is tough – what do you do?

Although by this stage in the recession those that have survived may think they can start to breathe a sigh of relief, this is actually the time when even more care is required. It is a sad historic fact that more businesses go to the wall when the economic cycle starts to improve than when it is on the way down or bumping along the bottom. Lack of working capital – eroded through the recession – is primarily the problem and a sudden pick-up in business can create insuperable strains.

Delay is seldom a good idea in any business, and never when a company is in difficulty. Studies have repeatedly shown that many failed businesses could have survived if only remedial action had been taken in time. When the going gets tough, it may be time to call in the specialists. Working with ailing businesses, corporate advisory specialists aim to rescue a company either by helping to raise required finance or, if necessary, helping to reconstruct the business. They work with the directors, shareholders, lenders and other stakeholders to find the optimum solution for all involved, with an emphasis on recovery.

If some form of insolvency is unavoidable, this may not need to be the end of the line. Insolvency is generally a last resort, and whether it be a complex corporate reconstruction and recovery situation, receivership, administration, company voluntary arrangement, liquidation or personal bankruptcy, early intervention is key to successful outcomes for all involved.

What next for growing businesses

The current economic climate has led to many businesses focusing on consolidation and cost efficiency to survive. One positive outcome of this is that most businesses at this stage in the cycle have developed the drive to push their businesses forward. But this does not mean that you can take a rest – far from it. The challenges are not going to go away quickly and the need for businesses to continuously re-evaluate their position and goals, and revisit their business plans, remains as important as ever.

When preparing your plan, make sure that you carefully evaluate all needs and assess your financing needs properly. If you need additional funding, start seeking it earlier rather than later.

Improving your chances of securing the finance you need

Securing funding is proving more difficult than ever before but there are ways to improve your chances of securing finance and managing cash flow while positioning your business for the future.

Top tips for attracting and securing funding

- *Know your business.* Consider what your business's product or service is, how relevant it is in the current economic climate, and how sustainable it is in challenging times. Ensure that you have a strong business case in support of the strategy and longevity of your business before seeking funds. Keep your business plan up to date.
- *Closely manage your relationships with key clients.* Know your competitors.
- *Understand your finances.* Instigate robust forecasting and financial management. Know your debt levels, understand what type of debt you have, when those funds are going to roll over, and when and if loans will be renewable.
- *Know how much funding you need.* Take a long-term view, identify your end goal, and know how much funding you need.
- *Prepare your business for due diligence.* Usually carried out when an investment or acquisition is going to be made, the process of checking the facts of a business before seeking funds can save a lot of time and energy when negotiating an investment.
- *Seek advice.* Your relationship with your financiers and other professional advisers should be nurtured at all times, but even more so when times get tough. Ensuring that they know and understand your business as well as you do can help them determine what sort of funding is required – as well as when it is required – and seek out the best options for your business. Your advisers can prepare strategic reviews, examine the validity of forecasts and business plans, and carry out pre-lending reviews for banks and pre-investment reviews.

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Gary Miller is a director of Fisher Corporate Plc, part of HW Fisher & Company, and is head of the firm's transaction services team. With 10 years in the field of capital markets, Gary has provided advice on company flotations on PLUS markets, AIM and the Official List, reverse takeovers and public company takeovers, and other transactions involving the Takeover Code. Additionally, Gary has led a wide range of transactions, including rights issues, bank lending reviews, acquisitions and disposals. Gary also acts as an audit partner focusing on both PLUS and AIM markets across a broad range of sectors.

For more information, visit www.hwfisher.co.uk

Growth capital options for expanding SMEs

10.2

In times of economic strain, many small businesses are trading cautiously within limited budgets. But others continue to grow and require external funding to make it happen. Darren Hart, head of Santander's new Growth Capital team, explores the lending options available to SMEs needing to move to the next level

Businesses that are growing steadily or simply marking time usually rely on existing finance facilities to cover their day-to-day working capital issues. But what about rapidly expanding businesses? An entrepreneur who sees an opportunity to move their business to the next level will need additional finance in the form of 'growth capital'.

Growth capital is used in many ways. It could be that an entrepreneur plans to bolster market share through the acquisition of one or more competitors. Or perhaps the funding is linked to a move into new markets, product diversification, or a need to build production capacity following a string of contract wins.

Risk and reward

The common factor in these scenarios is that the business has to spend in order to deliver on its growth strategy. This could mean an investment in staff, production facilities, R&D or even marketing, and while this money must be spent upfront, there can be no guarantee of a return.

