Raising financial capital

Simon Stockley
Senior Teaching Faculty in Entrepreneurship
Objectives:

- Planning your funding strategy – key questions
- Appropriate funding sources
- Cash burn rate - the ‘Valley of Death’
- Valuing new ventures
- Structuring equity investments
- Sources of equity – Venture Capital
- Debt finance
The bootstrapper’s mantra….

“Never buy new what can be bought second-hand
Never buy what can be rented
Never rent what can be borrowed
Never borrow what can be begged
Never beg what can be salvaged”
The difference between species

Venture Capitalist  Corporate Banker

Both are dangerous, but at least VCs are predictable
Planning your funding strategy - ten key questions:

i. How much do you need?
ii. When do you need it?
iii. How long will it take to raise the money?
iv. How long will it last?
v. What will it be used for?
vi. What *type* of money do you need?
vii. From whom will you raise it?
viii. How expensive is the money?
ix. How and when do you plan to repay it?
x. Is the business actually fundable?
Additional factors to consider when raising money

1. The ‘type’ of business you are starting affects the type of financial capital you can access.

2. What ‘stage of development’ your business is at and how soon you are likely to generate sales revenue affects.

3. The perceived risks determine the returns expected by financiers.

4. Your attitude towards sharing ownership and control.

5. Your bargaining power relative to the providers of capital.

If you cannot convince an investor that they will get *six to ten times their money back* after 5 years they are VERY unlikely to invest…
# Debt vs. Equity

<table>
<thead>
<tr>
<th>Key Features</th>
<th>Equity</th>
<th>Debt</th>
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<tbody>
<tr>
<td>Dilution of ownership</td>
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<td>Cost of money</td>
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<td>✓</td>
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<td>Time taken to raise money</td>
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<td>Cost associated with raising money</td>
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<td>Available to ‘lifestyle’ businesses</td>
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<td>Paid back if business fails</td>
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<tr>
<td>Smart money</td>
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<tr>
<td>Requires regular repayments</td>
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<td>Can be raised pre-revenue</td>
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<td>Security taken over assets</td>
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<td>Directors guarantees required</td>
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<tr>
<td>Increases fixed costs and BEP</td>
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</table>
Who assumes the risk?

**Equity invested by business angels**
- Perform due diligence
- Require *warranties* from founders
- Require founders to invest their own money
- Funds released in stages based on the achievement of agreed milestones

**Money borrowed from a bank**
- Only lend to established businesses with sales revenue
- Take *security* (a legal right to sell) against the assets of the business
- Insist on *personal guarantees* from the Directors of the business
- Sometimes use the Enterprise Finance Guarantee Scheme (EFGS)
Perceived risk must be balanced by returns...

Risks - (MMIST)

- **Management** – will the team fall apart, can they execute?
- **Market** - is there a growing market, will customers buy?
- **Industry** - will competitors kill you, do you have a protectable advantage?
- **Supply chain** - will suppliers and distributors deal with you and on what terms?
- **Technology** - does it work, can you make it work, how much will this cost?

Risk Return

- **Pre-revenue start up**
  - Risk
  - Return
  - 45-60% IRR +

- **Start up with growing revenues**
  - Risk
  - Return
  - 30-45% IRR

- **Established business with growing revenues**
  - Risk
  - Return
  - 20-30% IRR

Perceived risk must be balanced by returns…
Risk and cost of equity capital

Cash flow

Seed 1st Round 2nd Round Growth capital
60% IRR + 45-60% IRR 30-40% IRR 20-30% IRR

Promised land

Valley of death

RISK
### Estimating the cost of equity (IRR)

#### Return Multiple

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<th>Term of investment (in years)</th>
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<th>3.0x</th>
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<th>5.0x</th>
<th>6.0x</th>
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<td>23%</td>
<td>25%</td>
<td>26%</td>
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</table>

**Useful formulae:**

\[
\text{Return Multiple} = (1 + \text{Internal Rate of Return})^{\text{Term of investment}}
\]

\[
\text{Internal Rate of Return} = (\text{Return Multiple}^{1/\text{Term of investment}}) - 1
\]
Health Warning

Do not try to finance your business with debt until you have reliable cash flow from sales…
Early Stage Funding Options

- Own savings, earned income, friends & family,
- Grants (TSB, EU, Regional), Accelerators
- Start-up loan scheme
- Equity crowd funds, Seed funds (SEIS)
- Business Angels
- Venture Capital
- Bank Loans
- Real Sales!

Until you have a workable business model your options are extremely limited...especially without secure IP
Financing the journey to the promised land

- Break even point (Avg. 36 months)
- Cash break even point (Avg. 60 months)
- Valley of death
- Promised land

Amount of external finance required
Different Firms, Different Profiles...

