introduction to raising finance

When a company is growing rapidly, for example when contemplating investment in capital equipment or an acquisition, its current financial resources may be inadequate. Few growing companies are able to finance their expansion plans from cash flow alone. They will therefore need to consider raising finance from other external sources. In addition, managers who are looking to buy-in to a business ("management buy-in" or "MBI") or buy-out (management buy-out" or "MBO") a business from its owners, may not have the resources to acquire the company. They will need to raise finance to achieve their objectives.

There are a number of potential sources of finance to meet the needs of a growing business or to finance an MBI or MBO:

- Existing shareholders and directors funds
- Family and friends
- Business angels
- Clearing banks (overdrafts, short or medium term loans)
- Factoring and invoice discounting
- Hire purchase and leasing
- Merchant banks (medium to longer term loans)
- Venture capital

A key consideration in choosing the source of new business finance is to strike a balance between equity and debt to ensure the funding structure suits the business.

The main differences between borrowed money (debt) and equity are that bankers request interest payments and capital repayments, and the borrowed money is usually secured on business assets or the personal assets of shareholders and/or directors. A bank also has the power to place a business into administration or bankruptcy if it defaults on debt interest or repayments or its prospects decline.

In contrast, equity investors take the risk of failure like other shareholders, whilst they will benefit through participation in increasing levels of profits and on the eventual sale of their stake. However in most circumstances venture capitalists will also require more complex investments (such as preference shares or loan stock) in additional to their equity stake.

The overall objective in raising finance for a company is to avoid exposing the business to excessive high borrowings, but without unnecessarily diluting the share capital. This will ensure that the financial risk of the company is kept at an optimal level.

Business Plan

Once a need to raise finance has been identified it is then necessary to prepare a business plan. If management intend to turn around a business or start a new phase of growth, a business plan is an important tool to articulate their ideas while convincing investors and other people to support it. The business plan should be updated regularly to assist in forward planning.

There are many potential contents of a business plan. The European Venture Capital Association suggest the following:

- Profiles of company founders directors and other key managers;
- Statistics relating to sales and markets;
- Names of potential customers and anticipated demand;
- Names of, information about and assessment of competitors;
- Financial information required to support specific projects (for example, major capital investment or new product development);
- Research and development information;
- Production process and sources of supply;
- Information on requirements for factory and plant;
- Magazine and newspaper articles about the business and industry;
- Regulations and laws that could affect the business product and process protection (patents, copyrights, trademarks).

The challenge for management in preparing a business plan is to communicate their ideas clearly and succinctly. The very process of researching and writing the business plan should help clarify ideas and identify gaps in management information about their business, competitors and the market.

Types of Finance - Introduction

A brief description of the key features of the main sources of business finance is provided below.

Venture Capital

Venture capital is a general term to describe a range of ordinary and preference shares where the investing institution acquires a share in the business. Venture capital is intended for higher risks such as start up situations and development capital for more mature investments. Replacement capital brings in an institution in place of one of the original shareholders of a business who wishes to realise their personal equity before the other shareholders. There are over 100 different venture capital funds in the UK and some have geographical or industry preferences. There are also certain large industrial companies which have funds available to invest in growing businesses and this 'corporate venturing' is an additional source of equity finance.

Grants and Soft Loans

Government, local authorities, local development agencies and the European Union are the major sources of grants and soft loans. Grants are normally made to facilitate the purchase of assets and either the generation of jobs or the training of employees. Soft loans are normally subsidised by a third party so that the terms of interest and security levels are less than the market rate. There are over 350 initiatives from the Department of Trade and Industry alone so it is a matter of identifying which sources will be appropriate in each case.

Invoice Discounting and Invoice Factoring

Finance can be raised against debts due from customers via invoice discounting or invoice factoring, thus improving cash flow. Debtors are used as the prime security for the lender and the borrower may obtain up to about 80 per cent of approved debts. In addition, a number of these sources of finance will now lend against stock and other assets and may be more suitable then bank lending. Invoice discounting is normally confidential (the customer is not aware that their payments are essentially insured) whereas factoring extends the simple discounting principle by also dealing with the administration of the sales ledger and debtor collection.

Hire Purchase and Leasing

Hire purchase agreements and leasing provide finance for the acquisition of specific assets such as cars, equipment and machinery involving a deposit and repayments over, typically, three to ten years. Technically, ownership of the asset remains with the lessor whereas title to the goods is eventually transferred to the hirer in a hire purchase agreement.

Loans

Medium term loans (up to seven years) and long term loans (including commercial mortgages) are provided for specific purposes such as acquiring an asset, business or shares. The loan is normally secured on the asset or assets and the interest rate may be variable or fixed. The Small Firms Loan Guarantee Scheme can provide up to £250,000 of borrowing supported by a government guarantee where all other sources of finance have been exhausted.

Mezzanine Debt

This is a loan finance where there is little or no security left after the senior debt has been secured. To reflect the higher risk of mezzanine funds, the lender will charge a rate of interest of perhaps four to eight per cent over bank base rate, may take an option to acquire some equity and may require repayment over a shorter term.

Bank Overdraft

An overdraft is an agreed sum by which a customer can overdraw their current account. It is normally secured on current assets, repayable on demand and used for short term working capital fluctuations. The interest cost is normally variable and linked to bank base rate.

Completing the finance-raising

Raising finance is often a complex process. Business management need to assess several alternatives and then negotiate terms which are acceptable to the finance provider. The main negotiating points are often as follows:

- Whether equity investors take a seat on the board
- Votes ascribed to equity investors
- Level of warranties and indemnities provided by the directors
- Financier's fees and costs
- Who bears costs of due diligence.

