Module 2: Facilitating Growth

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FOOD AND DRINK WALES

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Facilitating Growth

Introduction

This module assumes you have successfully set up your new business, have dealt with all the initial legal issues and are now looking to move beyond this first stage. It includes a number of areas you need to consider – we could think about these as the 'mechanics of growth'. As before, this can only ever be somewhat generic advice and is not designed to give you the detailed situation-specific advice you would get from an accountant, lawyer or other professional who could look at the precise circumstances of your business. You should always take appropriate advice, particularly where there are laws with potential penalties.

Strategy

Many management gurus have made a great deal of money from writing books about business strategy but it is a simple concept that refers to the course of action a business is aiming to take over the medium to long term in order to succeed. As we have noted previously, it is easy when your business is growing and thriving to get so caught up in the day-to-day activity that you have little time for anything else. However it is important to set aside some time, perhaps once per year, to take stock. Specifically you should consider:

- The **business performance** – did the last year go as well as planned, what was successful, what wasn't and why? Did you launch any new products, if so how effective was your NPD process? What are the key elements that the business relies on and has to get right (these are known as critical success factors).
- What **technical or operational** improvements are required in the factory? As mentioned in Module 1, food and drink manufacturers should be aiming for a minimum of SALSA accreditation and then as they grow perhaps commit to achieving BRC accreditation. Both SALSA and BRC are covered in more detail in Module 4.
- The **environment** in which you are operating including economic and technological factors, your markets and your competition. You should particularly consider whether there have been any material changes in these aspects or are they expected to change in the future.
- What are your **options going forward**? Are there new products you should be developing, or are there new markets you should be looking to exploit, including export markets? Should you consider new market channels e.g. target foodservice sector if you are currently only supplying into retail, can you be a B2B supplier (i.e. supplying ingredients for further processing by another food and drink manufacturer).
- Who are your **key employees**, what motivates them and how will your business keep them motivated? How vital are they to the business, do you have successors in mind for them and for you? What training is require for you and your team over the course of the next 12 months?
- What are you **personally looking** to achieve over the coming years, how do your aspirations for your business sit with your personal goals?

When developing and reviewing your business strategy/plan it can be useful to frame it around a recognised business tool such as **PESTEL analysis**. This gives you key headings that you need to take into account and from which you can undertake a SWOT analysis (strengths, weaknesses, opportunities and threats). The factors making up a PESTEL analysis are as follows:

Political – These are all about how and to what degree a government intervenes in the economy and specifically in this instance the food and drink sector – key areas include VAT on food, regulation on nutritional content, restrictions on marketing to children etc.

Economic – the state of the economy – economic growth, interest rates, exchange rates, inflation, disposable income of consumers and businesses and the likely impact on the food and drink sector.

Social – These factors include – population growth, age distribution, health consciousness and so on. These factors are of particular interest as they have a direct effect on how marketeers understand customers and what drives them in terms of their food choices, shopping and eating out behaviours.

Technical – the technological landscape changes and how this impacts the way we make and market our products. Technological factors impact on food businesses in three distinct ways:

- New ways of producing goods and services
- New ways of distributing goods and services e.g. online grocery shopping
- New ways of communicating with target markets e.g. social media

Legal – Legal factors include – health and safety, equal opportunities, advertising standards, consumer rights and laws, product labelling and product safety. It is clear that companies need to know what is and what is not legal in order to trade successfully. Recent changes in the food and drink sector include food labelling particularly in the context of allergens.

Environmental – these factors are growing in importance due to the increasing scarcity of raw materials, and government targets which impact on business e.g. pollution, food packaging waste, doing business as an ethical and sustainable company. Carbon footprint targets set by governments provide a good example of where one factor could be classed as political and environmental at the same time. More and more consumers are demanding that the products they buy are sourced ethically, and if possible from a sustainable source.

As a final point you should start to consider whether you have an exit strategy for your business, will you ever want to walk away from it, or perhaps sell it or do you want to pass it to your children? Your long term goal will have an impact on how you run your business today.

The rest of this section will give you the tools to be able to consider your business's strategy and how to achieve it over the coming years.

Mission statement

Once you have decided the overall direction of your business, it can be useful to document it as a mission statement. This gives a clear point of reference for future decision making. The key, long-term business goals for the organisation should be captured within the mission statement.

A mission statement commonly has the following components:

- **Purpose** – what the business is for and/or who it is for. A commercial business would typically include generating a financial return for shareholders.
- **Scope** – where it wants to do this, its products and markets.

- **Strategy** – how the business will compete in its market, and over the long-term how it will succeed.
- **Principles** – ways of doing business, underlying values that influence behaviour.