**Technology firm**
- Large investment required
- Late break-even
- Huge upside (Microsoft)

**Consulting firm**
- Low investment required
- Early break-even
- Modest upside
A guaranteed method for putting off investors!

“We have a virtually risk free investment opportunity offering HUGE returns..!”

“We are going to build the next Facebook, all we need is £100,000…!”

What you’re actually communicating:

“We are un-investable because we haven’t got a clue what we’re doing…!”
A typical lean start up cash flow profile

‘Customer creation and growth can consume a huge amount of cash…’
Filling the ‘Valley of Death’

- Founders funds
- Grant
- Equity crowd funding
- Angel syndicate

Bank balance

- ve
- 0
+ ve

Time

Promised land

Valley of death
Your relative bargaining power when raising money from equity investors

Assuming you sell the business for £4.0m in five years time:
- Selling 20% leaves £3.2m
- Selling 30% leaves £2.8m
- Selling 50% leaves £2.0m

7 months cost you £1.2m!
How long does it take to raise money?

- Venture capital – 12 to 18 months
- Angel equity – 6 to 9 months
- Crowd funding – 3 to 6 months
- Bank debt – 2 months
- Off Balance Sheet finance – 1 month

*It always takes longer than you anticipate!!*
Valuation

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Most Angels and VCs wish to **exit after 5 years** (the target year)

The **internal rate of return** required (discount rate) will depend on the level of perceived risk. Let’s call it 45%

The multiple (M) of the investment required by the investor is simply calculated as follows:

\[
M = (1 + \text{internal rate of return})^{\text{the target year}}
\]

Thus \[ M = (1 + 0.45)^5 = 6.41 \]
The **capital return (CR)** is simply the multiple (M) times the original investment (I). Let's call I £1.1m giving us:

\[
CR = 6.41 \times 1.1 = £7.05\text{m}
\]

The **percentage ownership (PO)** expected by the investor will be:

\[
PO = \frac{\text{Capital Return}}{\text{Market Valuation (in target year)}} \times 100\%
\]

Our task is now to estimate a **market value (MV)** in year 5 (the target year). The most common way of doing this is to use the *price to earnings ratio (PE)* for comparative firms. Thus:

\[
\text{Market value} = \text{PE} \times \text{projected earnings in target year (NPBIT)}
\]

*Note: PE ratio = share price/earnings per share \quad (EPS = \text{NPBIT/number of shares})*
Let’s assume that the PE ratio for similar quoted firms is 26 and that **projected NPBIT** in year 5 is £1m

The **unadjusted Market Value** in year 5 is thus 26 x £1.0m = £26.0m

The required percentage ownership is, therefore:

\[
\frac{7.05}{26.00} \times 100\% = 27.1\%
\]

In practice, however, the PE of quoted companies may be subject to a discount by the investor. This can easily amount to **30%** but is a matter for negotiation….Thus:

\[
\text{PE (adjusted)} = \text{PE} - (\text{PE} \times \text{discount rate})
\]

So

\[
\text{PE (adjusted)} = 26 - (26 \times 0.30) = 18.20
\]
Thus, if a discount rate of 30% is applied the percentage ownership required rises:

\[
\frac{7.05}{18.20} \times 100% = 38.7\%
\]

Therefore, it is in your interests to persuade the investor that:

1. The risks (managerial, market, industry and technological) are low so that the required annual rate of return (which reflects financial risk) can be reduced

2. That earnings in the target year are realistic so as to avoid too heavy a discount

3. That the PE ratio is indeed comparable.
“What does your business have that justifies your pre-money valuation?”

• Rapid traction and (better still) real sales…

• Investors understand that success is 1% inspiration and 99% effort

• Investors respect passionate, focussed and hard working teams that deliver tangible results quickly...

• 80% Action  20% Analysis (unlike Business School)

• Your past and present achievements (e.g. tangible business results) count for more than wishful thinking.

The value of your business is what someone is prepared to pay!
1. In the absence of defensible IP a business idea *has no value*

2. Understand precisely what adds value from the POV of an investor

3. Spend your time working on these things!
The investment lifecycle of a start-up

Founders

Seed £2

Angel + Equity crowd fund £6

1st Round

Angel + Equity crowd fund £14

2nd Round

Time

0 9 18 36 72

Exit..?
Structuring equity investments

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Senior Teaching Faculty in Entrepreneurship
The business was founded in 2005 with 10000 shares split between Liz (7000) and Simon (3000)

At this point we do not know the value of these shares...

The share price (or value) of an unquoted company is only known at the time the deal is done...

