ORGANISATION

Capital raising

Capital is either raised from debt or equity. There are hybrid instruments and government grants that muddy the waters because they contain a mixture of each source of funding. By and large, capital is readily identified as debt or equity.

The first sources of capital to consider are *internal* ones: for example, loans or equity contributions from family. Then, *external* sources of capital: typically, debt (usually borrowed money) or equity sources (investors contributing in exchange for a share of the enterprise). Finally, alternative sources include franchising, licensing, government grants and other means including financing and crowd-sourced funding, as well as the hybrids such as some kinds of preference shares.

What are internal sources of capital?

Internal sources of capital are those generated from either the business itself or the owner-manager. Where an owner-investor is able to inject further capital into the business, usually they do so from personal sources. This often occurs in smaller businesses, including family businesses. Doing so, including where additional capital is contributed by family and/or close associates, may place undue pressure on finances should the investment fail. This is because a high level of investment concentration is made on a single investment and, in the absence of diversification of capital resources, will inevitably cause significant stress in the event that the investment fails.

The best practice from a governance standpoint is to first ensure that the business is complying with its accounting and taxation obligations. When that is determined it is a relatively straightforward exercise to generate cash flow statements and to examine them for increased efficiency. This will often be accompanied by a review of existing external (usually bank financing) arrangements. A useful way therefore of providing internal capital is often to reorganise it and/or be more efficient with it, including for example: improvements to accounts payable; factoring accounts receivable; leasing items that were being considered for purchase; or entering into a sale and lease back of existing business capital.

The biggest advantage with internal funding is the alignment of the current owners to the investment objectives is least impacted. Generally, it has a short time frame and the fewest legal restraints.

What are the most common debt sources?

Debt capital is capital that is borrowed typically from a bank or finance company. The debt must be repaid, and, with interest as set out in the loan agreement. The debt may be secured against an asset of the business and/or assets belonging to shareholders/investors. The nature of the security given will affect the interest rate (cost) of the borrowed money. The advantage of debt is that it avoids dilution of equity interests and is usually inexpensive (relative to the cost of equity) because the interest cost of the debt is tax deductible.

Usually, borrowers approach their bank when seeking debt capital and financial institutions have fairly sophisticated means of determining the credit worthiness of a prospective borrower: information that, while not always satisfying, is useful.

Questions relevant in the borrowing process include:

- Is it possible to borrow funds and if so on what terms and conditions?
- If an existing customer, is an increase of present credit lines possible and will the terms and conditions change?
- Will the bank/lender accept company assets as collateral for a term loan?
- Are current assets (such as accounts receivables) able to be factored?
- Are current assets (such as inventory) able to be used as collateral for a loan?
- Will the bank/lender give better terms if 'senior debt' is offered by the borrower? (for example, a first charge mortgage over the assets of the business)
- Will the bank/lender require a director's guarantee over the borrower's personal debts in order to satisfy a debt that the company business does not or cannot honour?

There are a variety of security measures that a bank/lender will require (and/or that a borrower will offer) in order to facilitate a loan. A charge against a particular asset (previously referred to as a fixed charge) such as a mortgage over land and buildings is common and may be over the business assets and/or the assets of investors/shareholders. Such a charge precludes the sale of the asset without first releasing the lender's security. More usefully, a charge is often taken over the circulating capital of the business (typically its current assets including cash at bank and inventory) by way of a circulatory charge (previously referred to as a floating charge) and this charge has the characteristic of allowing the business to trade and use the subject matter of the charge, provided the terms and conditions of the loan are followed.

Lenders will require that charges taken over property of the company are registered in accordance with the *Personal Property Securities Act 2009* (Cth) to protect their interests.

When assessing the benefits of each debt product, attention needs to be given to the:

- cost of debt versus the cost of equity;
- impact of gearing (borrowing money) on the company's financial statements (including cash flow);
- potential for movements in interest rates and exchange rates; and
- likely changes in government monetary policies and any capital transfer restrictions in other countries where the company transacts.

Business loans are available as:

- short-term liquidity to fund seasonal needs ('working capital'); usually a bank overdraft or a cash advance;
- medium-term loans that typically include:
  - loans from 1 to 7 years with the bank requiring security and often quarterly financials;
  - leasing for such things as cars or plants with the purchases being made by a finance company and then leased back; or
  - commercial hire purchase; and
- long-term loans that are used to fund the purchase of large assets, typically requiring a detailed application process together with a business plan.

