Managing Business Activities

Theme 2 for Edexcel Business AS and A level

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informe

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Alan Hewison is an experienced enthusiast for the courses which have evolved from the Nuffield Economics and Business project. He has taught, examined and written for these courses since their inception.

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This book follows the specification sequence for theme 2 in the Edexcel AS and A level Business course from 2015. At the end of each of the five specification sections there is a question in the format to be expected in the Managing Business Activities exam paper. Three of these are data response questions and two are open-ended extended writing questions. Tackling these is intended to be part of the learning process as well as to introduce students to the types of questions they will meet.

We are very grateful to the businesses which have allowed us to use their experience to give real contexts for business ideas. In the case of small businesses, we have changed names when asked to and have simplified some situations. However, we have tried to stay real rather than rely on fictional case studies.

We are also grateful to everyone, too many people to name, whose ideas have contributed to the earlier books (and courses) on which this is built.

The mistakes herein are ours.

Chapter 1

Raising finance: internal

Tangle Teezers

Shaun Pulfrey describes his former self as "the go-to guy in hairdressing salons for getting tangles out of hair." His ideas for a better brush to tackle tangles became the foundation for Tangle Teezers. In his view the most difficult thing about starting the business was sacrificing his normal life. He did not go out. All his energy and money was poured into making it work. It was quite solitary too, spending hours in the British Library reading up on injection plastic moulding and patents. "From a guy that loved to socialise, I went to a person who didn't go on holidays, buy clothes or see friends properly for about three years."

Financing the business was another problem. He made a pitch on Dragons' Den but was turned down. Despite this, viewers who saw the show sent in about 1,500 orders. He re-mortgaged his flat in London to keep going for 6 months. The business took off, with rapid expansion and a Queen's Award for Enterprise in Innovation. The brushes are now widely available and the firm's value was estimated in 2015 at £65m.

Questions

1. How did Shaun's appearance on Dragons' Den affect his business?
2. What could Shaun have done if the business failed?

The financial crisis that began in 2008 made finance much harder to obtain as banks and other organisations restricted their lending. Since then the situation has improved a little, but the CBI (Confederation of British Industry) reports that although traditional forms of finance, such as overdrafts and loans, are still the main source of finance (UK banks account for nearly 80% of all credit) businesses are increasingly looking to alternative finance options. Some of these such as crowdfunding and peer-to-peer funding are examined in the next section.

Businesses now have an increasing choice of lenders, with new so-called 'challenger banks' entering the market. Two of them, Shawbrook and Aldermore, increased their loans and advances to customers by 82.8% and 52.7% respectively between 2012 and 2014. There has also been an increase in the use of equity financing (finance that is given in exchange for a share in the business) such as business angels, some types of crowdfunding and venture capital, but there is still a long way to go compared to other countries. Just 3% of SMEs (small and medium-sized businesses) use equity finance in the UK, while the EU average is 7% and in countries such as Denmark and Sweden, it accounts for 46% and 31% of SME financing respectively.

Finance is the money that businesses need to start and to operate. Businesses need finance at different times and for a number of different reasons.

Start-ups

Starting a new business involves numerous costs. Some of these will be large one-off payments for things like premises and equipment and can be extensive. In its early days the business may also need finance to pay costs such as wages and raw materials until it becomes established and generates enough income from its sales. Finding start-up funding is often a major challenge to new businesses. Underestimating how much is needed is a route to rapid disaster.

Working capital

If all goes well, a business will eventually begin to make a profit. However, profit is not the same as cash (working capital) and cash is the lifeblood of a business. Sometimes a business will have to pay bills before receiving revenue from its sales. Without sufficient cash the business will not be able to pay its bills on a day-to-day basis and may get into trouble. This means that additional finance is needed on a temporary basis to provide sufficient working capital to cope with any cash flow problems.

Activity

Imagine you are thinking of starting a business and setting up a mobile sandwich, snack and cake delivery service for office workers in a nearby business park.

List as many reasons as you can think of for this business needing finance, both now and in the future.

Where would you get it from?

Depreciation – depreciation is a term that describes the loss in value of assets (things of value). For example a new delivery van may cost £25,000 but a year later is only worth £20,000. Three years later it is only worth £10,000 and may need replacing. It has depreciated by £15,000. When the business needs to buy a new one, finance will be needed. This principle applies to many other physical assets, machinery wears out and needs replacing, buildings need repairing, and computer systems need upgrading. All of this is likely to require the use of finance.