After 18 months an investor, Bob, offers to invest £18,000 in return for a 45% equity stake in the business.

Structuring the deal:

Stage 1. The first step is to calculate the **pre-money valuation** (its value before the investment is made):

Pre-Money Value = (Amount of investment/equity stake) – amount of investment

So:

\[
(\frac{£18,000}{0.45}) - £18,000 = £22,000
\]
Stage 2. We now need to calculate the **value of each share** which is simply:

Pre-money valuation/number of shares. So, £22,000/10000 = **£2.20**

Note: The share price (or value) of an unquoted company is only known at the time the deal is done...

You need to understand that equity investments are **negotiated in percentages** (e.g. 45% for £18,000) but **structured using shares**.

When a business raises money by selling equity it **issues new shares** to the investor. The investor does not take a proportion of the shares that already exist (e.g. 45% of 10,000 shares)

Stage 3. Calculate the **number of new shares** to be issued. The deal share price is £2.20 and £18,000 is being invested. The number of new shares will, therefore be: £18,000/£2.20 = **8182**

The total number of shares is now 10,000 + 8182 = 18182
In summary:

1. Calculate the ‘pre-money valuation’

2. Calculate the deal share price by dividing the pre-money valuation by the number of shares

3. Determine the number of new shares to be issued by dividing the investment amount by the deal share price.
Second round investment

In early 2009 Liz, Simon and Bob agreed to sell 30% of the equity in Nosh to Johnston Press for £165,000

Structuring the deal:

Stage 1. Calculate the **pre-money valuation** (its value before the investment is made):

Pre-Money Value = (Amount of investment/equity stake) – amount of investment

So: (£165,000 / 0.30) - £165,000 = £385,000

Stage 2. Calculate the **deal share price**

Pre-Money Value /number of shares = £385,000/18182

Deal share price is therefore £21.17
Stage 3. Calculate the **number of new shares to be issued**

Investment amount/deal share price = £165,000/21.17

Number of shares issued to Johnston Press = 7792

Bob is happy because his £18,000 is now worth £170,500 even though his ownership share has been diluted from 45% to 31%
A Bad Second round investment – ‘Down Round’

In early 2009 Liz, Simon and Bob agreed to sell 30% of the equity in Nosh to Johnston Press for £15,000.

They are not happy about this but they have no choice, without the investment the business will become insolvent.

Structuring the deal:

Stage 1. Calculate the pre-money valuation (its value before the investment is made):

Pre-Money Value = (Amount of investment/equity stake) – amount of investment

So: (£15,000 / 0.30) - £15,000 = £35,000

Stage 2. Calculate the deal share price

Pre-Money Value /number of shares = £35,000/18182

Deal share price is therefore £1.92 (Down from £2.20)
Stage 3. Calculate the **number of new shares to be issued**

Investment amount/deal share price = £15,000/1.92

Number of shares issued to Johnston Press = 7792

Bob has protected himself with a ‘full-ratchet’ anti-dilution clause....!

He will be **fully compensated** for his loss by the re-allocation of shares from Liz and Simon

**Stage 1:** Calculate the **financial loss** to Bob

\[
8182 \times (£2.20 - £1.92) = £2250
\]
Stage 2: Calculate the number of shares required to compensate him

£2250 / £1.92 = 1169

Stage 3: Calculate the number of shares reallocated from Liz and Simon

Liz = 1169 x 0.7 = 818
Simon = 1169 x 0.3 = 351

Stage 4: Calculate the new ownership percentages

Liz 7000-818 = 6182 23.8%
Simon 3000-351 = 2649 10.2%
Bob 8182 + (818+351) = 9351 36%
Johnston Press 7792 30%

The value of Bob’s original investment (£18,000) has been maintained.....
Early stage equity finance

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Senior Teaching Faculty in Entrepreneurship
Sources of Equity Finance

• Your personal wealth (savings, equity in house) and that of business partners
• Family
• Crowd funding <£1m
• Business Angels <£1m (some syndicates may do more)
• Venture capital >£2m
• Corporate partners
Crowd funding – ‘The democratisation of capital…?’

- New platforms are launching with increasing frequency
- Crowd funding transactions in the UK are currently growing at over 100% per annum!

