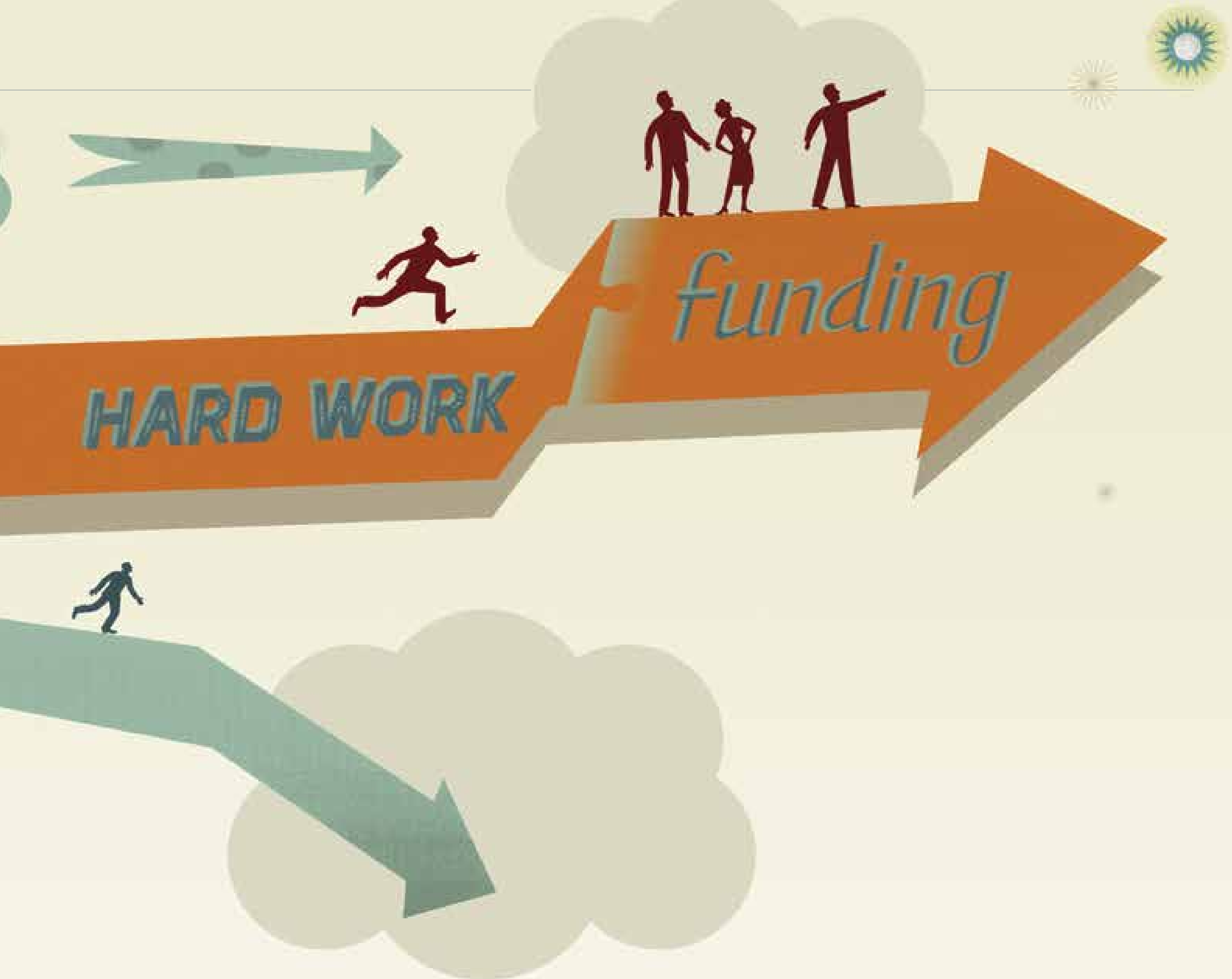
Outside the box

With bank finance still hard to come by, many entrepreneurs are thinking differently about how to raise the capital they need to grow. But what's right for you will depend on the business itself, future plans and the extent to which you're willing to sacrifice equity and control. **Tim Smedley** outlines the main options

Illustration: Getty images



Despite constant pressure from the Chancellor, George Osborne, high street banks remain stubbornly reluctant to lend to small businesses. For the first time, the rejection rate for small and medium-sized firms now stands at around 50 per cent, according to research by the Treasury and the Department for Business, Innovation and Skills (BIS).

However, there are two areas of small business finance that actually grew between 2012 and 2014, by 401 per cent and 250 per cent respectively: equity crowdfunding and peer-to-peer (P2P) lending. Not only are these sectors set to continue to grow at astonishing rates, but they form only a small part of the alternative finance options available.

According to research by Nesta and the University of Cambridge, the UK alternative finance market reached an estimated £1.74 billion in 2014, providing capital to 7,180 small firms last year alone.

The best-suited form of alternative finance depends on the stage a business is at. The FSB uses the phrase 'escalator finance', says Mike Cherry, Director of Policy. "For whatever size of business, starting from the self-employed all the way to 250 employees, there are different types of finance that are more appropriate," he says.

