Financing your business

Before looking at your options for financing, it's important to do an initial assessment to determine whether the business is, theoretically, going to create financial profits for you and value for your customers. Knowing your basic funding requirements, you can then consider sources.

The first question is this: does your idea need capital funding or working capital funding? Or both? Capital funding is longer term and used to finance assets. Working capital funding supports your day-to-day operations. The general rule of thumb is to match the length of funding to the nature of the asset being purchased. For example, a piece of equipment with a useful life of five years could be financed by debt with a term of five years.

Funding is either internal or external. Here's a quick summary of the different options you have.

Internal sources

Personal wealth (debt or equity)

If you intend to use your own funds, you can introduce them either as debt or equity. If the business plan shows early-year losses, it could be tax efficient to start as a sole trader and obtain a tax repayment. When you start to become profitable, incorporate the business and reinvest future profits at a lower corporate tax rate. Each case needs to be considered on its own merits.

Family/friends (debt or equity)

These are usually 'softer' loans, by which we mean that the terms and conditions are usually less stringent than with other types of loan, but recipients of this kind of funding are often more diligent about repayment, as they are likely to be under an emotional obligation to ensure repayment. Unless the lender is in for the life of the business, the money should be introduced as a loan, with the terms and interest charges specified in a written loan agreement.

With all loans there will be a risk that the business may fail. To reduce the risk, the lender could also be given a legal charge over assets of the business. If the lender is in for the long term, and would like to see a profit when the business is sold, share capital might be more appropriate. If the company is profitable enough, the lender could then earn ongoing income from dividends.

External funding

Equity

Equity involves selling a part of the business and potentially reducing your control. This type of funding is long term in nature and is generally realised by the sale of part or all of the business in the future for a profit. Depending on the structure of the business, the equity holder often has voting rights regarding certain decisions and will own a percentage of the business. Equity holders may obtain a return on their capital from dividends taken from the profits that the business has made.

Tax incentives for investors

In many countries, governments offer tax incentives to encourage investment in business, which helps to promote national economic growth. The UK has several tax incentives, but the most common for SME entrepreneurs is the EIS; it allows investors to gain tax relief when they make the investment (UK 2017/18: 30%). There are a number of conditions regarding the use of EIS for business, largely in place to ensure the investment is genuine rather than some form of tax avoidance.

Equity crowdfunding

Businesses such as Crowdcube and Syndicate Room provide platforms to link your business to potential investors. In exchange for investment, you offer a percentage of the equity in the business. As soon as you start raising equity funds, you need to consider your existing shareholders and their rights before executing your plan.

Always ensure you have the consent of the existing shareholders before pursuing this option. With equity crowdfunding, you will be accountable to third-party shareholders. You will need to provide commentary to those shareholders on the trading of the business after the new investment.

Debt

Debt is funding that must be repaid, and it can place a significant burden on the business. It can vary from short-term overdrafts to long-term mortgages or debentures. Generally, a business needs to repay debt over a term and will pay interest for the benefit of using the funds. Interest payments are not usually dependent upon the business making a profit. Interest is usually tax deductible.

Businesses often don't understand the ramifications of bad planning when it comes to deciding on funding. It is common for entrepreneurs to chase capital funding at any cost and pay dearly later. This is another area where external advice can help change the business fundamentally.

Credit cards

These should be used only for short-term needs. And when it comes to funding your business, use a business credit card rather than a personal one. In many instances businesses cannot obtain the appropriate tax relief because of inadequate record keeping with a personal credit card. The balance should be paid off in full monthly.

Bank overdraft

Almost all entrepreneurs have a bank overdraft, and as long as it's used correctly, it's a reasonably cheap and flexible form of funding. There are some key points to note, though. It's almost always repayable on demand, though in practice this happens rarely. An overdraft usually requires a personal guarantee from the directors, which means the bank can obtain any shortfall of funds from the directors should the business fail, even if it's a limited company.

A bank overdraft should be used only for monthly/ quarterly cycles of cash flow. That means you should be returning to a positive balance every business cycle. If you have a permanent overdraft, you need to consider alternative funding.

Bank loans

Bank loans are commonly used to fund capital purchases and should match the life of the asset being purchased. This way, when it's time to replace the asset, you're able to take out a new loan. Bank loans typically come with an arrangement fee and a variable interest rate and are often, but not always, secured on a specific asset.

Supplier credit

Supplier credit involves negotiating appropriate credit terms with your suppliers before dealing with them and then sticking to those terms. Delaying payment to a supplier after you've received the service without credit terms in place isn't conducive to a good future business relationship.

At the beginning of a supplier relationship, the salesperson you're negotiating with will likely be keen to make the sale, so at this point you can ask for, and in many cases receive, favourable payment terms. Negotiating credit terms fairly at the start of a relationship with a supplier can significantly reduce the amount of other funding required.

Asset funding

This type of funding is similar to a bank loan but is secured to the asset (commonly vehicles or large items such as plant and machinery) the lender is funding. If repayments are missed, the lender usually takes title of the asset. Because the lender has security over an asset, it's much less likely that they will ask for a personal guarantee.

Factoring/invoice discounting

Factoring or invoice discounting both involve raising finance based on the value of your customer invoices; you receive payment as soon as the invoice is raised rather than when the customer pays. The difference between factoring and invoice discounting comes down to the degree to which your customer is aware of the form of finance.

In general terms, a funder will provide a factoring facility, which is a percentage of the amount of customer debt owed to the business. For factoring, your customer will usually know that you have factored the debt and will pay the factor directly.

With invoice discounting, the cash flow benefits are similar, in that the invoice discounting provider pays you as soon as the invoice is raised, and your customer will pay your business under their normal terms. You then effectively repay the funder.

Factoring/invoice discounting is best avoided unless your client base is strong, stable and spread across many customers.

Crowdfunding

Crowdfunding involves obtaining funding from many (a crowd) and repaying the funders with interest. The source of the loan is usually an internet platform which connects businesses with potential lenders and cuts out the traditional large-bank middleman.

Customer advances

Another source of capital is customers! Depending on your product or service, you may be able to set terms that remove the working capital headaches. If you import goods, for instance, why not ask a customer for a deposit, which could finance your deposit to your supplier?

If you provide an annual service, perhaps ask your customer to pay throughout the year, rather than once at the end of the year. It might sound trivial, but the difference to your cash flow could be radical.

Cloud-based direct ledger

A relatively new concept, this is a variant of factoring, with many of the advantages and few of the drawbacks. Cloud-based direct ledger financing involves selling invoices to a market on an *individual* basis for a discount rate.

Specialist lending

Many industries have specialist lenders, and depending on your industry, they may be the best source of funding for you. These lenders understand your industry, which is a benefit, but they often charge a premium for the value of their understanding.