Expansion – There may come a time when the business will want to expand. This may be in the form of physical expansion such as new buildings, extra productive capacity or extending the scope of its sales by launching into new markets with extra promotion and distribution costs. All this is likely to involve the need for extra finance to pay for it.

Finance is available from a number of sources. Each source has its advantages and disadvantages for the business and each will be appropriate in different situations. Access to a particular kind of finance may also be determined by the type and size of a business. Businesses must decide between a range of Internal and External sources of finance. Businesses, particularly larger ones, may use a number of sources both internal and external.

Internal finance

These terms mean what they say… if the finance comes from *inside* the business it is **Internal**. If the finance comes from *outside* the business it is **External**.

Figure 1.1: Internal sources of finance

The great advantage of internal finance is that it should cost less than external finance because interest payments will be lower or non-existent. When owners put in their own finance, they are losing only the interest that the money might have made in a savings account. (This is the opportunity cost of the funds.) Similarly, retained profits are the savings of the company. They have an opportunity cost but the interest lost will be less than the interest that would have to be paid on a loan from the bank. Selling assets that are not being utilised frees up cash for other purposes. There may be selling costs, but there will be no interest to pay.

Owner's capital: personal savings

Owner's capital refers to any monies that the owner may have access to. It is sometimes referred to as Owner's equity. This may be in the form of savings built up over time; it may come from an inheritance or from a redundancy payment. It is estimated that more than one in six new business start-ups are established following redundancy. Using your own capital has the advantage that it does not have to be repaid and carries no interest charges. It may also help in obtaining further finance once the business is established, as other lenders may be more willing to lend if the owner has a personal stake in the business.

Use of savings is best suited for sole trader and partnership start-ups, but the very real risk of the business not succeeding means that the owner's capital can be lost. Before sinking savings into a business, it is important to weigh up the risk of losing these savings realistically. Risk averse people will think carefully first, but many new entrepreneurs are unrealistically optimistic. New internet based businesses can often require less start-up finance than other types of business – with no dedicated business premises, for example. Such businesses have the advantage that less is being risked.

New partnerships often involve an entrepreneur who will take charge of business working together with a partner who takes little or no part in day to day decision making but contributes most or all of the starting capital. This requires strong trust between the partners and clear decisions on how any profits will be shared.

Retained profit

Retained profit is all the money that is left after all deductions have been taken away from total sales revenue including tax, interest and any dividends paid to shareholders. It can then potentially be re-invested into the business. It is usually regarded as one of the best forms of finance to use as it belongs to the business already and does not involve debt. There is no need to pay it back and there is no interest to pay for its use. An economist would argue that there is an opportunity cost. For the business owner(s) this could mean not taking any dividend or other form of profit, so that the maximum possible retained profit is available to finance expansion.

For many businesses the main disadvantage here is that the level of retained profits may not be large enough to meet their finance needs. Waiting for more retained profit to accumulate can mean losing potentially profitable business opportunities. It is also unsuitable for start-ups as by their very nature they will not have any retained profits.

Sale of assets

All businesses have assets (things of value e.g. buildings, land, vehicles, machinery) and these can be sold in order to raise money. In some circumstances this can be very beneficial. It may be that a business has some land or buildings that it no longer requires, perhaps because it now outsources some or all of its production. Alternatively, a business might have developed several products before deciding to focus on one profitable area. Surplus assets can be sold to raise finance that does not need to be repaid or carry interest charges.

Sometimes a business will sell assets such as vehicles or machinery and then lease or rent the assets back again, trading off the financial gain against continuous future payments. This assumes that a business has assets to sell in the first place; many businesses will be making full use of their assets and be unable to operate without them. A business 'sitting on' valuable but unused assets will appear not to be using current finance very efficiently. Once again, this method of finance is unsuitable for start-ups as they will not have any assets yet.

Chapter 2

External finance

Cheese Posties

Kickstarter is a crowdfunding platform. This means that would-be entrepreneurs can use the site to invite anyone interested in helping to finance a business venture.

Dave Rotheroe thinks there could be a market for 'Cheese Posties'. His plan is to mail out a different grilled cheese sandwich to subscribers each week. High quality ingredients, such as artisan bread and fine cheeses, will offer 'Mouth-watering melting combos'. Examples mentioned on Kickstarter include 'balsamic blueberry and cream cheese' and 'chocolate cheesecake'.

