

**INTEREST FREE NON REPAYABLE  
BUSINESS FUNDING**

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## **1 INTRODUCTION**

If you've ever been involved in a start up venture you can probably remember the effort required to raise funds when the business was set up and are quite sure that there is absolutely no opportunity for funding at zero interest rates and no payback. You know, you did your homework at the time and further you remember you cannot even raise funds without a fairly detailed and professional looking business plan complete with financial projections and sensitivity analysis. You can probably still lay your hands on that first business plan. Unfortunately most organisations have not referred to the plan since they raised the funds and only have a rough idea how actual business has compared to those original forecasts.

The difference occurs when a company has been in business for a number of years and it is this which opens up the possibility of realising what amounts to an interest free, non repayable source of business funding. The potential opportunity, however, is rarely considered as a first option when the need arises for secondary funding to develop the business.

Raising business funds is generally considered to be a tricky business. There are a number of options or routes which could be taken. How do you know which is the most suitable for the circumstances. Further to this most routes require the presentation of an up to date business plan and there is some truth in the 'motherhood and apple pie' statement that when you don't need the money people are tripping over themselves to loan it to you. The second you need the money they all run for cover or start demanding personal guarantees from the directors.

This article reviews the most common sources of business funding, comments on the likely requirements to secure them and in what circumstances they are a suitable source. The article then considers why sources of funding 'run for cover' the second you need the money, and suggests ways of avoiding this. The article then considers the alternative 'free funding' option, explains how to gain access, and argues that this option should be aggressively pursued by all organisations whether they need funding or not.

Finally the article will explain why, in the opinion of the author, personal guarantees should never be given except in a small number of very precise circumstances.

## **2 TRADITIONAL SOURCES OF FUNDING**

Unless you're considering floating and gaining a AIM or full stock market listing then the usual sources of business funding potentially available to you are:

- Bank Loan / Overdraft facilities – commonly known as senior debt
- Mortgages, Hire Purchase, Lease purchase
- Asset finance
- Sale and Lease back
- Debt Finance – Factoring, Invoice discounting
- Stock Finance
- Business Angels – Private equity finance
- Mezzanine finance
- Venture Capital – Equity finance

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The most common needs for funding in existing firms are listed in no particular order as:

- Acquisition
- Discharge of existing debts
- Buy out a partner
- Refurbish / expand premises
- Pay VAT PAYE and NI
- Fund new product and or growth opportunity

The type of funding you should go for depends to some extent on the use you intend to put the money to, but mostly upon the business circumstances at the time. These circumstances range from the level and quality of security available, to how well you can display an ability to furnish the debt, to future growth opportunities and, in relation to equity capital, the availability and feasibility of exit strategies.

It should be remembered that funders are in business to lend you money. They make their money by making loans at given interest rates and then having the money repaid. If you default then they are out of pocket. Risk is therefore an important consideration for funders. The higher the perceived risk the higher will be the potential return required by the funder and hence the coupon value or interest rate required.

The requirement for business plans and financial projections by a potential funder is all to do with their need to assess this risk.

It should be remembered that the lower the perceived risk, irrespective of the type of funding you are going for, the lower will be the demanded coupon rate. The more you can do to minimise this risk in the eyes of the potential funder the more chance you have of negotiating the best possible coupon rates and hence the cheaper will be the funding to the company. In some cases, of course it may be the difference between being offered funding or not.

Good security is obviously high on the list for minimising coupon rates but there are others. A company with a clear forward business strategy and an ability to display a competent committed management team will always impress. A company which knows where it's at because it produces regular management accounts and compares its performance with forecasts is a pre requisite for some forms of funding but will go a long way to minimising the perceived risk in all areas. This is particularly the case if the forecasts can be seen to be realistic and achievable and managers are seen to take corrective action when performance departs from plan.

Obviously a company with the appropriate financial controls and an ability to operate efficiently and competitively in its chosen market reduces risk. There should be no significant threats to the market segment or niche within which the company operates.

Finally funders will want to take a look at previous forecasts and compare them with actual performance. A sensible explanation will be required for any serious adverse variances.

With all of this in mind a quick commentary on the types of funding and their general requirements will be useful.

