



## Financing your business

### Solid Foundations

Whether you are starting up a new business or running an established one, a solid financial base is essential.

The right financing package will carry you through temporary **difficulties** - yet allow you to make the most of growth **opportunities** when they arise.

This chapter focuses on four areas:

Deciding how much money you need.

Investment finance.

Different forms of borrowing.

### How much money do you need?

1. Draw up a **budget** based on your business plan.

The budget shows your forecast sales, expenditure and **cash flow** for each month.

The forecasts must be **realistic**.

Inexperienced businessmen tend to make over-optimistic forecasts. Sales turn out to be lower and later than expected, getting paid takes longer and costs are higher.

Identify **how much** financing you require and when you will need it.

A **new business** may spend more than it earns in the first and second year. The amount of financing required may increase throughout this time.

Many businesses, particularly in Jersey, have **seasonal** sales patterns which lead to cash flow peaks and troughs.

3. Include some **contingency** funding.

How much extra finance might you need.

Consider worst case scenarios to help you decide how much finance you should have available. What if a product launch is delayed, you lose your best customer, costs over-run, or interest rates go up?

How **accurate** is your forecast? If you are unsure, you may need to set up substantial contingency funding.

4. Plan to arrange **all** your financing.

Even if you do not need all the money at once, do not wait until your need for the extra finance becomes urgent. For example, borrowing £20,000 in January then asking for £20,000 more in April may 'alarm' the bank. Let them know the total amount in the first place – and preferably ask to "draw it down" in stages.

## Investment finance

It will be difficult to borrow money from a bank unless you can provide an adequate financial base of money invested in the business.

### 1. **Your own** capital.

Cash you have saved, or investments you can sell.

Investments like your home can be used as security for a loan.

Profit reserves previously built up in the business.

### 2. **Family** and friends who are willing to invest in your business.

To avoid the risk of personal friction:

Only ask for amounts they can afford to lose.

Show them your business plan and give them time to think it over.

Discuss several 'what if' scenarios.

For example, what if you wanted to pay yourself a bigger salary, expand, relocate, hire more staff, or even, what if the business were to fail?

Put the terms of **ANY** agreement in writing.

### 3. **Outside** investors.

You are unlikely to attract outside investors unless you can show a strong track record and a credible business plan.

Investors - who purchase an equity stake in the business - will expect to be offered high potential returns to compensate for the risk.

## Bank finance

Apart from your own family, the most likely source of borrowing is the bank.

### 1. **Overdraft finance**

Overdrafts are useful for financing **temporary** - or fluctuating - cash shortages. An overdraft can also be used to provide capital to set up a business.

You pay interest only on the amount you are overdrawn each day.

Exceeding your overdraft limit can be costly.

The bank may bounce your cheques if you exceed your agreed borrowing limit - ruining your credit with suppliers - or penalise you with bank charges and higher interest rates.

The bank could, in principle, demand repayment at any time.

Your overdraft limit is usually agreed for six to twelve months, after which it may be extended.

However, the limit can be reduced if the bank decides this is necessary.

### 2. **Loan finance**

Loan finance is suitable if you need a fixed amount of finance for a year or more.

Most loans are for a **fixed period** of one to five years. Mortgages and some other loans may be as long as 25 years.

**Repayments** are agreed in advance.

Paying equal monthly instalments of capital plus interest is a common choice. You may be able to negotiate a 'repayment holiday' to allow time for your cash flow to improve before the first repayment is due.

Loans are more suitable than overdrafts for **longer term** finance. This is because the bank cannot demand you repay the loan early, unless you fail to meet your obligations (which are agreed in advance).

### 3. **Costs**

For both overdrafts and loans:

The interest rate is usually set at a margin over the bank base rate, which can vary.

The % on loans is usually between 2% and 6% above base rate, depending on how risky the bank thinks the loan is. Alternatively, the interest rate may be fixed (e.g. 10%).

An arrangement fee of about 1% is usually charged when you set up an overdraft facility or loan.

A renewal fee is usually charged when an overdraft facility is extended.

You may incur costs arranging security.

## **Other finance**

Trade credit (paying your suppliers after 30 - 60 days) and bank finance may be all that a small business needs. Where a proposal involves the purchase of plant or equipment, (including motor vehicles), the following forms of financing may be applicable.

### 1. **Leasing.**

Instead of buying the equipment, you rent it for a fixed period - usually three to five years.

Payments are spread out over the period, helping your cash flow.

You will receive tax relief on lease payments.

### 2. **Hire Purchase**

You can claim a capital allowance on the equipment and the interest payments receive tax relief.

## **Security for borrowings**

For any borrowing, you will need to show that your business can afford the capital and interest payments. In addition, a bank will usually want some sort of security to ensure that the bank is repaid if things go wrong.

Two common options are:

A legal '**charge**' over property, which can then be sold by the bank if you default.

A **guarantee** from a third party who will be liable to pay the debt if you default.

Often **insurance** is also required to protect the bank if you are unable to work, as well as to protect yourself against accidents, sickness or death.

Any existing finance arrangements - e.g. other loans or leasing arrangements - will reduce the amount of security you can offer the bank.

## Your bank manager

A good relationship with your bank is a natural element of good commercial management. At some stage, you may need to rely on the bank's support - for expansion, or to help you through a difficult patch.

Before lending you any money, the bank manager will want to see a viable business plan.

Provide the bank with regular management information summarising sales, margins and costs.

The best format is a table of figures comparing what you actually achieved against your budget, and against the previous year.

Add comments to explain any differences and mention important events you expect to happen (for example, an order you expect to win).

3. Warn the bank if you anticipate running into any financial difficulties.

Demonstrate to the bank that they can trust you, your information and your judgement. **Avoid surprises.**

## The matching principle

Match the type of finance to the purpose for which it is used.

1. For working capital use an overdraft.

Working capital is the money you need to cover the delay between paying suppliers and receiving payment from customers.

2. For equipment and vehicles used fixed term loans, hire purchase or leasing.

The term of the loan should match, or be shorter than, the expected life of the asset you will be buying.

3. For property use a long term mortgage.

If you are buying a commercial property, discuss what options are available for a commercial mortgage.

Using the wrong type of finance can be disastrous. For example, if you use up your overdraft buying equipment to increase production, you will have no further short term finance available as your need for working capital increases.