5 FINANCING A START-UP COMPANY

After studying this chapter, you should:

- *understand why start-up companies need capital;*
- *be able to produce a simple business plan;*
- *understand the different ways in which capital can be raised and the advantages and disadvantages of each.*

5.1 WHY CAPITAL IS NEEDED

It is very difficult to start any commercial venture without having some money in hand, because your customers will not be willing to pay you until you have provided them with the service or the product they are buying. You, however, have to buy the things you need to make the product or to provide the service, and you have to live while you are making or doing it.

To take a very simple example, suppose that you are setting up in business painting houses. You need to buy paint brushes, paint, ladders and so on. It may take you two weeks to paint a house and during this time you have to live. You will only get paid when you've finished painting your first house. Indeed, you may well find that your customers don't always pay immediately but take another two or three weeks to pay. The amount of money you need may not be very large but you will find yourself in difficulties if you haven't got it.

If you are setting up a company to build websites, you are likely to need much more money. First, because your customers are likely to be other companies, it will take you longer to get paid. In normal commercial practice, invoices for services are issued at the end of a month to cover the work that has been done during the month. A client is unlikely to pay an invoice within less than one month of receiving it. Two months is more likely with commercial clients and three months is not uncommon; some large companies are notorious for not paying invoices for as much as six or even 12 months. The result is that you need enough cash in hand to be able to live for at least three months. Additional money will be needed for the expenses of starting the company.

If you intend to develop a package, the sum of money needed is likely to be even larger. While the package is being developed, there will be no revenue coming into the company. For this period cash will be needed for:

- salaries, however small, for the founders and for any other staff they may need to employ;
- rent, rates, heating and lighting of the premises used;
- equipment and consumables;
- costs of advertising and marketing the products;
- miscellaneous expenses, ranging from company stationery to travelling expenses for any trips that may be necessary;
- interest on any money borrowed.

Although it is often possible to carry out the early stages of development in the founders' spare time, working from their homes, this is not usually satisfactory once commercial sales have started. However successful the development of the packages, it will take some months before sales reach a level sufficient to cover the company's ongoing costs, so, even after development is complete, more cash will be needed.

5.2 THE BUSINESS PLAN

The first step in raising the money is to produce a **business plan**. This is a document that explains your plans to potential funders and tries to convince them that these plans are well thought out and realistic, and that the venture is likely to be successful. It should contain:

- a description of what the company will be doing, together with information to show that it is technically feasible and that the founders of the company have the necessary expertise;
- a description of the market the company is aiming at, an estimate of its size, and an assessment of the competition. It might contain statements like the following: 'The company's target market will be small firms providing repair and maintenance services to householders, within a radius of 15 miles of the centre of Llanafan. So far as can be estimated from the data provided by the Llanafan Chamber of Commerce, there are around 1,200 such firms in the area, only 16 of which have websites. There are two other companies offering website design and hosting services in the area but neither appears interested in this market.'
- a prediction of the financial performance of the company. This will include budgets, cash flow predictions, and projected balance sheets and profit and loss accounts. These are dealt with in the following chapters.

Armed with the business plan, you are in a position to approach people who might be willing to lend you money, invest money in your company, or even give you money.

It is a mistake to think of a business plan as a prediction of what will happen when and if you succeed in starting your company. It should be seen much more as a scenario that demonstrates that your company has a reasonable chance of success. The attempt to produce a business plan will often show that what a new company is trying to do has very little chance of succeeding. This should have been true of many of the dot.com companies that failed in the crash of 2001. Their predictions of the size of their market were quite unrealistic and any shrewd investor might have seen this.

5.3 SOURCES OF FINANCE

Government policy in the UK has, over recent years, strongly encouraged the growth of small companies and, as a result, there are many possible sources of funding. However, they can all be grouped under three headings: grants, loans and sale of equity. Many other countries have similar policies but there are big differences between countries in the way that the policies are implemented, and policy within a single country can swing violently over time.