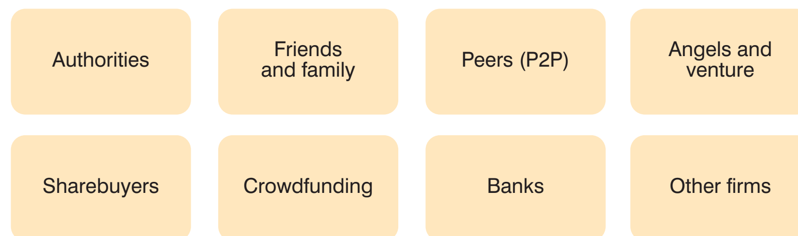
People who gave funding were promised rewards tied to the amount pledged. £5 or £10 pledges were mainly rewarded with Cheese Posties. By late June 2015, around 150 backers had promised the £2,000 Dave wanted. They were only charged when the target was reached.

Questions

1. In your opinion, are Cheese Posties a viable business?
2. Could Dave have financed Cheese Posties with his own money?
3. Apart from not using any savings he had, what other advantages does using Kickstarter offer?

External finance requires some other person(s) or organisation to give up the use of their money so that you can spend it. Most often, they will need either interest payments or part-ownership to persuade them to do this, though there are exceptions (such as Cheese Posties). There are more external sources than internal ones, and most businesses will have to rely on them at one time or another.

Figure 2.1: External sources of finance



Authorities and donors

The government and local authorities provide a wide range of financial and other support for businesses in the form of grants, subsidies and tax relief schemes (the gov.uk website currently lists 603 such schemes!). The enterprise allowance helps those who qualify with living costs when they start a business. Other organisations support things such as environmentally friendly start-ups. The Prince's Trust particularly helps young entrepreneurs.

Family and friends

Older relatives might have retirement or other savings which earn little interest, combined with a desire to support members of their family. Friends might share enthusiasm for a business idea and be willing to offer some finance if they are able to. There are advantages to finance from family or friends rather than other

sources. They are more likely to be flexible and relaxed about terms and conditions, and may offer loans without security or accept less security than banks. They may also provide interest-free or low rate finance and be happy with a longer repayment period. Parents or grandparents might even give money. One way to formalise arrangements with family and friends is to form a private limited company (see share issues below).

Banks

Banks are financial intermediaries. Their business is to hold savings for those who have them and to lend out money to borrowers. The best known are the big 4 high street banks, who offer services to both new and established businesses and usually a quick decision process. Although different high street banks offer similar services, a business customer would be well advised to shop around for the best deal. Banks will want some form of security if they are to loan money to a business.

Other banks are also available. Challenger banks are expanding rapidly. Private Banks such as Coutts offer lending services. There are specialised social finance banks and other financial bodies that can provide finance for social enterprises and co-operatives. The Islamic Bank of Britain and many other banks provide Sharia-compliant lending which is acceptable to Muslims.

Peers (P2P)

The first building societies were clubs where people jointly contributed savings and used loans for house purchase (in turn) when funds were available. Initially, members came from the same community. Nowadays, websites can bring lenders and borrowers together. They can cut out the banking intermediaries and so offer savers a better return and borrowers lower interest charges.

Zopa is currently the UK's largest peer-to-peer lending service and expects to have lent over £1bn by the end of 2015. Zopa will lend up to £25,000 to sole traders who have been operating for at least two years. It is therefore not suitable for larger businesses or start-ups.

Angels and Venture Capital

Business Angels are usually high-net worth individuals who invest in early stage or high growth businesses, either directly or through organised networks such as the Enterprise Investment Scheme or Seed Enterprise Investment Scheme. These government backed schemes are designed to help smaller early-stage businesses and/or higher-risk businesses raise finance by offering a range of tax reliefs to investors who invest in these companies.

The CBI estimates that there are approximately 18,000 business angels in the UK, investing an estimated £850m per annum. They are normally knowledgeable and experienced in business and can act as a mentor for the business, providing useful advice and guidance for a growing business. Business angels are particularly well suited to businesses looking for early funding to grow rapidly.

Business Angels are also called Venture Capitalists. Some of them use their own money but there are also Venture Capital Funds where money put into the fund (by many people) is spread across a variety of growing businesses (chosen by specialist managers) to spread risk.