Business Structure

Limited company vs. sole trader

The first module of this toolkit assumed that you would establish your business as a sole trader. In this structure your business is treated as an extension of your own personal circumstances. Therefore any profit that the business makes is simply added to your salary and taxed as income tax. In addition, and of more concern, is that if the business has obligations (i.e. amounts it needs to pay someone, e.g. a creditor) then it is **you** that is liable. For instance if someone is hurt as a result of your business actions, then they could sue you personally and you could even end up having to sell your house to pay compensation. The most common alternative is to separate yourself from the business and give it its own legal identity – this is what a Limited (Ltd) Company is – a company whose liability is limited to the assets of that company only. There is a halfway house known as a partnership which we will mention at the end of this section.

As a Limited Company you will still own the business (you have shares in it) but for legal and tax purposes it is treated as a separate entity to you.

Ltd status confers an element of "status" that a sole trader does not have so you may find it easier to raise finance or strike deals with suppliers and customers.

There are however disadvantages:

- Your business needs to publish and file statutory accounts each year and file them at Companies House; your competitors can then download them.
- You may need to have an annual audit, which you have to pay for!

Setting up a Limited Company

If you search the internet you will see many sites offering to set up a Ltd. Company for you and, if you do it yourself this can be done for as little as £50. The cheapest way is often to buy an 'off the shelf' company which has already been set up and simply needs its name to be changed. However you should certainly consider taking the advice of an accountant or lawyer for this process. They will help you set up an appropriate share capital structure and Memorandum and Articles of Association (the formal "features" of your company) which can be difficult to change at a later date.

Partnerships

You may also hear of another business structure known as a partnership. This has similarities to a sole trader, but is where a group of people share the company. The profits are shared and the 'ownership' is shared. However there are is no separation between the owners and the company i.e. there are no direct shares in the company. Theoretically the assets (such as the houses) of the partners could still be at risk if the business found itself with a large obligation. For these reason partnerships are not a particularly common structure for food manufacturing business – it tends to be businesses such as accountancy and legal practices where they exist.

There are variations of these themes such as Limited Liability Partnerships, but the benefits of such complex structures would often be outweighed by the professional advice costs of setting them up, and again they are less suited to the manufacturing sector.

Human Resources

Introduction

You may have started your business alone but as it grows you need help and need to take on employees. This is a big step for your business and brings with it significant risks and responsibilities.

From a purely financial perspective, as we have mentioned already, employee costs are a fixed cost that the contribution from your trading has to cover so you should consider whether there are more flexible ways of achieving the same end, such as temporary employees or outsourcing.

However at some point you will need to take on staff simply for the extra capacity they bring. In addition, once you have employees your business is no longer 100% reliant on you, you may be able to delegate some of the day-to-day work and start to think about business expansion and the longer term direction – you may even be able to take a holiday!

It is often easier to identify when you need additional resource in your manufacturing or operations area as you start to see bottlenecks in your flow which greatly affects output. versus more office based roles. Recruitment decisions in this area are also less risky as staff are generally lower skilled and therefore lower paid. Recruiting more senior management such as account managers, financial controllers, and marketing managers, can be a more difficult process as there needs to be a clear cultural fit between the candidate and your organisation and of course these staff tend to cost more. Therefore risks of getting it wrong tend to be higher.

Practicalities

There are numerous laws and regulations relating to employees. This module will not attempt to explain employment law in detail, however the key regulations are introduced below:

- You must check if someone has the legal right to work in the UK.
- You will be responsible for calculating, collecting and remitting to HMRC both employees' income tax (Pay As You Earn) and National Insurance (both employee's and employer's). There are many agencies that will perform this task for you for a modest fee.
- There may be statutory deductions (such as student loan repayments) which you must collect from the employee's salary and pay to the government
- If an employee has a baby they are entitled to up to 52 weeks of leave and statutory maternity pay for up to 39 weeks subject to eligibility. Most of the cost of this can be reclaimed from the government. The government has recently increased the amount of leave and pay for paternity pay.
- If an employee is sick you must pay them an amount called statutory sick pay for a period of up to 26 weeks [as at February 2015 this was £87.55 per week].
- All employees are entitled to at least 28 days per year of paid holiday (including bank holidays).
- Employees should not work more than 48 hours per week, although they can opt out of this ruling.

- You must register as an employer with HMRC before you take on staff. This needs to be done before you pay your staff and can take up to 2 weeks. If you employ yourself as a director of the business then this rule also applies.
- There are very strict rules about the process if you wish to terminate an employment contract.
- You should ensure you have employers' liability insurance.
- You need to ensure you pay staff at least the National Minimum Wage. The rates over the last few years are shown in the table below [as at July 2015]. These are updated annually in October. Prospective employees must be school leaving age to qualify for the minimum wage, which in Wales means that they must be 16 by the end of the summer school holidays the year they plan to leave.