During the finance-raising process, accountants are often called to review the financial aspects of the plan. Their report may be formal or informal, an overview or an extensive review of the company's management information system, forecasting methods and their accuracy, review of latest management accounts including working capital, pension funding and employee contracts etc. This due diligence process is used to highlight any fundamental problems that may exist.

business angel finance

Business owners often report that company finance of £10,000 to £250,000 can be very difficult to obtain - even from traditional sources such as banks and venture capitalists. Banks generally require security and most venture capital firms are not interested in financing such small amounts. In these circumstances, companies often have to turn to "Business Angels".

Business angels are wealthy, entrepreneurial individuals who provide capital in return for a proportion of the company equity. They take a high personal risk in the expectation of owning part of a growing and successful business.

Businesses Suitable for Angel Investment

Businesses are unlikely to be suitable for investment by a business angel unless certain conditions are fulfilled.

(1) The business needs to raise a reasonably modest amount (typically between £10,000 to £250,000,and is willing to sell a shareholding in return for financing. Equity finance of over £250,000 is usually provided by venture capital firms rather than business angels. The exceptions are when several business angels invest together in a syndicate or when business angels co-invest alongside venture capital funds. The sums raised can easily exceed £250,000. Raising finance in the form of equity (shares) strengthens the business' balance sheet. Banks (or other lenders) may then be willing to provide additional debt finance.

(2) The owners and managers of the business are willing to develop a personal relationship with a business angel. This is important. Typically, business angels want hands-on involvement in the management of their investment, without necessarily exercising day-to-day control. This relationship can be a positive one for the business. A business angel with the right skills can strengthen a business by, for example, offering marketing and sales experience.

(3) The business can, and is prepared to offer the business angel the possibility of a high return (usually an expected average annual return of at least 20%–30% per annum). Most of this return will be realised in the form of capital gains over a period of several years.

(4) The business can demonstrate a strong understanding of its products and markets. Some business angels specialise by providing "expansion finance" for businesses with a proven track record, or in particular sectors. This enables an already successful business to grow faster. Business angels are also a significant source of start-up and early-stage capital for companies without a track record. A business plan based on convincing market research is essential.

(5) The business has an experienced and professional management team - as a minimum with strong product and sales skills. If there are weaknesses in the existing management

team, a business angel can often provide the missing skills or introduce the business to new management.

(6) The business can offer the business angel the possibility of an ‘exit’. Even if the business angel has no plans to realise the investment by any particular date, the angel will want the option to be available. The most common exits are:

- A trade sale of the business to another company.
- Repurchase of the business angel’s shares by the company.
- Purchase of the business angel’s shares by the company’s directors or another investor.

Finding an angel

Many contacts are made informally.For example: personal friends and family; wealthy business contacts; major suppliers and clients of the business. Investors can also be found by approaching formal angel networking organisations. Many of the most active business angels use these networks to find out about interesting investment opportunities.

introduction to venture capital

Venture Capital is a form of "risk capital". In other words, capital that is invested in a project (in this case - a business) where there is a substantial element of risk relating to the future creation of profits and cash flows. Risk capital is invested as shares (equity) rather than as a loan and the investor requires a higher"rate of return" to compensate him for his risk.

The main sources of venture capital in the UK are venture capital firms and "business angels" - private investors. Separate Tutor2u revision notes cover the operation of business angels. In these notes, we principally focus on venture capital firms. However, it should be pointed out the attributes that both venture capital firms and business angels look for in potential investments are often very similar.

What is venture capital?

Venture capital provides long-term, committed share capital, to help unquoted companies grow and succeed. If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he works, turnaround or revitalise a company, venture capital could help do this. Obtaining venture capital is substantially different from raising debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business . Venture capital is invested in exchange for an equity stake in the business. As a shareholder, the venture capitalist's return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist "exits" by selling its shareholding when the business is sold to another owner.

Venture capital in the UK originated in the late 18th century, when entrepreneurs found wealthy individuals to back their projects on an ad hoc basis. This informal method of financing became an industry in the late 1970s and early 1980s when a number of venture capital firms were founded. There are now over 100 active venture capital firms in the UK, which provide several billion pounds each year to unquoted companies mostly located in the UK.

What kind of businesses are attractive to venture capitalists?

Venture capitalist prefer to invest in "entrepreneurial businesses". This does not necessarily mean small or new businesses. Rather, it is more about the investment's aspirations and potential for growth, rather than by current size. Such businesses are aiming to grow rapidly to a significant size. As a rule of thumb, unless a business can offer the prospect of significant turnover growth within five years, it is unlikely to be of interest to a venture capital firm. Venture capital investors are only interested in companies with high growth prospects, which are managed by experienced and ambitious teams who are capable of turning their business plan into reality.

For how long do venture capitalists invest in a business?

Venture capital firms usually look to retain their investment for between three and seven years or more. The term of the investment is often linked to the growth profile of the business. Investments in more mature businesses, where the business performance can be improved quicker and easier, are often sold sooner than investments in early-stage or technology companies where it takes time to develop the business model.

Where do venture capital firms obtain their money?

Just as management teams compete for finance, so do venture capital firms. They raise their funds from several sources. To obtain their funds, venture capital firms have to demonstrate a good track record and the prospect of producing returns greater than can be achieved through fixed interest or quoted equity investments. Most UK venture capital firms raise their funds for investment from external sources, mainly institutional investors, such as pension funds and insurance companies.

