

TOPIC 1: SOURCES OF FINANCE FOR A START-UP BUSINESS

INTRODUCTION

Often the hardest part of starting a business is raising the money to get going. The entrepreneur might have a great idea and clear idea of how to turn it into a successful business. However, if sufficient finance can't be raised, it is unlikely that the business will get off the ground.

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

- *How much finance is required?*
- *When and how long the finance is needed for?*
- *What security (if any) can be provided?*
- *Whether the entrepreneur is prepared to give up some control (ownership) of the start-up in return for investment?*

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

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

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 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 suggests 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.

One way of categorising the sources of finance for a start-up is to divide them into sources which are from within the business (internal) and from outside providers (external).

INTERNAL SOURCES

The main internal sources of finance for a start-up are as follows:

Personal sources

These are the most important sources of finance for a start-up, and we deal with them in more detail in a later section.

Retained profits

*This is the cash that is generated by the business when it trades profitably – another important source of finance for any business, large or small. **Note that retained profits can generate cash the moment trading has begun.** For example, a start-up sells the first batch of stock for Ksh.5,000 cash which it had bought for Ksh.2,000. That means that retained profits are Ksh.3,000 which can be used to finance further expansion or to pay for other trading costs and expenses.*

Share capital – invested by the founder

The founding entrepreneur (/s) may decide to invest in the share capital of a company, founded for the purpose of forming the start-up. This is a common method of financing a start-up. The founder provides all the share capital of the company, retaining 100% control over the business.

*The key point to note here is that the entrepreneur may be using a variety of personal sources to invest in the shares. Once the investment has been made, it is the company that owns the money provided. The shareholder obtains a return on this investment through **dividends** (payments out of profits) and/or the value of the business when it is eventually sold.*

*A start-up company can also raise finance by selling shares to **external investors** – this is covered further below.*

EXTERNAL SOURCES

Loan capital

*This can take several forms, but the most common are a **bank loan** or **bank overdraft**.*

*A **bank loan** provides a **longer-term** kind of finance for a start-up, with the bank stating the fixed period over which the loan is provided (e.g. 5 years), the rate of interest and the timing and amount of repayments. The bank will usually require that the start-up provide some security for the loan, although this security normally comes in the form of personal guarantees provided by the entrepreneur, or assets pledged as security. Bank loans are good*

for financing investment in fixed assets and are generally at a lower rate of interest than a bank overdraft. However, they don't provide much flexibility.

A **bank overdraft** is a more short-term kind of finance which is also widely used by start-ups and small businesses. An overdraft is really a loan facility – the bank lets the business “owe it money” when the bank balance goes below zero, in return for charging a high rate of interest. As a result, an overdraft is a flexible source of finance, in the sense that it is only used when needed. Bank overdrafts are excellent for helping a business handle seasonal fluctuations in cash flow or when the business runs into short-term cash flow problems (e.g. a major customer fails to pay on time).

Share capital – outside investors

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

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

You will also see **Venture Capital** mentioned as a source of finance for start-ups. You need to be careful here. Venture capital is a specific kind of share investment that is made by **funds managed by professional investors**. Venture capitalists rarely invest in genuine start-ups or small businesses (their minimum investment is usually over Ksh.1m, often much more). They prefer to invest in businesses which have established themselves. Another term you may hear is “private equity” – this is just another term for venture capital.

A start-up is much more likely to receive investment from a business angel than a venture capitalist.

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 a number of venture capital funds in Kenya including Acacia, and some have geographical or industry preferences. There are also certain large industrial companies and NGOs 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 development banks and NGOs/ Donor agencies 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 a number of initiatives by the government through firms such as AFC, Development Bank of Kenya among others.

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 than 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.

Mezzanine Debt

This is 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.

Personal sources

As mentioned earlier, most start-ups make use of the personal financial arrangements of the founder. This can be personal savings or other cash balances that have been accumulated. It can be personal debt facilities which are made available to the business. It can also simply be the founder working for nothing! The following notes explain these in a little more detail.

Savings and other “nest-eggs”

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

Re-mortgaging is the most popular way of raising loan-related capital for a start-up. The

way this works is simple. The entrepreneur takes out a second or larger mortgage on a private property and then invests some or all of this money into the business. The use of mortgaging like this provides access to relatively low-cost finance, although the risk is that, if the business fails, then the property will be lost too. .

Borrowing from friends and family

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

Credit cards

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

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.

(AS A READING ASSIGNMENT YOU WILL NEED TO RESEARCH MORE ON THIS TOPIC)