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## **2.1 REQUIREMENTS OF THE TYPES OF FUNDING**

Given the importance of security and risk we will deal first with the low risk secured funds end of the spectrum first.

If you're looking to make a one off purchase of a piece of equipment then hire purchase or lease hire is probably the way to go. Which particular version will depend upon the VAT treatment and the company profitability in relation to capital allowances. The point of this type of funding however is that it is secured against a specific asset, the one you are buying. If you default there is no debate, the asset belongs to the hire purchase company and can be recovered with little expense or effort provided the asset is clearly identifiable. The HP company will require a means of unique identification such as non removable serial number and evidence of your ability to meet the repayments. Unless we are talking significant amounts of money in relation to the size of the company, the repayment test is likely to be met by provision of statements and latest accounts.

Given the clarity and quality of security HP loans can usually be arranged at relatively low interest rates and are often cheaper than conventional bank loans.

Most people know and understand the concept of mortgages for property. Security is clearly identified and of good quality. The emphasis is therefore on ability to service the debt. Mortgages tend to be taken over an extended number of years and hence the requirements to display the ability to pay are likely to be greater. This is likely to increase as the number of times cover of existing profits over repayments reduces.

Lower cover ratios are more likely to require full business plans and forecasts in addition to recent and historical accounts.

It is generally accepted that your ability to borrow senior debt should be maximised before considering other forms of loans. This really is a statement of using the cheapest source of funds first. Conventional Bank Loans and overdraft are therefore the next level to be considered.

Security is taken by a fixed and floating charge over the assets of the business. Such funding can usually be secured at 2 to 3% over base. Bank loans and overdrafts at any significant level will almost certainly require the presentation of a business plan in support of the application. Additionally the bank is likely insist upon the presentation of monthly management accounts complete with variance analysis and debtor and creditor lists. They may also require a formal valuation of the assets and if so you will have to pay for this.

The amount of security the bank will consider your assets worth is worthy of comment given that you may exhaust this source of finance quicker than you thought. When evaluating your assets the bank is interested in two things. Firstly their forced sale, or fire sale value, as it is known, and secondly how clearly and crisply will their fixed and floating charge give them priority to these assets.

With regards to valuation the bank has to be mindful of the process involved in realising cash if they have to rely upon their fixed and floating charge to recover the

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debt. The assets will have to be sold quickly at auction. There will be auction fees and, in all probability, Insolvency Practitioner fees if by this time the company has entered administration. Insolvency Practitioners charge according to a fee structure regulated by their controlling body. There are 7 or 8 such controlling bodies. Take a £1m turnover company. The IP fees would be in the order of £25k if they are on the banks approved list. The IP's 'expenses' have to be added on and the cynics in life would say that the level of expenses will be proportional to the realisable value of the business. This article does not wish to debate the validity of otherwise of the cynics view and simply wishes to draw attention to potential costs to be considered when valuing assets for security.

Ignoring debtors and creditors for the time being a general rule of thumb would be to take the net book value of the other assets and divide them by three. The resultant value is, give or take, the value up to which you can arrange secured loans.

This obviously does not apply to property, which can be considered as security up to 100% of its value.

The second consideration with regard to security is the crispness to which the fixed and floating charge will give priority to the holder of the debenture.

Last century there was little concern about the priority of a fixed and floating charge and banks were happy to include debtor book in the assets considered for security. This was a useful and certain source of funding which is no longer available.

In 1999 the Brumark case changed the banks view. Anyone interested in the detail of the case can no doubt find it on a web search but essentially unless separate bank accounts were used, the banks priority over debtors afforded by the fixed and floating charge could not be upheld.

Invoice factoring has been around for a long time but Brumark case made it the only effective way of funding with a debtor book as security.

There are various versions of this type of funding ranging from Confidential Invoice Finance through Invoice Finance to full Factoring service. Confidential Invoice Finance is a means of raising funds on the debtor book whilst you continue to manage the ledger and collect your debts as they become payable. Your customers will have no knowledge of the arrangements you have made. Invoice finance generally requires you to notate your invoices with the fact and full factoring results in the money being paid into the factoring company account.