5.3.1 Grants

A **grant** is a sum of money given to the company; although the company is obliged to demonstrate that it has been used for the purposes for which it was intended, it is not intended that the grant should ever be paid back to the organisation which gave it. Not surprisingly, grants are only available from government (local or national) and EU sources or, very occasionally, from charities. Very often, grants are limited to a certain proportion of the money spent on a particular development and are conditional upon the remainder being raised from other sources.

The availability of grants and other help for new companies depends very much on where the company is located, how many people it expects to employ, and on government policy at the time. Typically, in the UK, a new company, setting up in an area where maximum assistance is available, might expect to be provided with premises rent free or at half rent for the first 12 months; it might also expect a grant of £15,000 to £20,000, once it is employing five or six people, and a second similar grant when the number of employees reaches ten or a dozen. (Very much larger grants are available to established companies intending to make substantial investments that will lead to the creation of many jobs.)

These grants are usually:

- intended to assist with capital investment, typically investment in premises and equipment;
- subject to a number of conditions, in particular the raising of capital from other sources;
- limited to a certain proportion of the capital investment that the company can prove it has made.

This means that they are often of limited usefulness to small software companies, whose investment more usually takes the form of employees' time.

A variety of programmes, both national and European, offer grants to assist in the development of high technology products. These are likely to be particularly helpful to start-up companies aiming to develop new packages. Examples are the EU's Framework 7 and Horizon 2020 programmes, and the Smart scheme (previously known as Grants for Research and Development) run by the UK government's Technology Strategy Board. The Smart programme offers funding of up to £25,000 over nine months to small and medium-sized enterprises, providing up to 60 per cent of the cost of R&D projects in science, engineering and technology, from which successful new products, processes and services could emerge. For other programmes, it may be a requirement that the proposed development is collaborative, i.e. involves more than one company, and, in the case of European programmes, that the collaboration involves companies from at least two member states of the European Union. The assistance is almost invariably limited to 50 per cent of the cost of the development and often to less.

5.3.2 Loans

Although grants are undoubtedly very helpful, their effect on company finance is short term. The major sources of finance are loans and the sale of equity.

A loan is a sum of money lent to the company; interest is payable on it, at a rate that may be fixed or variable, and the loan is usually for a fixed period. The company has to pay back the loan eventually and, if it goes into liquidation, the lender is entitled to recover the loan from the sale of the assets of the company. In most cases, security (in this context sometimes known as collateral) is required for the loan. In other words, the company agrees that if it fails to make repayments, the lender is entitled to sell some of the company's assets in order to make up for the shortfall, rather in the same way that, if you borrow money to buy a house and then fail to keep up the repayments, the lender can sell the house to recover the loan.

It often happens that small companies do not have sufficient assets to cover the loan they are looking for. In this case, the lender may ask for personal guarantees from the directors of the company; this may mean that the directors have to use their own homes or other property as security for the loan.

It is usual to divide loans into overdrafts and long-term loans. An overdraft is the most flexible form of loan. Overdrafts are offered by banks; they allow a company (or an individual) to spend more money than is in its account, up to a specified maximum. Interest is only payable on the amount actually owned and the rate is normally comparatively low; it is usually fixed at a certain number of points above the bank base lending rate, the precise figure depending on the bank's view of the credit-worthiness of the borrower. Although overdrafts are the most flexible and usually the cheapest way to borrow, there is a price to be paid. A bank can withdraw overdraft facilities without warning, possibly for reasons of general policy that have nothing to do with the borrower. Many small companies have been forced into liquidation unnecessarily as a result of such action by banks.

In contrast, long-term loans are usually made for a fixed period at a fixed rate of interest. The borrower receives the capital (the amount of the loan) at the start of the period of the loan and is committed to paying interest on that amount throughout the period of the loan. Provided the borrower pays the interest on time, the lender cannot call in the loan. The borrower must repay the capital at the end of the period.

As a result of various government initiatives, a 'soft loan' may be available; this is a loan on terms which are less onerous than those that prevail for commercial loans. Soft loans are usually only available to start-up companies; the interest rates may be lower than commercial interest rates and security is not demanded.