What are the most common equity sources?

Venture capital funds

A venture capital fund is an investment fund that manages money from investors looking for private equity stakes in start-ups and SMEs. They tend to invest sums of $1-5 million.

General observations about venture capital funds include:

- they are professional investors and will be tough on terms;
- they tend to be limited to minority positions but can take an active role through the board;
- their investment horizon tends to be medium to long-term (usually five to seven years); and
- they provide excellent support and understand operational issues.

Private equity funds

Some private equity funds focus on niche opportunities (for example, 'turn arounds') whilst others specialise in specific industries. They tend to invest sums of $5-50 million.

General observations about private equity funds include:

- they are tough investors but can provide excellent support;
- they target more mature companies, generally with profits and positive cash flows;
- they frequently want a key manager in the team: often the finance manager; and
- their investment horizon is shorter then venture capital and usually medium to longer-term (usually four to five years).

Strategic corporate investors

A company may sometimes decide to 'strategically' invest in another company. These companies tend to be complimentary in nature rather than competitive. They tend to invest upstream or downstream in the same industry.

This investor class will differ significantly from venture capital or private equity in the following ways:

- corporate investors will be more active operationally;
- they invest with their own motive (for example, value add-on to their core business);
- they tend to be more generous in valuation and require less restrictive terms; and
- their typical investment horizon is four to five years but can change strategic direction.

Public markets – IPOs

An initial public offering (IPO) on a market can be time-consuming and expensive. However, when market conditions are suitable, an IPO can be an excellent source of capital for a mature business. IPOs tend to be used to raise amounts greater than $10 million to justify the transaction expenses.

There are a number of issues to consider:

- Advantages:
  - Public market credibility for company;
  - Access to raising additional equity and debt;
  - Marketability for company shares.
- Disadvantages:
  - Expensive to launch and maintain;
  - Requires the company to comply with regulatory obligations, including continuous disclosure and reporting requirements;
  - Limits to management ability to act (for example, related party transactions);
  - Existing shareholders, directors and senior executives may be subject to lock-up arrangements which prevent them from selling shares for up to two years from listing date.

Crowd-sourced equity funding

Recent amendments to the *Corporations Act 2001* now provide companies with a regulated framework to participate in crowd-sourced equity funding (CSF). CSF allows companies to raise funds from more investors than conventional equity funding who each invest relatively small amounts of capital, in exchange for company shares.

In order to be eligible for CSF, the company:

- cannot be a listed public company;
- cs one that holds less than AU$25 million in assets and revenue;
- must prepare compliant CSF offer documents;
- Must use a CSF service platform provided by an Australian-financial-services licensed intermediary; and
- is limited to raising no more than AU$5 million in any 12-month period.

Are disclosure documents required?

The *Corporations Act 2001* generally requires that a company provide prospective investors with a disclosure document.

However, there are a number of exceptions to this rule, including:

- small-scale offerings: that is, less than 20 offers in a 12-month period, raising less than $2 million;
- offers to professional, sophisticated or experienced investors;
- crowd-sourced equity funding offers.

What are some alternative sources of capital?

Licensing

A business may choose to license technology or business processes to an out-of-market company. This can provide additional income but will usually involve support and warranties to be extended for a period of time.

Franchising

Franchising can be an option for raising capital to expand. However, the *Corporations Act 2001* contains many legal requirements for franchisees. Care must be taken to seek early legal advice and to move cautiously with representations to potential franchisees. The following need to be considered:

- Advantages:
  - Common branding and marketing across large territories
  - Quality control
  - Common pricing, presentation of premises and packaging materials
- Disadvantages:
  - Legal compliance issues (for example, franchisees)
  - Establishment expenses and lengthy marketing/recruitment period

Government grants and loans

The state and federal governments run programs to encourage and support companies. A good starting point for Federal Government assistance is the Australian Government business web site at **business.gov.au**

Rewards-based crowdfunding

Crowdfunding may be utilised by a company by exchanging an incentive other than company shares with the investor. Currently rewards-based crowd funding is not regulated by legislation and is provided by intermediary platforms such as KickStarter, Pozible and OzCrowd. These web-based platforms allow the company to choose how to reward investors, such as providing products, discounted services, or other non-monetary measure of value.

As rewards-based crowdfunding is not regulated, and there is no standardised system connecting the company and the investor, the risk of illiquidity and uncertainty is greater.

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For more information **t:** 1300 739 119 **w:** companydirectors.com.au

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