A NEW ECONOMY
PUBLICATION

BUSINESS IN THE UK
A ROUTE MAP

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BDO

chapter 05

BUSINESS FINANCE

BUSINESS FINANCE

The UK is a highly developed economy and many diverse sources of funding are available to businesses although stringent vetting and security is often required. There are a wide range of financial institutions that offer business finance in different ways ranging from traditional banks through to peer-to-peer lending through online platforms.

THE BASIC OPTIONS

For traditional financing, security is usually required by the lending institution with a charge being taken over one or more of the company's assets (see below). Depending upon the company's risk profile and credit rating, personal guarantees may be also required. A simple option is to negotiate an overdraft facility on current accounts, although security may be required as with loans. Overdrafts are usually repayable on demand and charges can be higher than other borrowing.

The management of cashflow in a trading business can be assisted by debt factoring. The general principle is that the supplier company sells the right to receive the invoice amount to the Factoring company in return for a percentage of the face value of the debt, receivable immediately. The full debt is later collected either by the factor or the supplier. Costs and the percentage paid will vary depending upon the nature of the trade debtors.

Of course, reducing capital costs can be just as important in financing a business. Often, businesses starting out do not want to incur large initial capital expenditure, therefore, hire-purchase (HP) and leasing are widely used methods of acquiring assets. With HP transactions, the finance company purchases the goods and the lessee (the buyer business) uses the goods in return for regular payments. Legal title to the goods remains with the HP company until all payments have been made, at which point legal title transfers to the lessee. Leasing is very similar, except that the lessee does not necessarily become the legal owner.

GRANTS

Government grants are available at regional, national and European levels. to help businesses fund future R&D projects, develop assets and create jobs. Applying for a grant can be time-consuming and complex and many SMEs or large groups miss grant funding opportunities either due to a lack of information, expertise in public funding requirements or time to prepare a high standard grant proposal.

Usually businesses receive grant:

- **To grow and expand:** businesses may plan to invest in infrastructure, training, R&D and, as a result of this investment, they will create jobs. There are local grant providers who will be able to support this investment to boost the economy (for e.g. LEP funds, Scottish Enterprise, Invest NI or Welsh Government)
- **To innovate and undertake R&D:** when a company want to introduce disruptive technology and commercially innovative service/product offering, there are grant providers who can help support the journey (for e.g. Innovate UK, Wellcome Trust or European grant providers).

Our grant team in BDO can support client organisations through the whole journey, from identifying the right funding to preparing and submitting a high quality application as well as providing financial coordination services during the project to accelerate the grant repayment.

CASE STUDIES

Innovation (full service): Our Grants team within BDO's Innovation and Technology group helped a leading real-estate virtual content depository/tour provider company access an Innovate UK grant of about £700,000 towards a total project cost of £1 million that will allow them develop a disruptive automated property valuation solution. The Grants team supported them in the preparation of a high-quality grant application, ensuring minimal time and resource involvement from their side, while also efficiently coordinating the large project consortium.

Innovation (review service): We supported a client in securing £2.5M of grant from Innovate UK for a £7M project to develop a new passenger emergency oxygen delivery technology, which will have significant operational and environmental savings for the aerospace industry.

Regional growth: Our Grants experts assisted a client involved in the wholesale distribution of office imaging consumables receive a local business growth grant for 30% of total capital expenditure of £165,000 on a project to expand their office and warehouse space.

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ASSISTED AREAS

Assisted Areas are geographical places where regional aid can be offered to undertakings, typically businesses, under state aid rules. Maximum UK population coverage for the 2014-2020 Map is set at 27.05% by the European Commission. The Government has been consulting on the allocation of the non-predefined or 'discretionary' coverage (22.79% of UK population).

Following the UK's formal exit from the EU, the state aid rules may no longer apply in the UK (depending on what trading agreement is struck). The UK Government may increase the grants it offers to businesses in different regions of the UK.

