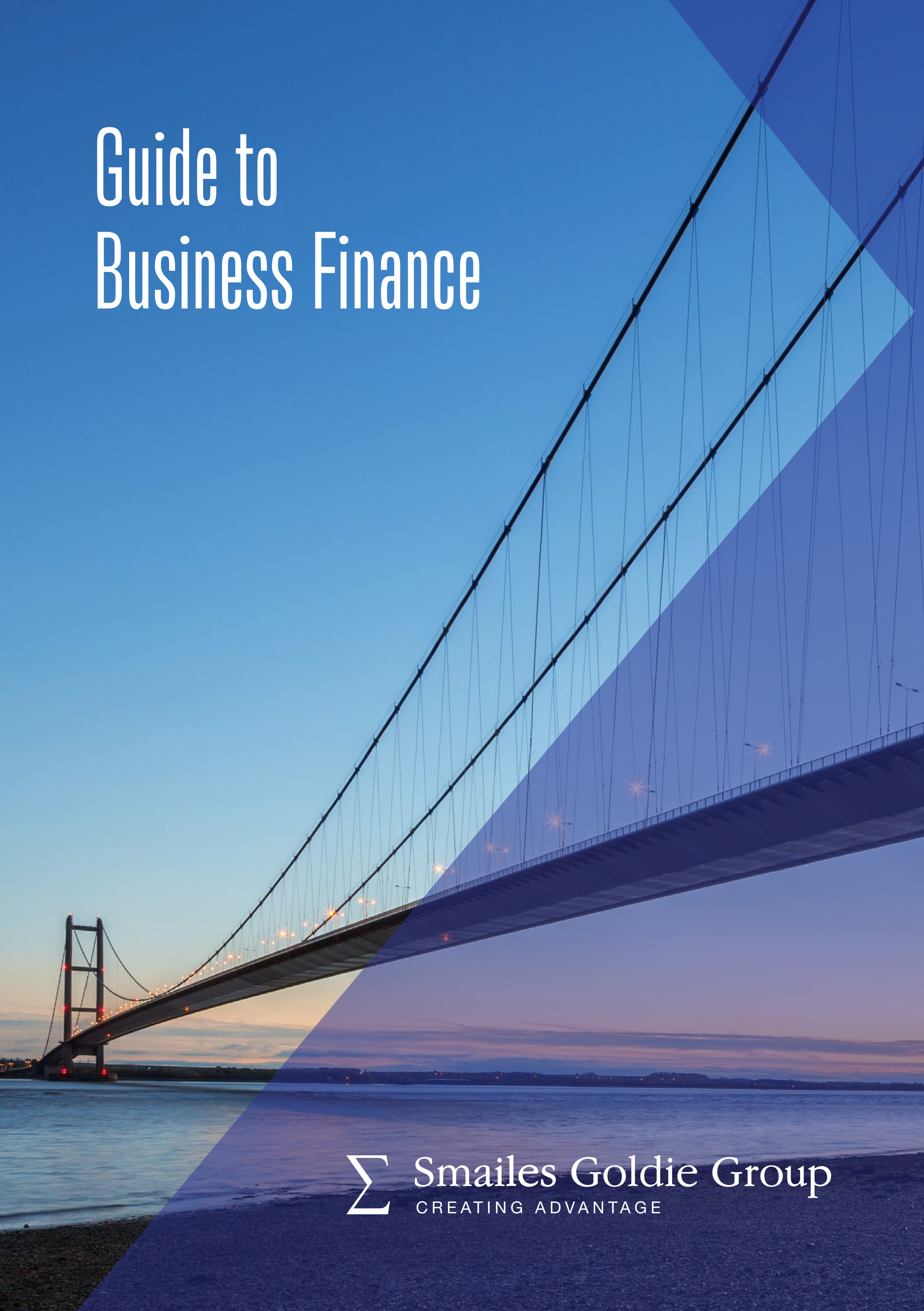
Guide to Business Finance



Smailes Goldie Group
CREATING ADVANTAGE

One thing holds true for all businesses of all sizes and in all sectors – doing business costs money.

Ideally, the costs involved in trading can simply be covered by revenue earned from work undertaken or goods sold in the past.

However, business in the real world is nowhere near as straightforward as that and there are numerous reasons why a business might need finance to help with the costs of doing business.

With the various government backed COVID-19 schemes now coming to an end we felt the time was right to produce a general guide to finance including the which product to use in each situation.

When might business finance be needed?

The first and most obvious circumstance is a start-up business that has not previously traded and so is not generating any revenue. The money to cover the costs of starting the business has to come from somewhere. Often, this will be the business owner's private finances but much of the time a great business idea costs more to implement than the person who came up with it can afford, which is where business finance for start-ups becomes so important.

A similar circumstance where revenue might not cover costs in where a business is looking to grow, especially if it pursuing rapid growth, growth through acquisitions or if growth requires the purchase of expensive equipment or assets.

