

# I NEED MONEY

BY SUE CHARLES

IF YOU ARE AN ENTREPRENEUR, YOUR FIRST SOURCE OF CAPITAL IS LIKELY TO BE YOUR OWN MONEY, THAT OF FRIENDS AND FAMILY AND "SWEAT EQUITY".

Jeff Bezos started Amazon.com with \$100,000 borrowed from his parents – he told them before he borrowed it that there was a strong probability that they would lose all their money as "I wanted to be able to go home for Thanksgiving dinner if things didn't work out". Your family may not have \$100,000 lying around, but they probably do have a spare bedroom or garage that you can start with. Microsoft, Virgin, Dell and Hewlett Packard are just a few of the businesses that started in borrowed premises or with borrowed funds. When this money runs out (and it will very fast!) then in the UK there are four other options: grant funding, bank finance, mezzanine finance or equity finance (venture capital). Which one is right for you depends on the assets you have and the profit stream you are building up or projecting.

## 1. Grant funding

There are many government-funded organisations that you can source for grants. The Engineering and Physical Sciences Research Council (EPSRC) is the largest of the seven UK Research Councils, which includes the Medical Research Council. It funds research and postgraduate training in universities and other organizations throughout the UK.

It is worth looking to the DTI whose Enterprise Grants are a form of financial assistance aimed at helping small and medium sized businesses make capital investments in their business that would not otherwise go ahead. Additionally there are a whole number of new research & Development (R&D) grant products from the DTI (replacing the old SMART initiative) that provide help to individuals and small and medium-sized enterprises (SMEs) to make better use of technology and to develop technologically innovative products and processes. These range from £20,000 for a micro project (eg to develop a prototype) up to £500,000 for exceptional technology projects.

The best way to find out about what grants you might be eligible for, is to visit your local Business Link, NHS Innovation hub or attend events such as those run by Medical Futures.

## 2. Bank finance

Banks make low-risk loans to businesses against security. They may take a charge against the business's assets or they may require personal guarantees, in which case your own assets are at risk. There are three main options:

- **Overdrafts.** Rolling credit; in other words, as long as you don't go over your overdraft limit and keep paying the interest, you can generally keep the outstanding balance indefinitely. The bank takes a floating charge over your assets (i.e. the loan is secured against all available assets rather than



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particular ones) and may well require a personal guarantee. Larger companies will get better interest rates. In general you will only get an overdraft if the bank is covered by a charge and/or personal guarantee, because high street banks are not in the risk business!

- **Factoring.** A bank or other finance house does some or all of your credit control for you and in effect uses your debtors as security for a loan. The amount you may borrow is established by a draw-down percentage (agreed at the outset) on the proportion of the money owed to you. Confidential invoice discounting is a variant on this principle in which your debtors don't know that you are using a factoring house. Charges vary according to how much credit control you do yourself and the future of a factoring agreement depends on how successful your factor is in collecting money from your debtors.

- **Term loans.** These are generally secured against assets. The entire amount must be repaid over a set period, usually from five to seven years, with instalments payable every year or six months. A term loan may become more appropriate than an overdraft as your business grows and requires more money for specific projects.

You are unlikely to be offered a term loan if your debt-to-equity ratio is greater than 2:1.

### 3. Mezzanine finance

Mezzanine finance is so called because it is intermediate between bank lending and equity funding and the debt is unsecured. A mezzanine investor (generally a merchant bank or development capital fund manager) accepts a higher risk in return for income at a higher rate of interest and a stake in your company's equity that provides a potential capital gain on flotation or sale.

Consider mezzanine finance as an alternative solution to more expensive equity finance or conventional bank finance, which is only available on relatively low-risk ventures. Most of the major banks run specialist mezzanine teams.

### 4. Venture capital

Equity funding is when a funder buys a stake in your business in exchange for cash to start or expand the business (a private equity transaction) or in some cases to buy it from another company or individual. They increase a company's value to its owners, without taking day-to-day management control.

As a basic guideline there are two main sources of venture capital with broadly different investment preferences – venture capital firms and business angels.

The majority of venture capital firms target firms requiring investment of over £100,000, mainly in expansion stage companies and management buyouts. The overall average deal size in 1999 was £5.6 million, although 51%

of companies backed in 1999 received sums of venture capital of less than £1 million. There are some specialist and regional firms that invest outside these parameters.

Business angels tend to invest between £10,000 and £100,000 in start-up and other early stage financings – the average investment in 1998/9 was around £50,000. The DTI sponsors a National Business Angel's Network, which puts private investors in contact with companies seeking their investment.

The money raised by venture capitalists can come from a variety of sources (for example, a bank that owns the venture capital company, a wealthy individual or a pension fund). The investment stages include:

- **Seed** (at the conception stage), where proof of principle is established, patents are filed and you might typically raise £10,000 to £500,000
- **Start-up**, where a company proper is established, usually with premises and a management team – investment at this stage can vary on business need, up to about £3-£5m
- **Early Stage**, that can last for one to three years as the business establishes itself and grows – at this stage a company may go through several funding rounds raising anything up to about £75m
- **Pre-IPO** (Initial Public Offering) where a company prepares for transition from a private company to a public company and appoints its professional City advisors
- **IPO onwards** – when the company lists on a stock exchange. Whilst a listing on AIM (the Alternative Investment Market) can be considered to raise as little as £10m, £50m+ is more usual. Once listed, the venture and angel investors have a route to exit their investment and the company is truly established and in the public eye.

Other terms you might encounter are management buy-in (MBI), management buy-out (MBO) and rescue/turnaround situations.

Venture capital investors not only provide equity capital but experience, contacts and advice when required, which sets venture capital apart from other sources of business capital. However, expect venture capitalists to demand a pre-tax return on their investment in your company equivalent to an average compound return in excess of 30% – remember they have investors to satisfy also. They will often make part of their investment in the form of ordinary shares with voting rights and part of their investment in the form of redeemable preference shares or unsecured loan stock, to be repaid over five to

ten years or on exit if earlier. These can also be convertible to equity.

The British Venture Capital Association (BVCA) will assist with finding a VC and you can search the BVCA's directory of members online at [www.bvca.co.uk](http://www.bvca.co.uk). Expect a venture round to be syndicated – i.e. to involve more than one investor.

#### Warning

Inspect venture capital agreements very closely for aggressive dividend policies that go for the throat after three to five years, rapidly pushing the expected dividends up to unacceptable levels. Also be wary of the terms associated with convertible shares and loans – it has not been unknown for VCs to pull the plug on this less secure financing.

If the source of your backers' funding is a closed-end fund, they must return the money to their investors (and so, obviously, withdraw it from your company) by a certain date.

Many venture capitalists (or private equity houses) now specialise in a particular sector of the market, in certain transaction types (e.g. management buyouts or privatisation) or in deals in excess of £100 million, so choose carefully.

#### Advice on how to target venture capital effectively

Raising any type of capital needs research and strategic targeting. Before approaching any source of venture capital you will need to:

- have a good business plan
- have assessed that venture capital is suitable for your business
- know how much venture capital you require and what it will be used for.
- Be selective and only approach those venture capital sources that meet your requirements.

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