However, an FSB-hosted round table – including representatives from the Treasury, BIS, number 10, trade bodies and alternative finance lenders – found that a key barrier is lack of information and awareness of options. Nesta's research shows 56 per cent of small firms are unaware of any type of alternative financing activities or platforms, and under 10 per cent have approached an alternative platform to seek finance.

Liam Collins, researcher at Nesta and co-author of four Nesta reports on both P2P lending and crowdfunding, equates the situation to "a lot of people standing around the pool, but not jumping in". "Small businesses are hesitant of trying these models because they are concerned about risk," he says.

Government opens finance portal

Following FSB lobbying, the Small Business Act 2015 includes a referrals mechanism for businesses that have been rejected for finance by mainstream lenders such as banks.

From early 2016, any business denied a loan will, with permission, be referred to a portal where they can instead be offered a loan by an alternative lender, such as a community development financial institution or a crowdfunder.

The move could lead to an increase in funding to small firms of up to £2 billion, according to the Alternative Business Funding Portal, and "a lot of opportunity for FSB members", says Mike Cherry, FSB Policy Director.

The scheme is administered by the British Business Bank, which supplies funding and guarantees to providers of finance for small firms.

While some forms of alternative finance remain unregulated, others – such as P2P loans – are regulated by the Financial Conduct Authority (FCA) and even included in ISA wrappers. One small business owner with experience of crowdfunding and P2P debt, Tom Ball, CEO of NearDesk (see case study, p32), argues that the risk is "for the investors and the platforms, not the entrepreneurs", but adds that, "if I were to spend the money on holidays and handbags, then I can be sued for every penny".

Alternative finance is not just for businesses turned down by banks. Small firms often choose alternative options ahead of bank loans to access "a better rate and a more flexible, quicker process", says Collins. So what are the alternative finance options, and which could work for your business?

Angel investors

The *Dragon's Den* of small business finance. Business angels are typically high-net worth individuals who make equity investments in businesses with growth potential. According to the Institute of Chartered Accountants in England and Wales (ICAEW), "some invest on their own, others through an angel syndicate or club".

Angel investing has a long history, but has recently benefited from the rise of online platforms. Around one-third of investors on crowdfunding sites are traditional business angels, says Collins, "using these sites to create more diverse portfolios, or using the crowd as a co-investor".

Pros: will have experience in growth businesses and/or your specific market, and could act as a mentor. Angels often make investment decisions quickly without bureaucratic hurdles.

Cons: tracking down the right angel can take time. They may demand more equity than you would ideally want to give, and may seek influence over strategic direction.

Further info: ukbusinessangelsassociation.org.uk

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Alternative finance in numbers

- **£1.74 billion** The value of the alternative finance market in the UK in 2014
- **£199,095** The average amount of money raised via crowdfunding
- **£23.6 million** The amount that community development financial institutions lent in the fourth quarter of 2014
- **£73,222** The average amount borrowed through P2P lending, from 796 investors

Crowdfunded equity

Like angel investing, but made up of many small stakes. Through sites such as Crowdcube and Seedrs, businesses can present their business plan, the amount of equity they are willing to offer and the total amount of investment required. This amount is then met cumulatively by many investors until the target is met. If it is not achieved, the bid has failed and the money is returned.

According to Nesta, the average amount raised is £199,095, with two-thirds of investors investing more than £1,000; 54 per cent of businesses seek expansion capital while 46 per cent seek seed capital.

Pros: as with angels, this approach can bring valuable knowledge and mentoring. Can be relatively quick and the money can be instantly accessible.

Cons: building the business case can be complicated, and you will need to put in legwork meeting larger investors face-to-face. The owner's share in the business will be diluted, and crowd-owners may want to influence strategic decision.

Further info: FSB guide to crowdfunding: www.fsb.org.uk/documents

P2P debt finance

Allows businesses to request loans at competitive rates that are met by many individual lenders. Once the rate of interest and security pledged are agreed by the platform – such as Funding Circle, RateSetter and Allianz Capital – the opportunity is presented to 'the crowd'.

The average amount borrowed is £73,222, according to Nesta, made up of an average 796 individual lenders. George Osborne has announced that P2P lending will soon be included in ISA

Mix and match

Veeno was founded in 2013 by two Italian graduates who wanted to bring an authentic taste of Italy to the north of England.

Veeno 'wine cafés' – in Manchester, Leeds and York – offer customers food and wine sourced directly from the family vineyard in Sicily. The goal is for 10 stores by end of 2015, and 80 UK-wide by 2018.

"We were attracted to equity investment because we wanted to grow fast," says co-founder and director Andrea Zecchino (pictured, left, with business partner Nino Caruso). "That's something you cannot do with traditional banks or friends-and-family investments."

Using Crowdcube, the company sought £200,000 offering 20 per cent equity. While this process was ultimately unsuccessful, it provided the profile needed to get the attention of angel investors, whom Zecchino met separately. Ultimately, this latter approach raised close to the original target, through 10 separate investors.