UK 2014-2020 REGIONAL AID MAP

Source: Crown copyright and database rights (March 2014). Ordnance Survey (100037028)

A full list of areas included on the 2014-2020 Assisted Areas Map is available at: https://www.gov.uk/government/consultations/assisted-areas-map-2014-to-2020-stage-2.

BUSINESS FINANCE

SOURCES OF FINANCE - DEBT

A business looking to set up in the UK will require capital to finance its operations and investment in fixed assets. There are a number of different sources of finance available, each with their own advantages and disadvantages.

BANKS – SECURED LOANS

A secured loan is a loan obtained with the use of property or other business assets as security for the loan. Borrowers will need to have a suitable credit rating to be approved for a secured loan.

The bank will set a term for the loan along with a schedule of repayments (amortisation) and lending covenants that must be complied with. Occasionally, it may be possible to agree a single bullet repayment at the end of the loan, or a mixture of amortisation and bullet. The bank would usually want to see a business plan covering the use of the loan, including financial projections and supporting documents, such as tax returns, bank statements, credit history and other financial information. Loans may be fixed rate or floating rate, and will usually have an arrangement fee and a margin over base lending rate.

Advantages:

- Relatively cheap source of finance
- Interest is usually a deduction for tax.

Disadvantages:

- Not achieving the funding target may mean returning any pledged amounts to investors
- Failed applications can risk damage to the reputation of the business
- Getting the rewards or returns wrong could mean giving away too much of the business to investors
- Having to communicate with a large number of disparate investors may be time consuming and difficult
- The need to make repayments over the life of the loan along with set up costs and documentation required to obtain
- The quantum may be limited by the amount of security, profits and covenants
- Aside from property, loans would not usually be for periods of longer than five years.

Often available from banks and specialist debt funds.

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ASSET-BASED LENDING

This is an advance secured by business assets such as debtors, inventory, or plant and machinery. These types of loans are usually used for working capital purposes to help a business bridge the gap between the timing difference of payments and receipts. A facility is usually advanced up to a percentage of the assets on which it is secured, and exclusions may apply for, say, concentration of debt or certain overseas debt.

A bank letter of credit is a similar form of finance typically advanced against overseas contracts and orders. Another form of finance would be HP or a lease to finance capital expenditure on fixed assets such as plant and motor vehicles.

Advantages:

- The ability to grow the facilities available as the underlying assets (such as debtors) grow with sales, can make it attractive
- Relatively quick to document and conduct due diligence on the assets.

Disadvantages:

- Can be expensive due to the inherent interest cost
- Technically repayable on demand.

Often available from banks, specialist asset based lenders and leasing companies.

Read about BDO's operational advisory services

FINANCIAL INSTRUMENTS

Bonds can be both a vehicle for investment and a source of long-term finance, with either fixed or floating interest rates. Companies issue bonds, pay interest at regular intervals and repay capital on redemption. Such bonds may also carry a right for conversion into the ordinary shares of the company.

Mini-bonds

Over the past few years, a number of companies have issued mini-bonds as a way of obtaining debt-based finance.

Often they are marketed to the customer base and may be better suited to consumer product type businesses. Some offer rates such as 7-8% interest to investors, or some form of the company's product alongside. They are generally unsecured, non-convertible and non-tradable.

WHAT – are 'mini-bonds'?

Mini-bonds are a means for businesses to borrow from private investors. They are effectively 'IOUs' which the company issues to investors. Typically, they have terms of three to five years, and investors earn regular interest receipts during the life of the mini-bond. At the end of the term, the investors are due back their initial investment.

Disadvantages:

- Unlike traditional bonds, mini-bonds cannot be traded and are not listed on any market. This means that they must be held until maturity and cannot be cashed in early - which can make them a less flexible choice for investors
- The issue of bonds requires an offering memorandum approved for financial promotion purposes under the Financial Services and Markets Act.

Often offered to investors by the company with assistance from professional advisors.

