

LAUNCH

raising finance

The difficulty of finding working capital is a problem which most companies will experience at some stage during their development. For companies in relative infancy it is a problem which is often acute.

Sources of finance

Companies often struggle to know who to turn to when seeking to raise working capital. Friends and family, business angels, banks and venture capitalists all to a greater or lesser extent will finance small businesses and there are also small amounts of public money, eg, Grant for Research and Development (GRD funding), which may be available if the company meets the necessary criteria.

Making contacts amongst those who regularly work with and advise young companies is a good way of getting to know what sort of finance would suit the particular business. Such advisers can also assist in preparing business plans, suggest contacts to approach for finance and generally assist the company to look as well presented as possible for the scrutiny of potential funders.

Types of finance

Investing in a relatively new company is a risk which may deter some traditional forms of finance. It involves investors taking a longer term view on their investment, particularly where there is a large amount of research and development to be funded, before any income will be received. Finance falls into two main categories:

- **Debt financing**
- **Equity financing**

Whatever the type of finance given, investors will want to carry out appropriate financial and legal due diligence to check the company and its affairs are in good shape. This will include checking the appropriate paperwork is in place, filings have been made at Companies House, intellectual property rights are properly vested in the company, key contracts are properly documented, there are suitable employment contracts for key individuals etc.

Debt finance

Debt financing is basically straight lending:

- a lender advances a sum of money to a company and charges interest on that sum.

The lender has no equity stake in the company although a lender may require the ability to convert debt into equity on the occurrence of certain events.

Debt can take a variety of forms and a company may require a combination of all or some of the following:

- **Term loan** – a fixed sum is lent for a fixed period, usually repayable in instalments, but once repaid cannot be redrawn.
- **Revolving credit** – a fixed sum is lent for a fixed period, but is available in tranches which can be repaid and drawn down again, giving greater flexibility.
- **Overdraft** – sums can be drawn and repaid at will, up to a fixed limit. An overdraft facility offers great flexibility, particularly on a trading account where cheques are being drawn and paid in regularly.

- Loan note/bond – a fixed sum is advanced for a fixed period, but the holder of the note or bond can transfer the benefit to a third party.

Lending may be secured or unsecured. Secured lending involves the lender taking a charge over certain assets of the borrower. This means that if a company defaults in repayment of the loan the lender can have recourse to the secured assets in order to satisfy the debt. The lender will rank ahead of unsecured creditors, such as trade creditors, and there is therefore a considerable advantage to it in taking security. As a result, secured lending will typically be at a lower rate of interest to unsecured lending. Secured lending is more difficult for early stage companies as there are often very few assets of value in existence at that point. However it is possible to take charges over intangible assets such as intellectual property rights.

Points to watch out for

The precise terms of the lending should be carefully checked to consider issues such as:

- The terms of repayment – can the company afford the repayments based on the income projections in the business plan?
- Interest payable – what is the rate and is it in line with the market?
- Right to repay early – are there any penalties for repaying early, for instance on a disposal or if you want to change banks?
- Remedies for default – in what circumstances can the lender claim repayment?
- Any ability to convert the debt into equity.
- Assignability of the debt.
- Covenants – are there restrictions on what the company can do without the bank's consent?
- If the lending is secured what assets are covered by the security and restrictions and what obligations are imposed in the security documentation? Common restrictions include:
 - restriction on granting other security (this is termed a negative pledge);
 - restrictions on disposal of assets;
 - obligations to maintain insurance and protect IPR; and
 - (sometimes) right to repayment on a change of control.

Equity finance

Equity finance is the most common source of funding for small companies. Friends and family, business angels and venture capital funds all tend to take either purely equity or a mixture of equity and debt. Equity finance is more risky than debt finance as shareholders are paid back only after other creditors in any insolvency of the company. Equity does however generally give a right to participate in future profits, although a distinction should be made between ordinary shares, which usually enjoy a right to share in profits and (although this is not always the case) a right to vote, and preference shares, which usually give a right to a fixed dividend ahead of other shareholders but generally confer no voting rights.

The distinction between debt and equity is further blurred by the use of instruments such as convertible loan stock which is a form of debt that is convertible into equity on certain terms.