"Crowdfunding was good marketing and publicity," says Zecchino. "It was sending the message: we are growing, we are doing well, and we are looking to open new outlets." Informal advice from investors is a real asset, he says, "but our decision-making is still fully autonomous".

Veeno is now seeking a P2P loan of £150,000 on fundingtree.co.uk, at a rate of 14.89 per cent, payable over 60 months, to support its next stage of growth. "It is expensive, but it is still the easiest way to raise a considerable amount of debt at this stage," he says.

Zecchino, who is an FSB member, is happy to be contacted to discuss the process with other members: see www.theveenocompany.com/contact/

wrappers – an move expected to create a surge in demand. Collins believes that people are "falling over themselves to put their money into SME debts".
Pros: terms can be tailored and repayments are straightforward. Could cost less in interest than an overdraft, and can be arranged more quickly than a bank loan.
Cons: being locked into a rigid repayment schedule can prove problematic if the firm's cash flow is seasonal or erratic.
Further info: www.crowdingin.com

Reward/donation crowdfunding

Popularised by sites such as Kickstarter, this approach involves people giving money simply because they want to see a project realised, such as a film, music album or gadget. While 'donation' crowdfunding is free money, 'reward' promises the investor a gift once the organisation is up and running, such as a visit to the relevant film set, signed album or first edition of a must-have gadget.
Pros: allows you to retain 100 per cent of the business.
Cons: only works for businesses with the requisite 'cool' or 'social value'. Requires a lot of marketing effort, and delivering rewards could prove more costly than other forms of finance.
Further info: FSB guide to crowdfunding: www.fsb.org.uk/documents

Community development financial institutions and credit unions

Community development financial institutions (CDFIs) make social and financial investments in local communities. As banks become ever more risk-averse, there is a widening gap of 'underserved markets' filled by around 60 CDFIs in the UK. In the fourth quarter of 2014, they lent £23.6 million to UK businesses.

Credit unions play a similar role, and are owned and controlled by local members. They make investment decisions in the best interests of the local community rather than for external shareholders. Around 362 credit unions operate across England, Scotland and Wales.

The FSB is "keen to see CDFIs and credit unions grow – they are important at a local and regional level", says Cherry.

> "Small businesses are hesitant of trying these models because they are concerned about risk"

Pros: offer finance to businesses that have been refused by other sources, especially those with a social impact. Loans typically offered at low interest.
Cons: can demand a high level of relationship management, which some businesses may find restrictive.
Further info: www.cdfa.org.uk and www.abcul.org/

Venture capital and private equity

The top of the 'finance escalator'. Venture capitalists (VCs) and private equity (PE) firms invest in firms with the potential for high returns, as part of a wider portfolio. They seek track records, and footholds in under-exploited markets. VCs tend to be hands-off and longer-term; PE is more hands-on and shorter-term, typically looking to sell on investments in five to seven years.
Pros: where the big money is; provides access to top business execs.
Cons: can be a time-consuming process. Legal fees will be incurred. Can be ruthless in pursuit of a business plan, whether it aligns with yours or not.
Further info: bvca.co.uk and venturecentral.co.uk

Devolved UK options

Scotland
The Scottish Loan Fund (SLF) provides loans ranging from £250,000 to £5 million to Scottish small businesses.
www.scottish-enterprise.com/

Wales
Finance Wales invests amounts ranging from £1,000 to £2 million in small firms based in Wales through Welsh Government-bacekd investment funds, including the £20 million Wales Capital Growth Fund.
www.financewales.co.uk/

Northern Ireland
InvestNI manages funds totalling £170 million to help small firms with growth potential, including the NI Small Business Loan Fund. The Halo business angel network has also delivered more than £9 million of investment from angels to Northern Irish companies.
www.nisp.co.uk/halo
www.investni.com

Case study: crowdfunding desks on demand

NearDesk connects spare desks in offices with the home and remote workers who need them. Described as 'the Oyster Card for desks', the scheme allows users to swipe in and rent desks by the hour.

The firm has raised almost all its finance through the equity-based crowdfunding platform Seedrs. The first round in 2013 raised £134,500, with just under 200 investors sharing 7.7 per cent equity. In July 2014, NearDesk's second round raised £1 million from 364 investors – including large investors Juno Capital and Renaissance Capital Partners – for 22.56 per cent equity.

"It's the best of both worlds," says NearDesk Chief Executive Officer Tom Ball (pictured). "There is a misunderstanding that you either do angel or you do crowd. In fact almost all crowdfunds are blended, with some people putting in bigger chunks having met you and gone through a longer process, and people putting in smaller chunks based on your pitch alone."

You need to "bring at least 20 per cent of those investors to the table by talking to them the old-fashioned way", says Ball. "It's not yet like eBay."

While more than 500 individuals may now own equity in the firm, their paperwork is managed entirely by Seedrs. Ball maintains communication on a voluntary basis: "I like the fact that I've got 500 humans who believe in me and want the business to succeed," he says.