Venture capital firms' investment preferences may be affected by the source of their funds. Many funds raised from external sources are structured as Limited Partnerships and usually have a fixed life of 10 years. Within this period the funds invest the money committed to them and by the end of the 10 years they will have had to return the investors' original money, plus any additional returns made. This generally requires the investments to be sold, or to be in the form of quoted shares, before the end of the fund.

Venture Capital Trusts (VCT's) are quoted vehicles that aim to encourage investment in smaller unlisted (unquoted and AIM quoted companies) UK companies by offering private investors tax incentives in return for a five-year investment commitment. The first were launched in Autumn 1995 and are mainly managed by UK venture capital firms. If funds are obtained from a VCT, there may be some restrictions regarding the company's future development within the first few years.

What is involved in the investment process?

The investment process, from reviewing the business plan to actually investing in a proposition, can take a venture capitalist anything from one month to one year but typically it takes between 3 and 6 months. There are always exceptions to the rule and deals can be done in extremely short time frames. Much depends on the quality of information provided and made available.

The key stage of the investment process is the initial evaluation of a business plan. Most approaches to venture capitalists are rejected at this stage. In considering the business plan, the venture capitalist will consider several principal aspects:

- Is the product or service commercially viable?
- Does the company have potential for sustained growth?
- Does management have the ability to exploit this potential and control the company through the growth phases?
- Does the possible reward justify the risk?
- Does the potential financial return on the investment meet their investment criteria?

In structuring its investment, the venture capitalist may use one or more of the following types of share capital:

Ordinary shares

These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied. Ordinary shares have votes. In a venture capital deal these are the shares typically held by the management and family shareholders rather than the venture capital firm.

Preferred ordinary shares

These are equity shares with special rights.For example, they may be entitled to a fixed dividend or share of the profits. Preferred ordinary shares have votes.

Preference shares

These are non-equity shares. They rank ahead of all classes of ordinary shares for both income and capital. Their income rights are defined and they are usually entitled to a fixed dividend (eg. 10% fixed). The shares may be redeemable on fixed dates or they may be irredeemable. Sometimes they may be redeemable at a fixed premium (eg. at 120% of cost). They may be convertible into a class of ordinary shares.

Loan capital

Venture capital loans typically are entitled to interest and are usually, though not necessarily repayable. Loans may be secured on the company's assets or may be unsecured. A secured loan will rank ahead of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Alternatively, it may have a warrant attached which gives the loan holder the option to subscribe for new equity shares on terms fixed in the warrant. They typically carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

Venture capital investments are often accompanied by additional financing at the point of investment. This is nearly always the case where the business in which the investment is being made is relatively mature or well-established. In this case, it is appropriate for a business to have a financing structure that includes both equity and debt.

Other forms of finance provided in addition to venture capitalist equity include:

- Clearing banks - principally provide overdrafts and short to medium-term loans at fixed or, more usually, variable rates of interest.

- Merchant banks - organise the provision of medium to longer-term loans, usually for larger amounts than clearing banks. Later they can play an important role in the process of "going public" by advising on the terms and price of public issues and by arranging underwriting when necessary.

- Finance houses - provide various forms of installment credit, ranging from hire purchase to leasing, often asset based and usually for a fixed term and at fixed interest rates.

Factoring companies - provide finance by buying trade debts at a discount, either on a recourse basis (you retain the credit risk on the debts) or on a non-recourse basis (the factoring company takes over the credit risk).

Government and European Commission sources - provide financial aid to UK companies, ranging from project grants (related to jobs created and safeguarded) to enterprise loans in selective areas.

Mezzanine firms - provide loan finance that is halfway between equity and secured debt. These facilities require either a second charge on the company's assets or are unsecured. Because the risk is consequently higher than senior debt, the interest charged by the mezzanine debt provider will be higher than that from the principal lenders and sometimes a modest equity "up-side" will be required through options or warrants. It is generally most appropriate for larger transactions.

Making the Investment - Due Diligence

To support an initial positive assessment of your business proposition, the venture capitalist will want to assess the technical and financial feasibility in detail.

External consultants are often used to assess market prospects and the technical feasibility of the proposition, unless the venture capital firm has the appropriately qualified people in-house. Chartered accountants are often called on to do much of the due diligence, such as to report on the financial projections and other financial aspects of the plan. These reports often follow a detailed study, or a one or two day overview may be all that is required by the venture capital firm. They will assess and review the following points concerning the company and its management:

- Management information systems
- Forecasting techniques and accuracy of past forecasting
- Assumptions on which financial assumptions are based
- The latest available management accounts, including the company's cash/debtor positions
- Bank facilities and leasing agreements
- Pensions funding
- Employee contracts, etc.

The due diligence review aims to support or contradict the venture capital firm's own initial impressions of the business plan formed during the initial stage. References may also be taken up on the company (eg. with suppliers, customers, and bankers).

introduction to business planning

What is the Business Plan?

The business plan sets out how the owners/managers of a business intend to realise its objectives. Without such a plan a business is likely to drift.

The business plan serves several purposes:it

(1)enables management to think through the business in a logical and structured way and to set out the stages in the achievement of the business objectives.
(2)enables management to plot progress against the plan (through the management accounts)
(3)ensures that both the resources needed to carry out the strategy and the time when they are required are identified.
(4)is a means for making all employees aware of the business's direction (assuming the key features of the business plan are communicated to employees)
(5)is an important document for for discussion with prospective investors and lenders of finance (e.g. banks and venture capitalists).
(6)links into the detailed, short-term, one-year budget.

