Where to go for funding?

Neal Judd sounds out banking and finance professionals on sources of funding.

The current market conditions have made it very challenging for small businesses and mid-market companies to access financing and this is likely to remain the situation in 2011. Traditional lenders, concerned at their exposure levels, are tightening their belts and their prevailing attitude to risk is putting the squeeze on firms seeking vital funding.

So where can a business owner turn to for finance at this time?

It is a sweeping generalisation to say that banks are not lending. They are still lending to their most credit worthy, established clients; and they are, of course, open to the 'right' new lending opportunities. In fact the issue, as the banks see it, is that there is much less demand for lending, 'This year market-wide demand for lending remains subdued with recent SME surveys pointing to only nine to ten per cent of businesses currently seeking finance,' according to Andy Mason, regional commercial director at HSBC.

So, if not a traditional bank, then where can a business owner go?

The independent asset finance houses (at least, those that do not have their own problems) are very much open for business, and are taking over facilities from the traditional banks. Even these independent houses, however, are being more cautious – partly spoilt for choice, but equally keen to avoid repeating past mistakes.

As Jeff Greenfield, business development director at Centric Commercial Finance explains, 'Today, companies are looking to the independent asset-based lending sector for much needed liquidity and turning to their assets to release working capital. Increasingly, these businesses are seeking access to a higher level of funds than their current traditional facilities allow, delivered with greater velocity and flexibility.'

At the core of an asset-based lending facility is invoice discounting, which provides an immediate injection of cash and ongoing working capital to create headroom for the business. Specific loan to value ratios are attributed to stock, plant and machinery and property to create a total funding programme. With asset-based lending, additional cashflow funding is available for those businesses with stronger profit generation.

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So once a business owner has raised finance by selling on their securable assets, where else can they then turn to access further finance?

Equity financing options

We now move away from the world of debt finance and into the sphere of equity finance. This necessitates consideration of certain fundamental issues, such as who has control of the business, and how does the equity investor make an acceptable return.

First, let's summarise the range of options available:

- friends and family
- high net worth, angel investors
- government initiated funds
- Venture Capital Trusts (VCTs)

Friends and family

Friends and family are very often a quick and easy source of finance. However, unless the business owner is lucky enough to be particularly well connected, this option tends to be limited to small amounts. There is also the problem that the investor is unlikely to properly understand the risks, nor add any commercial value to the business.

Angel investors

High net worth (HNW), or angel investors, have increasingly become a major source of finance for small businesses. HNWs are incentivised to make investments by the attractive tax benefits available, in particular, through the Enterprise Investment Scheme (EIS), which provides the investor with a range of tax benefits, including:

- an instant 20 per cent credit against their income tax for the year of, or the year preceding, the investment;
- capital gains tax rollover from gains

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made in the previous three years to the date of the investment and 12 months following the investment; and
- on disposal, in the event of a gain being realised, the gain should be exempt from capital gains tax.

Relief from inheritance tax under the business property rules is also available for investors holding shares in an unlisted company, which means that the shares would not be taxed by Inheritance Tax on the estate of the owner, thereby saving 40 per cent tax at current rates.

It must be pointed out that there are, of course, detailed rules relating to these reliefs, for eligibility for both the investor and the business, and personal circumstances will also determine whether these reliefs apply.

> "The income tax relief available for VCTs allows 30 per cent credit against an investor's income tax for the year."

High net worth investors are likely to be experienced in growing businesses, and have varied connections that will be beneficial to the growth of the business. However, as we are dealing with individuals, the strengths and weaknesses of each HNW investor will vary considerably.

It is imperative that a business owner takes the time to get to know their investor before consummating a transaction, properly understands their motivations, and takes detailed references, just as they would with a new employee. The Dragons Den-style confrontation over a deal is, I'm pleased to report, not all that common in the real world, but clearly careful consideration must be taken over the legal form of the relationship and the detailed terms.

The government

The government has for a long time been active in small company investments by seeking to alleviate the equity gap that it is felt exists above the threshold of most HNW investors and below that of the institutional equity investor.