And it's why raising growth capital can be tricky, especially for SMEs. Typically, a company in the market for growth finance will have moved well beyond the start-up phase and will be trading profitably with an established customer base. On paper, a plan to diversify into a new market or product is also an opportunity to grow revenues materially. In practice, there are no guarantees. Indeed, the growth strategy may fail to deliver and may also divert management attention from the original – and successful – business model.

That element of risk means that businesses may have to look beyond their current financiers to growth capital providers who feel comfortable with the uncertainty. There are a number of options, so it's important to choose a model that matches the needs and vision of the business.

Traditional lending – term loans

A term loan (often called senior debt) from a bank is the cheapest form of available finance, often because it will be secured on the business's assets. Businesses seeking growth capital should certainly talk to their existing lender or to other high-street institutions as a starting point.

However, this option may not be available for growth projects, especially in the current climate. Banks make a profit by charging interest and their main concern is the customer's ability to make good on the agreed repayment terms. If a company borrows to fund growth, the bank takes on a certain amount of risk but its return would be identical regardless of whether or not the client achieves its growth target. In other words, the lender doesn't share in the value created by the growth and so will focus more on the risks when assessing an application for funding.

It's also worth remembering that loan repayments will have an impact on cash flow, month by month, so if large sums are involved, senior debt may not be the most appropriate growth capital source.

Asset-backed lending (ABL) facilities are an alternative source of bank finance. They allow businesses to borrow against the value of plant and machinery and other assets. ABL can enable businesses to raise larger sums than through a standard term loan. Of course, this is only useful if the assets owned by a business have a significant value.

Private lending – equity investors

To many people, growth capital means private equity investment by business angels (wealthy individuals working alone or in networks), venture capitalists (VC) or, at the larger end of the market, private equity (PE) funds.

All of these equity investors buy a stake in the business that will be sold (at a profit) at a later date. The advantage for the entrepreneur is that – unlike, say, a term loan from a bank – there is no requirement to pay back the cash during the period of the investment. If the business thrives, the investor sells the shares and makes a handsome profit; typically the investor will look to double their money over three years. If the business fails, the investor takes a hit. Accordingly, PE investors are positioned at the higher end of the risk/return spectrum. And for the business, PE is at least cash flow friendly.

The active participation of an equity investor can also have a transformational effect on the business. An angel or VC can't run your business for you, but they will often take a seat on the board, provide advice, introduce you to useful contacts and help you find experienced managers.

Growth criteria

Angels, VCs and PE funds want companies with the potential to deliver significant returns. Given the perceived higher risk of investing in smaller businesses, angels will be seeking an even higher return than PE houses. Businesses that can't manage such growth will struggle to find equity investment.

Equally, by virtue of their size, SMEs also face the so-called funding gap. Angels typically invest up to £1 million; VC and PE funds (investing on behalf of larger institutions and therefore seeking a larger quantum profit) tend to invest £10 million plus in each transaction. Finding growth capital finance somewhere between the two can prove difficult.

Also, PE is expensive. Investors will want a meaningful stake in the company in return for their money. This not only dilutes ownership, but should be factored in as a cost as well. The industry benchmark puts the targeted return for PE investors at around 30 per cent per annum.

Mezzanine lending – the halfway house

Mezzanine finance is often described as a halfway house between PE and traditional bank finance. In common with banks, mezzanine financiers lend money and make a return by charging interest on the loan. They will be more generous in how much they lend but will charge a higher rate than on conventional loans, in order to reflect the risk.

Also, most mezzanine providers have warrants over a small number of shares in the company. So, if the company grows, they do get a modest gain from that value creation.

Why consider mezzanine finance? Well, like angel and PE investment, it can be cash flow friendly. Typically, all of the capital repayment is deferred until the loan matures. This means that a growing company won't be burdened with large monthly repayments and will only have to pay interest – typically quarterly.

Equally important, the equity stake warranted to the mezzanine provider will be much smaller than that required by an angel or PE house. In other words, mezzanine funding doesn't dilute the owner's shareholding very much at all.

Mezzanine finance is also a halfway house in terms of cost. It's a more expensive option than senior debt funding, but much less costly than PE investment. The percentage cost of capital is typically in the teens. However, there is an issue with accessibility. Very few providers work at the SME end of the market, lending less than £10 million, so supply is limited.

Mind the gap

The limited availability of growth capital to SMEs in the £0.5 to £10 million turnover bracket poses problems not just for individual businesses, but for the economy as a whole. Rapidly growing companies create jobs and wealth. Unless they can find funding to facilitate their expansion plans, Britain's economic recovery will almost

certainly be impaired. This is why measures to plug the funding gap have become a political priority. Witness the launch of the Regional Growth Fund, a government initiative aimed at funnelling cash to SMEs that would not otherwise be able to secure commercial finance.

