Financial Challenges and Pains faced by SMEs.
What funding options are available to them at the different stages of their development?

A Funding Whitepaper from UKBA

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1. Introduction

If only the Government and high street banks understood the challenges faced by SMEs in running their businesses. The sad fact is that this vital sector to the British economy is either overlooked entirely or offered finance only when they are firmly established and the need is not so great.

The challenges nearly always boil down to cash flow problems. However, if lending was increased to the SME sector not only would these challenges disappear but valuable jobs and growth could be created it is a win/win situation.

The challenges created by lack of cash flow include the inability to:

- Fund new orders due to debtors paying late
- Pay for vital imports of stock
- Pay VAT or PAYE on time
- Plan achievable growth
- Buy new technology
- Keep acceptable credit terms with suppliers
- Take advantage of volume discounts
- Introduce new products or services
- Increase stock on a seasonal basis
- Start a new business
- Acquire a new business
- Stave off a pending decline

It is very important for management teams to review their funding needs at least once a quarter. They need to be aware, at all times, of any cash flow difficulties that may be on the horizon and what solutions are available to them.

The solutions that will be available to them will differ depending on the stage of development that the company is at when the funding need appears. Not all funding solutions will be suitable or even available to all companies.

Suitable funding solutions need not be hard to arrange as long as the management teams are not taken by surprise. If they are taken by surprise, are not prepared and have to go cap in hand to the bank, they are then more likely to be offered the wrong solution, at increased rates and onerous terms and conditions. That is if they are offered funding at all.

The key to successful funding is to be aware of your needs well in advance. Firstly, prepare the ground thoroughly, research the marketplace and then make the funders compete for your business, just like any other supplier that you deal with. Money is just like any other product that you buy.

2. Stages of Growth

As mentioned above, not all funding sources will be available to you. It will depend on what stage of growth your company is experiencing. It is important to understand the stages that many companies will experience at some time during their life.

The following list contains many of these stages, although the list is not completely exhaustive. Some businesses will experience all the stages and some just a few. It is also possible that a number will only experience a couple of stages, going straight from concept to collapse.

The major stages of growth are as follows:

- Concept
- Start-up
- Growth
- Consolidation
- Acquisitions
- Management Buy Outs (MBOs)
- Management Buy Ins (MBIs)
- Decline
- Failure
- Phoenix

3. Funding Options

Now that we have identified the stages of growth, we need to identify the funding options that may be available, and when we have done that we can discuss which options go with what stages of growth.

Remember that funding seldom comes from a single source and in most cases is a mixture of different types of funding. It should also be noted that taking risks is not in the nature of funding providers and, in the marketplace that we are in at present, personal guarantees for any type of debt funding will be required. These can be either supported or unsupported. A supported personal guarantee normally involves the pledging of a property or other asset to guarantee the loan. Angels (explained later on) taking an equity stake are more likely to take risks but will still want to minimize them and this will require a much higher return to compensate for the risks that they are taking.

4. Types of funding available:

The 3Fs: Friends, Family and Fools: This type of funding is normally how an entrepreneur gets started. It is also expected that the management team themselves have invested as much as they can in the company, as other funding providers always look for 'pain' money that will keep the team focused. Funders will also wonder why they should risk their money if the management teams are not prepared to risk theirs.

Personal Mortgages: If the entrepreneur has free equity available in their home, and is prepared to risk it, then this is the simplest and often the fastest way to raise funds.

Commercial Mortgages: Once a company is established commercial mortgages may be available for expansion. 'Loan to Values' (LTV) in today's market place seldom exceeds 70%-75% and so a reasonable deposit will need to be available. Affordability will also be an important criteria.

Credit Cards: Using personal credit cards is not a recommended method of raising capital, because it is one of the most expensive financing methods. Unfortunately many people have resorted to raising funds in this way unaware of the fees and payment terms that are applicable.

There are, however, a number of companies that will buy your credit card receipts from you in advance, if you have been established for a while and have a trading history. This is not a cheap method of easing cash flow problems but can help out if you have short term problems.

Grants: These vary in amounts and are dependent on the part of the country that you live in. They are becoming much harder to find and secure. It is always a good idea to talk to a specialist who will know what is available locally.

Recruitment: Recruiting a non-executive chairman, with capital to invest, is often a neglected source of funding. If the right chairman is recruited he or she may also bring much needed market experience as well as a valuable contact list. This sort of recruitment is often undertaken on a success fee only basis; so no fees may be payable until the right candidate has been found and the capital injected.