The Link Between the Business Plan and the Budget

A budget can be defined as "a financial or quantitative statement", prepared for a specific accounting period (typically a year), containing the plans and policies to be pursued during that period.

The main purposes of a budget are:

(1)to monitor business unit and managerial performance (the latter possibly linking into bonus arrangements)
(2)to forecast the out-turn of the period's trading (through the use of flexed budgets and based on variance analyses)
(3)to assist with cost control.

Generally, a functional budget is prepared for each functional area within a business (e.g. call-centre, marketing, production, research and development, finance and administration). In addition, it is also normal to produce a "capital budget" detailing the capital investment required for the period, a "cash flow budget", a "stock budget" and a "master budget", which includes the budgeted profit and loss account and balance sheet.

Preparing a Business Plan

A business plan has to be particular to the organisation in question, its situation and time. However, a business plan is not just a document, to be produced and filed. Business planning is a continuous process. The business plan has to be a living document, constantly in use to monitor, control and guide the progress of a business. That means it should be under regular review and will need to be amended in line with changing circumstances.

Before preparing the plan management should:
- review previous business plans (if any) and their outcome. This review will help highlight which areas of the business have proved difficult to forecast historically. For example, are sales difficult to estimate? If so why?
- be very clear as to their objectives - a business plan must have a purpose
- set out the key business assumptions on which their plans will be based (e.g. inflation, exchange rates, market growth, competitive pressures, etc.)
- take a critical look at their business. The classical way is by means of the strengths-weaknesses-opportunities-threats (SWOT) analysis, which identifies the business's situation from four key angles. The strategies adopted by a business will be largely based on the outcome of this analysis.

Preparing the Budget

A typical business plan looks up to three years forward and it is normal for the first year of the plan to be set out in considerable detail. This one-year plan, or budget, will be prepared in such a way that progress can be regularly monitored (usually monthly) by checking the variance between the actual performance and the budget, which will be phased to take account of seasonal variations.

The budget will show financial figures (cash, profit/loss working capital, etc) and also non-financial items such as personnel numbers, output, order book, etc. Budgets can be produced for units, departments and products as well as for the total organisation. Budgets for the forthcoming period are usually produced before the end of the current period. While it is not usual for budgets to be changed during the period to which they relate (apart from the most extraordinary circumstances) it is common practice for revised forecasts to be produced during the year as circumstances change.

A further refinement is to **flex** the budgets, i.e. to show performance at different levels of business. This makes comparisons with actual outcomes more meaningful in cases where activity levels differ from those included in the budget.

What Providers of Finance Want from a Business Plan

Almost invariably bank managers and other providers of finance will want to see a business plan before agreeing to provide finance. Not to have a business plan will be regarded as a bad sign. They will be looking not only at the plan, but at the persons behind it. They will want details of the owner/managers of the business, their background and experience, other activities, etc. They will be looking for management commitment, with enthusiasm tempered by realism. The plan must be thought through and not be a skimpy piece of work. A few figures on a spreadsheet are not enough.

The plan must be used to run the business and there must be a means for checking progress against the plan. An information system must be in place to provide regular details of progress against plan. Bank managers are particularly wary of businesses that are slow in producing internal performance figures. Lenders will want to guard against risk. In particular they will be looking for two assurances:

(1)that the business has the means of making regular payment of interest on the amount loaned, and

(2)that if everything goes wrong the bank can still get its money back (i.e. by having a debenture over the business's assets). Forward-looking financial statements, particularly the cash flow forecast, are therefore of critical importance. The bank wants openness and no surprises. If something is going wrong it does not want this covered up, it wants to be informed - quickly.

equity finance - introduction

Introduction

What is equity?

Equity is the term commonly used to describe the ordinary share capital of a business.

Ordinary shares in the equity capital of a business entitle the holders to all distributed profits after the holders of debentures and preference shares have been paid.

Ordinary (equity) shares

Ordinary shares are issued to the owners of a company. The ordinary shares of UK companies typically have a nominal or 'face' value (usually something like £1 or 5Op, but shares with a nominal value of 1p, 2p or 2Sp are not uncommon).

However, it is important to understand that the market value of a company's shares has little (if any) relationship to their nominal or face value. The market value of a company's shares is determined by the price another investor is prepared to pay for them. In the case of publicly-quoted companies, this is reflected in the market value of the ordinary shares traded on the stock exchange (the "share price").

In the case of privately-owned companies, where there is unlikely to be much trading in shares, market value is often determined when the business is sold or when a minority shareholding is valued for taxation purposes.

In your studies, you may also come across "Deferred ordinary shares". These are a form of ordinary shares, which are entitled to a dividend only after a certain date or only if profits rise above a certain amount. Voting rights might also differ from those attached to other ordinary shares.

Why might a company issue ordinary shares?

A new issue of shares might be made for several reasons:

(1) The company might want to raise more cash

For example might be needed for the expansion of a company's operations. If, for example, a company with 500,000 ordinary shares in issue decides to issue 125,000 new shares to raise cash, should it offer the new shares to existing shareholders, or should it sell them to new shareholders instead?

- Where a company sells the new shares to existing shareholders in proportion to their existing shareholding in the company, this is known as a **"rights issue"**.

(2) The company might want to issue new shares partly to raise cash but more importantly to 'float' its shares on a stock market.

When a UK company is floated, it must make available a minimum proportion of its shares to the general investing public.