Year	21 and over	18 to 20	Under 18	Apprentice
From Oct 2015	£6.70	£5.30	£3.87	£3.30
2014 (current rate)	£6.50	£5.13	£3.79	£2.73
2013	£6.31	£5.03	£3.72	£2.68
2012	£6.19	£4.98	£3.68	£2.65
2011	£6.08	£4.98	£3.68	£2.60
2010	£5.93	£4.92	£3.64	£2.50

- In July 2015, the UK Government announced a compulsory National Living Wage. The wage will guarantee everyone aged 25 and over £7.20 an hour from April 2016, with the figure rising to £9.00 by 2020.

The change will not affect people aged 24 and under currently being paid the minimum wage.

The detailed laws relating to employment are shown on the government's web site: www.gov.uk/browse/employing-people

Given the detailed nature of employment law you can hopefully see how important it is to keep detailed records of all staff related matters, such as holiday taken, amounts paid and deductions made.

ACAS

As a business owner, if you do not have a specific HR department it can be very useful to take courses run by industry bodies such as ACAS. These will ensure that you have the basics covered.

ACAS run training courses for small business and larger organisations in Wales (see their website for further details). They can also customise training sessions to run in-house and also work closely with organisations to assess their current situation and give recommendations on improvements that will increase efficiency.

ACAS Wales can help you solve specific problems in your workplace or improve performance. Their Senior Advisers can visit you or your factory, or discuss your issues over the phone, and give advice and guidance to suit your business's particular needs. www.acas.org.uk/wales

Another potential source of support is the Institute of Directors (IOD), benefits of joining the IOD includes access to a legal helpline, tax advice, research, exporting, as well as providing meeting rooms in major cities which you can use to meet with clients etc. There is an annual membership fee, however, if you do need to use their advisors, it can more than pay for itself. www.iod.com

Recruitment

Taking on new employees is a significant investment both financially and in terms of time spent managing them. You need to ensure that the current and projected revenue of the business will support the additional costs of new employees. It is therefore important that you consider alternatives such as temporary staff or paying existing staff overtime, before you take this important step.

When you are considering recruitment do not forget to look internally to see if any of your existing staff can take on a new role. Even if they need training to build up the required skills there is significantly less risk than an external hire as you know this person well. In addition internal promotion has a highly motivating impact on both the employee concerned and on other staff who see that there are internal prospects for advancement.

Steps to Take

Recruiting the right person with both the right skills and the ability to fit in is extremely important for you, your team and the employee concerned. You should approach recruitment in a methodical, open and honest way. The key steps are:

- Draw up a job description containing the features of the role and the main responsibilities. This is independent of the person specification.
- Document other factors such as employment rates in the local area, location(s), timescales
- Draw up a person specification, based on the job description, including the skills required for the job, required experience, personal characteristics and any formal qualifications
- Set a budget for the anticipated salary level, including other benefits such as company car, bonus, medical cover, pension contribution, etc.
- Set a budget for the recruitment process, advertising costs, recruitment consultant, etc.
- Decide on the recruitment process – will you have standard application forms or ask for a free form letter? How many interviews will there be, and who will interview?
- Decide whether you will use a recruitment consultant or do the work yourself. Consultants will have a database of suitable candidates, experience of salary levels, and will know what candidates look for in job adverts, etc. They can also screen the first batch of applications that you receive, saving you significant time. However they may charge 20% or more of the first year salary as a fee.

Where to recruit

Where you recruit will depend on a number of factors, including the type of employee you are looking for and their level of experience. In the food sector you can be looking for production floor employees, through to senior production/account managers. On the production side as you grow you may need to consider employing a quality control manager, or someone with a food technology background to become involved in food safety and new product development. In this instance, a good place to start your search would be the Welsh universities who have strong links to the food sector such as Cardiff Metropolitan University, Coleg Menai, and Aberystwyth University. In the case of market researchers or graduate employees on the marketing side, you are more likely to be looking at strong business degrees rather than food technology based qualifications.

Senior appointments may require the use of a recruitment consultant to help identify suitable candidates. If you do the work yourself there are a number of areas where you can look for potential employees:

- Friends and contacts of existing employees. Many organisations offer a small reward for a successful recommendation.
- Use your networks – customers, suppliers, local business groups.
- Social media – use your website, twitter feeds and Facebook page to announce any vacancies. You can turn this into a 'good news' story.
- Advertise – local, national and trade press and the internet. Obviously you need to tailor the location of any advert to the particular role you are looking to fill, e.g. Accountancy Age magazine for a new accountant. Key publications to consider for FMCG employees in the food and drink sector are The Grocer (retail) and Caterer & Hotel Keeper (foodservice). Both of these titles feature job vacancies in their weekly publications and online versions.
- Government Agencies such as Jobcentre Plus or Jobmatch. These may also be able to provide advice and assistance with training or funding

Note that you must be careful how you describe a role or ideal employee in a job advert to avoid breaching discrimination laws. For instance you cannot describe your ideal candidate as "young and enthusiastic" as this would contravene age discrimination legislation.