The company should consider whether it may qualify for EIS (enterprise investment scheme) or VCT (venture capital trust) purposes. Under the EIS and VCT rules, investors obtain tax reliefs for investments in certain types of smaller trading companies. So qualifying for EIS will be attractive to business angels whilst VCT qualifying status opens the door to another class of potential investors. Companies should however note that being a qualifying company for the purpose of these rules will place certain restrictions on the activities of the business for three years or more.

Business angels and friends and family will often invest on the back of fairly simple documentation without requiring extensive controls and protections. Venture capital funds commonly require bespoke documentation containing numerous controls and protections which can increase the costs and time taken to complete the fund raising.

Points to watch out for

- Price – getting the right price for any equity is key and valuations issued are often hotly contested.
- Board representation – investors may want a right to appoint one or more directors of the company. Ideally any board member should add value to the company by way of knowledge, experience and contacts, and not merely act as an observer for the investor.

- Share structure – investors commonly want a substantial minority (ie, less than 50 per cent but greater than 25 per cent) which enables them to block a special resolution (many key decisions require the consent of 75 per cent or more of the shareholders). Consider which shareholders, or which combinations of shareholders voting together, can pass ordinary resolutions which require greater than 50 per cent of voting shares.
- Preferential return – VCs often want a priority return on their investment either through the use of preference shares with a priority dividend or more commonly through “A” ordinary shares which have a priority return on exit events, usually a sale, float or liquidation of the company termed a “liquidation preference”.
- Veto rights – investors often wish to enhance their position as minority shareholders through veto rights on key decisions eg:
 - changes to share rights;
 - changes to constitutional documentation;
 - expenditure over certain thresholds;
 - granting of security;
 - issue of further shares or options;
 - disposal of assets;
 - employment of staff or staff over a certain salary;
 - changes to terms of directors' employment (including salary);
 - changes to the nature of the business;
 - capital expenditure over a certain threshold.
- Warranties – investors often ask for warranties from management as to the business and assets of the company. These need careful consideration and appropriate limits on management's liability need to be agreed.
- Restrictive covenants – investors may want to prevent management setting up a competing business or poaching staff and employees.
- Share transfer restrictions – commonly pre-emption (offer round) rights on share issues and transfers are included. In addition:
 - departing directors or employees may also be required to sell their shares;
 - on a change of control of the company “tag along rights” requiring selling shareholders to procure that an

offer is made to all shareholders and “drag along rights” meaning a selling shareholder can oblige the others to sell are often included; and

- equity investors will also want to see a clear route for 'exit' – a realisation of their investment usually within three to five years. The usual means of achieving this are seeking a listing of the shares on a recognised investment exchange, seeking a trade sale or carrying out a refinancing. The investors' desire for an exit may not always entirely coincide with the directors' views of the direction the company should take.

Some steps to take

- Consider the appropriate level of investment you require.
- Make sure your business plan is up to date and complete.
- Consider what level of investment is required and from whom (ie, banks, venture capitalists, business angels).
- Consider whether the company will qualify for enterprise investment scheme (EIS) purposes or venture capital trust (VCT) purposes as these tax incentives may be attractive to certain investors.
- Use contacts/research to make approaches to key potential investors.
- Appoint legal advisers at an early stage. As well as drafting any relevant documents they can assist with contacts and advise on the contents and circulation of business plans and help in negotiating the heads of terms.
- Ensure when approaching potential investors (particularly business angels) that communications, for example business plans, do not fall foul of the Financial Services and Markets Act 2000 as being an inducement or invitation to engage in investment business. Such communications, unless approved by an authorised person, may only be made to authorised (banks and venture capitalists are so authorised) or exempt persons. There are a number of exceptions for sophisticated and high net worth individuals but strict requirements for these exemptions must be complied with. Companies are strongly advised to take legal advice on this issue.
- Any term sheet should be carefully considered and appropriate advice taken. This is a summary of the key

points of the deal and it is difficult to renegotiate points covered in the term sheet at a later stage. The term sheet should be non binding save as to confidentiality and any binding "lock out" which will prevent the company negotiating with third parties during an exclusivity period. Again these should be negotiated carefully by the company.

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