Public limited companies can raise loans through stock exchanges by issuing what are known as **corporate bonds**. For private companies, however, loans are usually provided by banks or similar institutions. Even if a soft loan is available as part of a government initiative, it will usually be channelled through a commercial bank. In some instances, start-up companies are able to borrow money from relatives or friends of the founders – or, indeed, the founders may be able to lend the company money themselves. In such cases, it is important that the loan is put on the same sort of formal basis as a commercial loan. If it is not, and things go wrong for the company, there is real danger that confusion will lead to bitter arguments and will end up by spoiling personal relationships.

5.3.3 Equity capital

Equity capital is money paid to the company in exchange for a share in the ownership of the company, as described in the previous chapter.

The founders of a new company often find the initial capital from their own resources or from friends and family, but few are able to continue raising capital in this way. If a company looks to have good prospects but needs to raise more capital, it will usually need to resort to business angels or venture capitalists.

Business angels are wealthy individuals who provide equity capital for start-up companies and small firms that are seeking to grow rapidly. They are usually interested in investing in firms operating in areas of which they have some experience and, as well as providing capital, they will usually expect to offer advice on management and other business issues. Business angel networks are organisations that bring business angels together and provide mechanisms to assist small companies to find suitable business angels and vice versa. The networks usually operate at national or regional (i.e. sub-national) levels.

Venture capitalists are companies whose business is investing in small companies with high growth potential. They are usually only interested in fairly substantial investments, from, say, £500,000 upwards.

If the company is already operating, the shares issued to business angels or venture capitalists will usually be new shares, taken from the difference between the issued capital and the authorised capital. The new investors will probably be paying substantially over the par value of the shares.

Both business angels and venture capitalists aim to make money by helping the company to expand and become successful and then selling their shares at a profit. Of course, many of their investments will not be very successful and a significant number may fail completely. They aim to offset these losses by very substantial gains in the most successful cases; often this may happen when the company has grown enough to be floated on a stock exchange, so that its shares become publicly traded.

5.4 GEARING

The relationship between loan capital and equity capital in a company is important. It is known as **gearing** or **leverage**. Shareholders are at a much greater risk of getting a poor return on their capital or even losing it completely than are lenders but, in compensation for this, they stand to make a greater profit than lenders if all goes well.

Suppose a company is started with a share capital of £100, owned by its two founders, and that it has a fixed-term loan of £100,000, at an interest rate of 10 per cent. If in its first year the company makes an operating profit of £10,000, the interest charges will consume all the profit and the shareholders will receive nothing. If the company's operating profit doubles, to £20,000, the lender will still receive £10,000 but, neglecting taxation and assuming that all the profit is distributed to the shareholders, the shareholders will receive £10,000, a very handsome return on an investment of £100. Furthermore, as the profits increase, the value of the company, and hence the value of the shares, increases. If the company is sold, the shareholders will get much more than their original £100 investment, but the lenders will still only be entitled to their original £100,000, plus interest. If, on the other hand, the company is unsuccessful and goes into liquidation, the lenders will be at the front of the queue of people to whom money is owed, whereas the shareholders will get nothing until everyone else has been paid in full.

Such high levels of gearing are undesirable both from the point of view of the shareholders, because so much of the company's income is committed to interest payments, and from the point of view of the lenders, because shareholders may encourage the company to trade recklessly in the knowledge that they have little to lose and a lot to gain. Most lenders will be reluctant to lend money if a company seems too highly geared.

FURTHER READING

The UK government has a website that includes financial and other advice on setting up a business and gives valuable guidance on producing a business plan:
www.gov.uk/browse/business

The website of the Technology Strategy Board, which runs the Smart programme and various other programmes intended to encourage technological innovation:
www.innovateuk.org

Information about the UK Business Angels Association can be found at:
www.ukbusinessangelsassociation.org.uk/
and there are a number of regional networks of business angels in different parts of the UK. There is also a European Business Angels Network:
www.eban.org
as well as a World Business Angels Association, based in Brussels:
http://wbaa.biz

There are innumerable books on accounting and finance that will take the reader beyond what is covered in this book; most of them are, however, intended for budding accountants. A good treatment for non-specialists will be found in:

Atrill, P. and McLaney, E. (2012) *Accounting and finance for non-specialists.* 8th ed. Pearson Education.

This covers the material in this chapter and the next three.