Much of this is due to:

- The inability (or reluctance) of commercial banks to lend to small businesses since the financial crisis of 2008
- Low rates of interest available to savers
- Regulatory reform by the UK Government
- Tax incentives (such as SEIS) which reduce risks for investors
- The relatively low barriers to entry associated with launching a crowd funding platform
Types of crowd funding

Four broad categories:

1. **Equity** – Money is invested in the business in return for an ownership stake (e.g. Seedrs, Crowdcube, Syndicate Room)

2. **Debt** – Money is lent to the business (e.g. Funding circle)

3. **Reward** – Money is ‘given’ in return for non-monetary rewards such as the goods or services to be produced by the business (e.g. Kickstarter)

4. **Donation** – Money is given to support good causes (e.g. Justgiving, Spacehive)

Crowd funding helps to validate your ideas and gain exposure for your business…
Equity crowd funding platforms

• Average success rate is approximately 20%
• Transaction sizes have grown significantly in 2014
• Valuation – On most platforms you decide the valuation!
• All-or-nothing vs. keep what you get?
• Nominee structure?
• Fees – usually in the range of 5% to 7.5% of sum raised
• Due diligence – Basic legal checks but not into the idea or tech!
Raising money on equity crowdfunding platforms

1. Research - Study successful campaigns and the many online guides
2. Plan your campaign carefully
3. Set a realistic valuation – It increases the odds of success
4. Build awareness – use your personal and professional networks, social media and promote through your website (no spam though)!
5. Build momentum by ‘pump-priming’ the campaign
6. Make a professional video pitch
7. Proactively manage your campaign

Campaigns are quickly becoming FAR more professional..!
Business Angels

• Business Angels (‘Angels’) are high net worth individuals who invest their own money into early stage new ventures.

• Often (but not always) experienced entrepreneurs

• Often (but not always) provide ‘smart money’ by providing advice and making introductions to suppliers, distributors and customers

• £20-£250k is usual investment but some ‘super angels’ and angel syndicates may invest far larger amounts (£1m +)

• They use their contacts and angel networks to find investment opportunities

• Increasingly using ‘angel led’ crowd funding platforms such as Syndicate Room

• There are approximately 8,000 active angels in the UK

To be considered by angels, your investment should (must) be eligible for the Seed Enterprise Investment Scheme (SEIS)
Seed Enterprise Investment Scheme (SEIS)

For companies

• Maximum total SEIS investment £150,000
• Must be under two years old
• Fewer than 25 employees
• Gross assets of under £200,000
• Be in an approved sector
• UK registered with UK operations
• Funds must be used within 3 years

For investors

• Max investment £100,000
• 50% income tax relief
• Returns are free of CGT
• Losses written down against tax
• Can have ordinary shares only
• Scheme closes 5th April 2017

To avoid delays in closing your funding round, apply for your SEIS certificate well in advance
Returns to angel investors

- They understand that a high percentage of new ventures fail or underperform.
- Even with experience and due diligence it is very difficult to 'pick winners'.
- To manage this risk they build a portfolio of investments (8 to 10).
- They are unlikely to invest unless the upside potential is 6 to 10x their money back.
- Overall, returns average 2.2x (an IRR of 22.4% after 4 years).
- This compares very favourably to later stage venture capital funds!

The big question… “Will this investment give me at least 6 times my money back inside 5 years?”
## Business Angel resources

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<tr>
<th>Angel networks and service providers</th>
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<tr>
<td>News and information about angel investing</td>
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<td>A useful introduction to angel investing</td>
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</table>
Venture capital

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So...you want to raise venture capital?

“My name is Rupert
Although I am cultivated I am utterly ruthless
You are not my customer
You are not my friend
I do not care about you or your hirelings
If you fail me I WILL ruin you

Now...how may I help you?”
Venture Capitalists are Intermediaries

Investors (limited partners) ➔ VC Fund ➔ VC Firm
(e.g. Investment banks, pension funds, wealthy individuals, family offices)

VC Fund ➔ Companies
(e.g. Amazon.com, eBay, Ceres Power)

VC Firm
(General partners)
VCs think in milestones... and dream of EXITS

“Nobody makes real money until the exit...!”
The Venture Capital Cycle

**Investors in fund:**
- Pension funds
- Investment funds
- Wealthy individuals

**Return distributed as cash or shares**

- VC firm raises, invests and manages fund

VC firm keeps 20% of any return over 100% (Carried Interest) + charges a 2% management fee
Venture Capital - Some basics

- Equity is invested in rounds (seed, 1st Round, 2nd Round, etc.)
- Each round is released in ‘tranches’ based on the achievement of milestones
- Be prepared for founder share vesting clauses!
- Some terms will alarm you...
- They always require a board seat
- Deal structures vary widely, you need to take professional advice
VC Share Rights

The ‘convertible, redeemable, preferred ordinary share’...

They get their money back first and foremost under all circumstances...!

Example:

A VC invests £2.0m in return for a 50% stake in your company.

