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ICAEW Business Advice Service

Prepare for success

Financing a growing business

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The way a business is financed can have an important effect on profitability, especially when interest rates are likely to change. It may be possible to reduce interest payments on loans or overdrafts by more efficient use of cash, better stock control, improved buying terms, etc.

An expanding business means increasing turnover and consequent increases in debtors (amounts owed to the business). Growing businesses often need to improve their credit control, making efforts to ensure their customers pay promptly and do not default on their debts.

A growing business, when supported by a convincing business plan, should have a choice of financing options. Here are some of the questions which need to be resolved.

- Should money be raised by share capital, loans or an overdraft?
- What are the tax implications?
- What is the correct gearing level (the relationship between the capital contributed by the owners and the amount of money borrowed) for the business?
- If there is spare cash, can it be invested temporarily?
- Where will the cash get the best return while still being accessible if needed?

In the end the question comes down to raising debt or equity or sometimes both. Sometimes the equity route is compelling, either because the current shareholders cannot or will not inject any more finance, or because the current debt finance providers will not lend further money with further equity.

Listed below are some of the main sources of finance for growing businesses.

EQUITY FINANCE

As your business grows it might exhaust its borrowing abilities. Alternatively, your plans may involve incurring expenditure which will not result in the acquisition of tangible assets against which to raise finance – such as research and development or significant marketing expenditure. In these cases raising equity finance may be a solution.

Business angels

A business angel is an individual who may invest in your business in return for a stake in your company. They are most attracted to those businesses offering a good return. Business angels will also want a seat on the board and to receive regular updates on your company's progress, so you will have to be prepared to relinquish some control.

Venture capital

Venture capitalists tend not to fund start-ups but do provide finance for growing businesses in exchange for a significant stake in the company. As professional investors, they can bring significant financial and management expertise which might make it easier to attract further funding. Because venture capitalists rarely make investments below £2m, they will need to be convinced that your business has the potential for sustained growth and that you have a sound management team to move the business forward.

DEBT FINANCE

Banks

Loans

- For a set period and set repayment dates with fixed or variable interest applied.
- Normally secured by a charge over asset(s).
- Often has conditions attaching to the loan ('covenants') which can trigger a demand for immediate repayment if they are not met.

Overdraft

- The lender offers a facility with a limit with an agreed interest rate and probably secured.
- The business can dip in and out of the facility up to the limit.

Getting the best from your bank

- Banks require more information to support applications.
- Greater transparency leads to a better relationship.
- Increased information should make it easier for banks to understand your business and its business plan.
- Trends, changes and unplanned events should quickly become apparent.
- Banks do not like surprises; try to balance bad and good news.
- Try to build a relationship and keep the bank informed.

Invoice factoring and discounting

Invoice discounting makes cash available to your business from an invoice discounting firm on receipt of a debtor's invoice. The business is still responsible for collecting payment from the debtor. Such a facility is suitable for partnerships and limited companies selling goods or services on credit to other businesses and is a cost-effective alternative to overdrafts and bank loans.

In a similar manner to invoice discounting, a factor will buy your trade debts and pay you as soon as they receive a valid invoice. The factor directly collects the debt from your customer but will usually agree collection policies with you. Invoice factors and discounters advance around 80-90% of your invoice value, although the figure does depend on your industry sector, turnover, customer base and existing credit controls.

Asset finance

This is a secured business loan under which a financial institution lends you money using your assets as collateral. Ownership of the assets is retained by the lender for the duration of the contract. Such lenders prefer to deal with manufacturers, distributors and retailers who possess assets with a high recoverable value and a measurable residual value at the end of the borrowing period.

EXPORT FINANCE

Growing businesses often export for the first time. While exporting can have significant benefits for a business, there are some risks associated with it. Not least are the longer lead times between providing the goods or services and getting paid. Manufacturers who import raw materials face other challenges. Overseas suppliers want to be paid for materials before shipping, so the need arises for finance to fill the gap between importing the materials and the point that the finished goods are produced and paid for by the end customer

Export finance covers a wide range of tools all used by banks to help international trade to flourish. Two of these tools are described below.

- Bonds and guarantees – These enable the business to 'call' the bond or guarantee if the seller fails to deliver the goods or services. This enables the business to get financial compensation for the sellers' bank. These instruments include tender guarantee; advance payment guarantee; retention money guarantee; performance guarantee and customs bond.
- Letters of credit – These are issued by a bank guaranteeing that the buyer's payment will be received on time and for the correct amount, assuming the goods or services have been delivered as agreed. If the buyer is unable to pay any or the entire agreed amount, the bank will cover the shortfall. The bank also acts on behalf of the buyer – the holder of the letter of credit – by ensuring that the supplier will not be paid until the goods have been shipped.

NEW ONLINE SOURCES OF FUNDING

The internet offers the opportunity for smaller businesses to access finance through:

- debt funding
- equity finance
- working capital funding – factoring and invoice discounting.

A number of sites seek to match businesses looking for finance with individuals and businesses looking for diversification of risk and yield. The business models vary, so it is vital to understand how the risk of the proposition has been assessed. The cost is often proportionately higher than bank finance but the risk is often greater.

Debt finance (or peer-to-peer lending)

Platforms have criteria on which they base lending decisions; they usually require financial accounts and a trading track record; credit checks are carried out and lenders bid on loans by offering an interest rate at which they would lend. Borrowers then accept loan offers at the lowest interest rate. The Financial Conduct Authority (FCA) regulates P2P lending.

Equity crowdfunding

Before putting a pitch for equity investment on a crowdfunding platform, a business would need to show it is 'investment ready'. As with traditional equity finance, the business will need a business plan and financial forecasts. A video summarising the opportunity might also be included in the pitch.

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>> Useful websites

- UK Business Angels Association
  ukbusinessangelsassociation.org.uk
- British Venture Capital Association
  bvca.co.uk
- The British Bankers Association
  bba.org.uk
- Asset Based Finance Association
  abfa.org.uk
- Finance & Leasing Association
  fla.org.uk
- UK Export Finance
  gov.uk/government/organisations/uk-export-finance
- Peer-to-peer Finance Association
  p2pfa.info
- UK Crowdfunding Association
  ukcfa.org.uk

DSC Chartered Accountants
Tattersall House
East Parade
Harrogate
Hg1 5LT

Prepare for business, prepare for success.

ICAEW Business Advice Service

The ICAEW Business Advice Service (BAS) provides professional advice for start-ups and owner-run businesses.

As well as practical help online in the form of white papers, short PDFs and blog articles, we enable businesses to receive an initial consultation at no charge from an ICAEW Chartered Accountant.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 146,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

ICAEW Chartered Accountants are the biggest source of business advice, reaching over 1.5m businesses from more than 20,000 offices across the UK.

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