The Young Entrepreneur's guide to starting a business (Part 5)

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A whistle stop tour of alternative funding options for start-ups

As part of our "Young Entrepreneur’s guide to starting a business" series of articles, one of the important topics that we shall focus on is traditional ways of raising funds both organically and/or externally. Before we go down the more traditional route, however, we also thought it would be helpful to give you a whistle stop tour of several alternative funding options that are now available for start-ups.

Introduction

With UK Government funding initiatives such as the Growth Accelerator Scheme, the Enterprise Finance Guarantee Scheme and the Funding for Lending Scheme available, not to mention a myriad of UK and EU R&D grants, it is no surprise that entrepreneurs are pretty confused when it comes to researching their funding options. Add to that the rapid growth of flexible and diverse "crowdfunding" options via online platforms, and the days of entrepreneurs financing their companies through private equity/venture capital funding and/or bank lending alone now seem somewhat outdated.

The more traditional methods we are used to seeing when start-ups seek initial or further funding rounds would either be by way of an equity funding (i.e. being granted a shareholding/equity stake with certain rights in your business) or a debt funding (i.e. being granted a loan with certain repayment terms and rights attached). A slightly more flexible halfway house is the use of loan notes, whereby an investor lends money to a business and that loan may be converted into equity at a certain price on a predetermined future date or event. Examples of equity (and loan note) funders would be family, friends, business angels, venture capitalists and/or private equity funds. As to debt funders, added to the above list would of course be high street or commercial banks.

These methods of funding can often be seen as too rigid and expensive for start-ups; and sadly founders often fall into the trap of giving away too much of their business to investors too early (be it by way of equity, loan interest, control or all three) in a desperate attempt to raise seed funding. Conversely this is precisely the time when start-ups need as much flexibility and control as possible over their business on a daily basis, so as to really get their feet off the ground. There are of course distinct advantages too, but we will take a closer look at these more traditional funding methods later in our articles series.

In the meantime, are there any viable alternative funding options? In short, yes, if you look hard enough…

UK Government Schemes & Research and Development Grants

In response to the on-going recession, the UK government has implemented a range of schemes and grants for small and medium sized enterprises (SMEs) and entrepreneurs to help stimulate economic growth. To give you a flavour, here are just a few examples:

Start-Up Loan Scheme

This scheme provides Government loans on favourable terms to 18-30 year old young entrepreneurs living in England and looking for finance to start a business.

The value of each loan is dependent on the robustness of the applicant's business plan and there is no upper limit to the amount that can be loaned (though the average value is around £2,500). The loan must be paid back within five years at a fixed-rate of interest (RPI +3%), with the potential for capital repayment holidays if needed. And since the
loans are personal, a number of individuals from the same company can each apply for a loan to invest in that one company.

The scheme has come in for criticism given its low financial value of funding provided. However, additional benefits such as access to business support tools and support from successful entrepreneur mentors may in themselves make the scheme worthwhile for some.

**Smart Programme**

For those businesses where innovation is central to their business model and who plan to research and develop new products or services, the Technology Strategy Board’s "Smart Programme" (previously known as the "Grant for Research and Development") provides R&D grants to help SMEs in any sector.

These grants range from funding up to £20,000 for low cost, proof of market/research projects lasting no more than nine months to funding up to £250,000 for prototype development projects lasting no more than two years. However, all grants assume a minimum contribution from the business itself. For proof of market/research projects, the business would be expected to contribute at least 40% of the total project cost; for prototype development projects, the minimum contribution level is 55% for medium businesses and 65% for small businesses.

In addition, collaborative R&D funding is available to encourage partnerships between businesses and between business and academia on innovative projects in strategically important areas of science, engineering and technology. The Technology Strategy Board manages funding competition programmes on a regular basis and across a range of areas to decide where to apply their funding (see their website for further details [http://www.innovateuk.org/competitions.ashx](http://www.innovateuk.org/competitions.ashx)).

**Crowdfunding**

In recent years, crowdfunding has become a very popular (and rapidly growing) means of filling the funding void, by giving businesses direct access to finance via internet funding platforms.