Interview

Most recruitment processes include one or more interviews. It is important for both you and the candidate to meet each other face to face – after all you will have to work together in the years to come.

It is important that you plan for the interviews, ensure there is consistency between interviews with different candidates and that you take notes during the interview so you can remember the details when you come to make a decision.

You should write down a set of standard questions that you will ask each candidate so that you can compare their answers when you have finished the process.

Remember that an interview is a stressful process so try and put candidates at their ease and try to see beyond interview nerves. Although you are asking the questions – try to listen more than you talk. Depending on the role, many of your questions may be about their specific experience and skills, however you can also ask more general questions such as:

- Ask about their career history and experience – you'll have their CV but the interview enables you to verify it. It will also help you 'read between the lines' of their CV such as finding out their likes and dislikes.
- Go through any gaps in employment record – they may well have used their time constructively so don't see it as a negative from the outset.
- Greatest achievements to date and biggest mistake or challenge? These are standard questions.
- Where do they see themselves in three years' time?
- What do they know about your company and why would they like to work there? Have they done their homework i.e. taken the time and effort to research your business?

Once you have identified the right person and offered them the role you must send details of the job (including terms and conditions) in writing to your employee, this is called a written statement of employment, this also applies to temporary roles that are longer than one month.

Managing and motivating staff

Many of the problems that can occur between companies and their employees result from a lack of clarity, structure and documentation. It is therefore important that you discuss and as far as possible document the following both for existing employees and particularly for new ones.

- the work that the employee will be expected to do – this may be difficult with a small, growing company when everyone is expected to "pitch in", but for instance an employee may not be expecting to do heavy lifting, or visit customers in other countries.
- the precise terms of employment – salary, holiday allocation, hours and place of work, when pay reviews will occur, any restrictions (e.g. working for a competitor), notice period, bonus, uniforms, mobile phone availability etc. These should all be written up in a contract of employment and signed by employee and employer with both receiving a copy.

Company structure

As your business grows it will be impossible for you to manage all your staff and still contribute effectively to the overall decision-making and running of the business. You will need to put in place a clear structure of responsibility, control and reporting. As businesses grow this often takes the form of a functional structure where different teams within your business perform different functions, such as finance, sales and marketing, manufacturing, etc.

Family businesses

Many small start-up businesses are owned and managed by the same person or by a number of people from the same family. These businesses can have particular issues as they grow such as:

- infighting amongst family members as priorities diverge;
- reliance on family members for key roles when those people may not have the most appropriate skills;
- demotivation and lack of engagement of staff who are not family members;
- reliance on family members for financing of the business – this may limit the scope of the company to grow if they want to retain full control.

These issues can be difficult to address. It is important that the family members attempt to agree a common position and document their personal and company objectives

Delegation

Delegation is the entrusting of authority, power and responsibility to another. If you delegate successfully you will find a balance between your responsibilities and your capacity. Entrepreneurs can suffer from "Superhero Syndrome" – i.e. feel that they can and should do everything. However it is important that you learn how to delegate successfully so that your time can be freed up to focus on the future strategy of the business and look for new opportunities. If you appoint an account manager to handle any of your key accounts e.g. a major multiple retailer, then you will need to let them head up the day to day interaction with that account.

Key steps in delegation include:

- Outline the task – be clear, set out what you want done, by when and why.
- Set out clear KPI's (Key Performance Indicators) – the measures that will show whether they have done a good job or not, e.g. number of new lines developed/listed, new retail/foodservice accounts one.
- Ensure the employee has the skills to be able to do the job, show them or invest in training if not.
- Be aware that others may do things differently to you, different is not necessarily worse, it's just different!
- Avoid blame culture, people will learn from mistakes, perhaps part of the fault is with the delegator for not explaining or showing well enough.
- Empower Others – encourage responsibility and ownership.
- Stand back – try not to interfere, however have open door policy for them to ask for help.

Employee development

A key element in maintaining motivation and therefore performance of your employees is to put in place a structured process for regular appraisals and development. Most businesses have formal appraisals every 6 or 12 months.

Objectives

As with delegation, you cannot expect employees to perform in a particular way if you do not describe clearly what is expected of them. Typically at each 6-monthly or annual appraisal the manager and employee will agree a set of objectives for the coming period. As with strategic objectives (see the Part 3, the marketing module) these objectives should be SMART [Suitable, Measurable, Achievable, Realistic and Time-bound]. The objectives should be documented so that actual performance can be compared to the objectives in the next appraisal. Objectives, which may be relevant for food and drink sector will obviously depend on the role in question e.g.:

- Quality/Production manager may be tasked with achieving SALSA/BRC accreditation within a set time period or improving factory efficiencies.
- Account managers objectives will be focused around sales performance, rates of sale, distribution etc.

Appraisals

Appraisals are an opportunity to look back at the last year or 6 months and review the employee's performance. Good appraisals are structured, constructive and give the opportunity for a realistic dialogue of both successes and challenges.