> “Another situation where business finance can prove invaluable is where a business is in difficulty for whatever reason and revenues have fallen below the level they need to be to sustain the business – something many otherwise viable businesses experienced during the Coronavirus crisis.”

There can also be circumstances where a business is healthy but where cash flow fluctuates or there are issues with late payments, something that is a particular concern for seasonal businesses, manufacturers, importer, exporters and others that have uneven income across the year. Finance can provide a useful bridge in circumstances where cash flow needs to be maintained.

The options

The options for obtaining business finance are extremely wide-ranging and we have set out below a general overview of the key avenues available to businesses:

Working Capital Funding

Working capital finance is the amount of money needed to cover the difference between the value of stock and debtors in your business and the amount of creditors you have.

Maintaining a healthy cash flow is vital for any business, but doing so can be challenging, even where sales are strong. Fortunately, there are several finance solutions to help in these circumstances.

Credit Cards

Business credit cards work in a similar way to personal credits cards. Like their person equivalents, they are designed for short-term lending to fund purchases and to allow you to withdraw cash.

Several benefits come with using a business credit card, including improved cash flow at little or no cost, managing expenses efficiently, creating a credit record and separating personal finances from business finances.

Credit cards can be used by anyone in the business you authorise, including owners, directors and employees.

The costs of using a business credit card come in various forms, including annual fees, interest charges, late payment charges, overseas transaction charges and charges for cash withdrawals.

Overdrafts

Business overdrafts also work similarly to their consumer equivalents, allowing you to spend or withdraw amounts over and above the balance of the account and continue spending and withdrawing when you have a negative balance, up to an agreed amount.

They offer flexibility to deal with fluctuating cash flow over short periods and relatively low cost, although costs can mount up if used for significant periods.

Funders will assess requests for overdrafts across a range of criteria however in essence the amount requested should correspond to the balance between stock, debtors and creditors.

Debtor financing

Debtor finance is tied to the debts owed to your business and can take various forms, including invoice finance and factoring. These forms of finance are particularly useful as they can grow as a business grows as the amount of debt can increase with the level of trade debtors.

> “Invoice financing is a form of lending tied to unpaid invoices, whereby a lender covers the value of the outstanding balance in exchange for a fee worth a certain percentage of each invoice.”

This can be particularly useful in circumstances where slow or late payment of invoices is affecting cash flow.

Factoring is a similar form of finance where you sell the debts owed to you to a third party.

Debtor financing can smooth variations in cash flow and is especially useful for businesses with limited capital reserves.

Significantly, the creditworthiness of the party owing the debt is generally more important in obtaining debtor financing than the borrowing party.

Stock finance

Stock finance works in a similar way to debtor finance, except it helps smooth out the impact of the cost of purchased but unsold stock on your cash flow.

Essentially, it enables you to borrow against the value of your unsold stock. It is a solution that has been widespread amongst car dealerships, but which can also be available to other trading businesses usually as part of a wider invoice finance facility.

Finance for longer-term assets

Growing your business will often involve buying new assets, such as equipment, vehicles, machinery or premises. The costs of these items are often too large to be covered by general expenditure and finance is often the only viable way to continue with such plans.

Commercial mortgages

Commercial mortgages are a form of lending secured against property other than your residence and generally start from £25,000. The repayment terms tend to range from around three to 25 years.

In many ways, commercial mortgages work analogously to their person counterparts, but there are some key differences. Commercial mortgages tend to charge higher rates, as they are considered to be higher risk. It is also worth noting that loan to value ratios tend only to reach 65 to 75 per cent, rather than the 90 per cent plus ratios that can be available for personal mortgages.

Like personal mortgages, rates can often be fixed for the term of the loan or linked in to base rate.

There are some important benefits to commercial mortgages, such as offering lower interest rates than are available through commercial loans. This is achieved as the lender has security over the mortgaged asset.

Business Loans

Business loans can be obtained for virtually any amount from as little as a few hundred pounds all the way through to many millions.

However, unsurprisingly, whether you can borrow from any given lender at all will depend on strict criteria, as will the amount you can borrow, the interest rate you have to pay and the term of the loan.

> “You will generally want to obtain a loan at the lowest interest cost and with affordable repayments, coupled with the most advantageous general terms.”

Input from your accountant can make the difference in demonstrating the health of your business to prospective lenders and can sometimes enable you to access better deals than might otherwise be possible.

Hire Purchase

Hire purchase is commonly used for the purchase of vehicles, but can also be used for other assets such as machinery or specialist equipment.

Hire purchase involves paying a deposit of a certain percentage of the value of the asset (often around 10 per cent) followed by a fixed number of regular (usually monthly) payments. Unlike some other finance arrangements, you only take ownership of the asset on meeting all the monthly payments.

Hire purchase arrangements usually have low-interest rates and generally come with achievable creditworthiness requirements.

Leasing

As with hire purchase, leasing is closely associated with vehicles but can also be used for other assets. However, unlike hire purchase, leasing does not lead to ownership of the asset.