The workings of each are slightly different but the effect is the same. Up to 85% of the debtor book can be drawn down. What is actually allowed will depend upon the perceived quality of your debtors the normal level of credits given by your company and how good the controls within the company are considered to be. Your draw down facility will be reduced to take account of any reciprocal trading, concentrations of trade, and any trade with a customer above and beyond the credit limit considered appropriate by the factoring company for that customer.

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Such funding is usually relatively easy to arrange with bank statements and sight of recent accounts required. An audit of your controls within the business is also often required and this is usually conducted without charge by the factoring house.

There are a couple of other things of which you should be aware. You will normally pay a fixed fee for the service each year plus an interest charge on the draw down of 2 to 3% over base. There is therefore a cost to this service even if you never draw down and you are usually contracted to a minimum period.

One of the benefits of invoice finance which is often used as a selling point is that it automatically funds the increased working capital requirements of a growing business. As your turnover grows your debtor book increases in proportion and hence you have an increased funding source.

This of course is perfectly true but unless you are absolutely certain that your business will continue to grow or at the very least stay still, you should consider the opposite effect. The first effect of a reduced level of invoicing is to tighten your cash flow. You have become accustomed to paying your creditors due out of present invoicing rates. Your creditors due are as a consequence of previous activity rates and it will be a little time before they fall to matching the levels of the present activity levels

You should ensure that you have sufficient daylight in your arrangement to cover reducing invoicing rates to the extent that this may occur. Similarly if you have used this funding method to make a purchase of an asset you should be careful about the cover levels you have. If your invoicing rate declines so will your funding availability. You have, however, already spent the money on the asset.

Asset finance and stock finance etc are variations of secured funding and are methods of making clear the specific assets over which the funder has priority. Pursuing these may require deeds of priority to be drawn up if your bank has a fixed and floating charge. This is not usually an issue provided there is sufficient total security to cover the total funding required.

If you're running out of security there is always the Small Firms Loan Guarantee Scheme. This works like senior debt and is organised through your bank. If you meet the criteria the DTI provides security for the loan.

Mezzanine finance is a hybrid which provides a mix of debt and equity finance as a bespoke solution to the specific situation. It is called mezzanine since the debt is repayable after the usual senior debt. The providers of such finance are looking for a return of 10 to 20% and you can find providers for deals of £5m plus. Companies with a low growth prospect or an inability to significantly increase cash flow after the deal are not suited to this method of funding.

Equity finance is really what it says. In return for a stake in the business investment funds are made available. This is unsecured funding and is therefore at the expensive end. Through a mixture of fees, coupon rate on preference shares, dividends and exit strategy the venture capitalist will be looking for a return of around 30%. This may be expensive and you have to come to terms with sacrificing equity but the VC rarely wants a controlling interest. Just enough to give him the chance of the return he requires. Remember 70% of something is worth more than 100% of nothing. If you

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believe in your business opportunity but have insufficient security then equity finance should be seriously considered.

You will need full and exhaustive business plans, full business controls and monthly management account reporting and formal board meetings with copies of minutes being supplied. Also, possibly, a non exec director of the VC's choice. You, however, will have to pay for him. There will probably be restrictions on what you spend and how much you pay yourself and other directors but if you are professional and organised and able to achieve your plans these conditions are not onerous. In any event where else can you raise unsecured funding. They will also probably want a second charge ranking behind the banks.

You will also need to provide a clear, believable and achievable exit strategy for the VC over something of the order of a 3 to 5 year period. If you have what is commonly termed a lifestyle business there is little point in proposing an exit strategy of growth followed by sale. You would need to convince the VC that you actually would sell. The value of a minority shareholding is much less than a sale of the whole.

### **2.2 RUNNING FOR COVER**

It is often said the problem with banks is that they are constantly trying to loan you money when you don't need it but the second you need a loan they are not interested.

Hopefully, in view of that which has been discussed above, the reason for this is clear. Secured funding is all about perceived risk. Many people approach the bank for funding some time after they actually needed it. The overdraft limit has been reached, cheques are being bounced and then they turn up to see their bank manager to ask for increased facilities.

Compare this with a discussion with the bank manager along the lines of “

our current performance over the last few months has been 'x' as can be seen from our management accounts and the variance from our budget is consequential to 'y'. We are proposing the following actions to correct these variances. Modelling this revised plan shows that we are going to need increased funding of £z from July for a period of 18 months. Our sensitivity analysis shows that in worst case scenarios the increased funding requirement will be £z+ and will be required for a period of 2 years.”