It is important that appraisals are objective, focussed on the employee's performance and do not become simply a 'box ticking' exercise. A good appraisal should be motivating for the employee and informative for the manager.

Development Training

A key output of the appraisal is a training and development plan for the employee. Training is clearly valuable if it increases the skills of the employee and therefore their utility to the business – this could improve their performance in their current role or could enable them to do another role and save the company having to recruit.

Training can cover more than just one specific skill. For example a professional qualification gives employees a broader range of skills that they may use in the coming years. Investing in staff through training increases their motivation and improves overall staff retention.

Finally training can generate a strategic advantage for a company if it significantly improves the quality of its products or enables it to take advantage of wider opportunities (e.g. language training enabling a company to export).

Food and Drink Skills Sector Training

As mentioned previously there is a wide range of skills and qualifications looked for in the Food and Drink sector. These can range from business-based degrees through to apprenticeships in various elements of the production process. Given the importance of the Food and Drink sector to Welsh Government significant resources have been invested in understanding the skills that will be required by the sector over the coming decade. The Food and Drinks Skills Project (undertaken by Lantra on behave of Improve) and other training programmes aim to meet any skills gaps identified.

Improve Wales is the Skills Council for Food & Drink Manufacturing and processing in Wales. The support workforce development by providing cost effective access to specialist industry training and vocational education organisations. In addition to being responsible for certifying completion of Food & Drink manufacturing and processing related apprenticeships in Wales, Improve works with food manufacturers to continuously develop and maintain suites of National Occupational Standards (NOS) for the sector.

Lantra works closely with Improve Wales and amongst other services, delivers a range of business training and courses.

Further details can be found on both bodies' websites.

www.improveltd.co.uk/wales/

www.lantra.co.uk/Nations/Wales.aspx

www.lantra.co.uk/business/training-and-courses/course-finder

Finance

There are clearly significant financial benefits and considerations as your business grows. This section will describe the key issues.

Economies of scale and scope

The first module briefly mentioned these, but as your business grows the impact can be much more significant.

Economies of scale means that the average cost per unit of production will fall as you increase production volume. The most obvious example of this is the leverage you will have over suppliers. Simply put – if you buy 10,000 items of raw material from a supplier you should be able to negotiate

a much better price than if you only buy 100. You should make time to routinely review your variable cost base and consider whether you could get a better price – every reduction in cost flows directly through to improved profits.

As you grow as a business there may also be economies of scale in relation to fixed costs. Your fixed costs may not fall in total, but the average cost if you spread it across all your production volume will fall on a per-unit basis. Increasing volume will increase the contribution to those fixed costs and make the maximum use of those fixed costs, a concept commonly known as "sweating the assets". The benefit of economies of scale may be one reason to consider own label production for a retailer or foodservice operator. By contributing to your fixed costs, own label may enable you to invest more in your branded products.

Economies of scope means that your average costs per item fall as you increase the number of things you do or produce. For instance if you are producing a food item (e.g. jam), then it would be easier and cheaper to introduce a new product such as mustard as you have experience of the food regulations and the expertise required to manufacture and fill jars. You would also be able to rely on your existing brand which would reduce the amount you would need to spend on marketing.

Investing in capacity

As your business grows there is a danger that you simply run out of capacity, i.e. you cannot make enough products to satisfy demand. You need to constantly bear in mind how much you can produce and not over-promise. You also need to ensure you keep up with maintenance of your facilities once you are using them more intensely.

As your business grows you may need to also grow the assets that support it, such as buying new machinery, premises and general infrastructure. By this stage you will have a good feel for which machinery was a good investment and which was not. You should bear in mind that investments now could be much more substantial than when you started (for example bigger premises, much bigger machinery, etc.) and therefore require significant amounts of cash. In addition the depreciation as you spread the costs over the years to come will also be substantial – this increases your fixed costs and makes it more difficult to remain profitable if your sales and contribution fall.

You therefore need to consider any investment very carefully. Investment appraisal is a large subject on which many accounting books have been written, however a straightforward technique that can be used is Payback Period.

Payback period

Payback period takes the cash cost of an investment and then counts how many months or years it will take for the net cash benefit of the investment (the extra sales less all the extra costs specifically associated with it) to accumulate to the same level, i.e. how long to pay back the investment.
You need to be careful to include all the elements but also ensure you only include those that are incremental. For instance the cost of investment should include delivery costs of a new machine and the training course to learn how to operate it and the new sales/costs should include for instance the extra electricity to run it. If the machine will replace an existing one, then for a fair comparison, your payback calculation should include the 2nd hand proceeds of selling your old machine and the sales/costs should only include the extra production you make in addition to what you could have produced on your old machine.

Raising finance

In the first module we discussed the importance of cash to a new business and there is no difference as you move into the growth phase – the phrase "cash is king" is still true.