Other financial instruments

There are many different types traded on stock exchanges and often highly complex in their operation, are widely available in the UK. Futures contracts, for instance, are agreements between two parties to undertake a transaction at an agreed price on a specified date in the future and are most commonly used to buy or sell commodities and foreign currency against sterling. Swaps are exchanges of cash payment obligations. Currency swaps are agreements to use a certain currency for payment under a contract in exchange for another currency, and enable the companies involved to buy one of the currencies at a more favourable rate. Swaps remain a commonly used financial instrument. Similarly, there are interest rate swaps, which enable one company to exchange a fixed rate obligation for the variable rate obligation of another.

Read about BDO's capital markets services.

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SOURCE OF FINANCE – EQUITY

VENTURE CAPITAL OR PRIVATE EQUITY

Venture capital investors are institutions that invest in companies where they can see a growth opportunity evidenced by a compelling business plan.

Venture capital investors look for a strong management team, a large potential market and a unique product or service with strong competitive advantage. Some will take a minority investment in a company, while others may prefer a controlling interest. In any event, they will have some legal form of investor rights and protections as they are not actively involved in managing the company.

Advantages:

- Venture capital investors will usually come with the capacity to add additional funding in the future which allows for future expansion opportunities and the ability to up-scale the business

WHAT – types of company qualify for EIS?

Companies operating in some business sectors will not qualify for EIS. Banking, insurance, stock broking, legal and accounting business do not qualify, nor do businesses trading in land or developing property. As always, it is important to take advice on which Government sponsored schemes a business may be eligible to benefit from.

- They may also have other investments where some mutual business benefits could be obtained.

Disadvantages:

- Many venture capital sources are more private equity in nature, preferring to invest in more mature businesses than start-ups or early stage businesses
- They are returns and exit driven meaning that they will need to agree a valuation and a share of the equity that will deliver their required return (typically two to three times their investment and more for an earlier stage company), and will require an exit in a typical three to five-year investment horizon.

There is a wide range of venture capital and private equity companies in the market. The British Venture Capital Association ('BVCA') maintains a register and details on them.

Read about BDO's services for private equity.

ENTERPRISE INVESTMENT SCHEMES (EIS) AND SMALL ENTERPRISE INVESTMENT SCHEMES (SEIS)

This is a program used in the UK to make it easier for smaller companies to raise capital by providing their investors with tax relief as an added incentive to their investment. The Enterprise Investment Scheme (EIS) provides 30% of what the investor invests for the shares as a credit to reduce the investor's individual income tax owed for the year the shares are issued. The maximum amount of relief a taxpayer can claim on standard EIS investments is £300,000 a year, or the total tax liability, whichever is less. However, the £1m investment limit is increased to £2m (ie £600,000 in tax relief) where the funds over the standard £1m limit are invested in shares in a qualifying "knowledge intensive company". In addition, there is no capital gains tax when the shares are disposed of, provided a three year qualifying period has been met.

Broadly, companies qualifying for EIS must:

- Be commercially trading with a view to a profit
- Be unquoted (although AIM quoted companies are unquoted for this purpose)
- Have a UK permanent establishment
- Less than 7 years trading or 10 years if a "knowledge intensive company"
- Put the capital invested at "risk" (as assessed by HMRC against seven tests)
- Not be dealing in commodities, property or financial services or any other "excluded trade"
- Not be under control of another company
- Have gross assets of no more than £15m before (£16m after) the investment
- Have fewer than 250 employees (500 if a knowledge intensive company)
- Not have raised more than £5m under EIS/SEIS the related VCT scheme, and other relevant State aid in the past 12 months (however, EIS companies that also qualify as 'knowledge intensive' can raise up to £10m capital in a 12 month period)
- Use the money within two years of the investment.

Since April 2018, EIS companies that also qualify as 'knowledge intensive' can raise up to £10m capital in a 12 month period, subject to EU State aid approval.