These platforms allow businesses direct access to funding from friends, family and community entrepreneurs and can provide the start-up capital needed to kick-start business operations as well as investment for future development.

There are broadly three types of crowdfunding, with some platforms offering a hybrid of the various options:

(i) **Crowd Investing**

Funds are provided in return for equity (e.g. Seedrs and CrowdCube);

(ii) **Crowd Rewards / Favour Based Funding**

Funds are provided in return for rewards/favours from the company and no equity is given away (e.g. Kickstarter and Indiegogo); and

(iii) **Crowd Lending**

Funds are provided as a loan and paid back at a rate agreed between the parties (e.g. Funding Circle and Zopa).

(i) **Crowd Investing (e.g. Seedrs)**

Start-ups pitch their business to potential investors on the Seedrs website and offer equity in return for funding. Investors can back new companies by investing anything between £10 and the full amount a business is seeking (up to a maximum of £150,000) with Seed Enterprise Investment Scheme (SEIS) tax relief potentially available on such investments.

If the start-up does not receive all of the money it is seeking within three months, all investments are returned. Alternatively, if a start-up reaches its funding target, Seedrs will buy the shares on the investors’ behalf and hold the shares as nominee. As a result, the business also benefits from only dealing with one legal entity (in form of the
Seeds’ nominee) rather than a large and disparate number of small shareholders. Investors pay a fee of 7.5% on all returns and Seedrs charges start-ups 7.5% of the total funds raised.

Seedrs is the first online platform of its kind to be authorised and registered by the Financial Conduct Authority (FCA), though many of the platforms are not required to do so if they are not carrying out regulated activities or if they benefit from an exclusion from registration. Whilst FCA authorisation may prove attractive for certain institutional investors, in many respects one could argue that the entrepreneur and investor communities themselves may provide the best regulation (as they would soon steer clear of any sites that develop a bad reputation).

(ii) Crowd Rewards / Favour Based Funding (e.g. Kickstarter)

Kickstarter is a US based crowdfunding platform that launched in the UK in October of last year. Globally, nearly $500m has been pledged on 40,000 projects with a project success rate (i.e. successful launching of a funded project within its projected deadline) of 43%.

The website allows funding for specific projects to be crowd-sourced from friends, family and third-party donors. As with Seedrs, if a project fails to reach its funding target within a given deadline, donors pay nothing. If a project does reach its target, donors receive different levels of ‘rewards’ in proportion to their financial involvement. For instance, those who provided a sufficient level of funding for the Pebble E-Paper Watch (which has now raised over $10m from an original target of only $100k) subsequently received one of the watches in return for their investment, once manufacturing of them had begun. Kickstarter takes a 5% fee of the total funds raised and funds are collected through a third party payments processor, which charges an additional 3% to 5% of the investment.

(iii) Crowd Lending (e.g. Funding Circle)

Funding Circle provides an online platform for businesses to borrow sums of between £5,000 and £1m direct from investors using the site. Since it was formed in August 2010, nearly £100m of lending has been provided to over 1,700 businesses at an average return of 6.2%.

Businesses applying must first pass an initial credit assessment (using similar information on business borrowers as banks use from Experian) and have at least two years trading history into the community. Those businesses that are approved receive a credit rating from "C" for average risk to "A+" for very low risk and investors bid the sums and interest rates at which they are willing to lend over the course of a (maximum) auction period of 14 days. The auction process ensures that borrowers get the most competitive interest rates available and allows for lenders to spread their funding (and thus risk) over a number of businesses.

As of March this year, the UK Government has shown its support by pledging £20m in funding for successful loan applicants on Funding Circle. These Government funds are applied to 20% of any successful loan application that fits the criteria of the Government’s Business Finance Partnership initiative, with private lenders on the site making up the remaining 80% of loan funds.