It may seem counterintuitive but you are more in danger of running out of cash if you are growing rapidly than if your business is stable. The reason for this is due to something called the working capital cycle which relates to the time for which you have to fund your operations. Let's consider a simple business making say 1000 of an item every year. The selling price is £100 and the variable costs are £20 of raw materials and £30 of labour (giving a healthy profit of £50 per item). The product takes 3 months to make and your customer pays you 60 days after delivery. If the business receives an order for an extra 500 of the product the cash profile for these extra sales would be as follows:

			Cash (£)	Cumulative (£)
Month 1	Raw materials delivered, pay 1/3 of wages	500 x £30 x 1/3	(5,000)	(5,000)
Month 2	Pay materials invoice, pay 1/3 wages	(500 x £30 x 1/3) + (500 x £20)	(15,000)	(20,000)
Month 3	Pay last 1/3 wages, deliver product	500 x £30 x 1/3	(5,000)	(25,000)
Month 4				(25,000)
Month 5	Customer pays invoice	500 x £100	50,000	25,000

After five months the cash turns positive which is the same as the profit effect but you can see that you need to find £25,000 in cash to support this extra order for two months. Every time your sales grow there will be a short term dip in cash that you need to fund.

It is therefore important that you continue to forecast your profits and cash and keep a close eye on it.

Forecast your finance requirement

As a result of this working capital cycle and also the need to invest in machinery, premises and so on, it is highly likely that as your business grows you will need to find additional cash.

When setting up your business most of the financial investment probably came directly from you or your immediate family. Although, of course, you and they would be hoping that the business would be a success – you were probably more focused on the success of the underlying business than repaying these amounts.

However as you now think about raising additional finance, you will need to cast the net wider for sources of finance. You will therefore need to justify more precisely how anyone lending you money will get their money back. You therefore really need to return to your cash flow forecast and extend it to see whether and when you will be in a position to make payments to the lender. You must remember to include both an interest and loan (or capital) element. There is a simple spreadsheet attached which enables you to calculate what level of annual payment would be required to pay both the interest and loan repayment element of a loan. You can input the loan amount, interest rate and number of years in the yellow cells.

Company name: ABC Trading							
Interest calculation							
			Year 1	Year 2	Year 3	Year 4	Year 5
Initial loan	10,000	Brought f/wd	10,000	7,680	5,244	2,686	
Interest rate	5%	Int charge	500	384	262	134	
Num Years	4	Subtotal	10,500	8,064	5,506	2,820	
		Repayment	(2,820)	(2,820)	(2,820)	(2,820)	
		Carried forward	7,680	5,244	2,686	0	0

Sources of finance

There are a number of sources:

Own reserves, friends and family

Many businesses are set up using finance from the founder(s) such as using savings, a redundancy payment or re-mortgaging their house. Unfortunately these options can only be used once – so it is unlikely that you will be able to use the same source if you need to raise more money. If you are able to borrow further amounts from such sources you should use your extended cash flow to demonstrate to lenders how and when you will be able to repay them. In addition, as this further finance is likely to be less ad-hoc than the initial amounts you should draw up and sign an agreement between the company and the lender setting the amount and repayment terms.

Debt

In the same way that you take out a loan from the bank to buy a house or car, so banks will lend to companies. As we noted in the first module, as a new business you do not have a strong bargaining position. Banks would prefer to lend to stable, highly profitable businesses with long track records, significant assets that they can use as security and also a wide range of activities, which reduce the risk of one particular product or market. As you probably have none of these things you are perceived as risky and you may struggle to persuade a bank to lend to you at all, or they will charge a high rate of interest. Being a Limited Company gives you a certain level of credibility and 'status' and will help this process.

To increase your chance of getting a loan you should put together a "business plan" document. Simply put – you should ask yourself what questions a potential bank manager would ask before lending to you – the business plan should answer them. So it should describe you, your product, the market you operate in, what marks out your business as different from the competition, what results you've had to date (i.e. your accounts since your started), what security the bank would have (see below) and, perhaps most importantly, how the bank will get its money back – this will require you to include your cash flow forecast with details of the assumptions you are making.

The benefits of debt finance include:

- Certainty for both sides. The terms of the loan will set out the amount, repayment schedule, interest rate, etc. so you know clearly how much cash you need to generate to make the repayments
- Interest is tax deductible, i.e. You can reduce the profits that the business makes by the cost of interest and pay tax on the amount after this deduction. This reduces the net cost to you as a business, however you do of course need to be paying tax on your profits to benefit from this reduction.