Central government has introduced and part-funded many initiatives in recent years, both regionally and nationally, to allocate capital to small, growing businesses. Most often, this is done by tendering out management of small funds to professional venture capital managers, and setting strict investment criteria to focus the funds, in particular, in terms of amounts invested per transaction.

- **Capital for Enterprise Fund**
  One recent, highly publicised initiative was the £70 million Capital for Enterprise Fund that was managed by Maven Capital Partners and Octopus Ventures. This fund was a direct response to the issues being suffered by small businesses during the credit crisis, and was aimed at businesses struggling to obtain traditional bank finance or those that were over reliant on debt.
  This fund has now closed to new opportunities, Maven Capital Partners having invested their £35 million allocation in seventeen companies during 2009–2010. There is discussion of a repeat fund for 2010–2011 but as yet no formal announcement, so for now this option has been closed.
- **Growth funds**
  Another example of a government-initiated fund is the Catapult Growth Fund, a £30 million venture capital fund established to provide capital for expanding businesses, and funded, in part, by central government. The initial equity requirement available is between £500,000 and £2 million, available to all revenue generating businesses from early stage through to development capital, as well as transactions such as MBOs and MBIs. Their sector focus is a generalist approach, but with innovative growth sectors favoured, including technology, healthcare, medical devices, environment and support services.
  As Richard Bucknell of Catapult Venture Managers comments, 'In the absence of adequate security, lending for entrepreneurial growth businesses can be hard to come by. If there's anything the credit crunch has taught us, it must be that high leverage is not the most solid of foundations on which to grow and that longer term, committed equity could be a more appropriate solution. Refinancing of excessive bank debt, along with an injection of new money to fund growth can be the answer for established businesses that have stalled without the necessary working capital, while earlier stage enterprises can also benefit from venture capital investment where proven concepts demand additional financing to deliver on significant potential.'
- **RDA funds**
  The Regional Development Agencies (RDAs) have historically been delegated the function of managing small, local funding initiatives. With the announced demise of the RDAs across much of the country, there remains a lot of uncertainty as to what will happen to this important source of funding.
  Where monies have already been allocated to third party managers, it is likely that these allocations will be fully utilised and their management contracts honoured. A recently established government entity, Capital for Enterprise Limited, is expected to become the umbrella manager of all government funding initiatives, from the Enterprise Finance Guarantee (EFG) scheme for bank finance through to the local equity funding facilities.

Venture Capital Trusts (VCTs)

Another tax vehicle for investors, the VCT tax reliefs are similar to the EIS scheme. However, the income tax relief available is more generous, allowing a larger 30 per cent credit against an investor's income tax for the year.

Each VCT is listed and managed by a professional, FSA-registered fund manager, who receives an initial fee plus an ongoing annual fee. The manager will lay out their investment criteria in small unquoted companies to prospective investors, and market their funds to those individuals looking to allocate their annual allowance of up to £200,000 to VCT investments.

The expectations of an investor in a VCT fund, and therefore of the fund manager, are for high returns in exchange for the higher risk. The result is that the investment criteria set by VCT managers are extremely rigorous, and the restrictions placed on the business owner are often considerable.

As Ned Dorbin of Maven Capital Partners, a VCT fund manager, summarises, 'Maven's funds are looking to invest in businesses with a demonstrable track record and a credible strategy for growth.'

The VCT market has a large amount of capital at its disposal and time limits in which its investments must be made, so they are very much looking for new opportunities and actively taking stakes in high growth businesses.

As Ned explains, 'We understand that the current trading climate is difficult for many companies but we continue to be open for business to maintain our active rate of new investments.'

Future funding

The climate for funding businesses is going to remain tough for a while yet. There are clearly many sources of funds available to a business owner, but each has their strict criteria that need to be met, and most funders are spoilt for choice, so they can afford to be very selective.

It is imperative, therefore, that a business owner is properly equipped before they approach funders, of whatever form, because even a small failing in their preparation can make the difference between a successful outcome and a polite decline. □

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