The Breakthrough Growth Capital initiative

One initiative that will help fast-growing SMEs is Santander's recently launched Breakthrough Growth Capital programme.

Aimed at established, profitable and rapidly growing SMEs, the fund will provide up to £200 million in growth capital to around 40 companies per year over the next four to five years. The money will be made available through a bespoke variation on the mezzanine finance theme.

In common with conventional mezzanine finance, the Breakthrough investment's repayment structure minimizes the drain on cash flow during the crucial period when the business is putting its growth strategy into operation. Half of the 10 per cent interest margin plus London Interbank Offered Rate (LIBOR) is paid quarterly through the term of the loan. The remainder accrues up to the point at which the debt matures when it is paid with the original capital.

Crucially though, the fund differs from conventional mezzanine finance in that there is no equity component and thus no dilution of ownership. In other words, the bank receives its return solely through an interest charge.

Funding will be limited to businesses already growing at an average of around 20 per cent per year while also making a profit. Qualifying companies will be identified as Growth Champions and will benefit from a wider Breakthrough programme that provides support and advice to the companies selected, such as overseas trade missions and access to some of the best fast-growth and iconic businesses in the UK to learn from their experiences first hand.

Make the right choice

Businesses in search of growth capital must consider the pros and cons of all the options. PE investors bring the kind of expertise that can supercharge a company, but the cost of capital is high and there is a high dilution of ownership. Mezzanine finance is cheaper, but involves some dilution. Traditional bank lending is the cheapest option of all, but is likely to be structured in line with how your business looks today, without factoring in the growth, and large, regular repayments can be a drain on cash flow. Santander's commitment to growth capital through its Breakthrough programme is a very attractive option in terms of cost, retention of ownership and support, though it is limited to established companies with an existing track record of profitability and that meet its growth criteria.

Common to all avenues, it is crucial to recognize that, as businesses stand on the verge of transformational growth, they have to ensure that they have adequate

finance functions established which can take responsibility for key performance indicators (KPIs), accounts, growth projections, business plans and overall sound management practices.

With that in place, the good news is that there is more than one option to support growth. The key is to discuss the pros and cons with your advisers and your bank and then choose what is right for your business.

For more information on the different growth capital options available, contact Darren Hart on 07808 397401 or visit www.santanderbreakthrough.co.uk.

Peer-to-peer lending

10.3

How do you solve a problem like bank lending, asks James Meekings at Funding Circle

The engine room of the economy

Since the start of the 21st century, the UK has enjoyed a boom in our small business sector. In a little over 10 years, the number of small businesses has grown an incredible 90 per cent.[1] The Federation of Small Businesses now estimates that small businesses account for 99 per cent of all enterprise in the UK and 48.8 per cent of private sector turnover.[2]

However, despite this march of the makers, the economic crisis has been brutal in its treatment of small business owners. The story of banks failing to lend to small businesses, and the stifling impact this is having on the economic recovery, has become one of the most recurring news topics of the past two and a half years.

Since the start of 2009, small business owners have seen a number of initiatives introduced, all with the aim of shocking the industry back to health. From the Business Finance Taskforce through to Project Merlin (and many others along the way), none has yet proved overly successful.

The next idea up the sleeve of government is the National Loans Guarantee Scheme. However, the major banks have already admitted that this may not result in a net increase in lending to small businesses. In a bid to help ease the flow of credit to small businesses, the government has also allocated up to £100 million to lend through non-traditional channels. This chapter will explore how these alternative solutions can provide significant support for small businesses looking to access finance.

Bank loans: the start and the end of finance?

The traditional routes to finance have always started and ended with the high-street banks. In good times this worked well. However, as the global economic crisis has bitten, the appetite for risk-based lending among small businesses has evaporated.

The recent figures from the Bank of England are a clear indication of this: according to their results, total net lending across the five main UK banks fell in every quarter of

2011.[3] Even when banks have chosen to lend, credit is often offered months after application at inflated prices or unattractive terms, immediately deterring many small businesses.

A lack of demand for banks, not finance

The banks blame these problems on a weak appetite among small businesses. However, in reality the figures paint a very different picture: 35 per cent of small and medium-sized businesses sought finance in 2007, with this figure rising to 42 per cent in 2010. In 2007, successful loan applications to banks were around 90 per cent. This fell to 65 per cent in 2010.[4]

Here exists the fallacy: despite the exhortations made by the banks, it is not a lack of demand for finance; it is a lack of demand for bank finance.