The disadvantages of a bank loan include:

- Lack of flexibility, if your business has a difficult year then it still has to pay the interest and, depending on the schedule of payments, any elements of the loan capital that fall due – if you do not do so then the bank could apply to have your company wound up.
- Security – the bank will be much happier to lend to you if they can secure the loan on an asset such as property. Much like a mortgage on a house this means that if you fail to keep up the repayments the bank has the right to take the asset and sell it to recover its money. This security is why mortgage interest rates are relatively low – because there is little risk for the bank. However, clearly the bank now has some say over a key item of your business which you could therefore lose. You can only use an asset once to secure a loan.
- Bank covenants – these are the terms that a bank will include in the agreement with you over your loan. There may well be restrictions (such as not spending more than a certain amount on a new asset without getting approval from the bank) or obligations such as sending the bank copies of your monthly or quarterly accounts.

Equity

Equity is the general term for the interest that the owners of a business have via their shareholding. If you have set your company up as a Limited Company, then you will own shares in it. It is possible to issue more shares, these new shareholders are then part owners of the company along with you.

The benefits of equity funding include:

- Flexibility – these new owners will get a return either through dividends (when the company pays a proportion of its profit directly to all shareholders) or through capital growth where they see the value of their shares increase. However there is no requirement for a company to pay a dividend in tough years, or in any year – Microsoft did not pay a dividend until the company was 28 years old!
- With a larger amount of equity in your business you are perceived as less risky (the ratio of debt to equity is known as financial gearing, or just gearing). This may make it easier to trade with certain customers or suppliers and may make it easier to raise finance by debt at a later date.

The disadvantages of equity include:

- Control – your new shareholders are now part owners of the business and therefore have a say in how it is run. The extent of this depends on the proportion of the business that they own and how you have set up voting rights.
- You need to keep these new shareholders informed about the progress of the business, for example all shareholders are entitled to a copy of your annual accounts.
- These new shares are permanent (unlike debt which is eventually repaid), it is difficult to remove the shares from circulation.
- The shareholder can sell on these new shares, you could find that a proportion of your business ends up owned by someone with a very different attitude to your company and its products than you.

There are a number of other methods of raising finance, which will be considered briefly:

Venture capital

A venture capital firm will invest often large sums of money in rapidly growing businesses. In exchange for taking a substantial risk they aim to make a very high profit in a short (say less than 5 year) period and then exit the business. The benefits are the availability of substantial amounts of finance despite the risk involved and the expertise and experience that they bring. However the VC firms will almost certainly want a substantial proportion of your equity so they are effectively in control of your business. They will then look to sell their shareholding and you will have little say in the ownership of those shares.

Grants

As we have noted, setting up a new business is difficult and risky and banks may be reluctant to lend to them. Governments often provide grants to help new businesses get off the ground. The availability of grants is enormously dependent on your precise circumstances such as your location, the product/service you are selling, the number of people you employ and so on. There may be grants or other finance such as soft loans (loans with low interest rates or deferred repayment dates) available from local, regional and national governments or even the EU.

For more information on grants available from Welsh Government, visit www.gov.wales/funding/grants/?lang=en

Crowdfunding

This is a relatively recent innovation. It uses the internet to raise finance from a large number of investors (either as debt, equity or sometimes simply donations). Founded in Scotland in 2007, BrewDog first raised money via crowdfunding in 2010. Since then, the company has had two more 'Equity for Punks' fundraisings, the last raising £4.25 million in December 2013. Today the firm has 14,500 Equity Punk investors. Crowdfunding issues often entice investors with shareholder perks, and BrewDog's Equity for Punks is no exception. By buying its shares, small shareholders get 5% or 10% discounts in the company's chain of bars and 10% to 20% off when buying its ales online. They also get £10 of 'Beer Bucks' and a free birthday beer each year.

This may prove a useful source of finance if you have an eye-catching or unusual proposition but are struggling to raise finance through normal means.

Other

There are a number of other methods of getting cash into your business which do not involve issuing new shares or taking on debt:

Managing working capital

We have already identified that one of the reasons why you may need extra finance is the working capital cycle that you have to fund as your business grows. It is therefore clear that if you are able to reduce this cycle then you will need less financing.

If you are able to persuade customers to pay earlier or for you to pay your suppliers later then the working capital cycle will shrink – releasing cash back into your business. Simply dealing with receivables in a more disciplined way may have a significant impact; for instance you could set up a process where you telephone every customer a few days before their payment is due to remind them to pay. You must however balance this with any negative impacts, good credit terms will

encourage customers to buy from you and paying your suppliers promptly may ensure quality and certainty of supply.

Leasing

If you need finance to purchase a new asset such as a machine, photocopier or van it may be possible to lease it rather than purchase it outright. This then obviously means you do not have to find the finance up front. There may be other benefits such as maintenance, which is included in the lease contract. The tax treatment of leases is different to that of owned assets, so there may be benefits either way. Obviously if you lease an item you don't own it and therefore the lease company may have a say in how it is used and maintained (for instance painting your logo on the side of a leased van may have to be agreed with them).