Enterprise Finance Guarantee Scheme (EFGS) Loans: These loans are available from many sources and not only the high street banks. They are much more difficult to obtain than the Small Firms Loan Guarantee Scheme (SFLGS) loans that they replaced. The government gives the lender a 75% guarantee against default which the borrower has to pay a 2% per annum additional fee for. Even with this guarantee most banks still ask for 100% guarantees from the borrower. As these loans are a last resort, this seems to disqualify the very people that they are meant to help. A good funding expert will know which banks are lending at the moment and what will be required to make a successful application. Please note that the 75% government Guarantee is to the bank and not to the borrower, you will still be the first port of call for the Bank if you default on the EFG loan.

Invoice Discounting and Factoring (ID&F): Invoice discounting and factoring comes in many forms. It is a valuable source of funding if you have a growing debtor ledger. An ID & F provider will buy your debtors from you and thereby freeing the capital tied up in those invoices. The average ID & F provider will advance 75% of the value of the invoices and once the client pays then the remainder, less charges, is also paid to you.

Most companies in this marketplace will require you to undertake at least a one-year contract with a 3-month cancellation clause and will also require you to put all invoices through their system, even those that pay you quickly. There are, however, a number of companies that now offer **single/selective invoice discounting** which does not tie you to a contract and lets you discount or factor just one or two invoices at a time. You might need it when the VAT is due, or to fulfill that large order that has come in unexpectedly.

There are now also two companies that let you auction individual invoices to the highest bidder.

Trade Finance: If you have a confirmed order from a credit worthy client but the product is made abroad and the manufacturer wants payment in advance but your client wants/expects at least 30 days credit, then Trade Finance may be the answer. Trade funders may purchase the goods on your behalf and following delivery to the client collect what they are owed by using invoice discounting or factoring to get their money back.

Stock Funding: Stock is one of the hardest areas to fund and traditionally only available to those companies that have built up a good track record with a funder. There are some new stock funders emerging, who will buy stock for an organization and who will then hold the products in their own warehouses until you need to take delivery and have paid for the goods.

Angels: Angels are investors who are prepared to invest in start-up or growth companies for an equity stake in the company. They are prepared to take the risk of investing as long as they can see from the business plan that the management has got the required experience; that there is a sound and detailed sales and marketing plan, backed by a full explanation of all assumptions made and that all operational details have been thought through. They will require a high return on their investment and a clear exit strategy within a 3-5 year period. Make certain that you have registered for EIS/SEIS as this makes investing in your company even more interesting for an Angel due to the tax concessions that they will receive.

Crowdfunding: This is a recent interesting development and comes in 2 forms; equity crowdfunding and debt crowdfunding. The principle is the same in both situations, multiple small investors combine together to invest or lend money to a company. The amounts invested can be quite small, often only a few £100 from each investor, so the risks to a single individual are limited. This is an interesting way for start-up companies to get their first start in life. It is important not to overlook one of the advantages of traditional business angel investors, which is the experience and contacts that they often bring with their investment.

Turnaround/Recovery Angels: These angels are willing to take a much larger level of risk and specialise in turnaround or recovery situations. The types of companies that they are willing to consider are those that have fallen on hard times but which in the past were successful enterprises. In other words, good companies that have gone bad for an identifiable reason. These angels can act fast and will often talk to your creditors, including the taxman, and secure some much needed time for additional funds to be injected.

Bank Overdrafts: These do have their uses, if you can get one but they should come with a health and wealth warning. Bank overdrafts can be taken away overnight and so should be used with caution. In today's marketplace most of the high street banks are also looking for 100% personal guarantees and these often have to be supported by property or other tangible assets. Overdrafts are almost impossible to obtain if you are a start-up as many Banks no longer will lend solely on forecasts.

Commercial Loans: Rather than an overdraft, try and get your Bank to give you a commercial loan. These will also need to be supported by personal guarantees but will be for a fixed period of time and unless you default they cannot be taken away overnight.

Leasing and Hire Purchase (HP): Why use your valuable cash flow to buy assets for the company when you can lease them over a set period of time and keep your available capital for running and growing the business. Sale and leaseback is also a useful way of raising additional capital on assets that you already own outright. You can sell them to a leasing company who will give you a lump sum and then you can lease the assets back from them.

Short Term Debt Finance: Over the last 12 months a new type of funder has appeared in the marketplace. These funders will lend to companies' sums from £5,000 to £100,000 depending on the risk involved and the strength of the borrower. They will be more expensive than traditional lenders but are also more willing to lend.

Regional Venture Trusts: These are very useful for start-ups and growth companies as they will invest in interesting propositions with high growth potential. Normally they will invest more than Angels but less than Venture Capital.

Venture Capital (VC) and Venture Capital Trusts (VCT): VCs are normally looking for larger opportunities than the average SME can offer. A few, however, are beginning to look at sub £1m investments and they are therefore worth keeping in mind. Be prepared for some harsh negotiating and for some stringent reporting requirements. VCTs on the other hand are looking for smaller opportunities to invest in and are a useful source of funding.