Crowdfunding – our analysis

Taking Seedrs and Kickstarter as an example, although both are similar in principle, Seedrs provides general fundraising for businesses, whereas Kickstarter provides fundraising of individual projects only. A key difference is that whilst Seedrs offers investors a percentage of equity in return for investment (and continues to manage the equity on behalf of investors); Kickstarter donors receive ‘rewards’ such as products, benefits and experiences instead of equity. This way, start-up projects keep their equity and creators keep 100% ownership of their work.

Both funding platforms provide much needed access to seed capital for entrepreneurs and start-ups where the start-up business or project is too small for venture capital investment and too early for business angels. Seedrs and Kickstarter are also accessible ways to invest in new start-ups where tax relief can be claimed. If the investment is eligible for SEIS relief, then investors who back these start-ups can claim 50% upfront tax relief plus an exemption from 28% tax on any capital gains after three years.
But there are also potential downsides to this kind of fundraising. There is a risk that many of the businesses and projects pitched on both platforms will fail. In such cases, any equity is effectively worthless and the promised ‘rewards’ may never arrive.

Although online platforms offer an alternative way to fund start-ups, they still largely provide for small fundraising exercises. However, investments in the millions of pounds – for which, see the Pebble E-Paper Watch example above – have been made and are becoming increasingly common. Using Seedrs and Kickstarter to obtain investment from friends, family and the wider community may provide quick and easy access to capital, yet this is no substitute for the many years of experience and advice that an angel could bring to a business.

Overall, crowdfunding offers a variety and ease of access to funding (in particular the key working capital needed to get operations off the ground) without necessarily sacrificing equity in return (depending on which provider you use).

**Business Angels**

Business angels are wealthy men and women – often successful business people in their own right – who provide funds, expertise and access to contacts for fast-growth companies in exchange for an interest (most often equity participation) in those companies. The BBC's Dragon's Den provides a good example of business angels in action, albeit in a made-for-tv setting.

Business angels tends to make their investments in the range of £10k – £1m, filling the traditional "equity-gap" between funding above this level from venture capital and/or private equity investors and funding below this level from friends and family (although see above on Crowdfunding for recent shifts in approaches to fundraising).

The real value that business angels add, aside from their hard cash, is their business experience and network of contacts (be they suppliers, customers or additional investors), which is often just the kind of financial and professional boost that start-ups need to turn a good idea into a company of value. Ultimately that allows the company to then grow and hopefully attract subsequent venture capital and/or private equity investment (and even a public fundraising or sale further down the line). Indeed, many business angels would argue that raising finance is the easy part; using that finance to develop a successful business is the real challenge.

**To sum up**

The UK Government continues to promote various schemes, grants and initiatives in an attempt to help start-ups and small businesses but their benefits can be limited by the relatively small sums of funding available and the specific criteria required to qualify for them.

The best opportunities for start-ups (and certainly in the £10k – £1m market, where the sums are generally too small for venture capital and private equity to operate) would appear to be offered by crowdfunding and business angels, or a combination of the two. Indeed, some crowdfunding platforms such as CrowdCube offer access to investors not just as providers of finance but also of expertise as business mentors.

However, and particularly so for the less experienced entrepreneur, the guidance and contacts a business angel can provide may prove invaluable in getting a business to that £1m plus valuation where the bigger hitting investors of venture capital and private equity operate. The balance will come in how much equity and control you are willing to sacrifice in order to get there.

Although business conditions for start-ups remain tough, there are numerous avenues of funding available for the canny entrepreneur. We have explored just a few of those avenues above, but the message is pretty clear – if you search hard enough for something, you will find it!

**How We Can Help**

Farrer & Co can help you to stay on top of the various issues that confront your business from its creation to the time you decide to exit, so as to ensure your time spent is where it should be – on your business.
We can advise on setting up, developing and growing businesses, as well as bringing in external funding (be it by way of a more conventional or alternative method) and maintaining control for the next generation, all done in the most tax-efficient way possible.

If you require further information on anything covered in this briefing please contact richard.belsey@farrer.co.uk or fergal.mcloughlin@farrer.co.uk your usual contact at the firm on 020 3375 7000.

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