Spinout to Exit:
Getting the funds

Maximise your potential

Technology businesses (particularly those that are spin-outs) will typically require third party investment and potentially several rounds of that prior to becoming cash generative.

A key issue for any such businesses therefore, is how to meet an identified funding requirement so that the business can reach the next stage of its development.

The identification of a funding requirement, ideally over a year before it is needed, is one of the key outputs of a business plan. Once a company is operational it's important to regularly update financial forecasts to allow the management team time to raise funds before a lack of funding becomes critical to the business.

Once a funding requirement has been identified there are several different types of funding, the suitability of which will depend upon where in its lifecycle the business is. It is important in deciding to approach any individual or entity for investment to have carried out your research properly so that you ensure you only approach those whose investment criteria you fit.

Grants

Grant funding is typically money provided by an agency with special interest in the technology area a business is working in. That interest might be as part of a wider state-sponsored strategy to promote a specific technology or to develop a solution to a particular technological problem or it might be an interest of a medical charity such as Cancer Research.

At the moment in the UK usual sources of such funds are:

- Innovate UK (the Government agency for innovation)
- Other Government departments
- Medical charities

Funding from Innovate UK is categorised as follows:

- Funding for specific industry sectors (Emerging and enabling technologies; Health and Life Sciences, Infrastructure Systems; Manufacturing and Materials.)
- Funding open to any innovative business
- Open programme
- Knowledge Transfer Partnerships

Grants are applied for through funding competitions. In applying for a grant it is critical to ensure that your company fits the grant criteria. Some grants are made based on 'matched' funding, so in making an application it will be important to identify where that funding will come from.

Equity

Equity essentially comprises funds invested in a company in return for shares in that business.

Companies at every stage of their development may raise funds from the issue of equity shares, but the nature of the investor is likely to change as the company enters different stages of its development.

Business angels

These are high net worth individuals looking for investment opportunities, who will also often act as a source of expertise for the management team. Many of them will have significant experience in the technology area - perhaps having successfully exited from another business.

The typical investment size for an individual business angel is £25,000 to £250,000 but some can go as high as £2m for the right opportunity. As the average individual investment is fairly small, angels often like to invest in syndicates, spreading the risk across all investors with one angel taking a lead role. They will usually look to exit the company within 3-5 years.

The advantage of using business angels is that they can offer more than money by providing expertise and experience.

However, the disadvantages are that they can be difficult to find and managing the various interests of a large group of angels can be challenging. It is generally best to make approaches to angels through an intermediary or network rather than targeting them directly.

Venture Capital Trust

These are funds that enable their investors to participate in investing in a portfolio of smaller VCT-qualifying companies. Typical investment size would be from £200,000 upwards.

Business angels and Venture Capital Trusts will typically want to be able to access Enterprise Investment Scheme or Seed Enterprise Investment Scheme tax reliefs when they invest, so it is useful to be prepared for this and to ensure that the company and its shares will qualify. (see our factsheet on Investor Tax Reliefs).

Venture capital

These are investment funds seeking high rates of return on investments which are typically upwards of £2 million. Some funds are targeted at making investments below this value depending upon the sector and region. These funds are looking for companies with a high earning potential that are able to offer a defined exit plan and timetable, usually in the form of a sale or flotation. Increasingly, such funds will not be interested in investing unless the company is already generating revenue or close to this stage.

Venture Capitalists will want to get their money and profits out as fast as possible. It should be borne in mind that in making an investment they will typically want to have more control over the company than an angel will. This usually takes the form of a non-executive director on the board.

Only 1% of business plans received by venture capitalists are successful in securing investment.

Crowdfunding

Crowdfunding is an internet-based conduit whereby a number of (typically) individuals can invest in or loan funds to an entity. Entities that have raised funding in this way include political campaigns and not for profit campaigns as well as funding for businesses. In the UK, the Financial Conduct Authority has imposed restrictions around the level at which individual investors may advance monies.

Debt financing

Debt finance will usually only be relevant in circumstances where a company is revenue and profit generating. Overdrafts and bank loans are common sources of debt finance. Before lending, a bank will want to know that the company is a good risk. Typically, the company will need to present a credible business plan, provide evidence that the management team are competent and have a successful track record in business. Whatever the type of borrowing used the company will probably have to pay arrangement fees as well as interest. Terms and rates depend upon the bank's risk assessment of the company. Repayments can be very flexible to meet specific needs.

A bank lender will also require some form of security, either from the company, (in the form of a charge over the company's assets), or from the directors (in the form of personal guarantees), or both. A personal guarantee will require the directors to guarantee the company's ability to repay the debt by securing the loan against one of their assets, (usually their family home), unless they have other substantial assets.

Convertible loan notes

There are occasions when investors in a company choose to invest by way of a loan that has some optionality to convert to equity given particular circumstances. Some investors prefer to invest in this way rather than directly into equity. Where a fundraise is taking a while to complete sometimes the investors who are already committed will take convertible loan notes which will convert to equity once the full round is complete. The terms of convertible loan notes can be very flexible.

Business relationship funding

This is a source of funds that can be overlooked. It may be possible to introduce potential alliances to add value to both parties. It may produce an ultimate exit route in the medium to long term.

- **Joint Ventures:** Requires a legal agreement embodying the deal and another company;
- **Partnerships:** Two companies collaborate with possible funding;
- **Joint working relationships:** These are an informal partnership which may be more project specific where the parties can share resources;
- **Agencies:** These can be geographical or product specific and generally incorporate a payment for the right to the agency;
- **Alliances:** These do not require a separate company and can be embodied by a legal agreement to work together;
- **Trade or strategic investors:** Otherwise known as Corporate Partnering. This can be a good way to involve a much larger company in the business with a view to a possible trade sale to them further down the line;
- **Franchises:** This can allow the business to grow with minimal further direct investment but would be unusual in a technology based company.
- **Licensing:** This involves licensing intellectual property; a product or service to enable others to sell it or utilise it in some way. This can be a valuable source of revenue – and hence funding – for technology-based businesses in their earliest days.

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