Sharebuyers

Shares represent part ownership (a share) in a business. As part owners, shareholders are entitled to part of the profits and to a say in running the business. This is one way of setting up an arrangement with family and friends, using the private limited company (Ltd) system. Private Companies are generally smaller firms.

Public companies (PLCs) follow more complex rules (such as issuing a prospectus giving details on the business) and can issue (sell) shares to the public. This is rarely an option for new businesses, but it can fund expansion once a firm is established. For example, Sophos is a cyber-security business; its customers include the BBC and the NHS. It is expecting to raise £100m by going public and to be valued at about £1bn. It will use the finance to reduce its debt and consolidate its position as one of the leaders in its field.

Crowdfunding

New and small businesses conventionally raise finance from one or a few sources. Crowdfunding does the opposite and raises finance by asking large numbers of people for a small sum of money. The Statue of Liberty was financed this way long ago, but the internet, whereby millions of potential funders can be reached, has taken crowdfunding to a new level. Those seeking finance can post a profile of their business venture on numerous websites and appeal for investors. They can use other forms of social media to publicise their projects.

There are different types of crowdfunding:

Donation/Reward crowdfunding – Investors donate money because they believe in the ideas of the business. Such ventures may well be artistic or altruistic; the return for investors is a reward of some kind, a free t-shirt, free gifts, tickets to an event, Cheese Posties and so on.

Equity crowdfunding – People invest in an opportunity in exchange for a share in the business. Money is exchanged for shares, or a small stake in the business, project or venture. The process is similar to a traditional share issue.

Activity

www.buzzbnk.org   www.crowdfunder.co.uk   www.angelsden.com

Visit these websites and have a look at how they operate, note the wide range of different ventures and finance requirements. Look at how businesses can gain finance and the conditions under which it is given.

Choose two projects you would invest in and two you would not – explain your reasons.

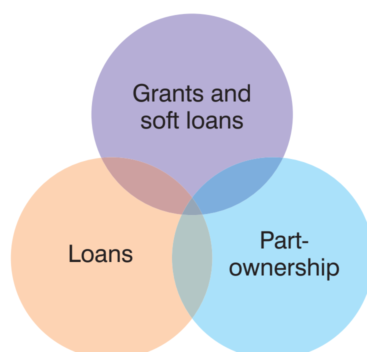
Other businesses

Businesses which see a firm as a customer (e.g. for services or raw materials) or a supplier if they use or retail the product, have an interest in the firm's success. Most often they will help in ways tied to deals between the two businesses. Occasionally a bigger established firm will take a smaller one 'under its wing' and offer support and finance either with a loan or for a share of ownership.

The most frequent way of supporting client firms is **trade credit**. Suppliers allow 30 days (sometimes more) after delivering supplies before payment is due. This allows retailers, for example, to sell some stock before they pay for it. **Factoring** means selling an invoice for goods a firm has supplied on credit before payment is due. The buyer gets a discounted price in return for holding the invoice until payment is made. **Leasing** and **hire purchase** are ways of renting assets rather than buying them. This saves the expense of paying 'up front'. The difference between the two is that hire purchase agreements end with the asset

owned by the firm using it; leased assets go back to the owner and the user often takes a new lease on fresh assets.

Figure 2.2: Methods of external finance



Grants and soft loans

> **Soft loans** are funds made available at favourable terms for the borrower, less than normal commercial interest rates.

People generally offer grants and soft loans either because they want to support the borrower (friends and family) or because they support what the business is doing. For example, government provides start-up grants and loans in areas with high unemployment such as the North East and Cumbria. To be eligible for this scheme you must be aged 18 or over and living in the area, and your business must be under 12 months old or in the planning stage. If successful a grant of up to £25,000 is possible. Other schemes aim to support exporters.

There really are a lot of schemes out there, try looking at https://www.gov.uk/browse/business/finance-support to see what is available and who is eligible.

Free (grants) or cheap money is obviously attractive and friends and family can offer good support for small firms. However, there are potential drawbacks to this sort of funding; a misunderstanding can damage relationships. There is the obvious risk that the business may fail and they lose their money. They may offer more than they can really afford to lose, or they may demand their money back when it suits them but not the business. They may also want to get more involved in the business, which the entrepreneur might not want. Government and charitable organisations often bundle useful advice with grants or soft loans. However, they are likely to want checks that the firm will do what they want done. This can involve copious form filling and continuing checks that can become a chore.