After 5 years the business is sold for £4.0m, what is the return to the investor?
If the company is sold for £4 million…

- VC receives its £2 million back (like a loan)
- £2 million remains
- VC receives its 50% share of remaining £2 million (= £1 million )

= £3 million for VC
= £1 million shared out by other shareholders

VC receives 75% of the proceeds…
And if the company is sold for £10 million

- VC receives its £2 million back (like a loan)
- £8 million remains
- VC receives its 50% share of remaining £8 million (= £4 million)

= £6 million for VC
= £4 million shared out by other shareholders

VC receives 60% of the proceeds…
But..beware of the ‘Liquidity Preference’

Company is sold for £4.0m and there is a 2x liquidity preference in the term sheet…

- VC receives its 2 x £2 million back (like a loan) = £4m
- £ zero remains

= £4 million for VC
= £ zero for the other shareholders

VC receives 100% of the proceeds…
And if the company is sold for £10 million

- VC receives its 2 x £2 million back (like a loan) = £4m
- £6 million remains
- VC receives its 50% share of remaining £6 million (= £3 million)

= £7 million for VC
= £3 million shared out by other shareholders

VC receives 70% of the proceeds...
VC decision making

- Plans submitted
- After quick scan
- After few hours study
- After full investigation
- After price negotiations

% Remaining

3.1 minutes
What VCs say they look for….

- **The team** - Especially positive if they have worked together before
- **Clean IP portfolio** - Especially in early stage tech firms
- **Sector** - Investors back what they know (so check out their portfolio).
- **Traction in large, growing markets**
- **Financial indicators** - Gross margin is a favourite
- **Entry valuation** - A black art…
- **Exit route** - Can I get out? When? How? Valuation?
- **Due diligence** - any skeletons?
Top deal killers...

- Poor quality management - leave positions vacant rather than recruit the wrong people
- Insufficient market size – the best plans address huge opportunities
- Insufficient “critical mass” to the technology - VCs will not back a one-shot wonder
- Problems with intellectual property portfolio

But….It depends heavily on the individual investor
Debt finance

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Those aged 18+ living in England and looking for finance to start a business

Average loan size is around £2,500, but the final amount will be determined by the business plan. There is no definite limit

It is a personal loan, which means if 4 or 5 people from the same company apply for a loan, all are eligible for an individual loan up to invest in their business

Paid back within 5 years at a fixed-rate of interest (currently 6%).

Capital repayment holidays are available, but interest must be covered monthly throughout

Start-up loans are accessible to anyone who had a business in its initial phase (up to 1 year from founding)

http://www.startuploans.co.uk/
Corporate bankers

- When it matters most they are likely to let you down
- They are allergic to risk
- Trust is an alien concept
- *Everything* is negotiable
- Beware of personal guarantees
- They hate surprises
- Communication is the key!
CAMPARI : The Banker’s Maxim

- **Character** - ‘respectable & trustworthy’?
- **Ability** - track record, team, potential
- **Margin** - % above base rate
- **Purpose** - expansion, rescue or buying toys
- **Amount** - is this realistic, too much or too little?
- **Repayment** - can you pay the interest *and* repay the principal
- **Insurance** - if required, is there security?
Enterprise Finance Guarantee (EFG) scheme

- The government will underwrite 75% of the loan
- An additional 2% is chargeable on the loan and paid to the Department of Business, Innovation and Skills
- Loans range in size from £1,000 to £1m
- The term of the loan can be from three months to 10 years
- EFG applies to:
  - New term loans
  - Refinancing an existing loan
  - Converting an overdraft into a fixed term loan
  - Guaranteeing an overdraft
  - Guaranteeing invoice financing

- Lending decisions are made by the bank who will only turn to the EFG if the usual security criteria cannot be met by the business
- Lenders will still usually require a personal guarantee!

This personal guarantee *cannot* include your ‘principal private residence’
Invoice Discounting

Your customers *will not* be aware that you are using an invoice discounter.

Goods sold to customer on 60 days credit

**Day 0:** Customer and invoice details sent to discounter

**Day 1:** Customer pays you

**Day 2:** Discounter pays you 80% of the invoice value

**Day 60:** You repay the discounter the 80%, plus interest.

**Interest rate:** 1.5% to 3% above base

**Credit management fee:** up to 0.5% of invoice value
Factoring

Day 1: Customer and invoice details sent to factor

Day 1: Invoice sent to customer by factor

Day 2: Factor pays you 80% of the invoice value

Day 60: Customer pays factor

Day 60+: Factor pays you the remainder of the invoice, less charges.

Goods sold to customer on 60 days credit

Interest rate: 1.5% to 3% above base

Credit management fee: up to 2.5% of invoice value