(3) The company might issue new shares to the shareholders of another company, in order to take it over

There are many examples of businesses that use their high share price as a way of making an offer for other businesses. The shareholders of the target business being acquired received shares in the buying business and perhaps also some cash.

Sources of equity finance

There are three main methods of raising equity:

(1) Retained profits: i.e. retaining profits, rather than paying them out as dividends. This is the most important source of equity

(2) Rights issues: i.e. an issue of new shares. After retained profits, rights issues are the next most important source

(3) New issues of shares to the public: i.e. an issue of new shares to new shareholders. In total in the UK, this is the least important source of equity finance

equity finance - new share issues to the public: introduction

Introduction

There are three main ways of raising equity finance:

- Retaining profits in the business (rather than distributing them to equity shareholders);

- Selling new shares to existing shareholders (a "rights issue")

- Selling new shares to the general public and investing institutions

This revision note outlines the process involved in the third method above.

How significant are new issues of shares in the UK?

Issues of new shares to the public account for around 10% of new equity finance in the UK.

Whilst not significant in the overall context of UK equity financing, when new issues do occur, they are often large in terms of the amount raised.

New issues are usually used at the time a business first obtains a listing on the Stock Exchange. This process is called an Initial Public Offering ("IPO") or a "flotation".

Methods

The process of a stock market flotation can apply both to private and nationalised share issues. There are also several methods that can be used. These methods are:

• An introduction

• Issue by tender

• Offer for sale

• Placing, and

• A public issue

In practice the "offer for sale" method is the most common method of flotation. There is no restriction on the amount of capital raised by this method.

The general procedures followed by the various methods of flotation are broadly the same. These include

- Advertising, e.g. in newspapers

- Following legal requirements, and Stock Exchange regulations in terms of the large volumes of information which must be provided. Great expense is incurred in providing this information, e.g. lawyers, accountants, other advisors.

Why issue new shares on a stock exchange?

The following are reasons why a company may seek a stock market listing:

(1) Access to a wider pool of finance

A stock market listing widens the number of potential investors. It may also improve the company's credit rating, making debt finance easier and cheaper to obtain.

(2) Improved marketability of shares

Shares that are traded on the stock market can be bought and sold in relatively small quantities at any time. Existing investors can easily realise a part of their holding.

(3) Transfer of capital to other uses

Founder owners may wish to liquidate the major part of their holding either for personal reasons or for investment in other new business opportunities.

(4) Enhancement of company image

Quoted companies are commonly believed to be more financially stable. A stock exchange listing may improve the image of the company with its customers and suppliers, allowing it to gain additional business and to improve its buying power.

(5) Facilitation of growth by acquisition

A listed company is in a better position to make a paper offer for a target company than an unlisted one.

However, the owners of a private company which becomes a listed plc (public company) must accept that the change is likely to involve a significant loss of control to a wider circle of investors. The risk of the company being taken over will also increase following listing.

asset finance - introduction to hire purchase and leasing

Introduction

The acquisition of assets - particularly expensive capital equipment - is a major commitment for many businesses. How that acquisition is funded requires careful planning.

Rather than pay for the asset outright using cash, it can often make sense for businesses to look for ways of spreading the cost of acquiring an asset, to coincide with the timing of the revenue generated by the business.The most common sources of medium term finance for investment in capital assets are Hire Purchase and Leasing.

Leasing and hire purchase are financial facilities which allow a business to use an asset over a fixed period, in return for regular payments. The business customer chooses the equipment it requires and the finance company buys it on behalf of the business.

Many kinds of business asset are suitable for financing using hire purchase or leasing, including:

- Plant and machinery
- Business cars
- Commercial vehicles
- Agricultural equipment
- Hotel equipment
- Medical and dental equipment
- Computers, including software packages
- Office equipment

Hire purchase

With a hire purchase agreement, after all the payments have been made, the business customer becomes the owner of the equipment. This ownership transfer either automatically or on payment of an option to purchase fee.

For tax purposes, from the beginning of the agreement the business customer is treated as the owner of the equipment and so can claim capital allowances. Capital allowances can be a significant tax incentive for businesses to invest in new plant and machinery or to upgrade information systems.

Under a hire purchase agreement, the business customer is normally responsible for maintenance of the equipment.

Leasing

The fundamental characteristic of a lease is that ownership never passes to the business customer.

Instead, the leasing company claims the capital allowances and passes some of the benefit on to the business customer, by way of reduced rental charges.

The business customer can generally deduct the full cost of lease rentals from taxable income, as a trading expense.

As with hire purchase, the business customer will normally be responsible for maintenance of the equipment.

There are a variety of types of leasing arrangement:

Finance Leasing

The finance lease or 'full payout lease' is closest to the hire purchase alternative. The leasing company recovers the full cost of the equipment, plus charges, over the period of the lease.

Although the business customer does not own the equipment, they have most of the 'risks and rewards' associated with ownership. They are responsible for maintaining and insuring the asset and must show the leased asset on their balance sheet as a capital item.

When the lease period ends, the leasing company will usually agree to a secondary lease period at significantly reduced payments. Alternatively, if the business wishes to stop using the equipment, it may be sold second-hand to an unrelated third party. The business arranges the sale on behalf of the leasing company and obtains the bulk of the sale proceeds.

Operating Leasing

If a business needs a piece of equipment for a shorter time, then operating leasing may be the answer. The leasing company will lease the equipment, expecting to sell it secondhand at the end of the lease, or to lease it again to someone else. It will, therefore, not need to recover the full cost of the equipment through the lease rentals.