As a result, leasing tends to be cheaper than hire purchase and there is a particular advantage in the case of rapidly depreciating assets.

Start-ups

Money is often the greatest hurdle for people wanting to start a new business, but there are various options available to people who are unable to fund a new venture out of their own pocket.

Business loans

A business start-up loan continues to be one of the best ways to get a business idea off the ground.

> “Ultimately, the bank will need to be persuaded that there is a low risk of you defaulting on the loan. The best way of doing this, and a basic requirement of the application process, is to provide a detailed business plan with robust forecasts.”

While there are currently fewer business loans for start-ups available on commercial terms, several lenders are offering Government-backed loans with support from the British Business Bank. While similar to some of the Coronavirus business support schemes, these are not directly part of the response to the Coronavirus outbreak.

Rates for start-up loans currently sit at around six per cent with loans generally available up to between £5,000 and £50,000.

Family loans and investments

The ‘Bank of Mum and Dad’ is well-known for helping first-time buyers make their first step on the housing ladder, but it can also be a good way of obtaining the finance needed to start a new business. Of course, family loans and investments can come from any friends and family and not just parents or grandparents.

This route to obtaining finance has several key benefits, including flexibility and low or no interest rates.

The downsides include the potential for undermining family relationships if things go wrong, such as through the potential for disputes over the terms of a loan or your management of the business.

Outside investment

Investment generally entails funding a business in exchange for equity in the business.

Investors can be private individuals or institutions and range enormously in how experienced they are and how hands-on they are with a business, amongst other things.

Investors will vary significantly in the size of the stake in the business they want for their cash and deals can allow you to buy back some or all of your original stake if certain criteria are met.

How an investment is structured will have significant ramifications for the future of your business and so it is critical that you obtain professional advice at the earliest stage if you are considering seeking investment.

Soft loans and grants

There are a wide variety of loans and grants that fall under the category of soft loans and grants, but they are generally those that have Government backing and better terms than are generally available elsewhere.

Soft loans include the Government-backed start-up loans detailed above, as well as those available from third sector organisations, trade bodies and local Government organisations.

Similarly, grants tend to be Government-backed but can also be offered by third sector organisations, large businesses, trade bodies and local Government. They tend to be offered for specific purposes or with conditions restricting their use to capital expenses only.

Both soft loans and grants can prove to be highly effective avenues to getting your business off the ground.

Business Angels

Angel investors are generally individual business owners or, increasingly commonly, collectives of business owners who put their own spare cash into high-growth start-ups in exchange for equity in the business.

One of the key benefits of angel investment is the knowledge and experience of the investors, which you can draw upon to help to overcome the challenges you face as you establish your own business.

At Smailes Goldie Group, we have partnered with Angel Groups – Humber, which sees us refer new and exciting businesses to a range of suitable investors.

International Trade Finance

Trading internationally can put particular pressure on cash flow as a result of the large amount of time between sending and receiving goods and payment. Several dedicated finance options have been developed to deal with this challenge.

Import Loans/Buyer Loans

Import loans – also sometimes referred to as buyer loans – help manage cash flow when bringing goods into the country.

The long period it can take to receive goods after paying for them as a result of transit delays and hold-ups at customs amongst other things can be severely detrimental. Import lenders will generally pay for the goods in the first instance with repayment often refinanced via debtor finance once the goods are sold.

Export finance schemes

Export finance schemes bear a strong resemblance to factoring, described above, whereby a loan is made against the value of unpaid invoices.

Export finance can be offered on normal commercial terms but UK Export Finance also provides several Government-backed export finance schemes.

UK Export Finance launched the General Export Facility in late 2020 providing an 80 per cent Government guarantee on financial support worth up to "around £25 million". Unlike some export finance schemes, the General Export Facility does not need to be tied to specific contracts or invoices and can be used towards a wide range of expenses arising from exporting.

Alternative Finance Options

Traditional finance options will not suit every circumstance and the internet has enabled a range of alternative finance options to develop in recent years.

Crowdfunding

Crowdfunding is a relatively recent development that enables businesses to obtain finance from a large number of people who individually contribute a small amount but collectively contribute a significant sum.

> “Crowdfunding is usually sought through various online platforms, although there are some notable examples of large businesses setting up their own crowdfunding platforms.”

Generally, crowdfunding offers either loans or equity in a business, but it can also involve early access to the business’s new consumer products or donations.

What to consider when seeking finance

Simply looking for the easiest funding to obtain is unlikely to meet the needs of a business in the long term. Debts that cannot be repaid comfortably can signal the end for a business, while new shareholders with wildly different plans for the business can be similarly problematic.

Business finance needs to be approached strategically and with a holistic view of the business and the needs of its owners.

A wide range of finance options exist and some of these are easier to obtain than others. They can usually also be configured in a near-infinite range of ways.

Identifying the right option for your business is not necessarily an easy task and so seeking advice can be vitally important.

Please contact us today for advice on financing your business plans.

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