5. Stages of Growth and the Funding Options available

Now let us put the stages of growth and the available funding options together. This is not an exact science and there will be overlap in a number of situations;

Concept Stage: There is very little help for you at this stage of a company's development. At this stage the company does not normally exist. This is where the 3F's come into their own as in loans from family and friends and even business colleagues that you have worked with before. Some small grants are sometimes available for doing market research and prototype building. Many people at this stage will also look to raising money from the free equity they may have in their home and some, unadvisedly, will even turn to their credit cards to make their concept a reality. There are also a number of micro funding organizations springing up that will invest in a concept in the hope of then assisting the company to get set up and started.

Start-up Stage: One has to be very careful at this stage and costly mistakes can be made. Very often the entrepreneur is so keen to get going that expensive funding is accepted or they sell too many shares for too little money. This will have a significant impact on your ability to raise further rounds of investment without losing control or becoming so diluted that you lose interest.

All the sources of funding available at the concept stage are also available at this stage plus some additional sources that you can now think about.

These include:

- Recruiting a non-executive chairman with both knowledge and capital
- Applying to a Bank for an EFGS loan which gives the banks a 75% guarantee by the government. You pay 2% per annum extra for this guarantee over and above whatever the bank charges for the loan. The banks do not like these loans as they are very risky for them and are therefore difficult to obtain. But they are a good source of funding and there are other organizations that have the right to offer them that are more sympathetic than the banks.
- Leasing and HP. Very helpful at this stage to finance cars, plant and machinery and IT equipment. Remember, however, that you need to be a UK homeowner and be prepared to give personal guarantees.
- Invoice Discounting or Factoring. This type of funding for a start-up is often very important. The funders are not particularly taking a risk on the start-up, they are taking the risk on your clients. Remember there are specialists that are happy to start providing very small sums to start with and others that will be very flexible and are quite happy to just buy one or two invoice at a time to suit your requirements. There are now two auction sites that lets you sell your invoices to the highest bidder.
- Angel Funding. This is perhaps the most important method of raising finance for a start-up, but it is also the most time consuming, the most difficult and the most expensive. You need a first class funding business plan, the returns for the investor will be high and so the business must be quickly scalable and there must be a realistic pre-investment valuation as well as a well-defined exit strategy. You need to have something that sets you apart from

your competitors. Something that makes you unique and gives you a sustainable business advantage.
- There are many national and local angel networks available, but it is much better to approach them through an experienced intermediary rather than go direct yourself. Crowdfunding has introduced a new type of angel into the market place and this type of funding can be very interesting, but you still need to have a great business plan. Small investors will care just as much about the return on investment and will need to believe that you can deliver the business plan.

Growth Stage: Once again all the ones mentioned at earlier stages will be available at this stage as well. The banks will be slightly more interested in you at this stage and overdrafts may be an option, but you should still try and avoid these and request a commercial loan instead. Remember, however that term loans have to be asset backed and have a defined payback plan. Commercial mortgages should also be easier to get at this stage.

Other sources of finance to consider are:

- Trade Finance
- Stock Finance
- Debt Crowdfunding
- Regional Venture Trusts either for equity funding or mezzanine loans.

Consolidation Stage: At this stage of the company's development you are much more interesting to funders and should be able to renegotiate existing deals. So at this stage look at all the previous debt deals that you arranged and see if you can now get better deals. So have a complete review of:

- Your commercial mortgage
- Bank debt; even consider a total change in banking arrangements
- Invoice discounting or factoring contract
- Your leasing and HP agreements
- All trade and stock funding facilities

Acquisition Stage: Having reviewed all your existing facilities at the previous stage, you now need to find additional funding to help finance any company acquisitions that you want to make. Looking at a likely target you should always look at their assets and decide if part of the cost of acquisition can be paid back by using invoice discounting or factoring to raise money from their debtor book and also consider selling and leaseback of any owned plant and machinery.

Other areas of funding to consider at this stage are:
- Angel Funding
- VCTs
- VCs

Decline Stage: Unfortunately many companies, at some time or another, will experience this stage and hopefully come out the other side stronger and fitter.

At this stage you may consider:

- Second charges on property
- Re-financing of any owned assets
- Short term finance such as single invoice discounting
- The sale of future credit card receipts
- You may also consider the recruitment of a non-exec chairman to bring in new ideas and capital from someone who has done it all before.

Failure and Phoenix: At this stage your only hope may be to approach the Angel networks that specialise in turnaround situations. Most pre-packs and phoenix operations fail because no new money and equally important no new ideas are brought into the company and the same mistakes are made all over again. Bring in the turnaround angels and you get both capital and ideas. Invoice discounting and factoring are also very useful at this stage as they do not rely on looking at the past history. Instead they look at the quality of your customers.

Notes: