Harlands Accountants

7 steps to financing your business

Establishing a solid financial base for your business should be one of the first tasks every start-up turns to.

Whatever kind of business you’re setting up - from a one-person operation based at home, to a high-tech manufacturing plant - you need to be clear about how much money you’re going to need and where you’re going to get it from.

Many small businesses rely on their savings and on loans from banks, family and friends. But there are other sources of finance and the better your understanding of these different types of finance, the stronger your position will be when you try to tap into them.

Different types of finance work in different ways and there are benefits to using the most appropriate source of finance. The more effort you put into understanding the basics of financing, the more likely it is that you’ll secure a finance package that balances your short-term needs with the long-term growth potential of your business.

So where should you start?

1 – Work out how much you need

Draw up a budget

Show your forecasts for sales and expenditure, and what your cash position will be each month. Include initial costs, such as purchasing equipment. Be realistic. Sales might well turn out to be lower and later than you hope and getting paid may take longer and costs can be higher

Work out how much you require and when you will need it

A start-up business may spend more than it earns for two or three years. The amount of financing you need continues to increase until you reach breakeven. Please also note that seasonal businesses have predictable cashflow peaks and troughs. For example, a toy manufacturer might spend on producing stock all year, but receive most of the year's income after high sales at Christmas.

Allow for some contingency

Think of the worst-case scenarios that could affect your plans — for example, a product launch might be delayed, you could lose your best customer or costs might increase. Assess how accurate your forecasts are. If you are unsure, you might need sizeable contingency funding to support the business.

Arrange all your finance at the same time

Don't wait until your need for extra funds become too urgent. Let your funders know the total amount you want to borrow, even if you want to borrow in stages. Otherwise, asking for more funds a few months after you first borrow might alarm your funders.

2 – Assess which funding is suitable

Decide how much investment you need

It will be difficult to borrow money from a bank unless you can point to an adequate financial base of money invested in the business. Businesses normally use investment finance to cover development costs and start-up losses. They are also seen as your "pain money" that you've risked towards this business which is a positive for all funders.

Decide what short-term borrowings would suit

An overdraft is often the best way of funding working capital (the cash you need to cover the delay between paying suppliers and receiving payments from customers). With an overdraft, you pay interest only on the amount you are overdrawn each day however exceeding your overdraft limit incurs bank charges and higher interest rates.

The bank may bounce your cheques, damaging your credit with suppliers. Alternatives sources can also include factoring and invoice discounting which are explained in section 6.

Decide what longer-term borrowing you want.

Loans and other forms of borrowing are usually the best way of financing equipment, vehicles and long-term borrowing requirements. Different forms of borrowing might enable you to raise more money than loans, but can involve higher costs. Most loans are for a fixed period of one to ten years. For property, you can use a long-term mortgage. The term of any loan should match, or be shorter than, the expected life of the asset you are acquiring. For example, if you are buying leased premises, the mortgage must be repaid before the lease ends. Using your overdraft to finance longterm borrowings can be disastrous. For example, if you use your overdraft facility to buy equipment, you might have no short-term finance available to you if your need for working capital increases or contingencies

3 – Sort out investment finance

Consider taking out a mortgage on your personal property

Mortgage rates are lower than business lending rates. Some mortgages have flexible repayment arrangements that can help reduce the risk of defaulting. Your home will be at risk if your business fails and you cannot make the mortgage payments

Consider asking family and friends to invest

Make it clear that they should only invest amounts they can afford to lose. Show them your business plan and give them time to think it over. Discuss 'what-if' scenarios, such as what will happen if you go bust, want to pay yourself a big salary or want to take bigger risks

Consider whether outside investors are an option.

You are unlikely to attract outside investors unless you and your team can show a strong track record and a credible business plan. You must be prepared to give up a share of your business. However, the investor might also bring experience that will drive your business forward. Investors will expect to be offered high potential returns to compensate for the risk they are taking. They will want an 'exit' plan so that they can realise their profits in three to seven years' time. 'Business angels' (wealthy entrepreneurial individuals) might be prepared to invest between £10,000 and £250,000 (and sometimes more). Find business angel networks through the UK Business Angels Association or by talking to your accountant. Crowdfunding is an increasingly popular alternative to bank lending when relatively small amounts are required. Crowdfunding allows groups of interested investors to come together, each investing a small amount in the business seeking funding. See the UK Crowdfunding Association at www.ukcfa.org.uk or one of our north east crowd funders www.growthfunder.co.uk

4 – Establish your creditworthiness

Prepare a business plan

Your business plan must include a comprehensive budget (see section 1). Your accountant or bank manager can advise you what information is required and how figures should be presented when seeking a loan.

Asses what your business assets are worth as security

Banks will value your assets conservatively when you use them as security. For example, they will usually lend only 50-60% of the value of business property and trade debtors. Equipment will be valued at its resale price (usually at auction). Any existing financing arrangements, such as other loans or leasing arrangements, are likely to reduce the amount of security you can offer the bank.

Check whether you are eligible for the Enterprise Finance Guarantee (EFG).

Start-up businesses that cannot provide enough security might be able to get an EFG for loans of between £1,000 and £1,000,000. In return for an annual fee of 2%, the Government guarantees to repay the lender 75% of the value of the loan if you default. Total costs may be slightly higher than for an ordinary loan. Your bank manager can advise you whether you are eligible.

Decide whether you are prepared to offer a personal guarantee. (PG)

You might give a personal guarantee for business debts. Your personal assets (including your house) can be at risk if the guarantee is called upon. Sole traders (those in a partnership) are already personally liable for all business debts. Directors of limited companies are often asked to provide personal guarantees in case the business fails. You might be able to negotiate a limit to the amount of any personal guarantee or how long it lasts

5 – Arrange overdrafts and loans

Check what borrowing costs will be

Interest rates are usually set at a margin over the bank base rate, which can vary. Margins on loans are very variable, depending on how risky the bank thinks the loan is. Alternatively, the interest rate on a loan may be fixed at a flat rate. An arrangement fee is usually levied when an overdraft facility or loan is set up. Typically the fee is one to 1.25% of the facility requested. A renewal fee is sometimes charged when an overdraft facility is extended. You might incur costs arranging security

Compare different lenders for the best deal

Even if you decide that you want to stay with the bank you already have a relationship with, you will be in a stronger negotiating position. If you have difficulty borrowing from mainstream banks, you may be able to get financing from a Community Development Finance Institution (CDFI). Search for local CDFIs at www.findingfinance.org.uk

Negotiate your overdraft facility

Your overdraft limit is usually agreed for six to 12 months, after which it must be extended by negotiation. Your limit can be reduced if the bank decides this is necessary. In principle, the bank can demand repayment in full at any time, usually at just 24 hours' notice.

Negotiate any loans.

Agree the term of the loan. Agree what the repayment schedule will be. Paying equal amounts of capital and interest is a common choice. Alternatively, you might be able to arrange an initial 'payment holiday' to allow time for your cashflow to pick up before the first payment is due. A fixed-rate loan makes it easier to budget for future costs.

6 – Arrange other financing

Assess which are the best options

Leasing, hire purchase (HP) and factoring (see section 6.4) can each enable a business to raise more money than traditional bank finance, but the costs might be higher. Comparing the costs of different forms of finance is complicated. Key factors include fees, interest rates, the period of the finance and the tax implications. Ask your accountant for advice. Focus on cashflow first. Only if your cashflow is healthy and robust should you try to save money by relying on overdraft finance

Consider leasing equipment that you do not need to own

Instead of buying the item, you rent it for a fixed period (usually three to five years). Payments are spread out over the period, helping your cashflow. You may get tax relief on lease payments. You might get the option to purchase the equipment at the end of the lease period. When you lease a vehicle, contract hire gives you the option to fix maintenance costs as well.

Consider hire purchase as an alternative to leasing.

You buy the equipment, but payments of capital and interest are spread over a fixed period — usually three to five years. You can claim capital allowances for the equipment on your tax return, and the interest payments receive full tax relief. There are also grant schemes ran by Lombard Asset Finance to help finance equipment.

Consider using factoring to reduce the amount of capital tied up in unpaid sales.

You can receive up to 85% (typically 80%) of the face value of each invoice immediately, and the balance (less charges) once the invoice is paid. The factoring company collects payments on your behalf. Invoice discounting is a similar option, but you continue to collect payments yourself. It can be difficult to stop using factoring if you later decide that you want to switch to normal bank finance.

7 – Work with your bank

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Keep the bank informed.

Provide regular updates on the financial position of the business. This should include information on sales, costs and margins and updated forecasts for the future. Explain any differences between the figures you have achieved and your original budget. Mention any key events you expect (e.g. an order you think you will win).

Warn the bank as soon as possible if you expect to run into difficulties

Let your bank know in advance if you will be unable to make a loan repayment or expect to exceed your overdraft limit. If you have a good relationship with your bank manager and you are open and honest about any short-term problems, your bank might be willing to temporarily extend your overdraft facility

Signposting:

Find business angel networks through the UK Business Angels Association (https://www.ukbaa.org.uk/).

Find venture capital investors through the British Private Equity and Venture Capital Association

For information about the Enterprise Finance Guarantee, contact your bank manager

Find out about Community Development Finance Institutions Find out about Crowdfunding providers on the UK Crowdfunding Association website

Harlands Accountants

If you would like to talk to us about raising finance for your business please contact our great team.

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