making your business grow

Iln the coming months, **The Informed Executive** will be carrying a selection of editorial features under the umbrella of **making your business grow**. In this edition, we get to grips with **funding expansion**, probably the greatest dilemma faced by entrepreneurs today after ensuring they have the cash flow to operate.

Our examination of trade finance in the preceding pages referred to some of the iniatives that have been tried, with varying degrees of success, in the past three decades. Whatever their eventual effectiveness, they laid the first plank for many smaller businesses to bridge the gap between the financial resources they had to hand, and the funds needed to get their businesses to a critical mass.

As start-ups mature and clear the three-year hurdle – probably one of the more reliable indications that they are more than a flash in the pan - the investors and management generally reach another critical point on their development path.

Taking the business anywhere further will require additional capital, unless the business is so profitable that the owners can plough back into the business enough of the retained profits to avoid their having to explore the possibilities of fund-raising.

Planning a course of action

It is one thing talking about businesses and investors as disembodied third parties on the page of a corporate finance textbook; quite another when you are the investor or manager and it is your business under the spotlight. You are faced with a series of strategic questions which determine the way ahead:

- Where do you go from here?
- How do you influence that way ahead?
- More specifically, how do you finance the transition as painlessly and as cost-effectively as possible?

You are having to look at bringing new equity capital to the table. How you do that will depend in part on the legal structure of the business that you are ruinning. The chances are that it is a *private* limited company, the simplest form of incorporated business.

One of the reasons why you set up a limited company in the first instance, rather than operate as a partnership or sole trader, is that a company is a legal entity with a 'personality' separate from that of the directors and investors.

Unless you do something which takes you outside the boundaries of company law, your personal assets are not normally at risk if the business were to fail. Of course there are exceptions, such as your agreeing to guarantee a bank loan which the company fails to repay.

If you have been involved in running limited companies for some time, it will have been apparent that the 'breed' has been subjected to a regulatory environment which has not stood still for long in that time.

In an attempt to crack down on individuals who used the protective status of limited liability to conceal questionable practices, the Government required companies to file annual reports in copious detail, whether they were a two-man business in Brighton or an enterprise turning over £500 million a year.

provide **succession** in family businesses
make **acquisitions**
merge or **restructure** your business
fuel the **expansion** of a company
launch a new undertaking

Accepting that as regulatory overkill, the previous Government allowed smaller businesses (defined in terms of turnover) to file progressively more simplified accounts.

The participants in a private company have another important provision built into the legal framework of the business. There are rules about the transer of shares in such a business, which prevent shareholders acquiring or disposing of their stake without the agreement of the company's board and thereby changing control of a company against the interests of its founders.

Freedom to transfer shares

There are no such restrictions on the transfer of shares in a public limited company, the next status up from the private entity.

The format is essential if a business is planning to attract funds from specialist investors or to raise money from the public: these investors have to be in a position to dispose of their stake (whether or not there are willing purchasers for those shares is another matter, of course.)

Securing public status for your business is more expensive than remaining private and the reporting requirements are considerably more onerous; a protection for any investors in the business.

Turning your business from a private to a public limited company (Plc) does not mean that its shares can be traded on a recognised investment exchange – whether the London Stock Exchange, its AIM 'junior' market, or one of the smaller stock trading facilities such as PLUS Quoted or ShareMark.

Access to that kind of trading and hence the ability to raise money through share offers to the public comes at a significant financial cost and a regulatory infrastructure that is a bridge too far for most SMEs.

Seeking private equity investors

That summary of corporate structure helps to illustrate the kind of boundaries within which you are operating if you intend to attract investment in share capital from anyone other than friends and family.

The remainder of this feature is focusing therefore on the issues behind attracting external investors into your company. Compared with the types of funding to which you would previously had access (family and friends taking stakes, conventional bank loans and overdrafts, for example), private equity investment has some distinctive features.

The funds provided are in the form of shares rather than loans or bank overdraft and are wholly at risk like the funds invested in the company by its original shareholders. Subject to any divergence of views within the enlarged organisation, all of the investing parties have a common interest in seeing the value of their capital stakes grow.

Before the recession started to bite hard on the smaller business sector, company owners were not adverse to seeking capital injections from private business funds set up for the purpose, and a breed of individuals collectively known as 'business angels'.

In the absence of significant bank finance, the number turning to business angels for top-up funds is increasing, even though the total pot available has not increased in proportion. There is growing evidence that third parties are selecting only ventures with minimal risk, while in a position to extract increasingly unfavourable terms from the entrepreneurs approaching them.

The counter to that argument is that Angels can bring value to an investee company through management and financial skills, and access to new market opportunities.