This type of leasing is common for **equipment where there is a well-established secondhand market** (e.g. cars and construction equipment). The lease period will usually be for two to three years, although it may be much longer, but is always less than the working life of the machine.

Assets financed under operating leases are not shown as assets on the balance sheet. Instead, the entire operating lease cost is treated as a cost in the profit and loss account.

Contract Hire

Contract hire is a form of operating lease and it is often used for vehicles.

The leasing company undertakes some responsibility for the management and maintenance of the vehicles. Services can include regular maintenance and repair costs, replacement of tyres and batteries, providing replacement vehicles, roadside assistance and recovery services and payment of the vehicle licences.

overdraft financing

Overdraft financing is provided when businesses make payments from their business current account exceeding the available cash balance. An overdraft facility enables businesses to obtain short-term funding - although in theory the amount loaned is repayable on demand by the bank.

There are several important factors to consider when assessing the appropriateness of an overdraft as a source of funding for SME's:

- The amount borrowed should not exceed the agreed limit ("**facility**"). The amount of the facility made available is a matter for negotiation with the bank;

- Interest is charged on the amount overdrawn - at a rate that is above the Bank Base Rate. The bank may also charge an overdraft facility fee;

- Overdrafts are generally meant to cover short-term financing requirements - they are not generally meant to provide a permanent source of finance

- Depending on the size of the overdraft facility, the bank may require the SME to provide some security - for example by securing the overdraft against tangible fixed assets, or against personal guarantees provided by the directors

The amount of an overdraft at any one time will depend on the cash flows of the business, the timing of receipts and payments, seasonal trends in the sales and so on. This can be illustrated using the data below. In the example cash flow statement given below, the SME generates a positive overall cash flow in a full year. However, due to the timing of sales receipts compared with supplier payments, the business needs to fund a temporary overdraft during the year:

	Opening Balance	Sales Receipts	Cash Payments	Monthly Cash Flow	Closing Balance
January	0	225,000	200,000	25,000	25,000
February	25,000	235,000	225,000	10,000	35,000
March	35,000	195,000	225,000	-30,000	5,000
April	5,000	215,000	250,000	-35,000	-30,000
May	-30,000	260,000	275,000	-15,000	-45,000
June	-45,000	315,000	325,000	-10,000	-55,000
July	-55,000	255,000	275,000	-20,000	-75,000
August	-75,000	240,000	225,000	15,000	-60,000
September	-60,000	240,000	200,000	40,000	-20,000
October	-20,000	200,000	175,000	25,000	5,000
November	5,000	230,000	200,000	30,000	35,000
December	35,000	275,000	225,000	50,000	85,000
Total		2,885,000	2,800,000	85,000	

In the example above, the business requires a maximum overdraft facility of £75,000 in July. Thereafter, the overdraft balance reduces as sales receipts exceed cash payments.

If the business finds that an overdraft facility appears to be becoming a long-term feature of the business, the bank may suggest converting the overdraft into a medium-term loan.

Comparison of Bank Overdrafts and Bank Loans

The key advantages of overdrafts and loans in certain business situations:

Advantages of an overdraft over a loan

Customer only pays interest when overdrawn

Bank has flexibility to review and adjust the level of the overdraft facility, perhaps on a short-term basis

Overdraft can be effectively be used as a medium-term loan – the facility is simply renewed each time the bank comes to review it

Being part of short-term debt, the overdraft balance is not normally included in calculations of the business’ financial gearing

Advantages of a loan over an overdraft

Business and bank know precisely what the repayments of the loan will be and how much interest is payable and when. This makes cash flow planning more predictable

The loan is committed – the business does not have to worry about the loan being withdrawn whilst it complies with the terms of the loan

sources of finance for small and growing businesses

Introduction

In this revision note , we concentrate on how small and medium-sized businesses ("SME's") obtain finance.

SME's can be defined as having three main characteristics:

• Companies are not quoted on a stock exchange – they are "unquoted"

• Ownership of the business is typically restricted to a few individuals. Often this is a family connection between the shareholders

• Many SME's are the means by which individuals (or small groups) effectively achieve self-employment

The SME sector is a vital one in the UK economy. In 1999, the Department for Trade and Industry (DTI) estimated that there are 3.7 SME businesses in the UK. Sole traders account for the majority of the businesses in the UK (63 per cent) but a smaller proportion of the number of employees (23 per cent) and an even smaller proportion of turnover (9 per cent). As a proportion of all businesses in the UK, SME's account for some 55 per cent of employment and 45 per cent of turnover.

Why do SME's find financing a problem?

The main problem faced by SME's when trying to obtain funding is that of uncertainty:

• SME's rarely have a long history or successful track record that potential investors can rely on in making an investment;

• Larger companies (particularly those quoted on a stock exchange) are required to prepare and publish much more detailed financial information – which can actually assist the finance-raising process;

• Banks are particularly nervous of smaller businesses due to a perception that they represent a greater credit risk.

Because the information is not available in other ways, SME's will have to provide it when they seek finance. They will need to give a business plan, list of the company assets, details of the experience of directors and managers and demonstrate how they can give providers of finance some security for amounts provided.

Prospective lenders – usually banks – will then make a decision based on the information provided. The terms of the loan (interest rate, term, security, repayment details) will depend on the risk involved and the lender will also want to monitor their investment.

A common problem is often that the banks will be unwilling to increase loan funding without an increase in the security given (which the SME owners may be unable or unwilling to provide).