The question is which approach generates most confidence, suggests a business under control, and hence reduces the perceived risk of providing funding. If you do not want your bank manager to run for cover keep him informed and do not deliver surprises.

This is easy to say and easy to do if you have the right management controls, regular management accounts, reviews of actual performance against forecast, and projections amended to take account of actual results.

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### **3 INTEREST FREE NON REPAYABLE FUNDING**

All conventional funding has a price dependent upon the perceived risk and will require you to undertake various tasks so as to secure that funding. Despite this however it is to conventional funding that most people turn first. However if you are planning your business development you will be aware of the need for funding well in advance and can take steps to release capital so as to reduce the need for interest bearing funding or, perhaps, to remove the need altogether.

The source of this free funding is best explained by an example.

PDC Ltd has been trading for around five years and has a turnover of £2m. Its trading terms are net monthly (equivalent to 45 days) but its average debtor days is 75 days. It has a 60% GP and its average creditor days is 45 days. Clearly it is paying its suppliers to terms which is no bad thing if you want good service.

PDC Ltd is probably not aware of these statistics on its business but if it were it could consider taking steps to achieve the following.

Improve its credit control and reduce its debtor days to 60. When achieved this will release from working capital, to be used else where in the business some **£97,000**.

Negotiate with suppliers for better trading terms than net monthly. PDC Ltd is a good customer with a history of paying on time. With the right approach there is a good chance of achieving net 2 monthly (equivalent to 75 days). When achieved this will release from working capital, to be used elsewhere in the business some **£77,000**.

Suppose PDC Ltd visited its purchasing arrangements and discovered that it could reduce its purchase costs by 5%. Forgetting the marginal effect on working capital this will amount to £40,000 savings per year. The actual amount available for reinvestment of course depends upon the effective marginal rate of corporation tax. At 21% this would generate **£31,000** per year of extra funds.

We could go on to consider the effect of stock turn improvements and efficiency gains within operating costs but the point is probably made.

Companies form and develop and as they grow they inevitably build in inefficiencies. With some attention significant sums of capital can be released.

### **4 CONCLUSIONS**

If a company is to be successful in raising funding efficiently and at the lowest possible cost it must be in control of its business and be able to predict, quantify and explain the reason for a funding requirement. This requires clear and achievable business plans with a process of review of actual performance against projections. Projections must then be adjusted to reflect actual performance.

Periodic reviews to unlock the 'free' funding tied up within the business should be undertaken. Not only can this significantly reduce the cost of future funding

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requirements but it will make it easier to raise the traditional funding that may be required.

The introduction promised a view on personal guarantees. When raising funding these will often be requested from the directors of the company. It's a way of increasing the security against the loan and it can be inferred that it is only a paper exercise since if the worst comes to the worst there would be enough security in the company to see that the personal guarantee did not have to be paid.

Refuse to give the personal guarantee on the basis that the business proposal should stand or fall on its merits. If it does not stand up then perhaps you should reconsider pursuing the proposal. If there is sufficient security and the risk adjudged acceptable then the potential funder will often proceed without the personal guarantees.

If there is insufficient security then perhaps you might consider the PG route but spare a thought first of all for the following. If you have the personal assets to cover the PG if the worst comes to the worst then it may be cheaper to raise the money personally on those assets and loan it to the company. Not only may this be a cheaper route but it clearly displays your risk.

Make no mistake. If the worst comes to the worst the funder will call in your PG and you will probably find that this is payable as soon as the loans are in default instead of when the business assets are realised and fail to cover the loan. Remember that in an administration situation there can be significant costs to be met before the debenture holder is paid. You will probably also find that the PG makes you responsible for any recovery costs and the accrued interest charges for non payment are likely to be on the high side.

*Charles Brooks is an MBA graduate with many years experience of raising funds for acquisitions. He is currently MD of Comprehensive Business Management Ltd which provides business strategy/planning services and assists with cost saving, efficiency gain and working capital release programmes. Up to one day free consultancy to assess and quantify the potential for savings is available and if you work with CBM they will guarantee the savings.*

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