Loans

The big advantage of a loan is that the borrower keeps ownership and control of the firm and once it is repaid there is no further payment or loss of profit. The interest payable is usually fixed, so if the firm does well it will be manageable. Lenders want security that they will get their money back, preferably with interest. This can involve **collateral**, such as a claim on your house, and many lenders want to look into how safe the business is as a borrower and how much the entrepreneur has put in from their own assets. This often entails preparing a detailed **business plan** (see Chapter 4).

> Property or other assets that a borrower offers a lender to secure a loan becomes **collateral**. If the borrower stops making the promised payments, the lender can claim the collateral to recover the debt.

Peer-to-peer lending has expanded rapidly.

Loans can be expensive, though P2P loans are generally cheaper than banks. Failure to repay a loan can mean the end of a business. A lender becomes a creditor and can take action to force the closure of a firm and sale of its assets in order to get back what they can. Any collateral can also be claimed to repay the debt. Whereas banks will normally give quick decisions, P2P loan requests can sit on websites for a period of time with no certainty that enough lenders will sign up. The after-effects of the financial crisis of 2008 made obtaining credit from banks much harder, particularly for small businesses and start-ups.

Banks, the main traditional lenders, offer two types of lending. A bank loan (like many other loans) has an agreed schedule of repayments at set times. A repayment loan is most often linked to new equipment or small-scale expansion, something repayable within two or so years. An overdraft is an agreement that allows a firm to borrow what it needs up to a set limit, with interest charged on what is actually used. So, for example, a house builder using an overdraft for working capital might increase the overdraft as costs mount up through a project, but then reduce or end the overdraft when the houses are sold. One downside of an overdraft is that the agreement is subject to periodic renewal. In the last recession banks effectively forced many firms out of business by not renewing overdrafts.

Part-ownership (shares)

There are several means of funding which entail shares or similar part-ownership being exchanged for the injection of funds. The advantage these all share is that the money need never be repaid by the business. Shareholders who want money back have to find someone to sell their shares to. There isn't even any interest to be paid. An extra advantage with Business Angels/Venture Capitalists is that they tend to have experience of business strategy and can often give wise advice together with the funding.

There are two big drawbacks. The first of these is that new part-owners become entitled to share in profits and to have a say in how the business is run. The previous owner(s) retain some shares but can become a minority. With a PLC, for example, owners of 51% of share capital can instruct the directors on what to do. If a 'hostile' larger firm acquires 51% of the shares, they can force through a takeover and replace the original directors.

Shareholders' profit payments, called dividends, are in proportion to the share of the business owned. Paying dividends leaves less for the original owners, so a loan could be cheaper for a very profitable firm.

Sometimes a dividend may still be paid even if the company makes a loss, in order to keep shareholders happy and prevent them from selling shares – which would cause the value of the company to drop. Adidas ended 2014 reporting a net loss of €139 million in the final quarter but still paid a dividend.

The formalities and expense of a public share issue make this unsuitable for a small firm. Crowdfunding or venture capital might be more suitable. Crowdfunding success is even less predictable than P2P loans. Against that, even an untried new business idea can sometimes get crowdfunding.

Venture capitalists invest in early stage, high-risk businesses with the potential for high returns or potential for high-growth. They are hard-nosed and experienced at negotiating bargains which give them a big slice of future profits. Against that, their specialist skills can help a small business move up to bigger things. Quite often, these investors will want to move on after 5 years or so, selling their stake in the business back to the founder(s) or on to new investors.

Methods of finance summary

Type	Best suited to	Main Advantages	Main Disadvantages
Internal	Rich people and firms with profits from past.	No cash cost/terms. Helps security for added external finance.	Opportunity cost. Carry all the risk.
Grants and soft loans	Start-up, small and innovating firms. Exporters.	Free or cheap. Simple (family/friends).	Complex process and conditions/expecta-tions (especially government).
Loans	Short/medium term. Firms with collateral.	Limited duration. Often cheaper if P2P.	Fees and interest possibly high. Must be repaid or closure of firm likely.
Part-ownership	Small Ltd company. Expanding firm. Crowdfunding possibly for Start-ups.	No set repayment. Angels/venture can bring good advice.	Future profits shared. Might lose some control to newcomers. PLC set-up expensive.