A particular problem of uncertainty relates to businesses with a low asset base. These are companies without substantial tangible assets which can be use to provide security for lenders.

When an SME is not growing significantly, financing may not be a major problem. However, the financing problem becomes very important when a company is growing rapidly, for example when contemplating investment in capital equipment or an acquisition.

Few growing companies are able to finance their expansion plans from cash flow alone. They will therefore need to consider raising finance from other external sources. In addition, managers who are looking to buy-in to a business ("management buy-in" or "MBI") or buy-out (management buy-out" or "MBO") a business from its owners, may not have the resources to acquire the company. They will need to raise finance to achieve their objectives.

Sources of finance for SME’s

There are a number of potential sources of finance to meet the needs of small and growing businesses:

• Existing shareholders and directors funds (“owner financing”)
• Overdraft financing
• Trade credit
• Equity finance
• Business angel financing
• Venture capital
• Factoring and invoice discounting
• Hire purchase and leasing
• Merchant banks (medium to longer term loans

A key consideration in choosing the source of new business finance is to strike a balance between equity and debt to ensure the funding structure suits the business.

The main differences between borrowed money (debt) and equity are that bankers request interest payments and capital repayments, and the borrowed money is usually secured on business assets or the personal assets of shareholders and/or directors. A bank also has the power to place a business into administration or bankruptcy if it defaults on debt interest or repayments or its prospects decline.

In contrast, equity investors take the risk of failure like other shareholders, whilst they will benefit through participation in increasing levels of profits and on the eventual sale of their stake. However, in most circumstances venture capitalists will also require more complex investments (such as preference shares or loan stock) in additional to their equity stake.

The overall objective in raising finance for a company is to avoid exposing the business to excessive high borrowings, but without unnecessarily diluting the share capital. This will ensure that the financial risk of the company is kept at an optimal level.

financing a business - grants and subsidies

There are a wide range of grants and subsidised loans available to UK businesses. Finance is available to help support business expansion, to provide funding for research and development, to support training initiatives, to help acquire new premises or refurbish existing buildings or to support international expansion.

Whilst the provision of actual cash is usually the most important issue, grant aid help can come in many different forms. For example, certain grant agencies will provide assistance in finding investors, to help in generating new export leads or introducing experts to accelerate the development of new product ideas and strategies.

The availability of grants and subsidies often depends on which sector a business is in, where it is located, how well the application is made and timing (some grants only last for a certain period or until the funding has been allocated). The key factor in winning grants and subsidies is whether the funding results in the creation of jobs, especially in regional or local areas that particularly need them. Accordingly, we have set out below further detail on the main forms of regional grant aid currently available in the UK

Restrictions on Grants

Match funding
One of the strings attached to a grant is that businesses have to put up some of their own funding in addition to grant they might receive. It's rare for a grant to cover more than 50% of the cost of a particular venture or project . In most cases between 15% and 50% will be offered by the grant provider.

Specific projects
Grant funding will usually relate to a specific project. This could be a relocation, the development of a new product, the investigation of a new export market. With major grants such as Enterprise Grants and Regional Selective Assistance the project must become viable within a certain timeframe. In addition, the project plan will need to be well developed and defined, with identifiable deliverables. It is likely that a well-constructed business plan will be an important part of the proposal.

Assisted Areas - the Key Source of UK Grants

Certain areas in the UK qualify for funding because they satisfy criteria for special assistance drawn up by the European Commission on National Regional aid. The legislation that sets out the criteria is called Article 87 (3). The main form of aid in these areas is Regional Selective Assistance ("RSA") - a discretionary grant aimed at safeguarding and creating employment and increasing regional prosperity. It is designed to cover a percentage of the costs involved when a company embarks on a project over £500,000. There are three "Tiers" which define the nature of grant aid under Article 87(3):

TIER 1

'Tier 1' means that over three years 1994 to 1996 these areas had a GDP (Gross Domestic Product) per capital of below 75% of the EU average. In short, these are the areas with the greatest economic need. Tier 1 areas are eligible for RSA grant for large capital projects, and in additionally smaller companies in the area may receive Enterprise Grant - aimed at covering a percentage of project costs for initiatives costing under £500,000.The areas for 2000 to 2006 are:

Cornwall
Merseyside
South Yorkshire
West Wales and the Valleys

TIER 2

Tier 2 areas are those that are defined to have areas of acute labour market need. Tier 2 is eligible both Enterprise Grant and for RSA - although for RSA the % of project costs supported will be lower than Tier 1. Additionally, the Highlands and Islands Enterprise area in Scotland was awarded assisted area status under Article 87(3)c in recognition of the problems imposed by its sparse population. The Scottish Executive administers RSA grant for projects over £100,000, and for project under that amount the 'Invest for Growth Scheme'.

'TIER 3': ENTERPRISE GRANT AREAS

A third tier where assistance is available to businesses employing up to 250 people. The areas extend beyond tiers 1 and 2, and complement existing measures to support and encourage the development of small business, acknowledging the essential role small business plays in regional development. RSA is not available in these areas - but as the name suggests, Enterprise Grant is.The Enterprise Grant Areas cover:

Local authority districts with high unemployment or low employment rates
Ex-Coalfield areas
Rural development areas

RURAL DEVELOPMENT AREAS/RURAL PRIORITY AREAS

Granted aid by the Rural Development Commission, Rural Development Areas are in those parts of rural England suffering a concentration of economic and social needs, where rural regeneration activities are focused. There are 31 individual RDA's covering 35% of England´s land area and some 7% of the population.