Private equity investors are **entrepreneurs** who generate their returns not through earning interest but through **developing the companies** in which they have invested. Their risks are usually averaged out across a broader portfolio. With the **prospect of significant capital returns** when a 'client' company is sold, or listed on a stock exchange, investors have an **incentive** to support the development of those businesses.

Changes to the investment scene

At the beginning of July, the Government announced a consultation on proposals to encourage additional investment in small and start-up businesses with high growth potential . The Government intends to set up a Business Angel Seed Investment Scheme (BASIS) which will target seed investment by business angels.

The proposals come after changes that were announced in the 2011 Budget to reform, extend and simplify the established Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs). All of the new features draw on evidence suggests that SMEs and start-ups encounter difficulties in accessing equity finance up to £10 million.

Since their introduction in the 1990s, the EIS and VCTs have supported over £11.5bn of equity investment into UK businesses. The schemes incentivise investment in smaller, qualifying companies by offering a range of income and capital gains tax reliefs to individual investors who subscribe for new shares in a VCT or in a company qualifying under EIS rules.

In relation to EIS and VCT, the government is seeking to increase the level of tax reliefs and qualifying investment ceilings for investors. It is raising the rate of EIS income tax relief from 20% to 30% from April 2011, increasing the annual EIS investment limit for individuals to £1m from April 2012 and increasing the qualifying company limits to 250 employees and gross assets of £15m for both EIS and VCTs from April 2012.

It will also increase the annual investment limit for qualifying companies to £10m for EIS and VCTs from April 2012. 'Qualifying' excludes certain categories of business activity where the risk is assumed to be relatively low but still includes companies whose shares are being quoted on one of the 'junior' markets such as AIM or PLUS Quoted Market.

Applying new funds

The greater flow of new capital which the Treasury hopes will be stimulated will find applications across the spectrum. BASIS-linked funds will help kick-start businesses for which no other capital may be available, while EIS and VCT funds will be used primarily to

- provide succession in family-owned companies,
- make acquisitions,
- merge or restructure businesses,
- fuel the expansion of a company based on the introduction of innovative products or services.
- launch a new undertaking or even provide the seed capital for a company about to be started.

Money is not easy to attract

It is not enough just to present good ideas to a potential investor. Financing of such early projects was a phenomenon of the late 90s. This will not return during the coming decade - if ever. There is a trend away from the 'early stage segment', which includes start-ups.

In search of an investor

- Produce a quality business plan
- Form a management team with the right skills
- Ensure that management is highly motivated
- Be able to tell an exciting growth story
- Take time to find an investor
- Check out investors before you commit

Persuading others to share the risk

If you feel that you do have these pre-requisites and that you are in need of risk-carrying equity in order to build up and grow a profitable business then you should keep in mind several points when looking for an investor:

- Produce a business plan that gives a clear impression of your business model and your visions for the future. It should be clearly structured in the eyes of anyone who does not share your enthusiasm in the business. And above all make sure that you put your focus on business aspects and not on the technical details of your innovation.
- Form a management team. There is no investment operation willing to put its money into just one person who might have a car accident or just win £4 million in the lottery which might jeopardise his incentive and his efforts to grow his company.
- Make sure that all members of the management team are highly motivated and are able to exhibit a track record fitting the business model promoted by your business plan.
- Be able to tell an exciting growth story for your business and don't forget to prepare a punch line. All investing is about a profitable exit from an investment in several years time from the start.
- Take your time to search for an investor who fits your business, your specific way of doing the business as well as your mentality in doing business and in dealing with problems. Equity Investors are going to be close partners over a period of several years in an undertaking that will substantially influence your life.
- And finally, check your investors, their know-how, networks and financial resources – factors that will influence the value added to your company through their involvement. Investors will have been no less thorough by the time they commit their money to your control.

Into the public arena

The process of making an Initial Public Offering is probably the most traumatic commitment that any team of managers will make in the life of their organisation.

A decision to proceed with an IPO will probably have come in the wake of one or more rounds of private equity financing which, in turn, will have followed on the heels of funds contributed by the company's founders, their families and private backers.

In theory at least, the public offering is a significant step on the path towards rewarding those early investors in a business for their foresight and commercial acumen. Practice would suggest that this goal is not necessarily realised. One reason is that offering shares to the public – whether institutional or private investors – has become progressively more complex, and is likely to become even more so in the light of European directives.

Planted by legislators out of touch with commercial reality, the minefield of regulations and red tape to be negotiated en route to an IPO can create more problems for the business community than the abuses which it is intended to prevent.

All of those pitfalls apart, there is considerable merit in an established business at least considering a flotation, and in the next edition, we shall be looking at the feasibility of public listings. §