Debt factoring

It is possible to sell your outstanding customer invoices (your receivables) to a debt factoring company, which obviously means you do not have to finance the wait until the customer pays. The debt factor will give you a proportion of the face value of each invoice (e.g. 90p for every £1 due). There are a number of variations:

- The arrangement can either be on a non-recourse basis (if the customer does not eventually pay the invoice there is no come back to you, the debt factor suffers the loss) or a recourse basis (if the customer doesn't pay the factor can claim some or all of the amount from you).
- The mechanics of the collection process (chasing the customer and so on) can be performed by the debt factoring company or remain with you.
- Invoice Discounting is similar to factoring but is akin to a loan secured on your receivables, it relates to your overall receivables balance, you retain the collection process and in general the risk of non-payment.

The advantages of debt factoring are principally the up-front cash that you receive and the ability to transfer the risk of non-payment. You may also save the time and effort spent on collection if the factoring company takes over this stage. In addition it is a flexible form of finance, if your sales grow the finance you receive through a factoring arrangement also grows.

The disadvantages are that it can be an expensive form of borrowing in comparison to debt (especially if on a non-recourse basis) and the damage it can do to your reputation if you relinquish control of collection – you could find an aggressive factoring company chasing payment from your best customer!

Management & control

As your business grows it is inevitable that it will at times take all your waking hours to cope with the day-to-day activities and problems. However it is important that you start to actually manage your business rather than simply being swept along by the exhilaration and stress of activity. Aspects that you need to consider include:

Structure

In order to cope with increased levels of activity you will need to take on staff. It is important that these staff have clear roles within a clear business structure. You may need to create specific functions within your business such as finance or production so that staff can concentrate on just one area of

activity, this increases the efficient use of those staff. You may also need to create a seniority structure (bosses and subordinates) to monitor and control your staff.

If you have become a Limited Company then you will need to specify a small number of people as directors who meet formally as a Board of Directors. These will need to have a range of relevant skills to support the business's growth. Directors have specific legal responsibilities that are described at the link below.

www.gov.uk/running-a-limited-company/directors-responsibilities

Processes

In the early days of a business, when you were the only employee, there was no need to define and document how the business operated. However as it grows there will be an increasing distance between you and some of your staff and there will be a greater and more complex range of activities. Therefore if you want someone to do something in a particular way you need to document that method and communicate it to him or her.

Management accounts

Budget

At the very beginning of the first module we noted that accounts enable you to track the progress of your business. You can then compare the actual results to your forecast and take corrective action if needed. As businesses grow they formalize this process. Businesses generally produce a one-year forecast called a budget. They will then produce a full set of accounts each month covering the trading performance of the business that month and compare them to the budget.

Reviewing performance

It is important that you get into the habit of going through this process properly and regularly – most businesses produce and review management accounts on a monthly basis. If the business is busy it is easy to defer these reviews. However if you diarize a formal monthly meeting it gives you the opportunity to stand back and check that you really understand what is happening in your business, there may be overall trends that you haven't spotted. Your review enables you to spot issues early and take corrective action.

Although these modules are intended to be an introduction to finance and financial concepts and not a lesson in how to produce a set of accounts, it is worth describing a number of the techniques and ratios that accountants use to understand the story of the accounts. These will be useful in your monthly review if you compare the ratios of your budget figures to the actual amounts each month.

Profit – it is obvious, but clearly your business needs to make a profit to survive – the profit line at the bottom of your profit and loss account is the most important line. You need to understand why and how your business is making a profit or loss if you are to make decisions that improve matters.

Gross profit margin (GPM = contribution/revenue expressed as a %). In externally published (statutory) accounts contribution is known as Gross Profit. This ratio gives you profitability of each product you sell. If your volume rises the GPM should not change as both revenue and variable costs will rise by the same proportion. To increase GPM you need to either increase price per item, or reduce the cost per unit in the cost card.

You may hear of **mark-up**, this is similar concept to GPM and is calculated as (sales – variable costs)/variable costs and again is expressed as a %. It measures the extra (mark up) you add onto your

variable costs to get to your selling price. It is often used when deciding what price to sell a product for. The example below demonstrates the calculations:

	£
Sales	50
Variable costs	-30
Contribution	20

gross profit margin $\frac{20}{50}$ = 40%

mark up = $\frac{50 - 30}{30}$ = 67%

Net profit margin (Net profit/revenue expressed as a %). Net profit is the profit after both variable and fixed costs. Net profit margin therefore indicates the profitability per item if you are including all costs. A low net margin generally indicates that you have a problem with high fixed costs.

Operational gearing (= fixed costs/variable costs). You should aim for this ratio to be low as this will mean that as your volumes rise there is a large increase in net profit. If your operational gearing is high then your business is very susceptible to a fall in volumes due to the high fixed cost base.

	£
Sales	50
Variable costs	(30)
Contribution	20
Fixed costs	(10)
Net profit	10

Operational gearing = $\frac{10}{30}$ = 33%