Examples of Organisations offering Grants and Subsidies

Grant aid is not just available as part of UK and European government attempts to invest in economically-poor areas. The following list of organisations also provide grants and subsidies to UK business meeting certain criteria:

The Department of Trade and Industry: e.g. small firms loan guarantee scheme
The Princes Trust: grants for people aged 14-30 to help them set up in business

Export Marketing Research Scheme run by the British Chambers of Commerce
New Deal - Disabled and Long-term III

equity finance - rights issues

Introduction

What is a rights issue?

A rights issue is an issue of new shares for cash to existing shareholders in proportion to their existing holdings.

A rights issue is, therefore, a way of raising new cash from shareholders - this is an important source of new equity funding for publicly quoted companies.

Why issue shares to existing shareholders?

Legally a rights issue must be made before a new issue to the public. This is because existing shareholders have the "right of first refusal" (otherwise known as a "preemption right") on the new shares.

By taking these preemption rights up, existing shareholders can maintain their existing percentage holding in the company.

However, shareholders can, and often do, waive these rights, by selling them to others. Shareholders can also vote to rescind their preemption rights.

How are the shares sold in a rights issue priced?

The price at which the new shares are issued is generally much less than the prevailing market price for the shares. A discount of up to 20-30% is fairly common.

Why would a business offer new shares at a price well below the current share price?

The main reason is to make the offer relatively attractive to shareholders and encourage them either to take up their rights or sell them so the share issue is **"fully subscribed"**.

The price discount also acts as a safeguard should the market price of the company's shares fall before the issue is completed. If the market share price were to fall below the rights issue price, the issue would not have much chance of being a success - since shareholders could buy the shares cheaper in the market than by taking up their rights to buy through the new issue.

Do existing shareholders have to take up their rights to buy new shares?

In a word - no.

Shareholders who do not wish to take up their rights may sell them on the stock market or via the firm making the rights issue, either to other existing shareholders or new shareholders. The buyer then has the right to take up the shares on the same basis as the seller

Other factors to consider in rights issues

In addition to the price at which a rights issue is offered, there are several other factors that need to be considered:

Issue Costs

Rights issues are a relatively cheap way of raising capital for a quoted company since the costs of preparing a brochure, underwriting commission or press advertising involved in a new issue of shares are largely avoided.

However, it still costs money to complete a rights issue. Issue costs are often estimated at around 4% on equity funds raised of around £2 million raised. However, as many of the costs of the rights issue are fixed (e.g. accountants and lawyers fees) the % cost falls as the sum raised increases.

Shareholder reactions

Shareholders may react badly to firms continually making rights issues as they are forced either to take up their rights or sell them. They may sell their shares in the company, driving down the market price

Control

Unless large numbers of existing shareholders sell their rights to new shareholders there should be little impact in terms of control of the business by existing shareholders

Unlisted companies

Unlisted companies often find rights issues difficult to use, because shareholders unable to raise sufficient funds to take up their rights may not have available the alternative of selling them where the firm's shares are not listed. This could mean that the firm is forced to rely on retained profits as the main source of equity, or seek to raise venture capital or take on debt.

asset finance - advantages and disadvantages of hire purchase and leasing as a source of asset finance

Introduction

As we discussed in our introduction to asset finance, the use of hire purchase or leasing is a popular method of funding the acquisition of capital assets. However, these methods are not necessarily suitable for every business or for every asset purchase. There are a number of considerations to be made, as described below:

Certainty

One important advantage is that a hire purchase or leasing agreement is a medium term funding facility, which cannot be withdrawn, provided the business makes the payments as they fall due.

The uncertainty that may be associated with alternative funding facilities such as overdrafts, which are repayable on demand, is removed.

However, it should be borne in mind that both hire purchase and leasing agreements are long term commitments. It may not be possible, or could prove costly, to terminate them early.

Budgeting

The regular nature of the hire purchase or lease payments (which are also usually of fixed amounts as well) helps a business to forecast cash flow. The business is able to compare the payments with the expected revenue and profits generated by the use of the asset.

Fixed Rate Finance

In most cases the payments are fixed throughout the hire purchase or lease agreement, so a business will know at the beginning of the agreement what their repayments will be. This can be beneficial in times of low, stable or rising interest rates but may appear expensive if interest rates are falling.

On some agreements, such as those for a longer term, the finance company may offer the option of variable rate agreements. In such cases, rentals or installments will vary with current interest rates; hence it may be more difficult to budget for the level of payment.

The Effect Of Security

Under both hire purchase and leasing, the finance company retains legal ownership of the equipment, at least until the end of the agreement. This normally gives the finance company better security than lenders of other types of loan or overdraft facilities. The finance company may therefore be able to offer better terms.

The decision to provide finance to a small or medium sized business depends on that business' credit standing and potential. Because the finance company has security in the equipment, it could tip the balance in favour of a positive credit decision.

Maximum Finance

Hire purchase and leasing could provide finance for the entire cost of the equipment. There may however, be a need to put down a deposit for hire purchase or to make one or more payments in advance under a lease. It may be possible for the business to 'trade-in' other assets which they own, as a means of raising the deposit.

Tax Advantages

Hire purchase and leasing give the business the choice of how to take advantage of capital allowances.

If the business is profitable, it can claim its own capital allowances through hire purchase or outright purchase.

If it is not in a tax paying position or pays corporation tax at the small companies rate, then a lease could be more beneficial to the business. The leasing company will claim the capital allowances and pass the benefits on to the business by way of reduced rentals.