Small Enterprise Investment Scheme (SEIS)

The SEIS follows the nature of EIS. However, this scheme is more effective and attractive to start-up businesses as the qualifying business must have been trading for less than two years, and has a higher tax relief for investors. The main qualification conditions are similar to the EIS scheme, with the following differences:

- Gross assets of no more than £200,000 before the investment
- Less than 2 years trading
- Fewer than 25 full time employees
- Not previously raised funds under EIS or VCT
- Raise no more than £150,000 under SEIS
- Use money within three years of investment.

Advantages

- Tax advantages improve the appeal of the investment and the returns.

Disadvantages

- Relatively complex laws and restrictions on the operations of the business.

Read about BDO's venture capital tax reliefs services.

For more about EIS and SEIS read the EISA Funding Guide at www.eisa.org.uk/eisa-funding-guide/.

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VENTURE CAPITAL TRUSTS (VCTS)

A VCT is a tax efficient UK collective investment scheme designed to provide private equity capital for small expanding companies, and income and capital gains for investors.

VCTs are a form of publicly traded private equity, comparable to business development companies in the United States. Qualifying companies are unquoted Companies (which have a UK permanent establishment) with qualifying trades (similar to EIS).

- In the 2018/19 tax year, close to £731m was raised by VCTs to invest in companies.

Advantages

- Ability to invest funds up to £5m (£10m in 'knowledge intensive' companies).

Disadvantages

- As investors, VCTs are similar to venture capital and private equity.

Read about BDO's business planning and advisory services.

BUSINESS ANGELS

A business angel is an investor who provides financial backing for smaller start-ups or entrepreneurs. The capital provided can range from a one-time injection of seed money, to ongoing support to carry the company through subsequent funding rounds. An angel may be able to take advantage of tax benefits offered under the Enterprise Investment Scheme (see page 42), which would also tie them in for a qualifying period.

The investor may be seeking an exit at the end of the period which may come in the form of a buy back by the company, a sale to another investor, an IPO, or the sale of the business.

Advantages:

- Angel investors may be the only source of equity available for an early stage business, and may be less involved in the business than a typical private equity institution
- An angel may choose to invest in a business or sector where they made their own money and may then be able to offer support and insight for the company.

Disadvantages:

- Typically for smaller sums of money and involves giving up a share of your business
- Angels may be harder for a company to find, compared to the well-known institutional sources of finance
- It may prove difficult to agree a valuation of the business for investment purposes.

There are a number of Business Angel networks.

CROWDFUNDING

Crowdfunding is a way of raising finance by spreading the funding required over a large number of people so that each is investing a smaller amount of money.

Crowdfunding uses internet based platforms to communicate with potential investors.

Typically, those seeking funds will set up a profile of their project on the platform. There are different types of crowdfunding: donation, debt and equity.

Donation/reward crowdfunding

People invest simply because they believe in the cause. Rewards can be offered such as acknowledgements on a product, tickets to an event, regular news updates, product gifts. Returns are considered intangible. Donors may have a social or personal motivation for putting their money in and expect no return back, except perhaps to feel good about helping the project.

Debt crowdfunding

Investors should receive their money back with interest. Also called peer-to-peer lending, it allows for the lending of money while bypassing traditional banks. Returns are financial, but investors also have the benefit of having contributed to the success of an idea they believe in. In the case of microfinance, where very small sums of money are leant to low income borrowers (often in developing countries), no interest may be paid on the loan and investors are rewarded by the social benefit.

Equity crowdfunding

People invest in an unquoted company in exchange for equity. Money is invested for shares representing a small stake in the business, project or venture. As with other types of shares, if it is successful the value should go up, but it carries the risk of value going down.

Advantages

- Different types of crowdfunding require different types of return and it can frequently be a fast (or the only) way of raising finance
- Investors may become loyal customers
- The pitching of the business on the platform may be a valuable form of marketing for the business.

Disadvantages

- Not achieving the funding target may mean returning any pledged amounts to investors
- Failed applications can risk damage to the reputation of the business
- Getting the rewards or returns wrong could mean giving away too much of the business to investors
- Having to communicate with a large number of disparate investors may be time consuming and difficult.

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