An absence of competition

A significant part of the reason why this myth exists is because there is a lack of alternatives for small businesses when they seek finance. Banks have become so ingrained in our culture that, until recently, if a bank told a small business owner they could not, or would not, lend to them, the owner would assume it was the end of their search. No alternative routes to consider. No opportunity to grow. And they'd be right.

The top five UK banks make up 90 per cent of the lending market. It is devoid of competition and now exists in a state of deadlock.

A new approach to finance

Taking all this into account, it is tempting to look at the picture with a despondent and gloomy view. After all, if businesses cannot obtain finance from traditional routes, where else can they go – and how will the economy start to prosper?

The pain of the economic crisis has led to the birth of new ideas, which aren't reliant on the behemoths of the high street, and offer, for the first time, genuine choice for business owners.

There are new banks starting to enter the market offering fresh competition, and a variety of other options that deserve greater attention. Schemes such as the Community Development Finance Institutions, well established in the United States, already provide credit to underserved markets and are growing in popularity. Business angels are also a popular source for early-stage businesses – both for the financial backing they bring and for the advice and mentoring they can provide. At the same time, the government has promised to support the emergence of innovative new players that are challenging the status quo.

The largest and perhaps most exciting platform to emerge in this industry is peer-to-peer lending. In a little under two years, it has rapidly grown in popularity and has the potential to permanently redraw the landlines of the lending industry.

Peer-to-peer lending originated in the UK about seven years ago, connecting people looking to invest their money with borrowers looking for access to fast and convenient finance. This type of finance originally enabled people to lend money to each other, but this process has evolved, with groups of people now able to lend small amounts directly to creditworthy businesses.

The concept is straightforward: groups of ordinary people (sometimes up to 300–400) lend small amounts of money to lots of different businesses. From a business's point of view each loan is comprised of small amounts of borrowing from many different people who compete to lend to a business, enabling it to borrow at a highly competitive rate.

The advantages to businesses of using a peer-to-peer lending platform are:

- quick and convenient finance in a matter of days;
- fixed-rate monthly repayments;
- no application fees or early repayment charges.

At Funding Circle, we work by enabling individual investors to lend directly to small businesses. Businesses complete an initial online application form which takes approximately 30 minutes. Funding Circle's credit assessment team then review every application. Businesses must be a limited company, have at least two years' worth of accounts posted with Companies House and a strong credit rating score to be accepted on to the marketplace. Loan values range from £5,000 to £250,000, with the length of loans either one, three or five years.

With no bank in the middle, both investors and borrowers achieve a better deal. On average, investors earn 8.3 per gross yield on their investment.

The industry is growing at a considerable rate too. Since Funding Circle launched, we've helped individuals lend more than £30 million to 800 small businesses in the UK, and at present we're lending more than £1 million per week.

And we're not alone. Others, such as Seedrs and Crowdcube, are also using the crowd funding mechanism for equity finance. At the same time, the government announced in its Budget that peer-to-peer lending will be looked at as part of the £100 million Business Finance Partnership scheme, which aims to accelerate credit to small businesses via non-traditional channels.

For the first time in generations, business owners now have real choice about how to achieve finance. When one small business owner approached Funding Circle he'd met with three different banks, none of whom were prepared to lend despite the business having signed contracts from customers. In the end, their only recommendation was that he remortgaged his house.

Instead, he chose to approach Funding Circle; he received his money in two weeks and has since been able to grow his business and take on new members of staff. This simply would not have been possible via the traditional methods.

Bank finance may be the most common route to finance for small businesses, but it is no longer the only option. And perhaps it's not even the best.

Time to think differently

The biggest challenge to us and other new, disruptive players is education and awareness. It's natural that many will feel comfortable sticking with the tried and tested method.

However, the time of hegemonic banking is passing, and businesses should feel empowered to be able to have a different type of relationship with their bank: one that isn't based on exclusivity. It is pleasing that according to a recent survey by Huddlebuy, the group buying website, 65 per cent of small business owners said that they will seek alternative funding measures for their business in 2012. Indeed, we have seen many examples of businesses that continue to have a positive relationship with their bank, but as a result of requiring finance quickly decided to use a different route to obtain their money.

Competition in the market can only be a good thing, and if the banks cannot provide the products or level of services small businesses demand then it is only natural that owners will look at other methods. This is what occurs in many other sectors in the business world, and it is finally coming to financial services.

With the right government support, there is a good opportunity that the future for small businesses can be positive, and owners can get on with what they do best: serving customers and growing their business.

Notes

1. Experian: *SME Lending: A blueprint for growth*
2. http://www.fsb.org.uk/stats
3. http://www.bbc.co.uk/news/business-17009985
4. http://www.ons.gov.uk/ons/rel/fi/access-to-finance/2007-and-2010/stb-access-to-finance.html

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