

Sources of Funding for Spin-Out and Start-Up Companies

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INTRODUCTION

All businesses, regardless of their size, require funding to implement their business plans. Funding is especially crucial for early stage and spin-out companies to ensure the best possible chance of success.

This briefing note sets out some of the more common sources of such funding and the forms of investment that this funding might take.

SOURCES OF FUNDING

Friends and Family

Friends and/or families may be willing to provide some form of funding, but the amount available will of course depend on how much they are willing, or can afford, to provide. Due to the large costs involved with developing and taking products/services to market and in the absence of revenue it is likely that other sources of funding will also have to be pursued.

Bank debt

Most banks offer small business loans but these can often be difficult to obtain by spin-out companies principally due to the lack of available security and trading history. Banks may well require personal guarantees from directors. However, many spin-out companies take advantage of overdraft facilities provided by banks (which can sit alongside small business loans or on their own) and some banks offer access to a Government sponsored scheme known as the Small Firms Loan Guarantee Scheme where no assets are available for use as security.

Grants

There are various bodies that provide grant funding. The availability of this is very much dependent on the sector in which the company is to operate/operates and some grants will only be available to businesses operating in certain geographic areas. Most forms of grant funding will require the applicant to fulfil certain criteria before the funding will be made available.

One source of grant funding is the Scottish Government which runs a few schemes such as: (i) SMART:Scotland - for those operating in the technology sector; (ii) Regional Selective Assistance grants - aimed at small and medium sized businesses; and (iii) Scottish Enterprise Proof of Concept – aimed at technologies emerging from Scotland's universities, research institutes and NHS boards.

Seed Funds

These are investment funds set up specifically aimed at investing in early stage companies. These tend to be operated by some of the venture capital houses, for example Frontier IP Limited (a subsidiary of Sigma Capital Group plc) has been set up with the aim of investing in spin-out companies and assisting with the commercialisation.

Seed funding is also available from Scottish Enterprise. The Scottish Enterprise Seed Fund makes investment in early stage companies of between £20,000 and £100,000. Scottish Enterprises also operates other funds (the Co-Investment Fund and the Venture Fund) which provide larger amounts of funding but are not specifically aimed at early stage companies.

Business Angels

These are typically wealthy individuals who look to invest in early stage companies in return for equity. Many of them have a wealth of different contacts which can be utilised by the company to assist with its development. Often business angel investment can act as a catalyst for attracting funds from other sources. Networking events aimed at spin-out companies are often a good way to meet potential business angels and there are various organisations which aim to make introductions, for example the British Business Angels Association and LINC Scotland.

Venture Capital

These companies normally operate several funds with the objective of making investments which will offer a high return, over a certain time period. They tend to only invest larger sums (£500k+). Often they will also

look to introduce management and/or operational capabilities to investee companies. The British Venture Capital Association provides further information as to those who provide venture capital funding in Great Britain.

New Directors

Many early stage companies will look to appoint additional Executive and Non-Executive Directors (eg. a Chairman) who can bring expertise to the management and/or operation of the company, some of whom may be willing to provide some personal funding, often to show their commitment to the venture.

Other sources of assistance

Not all assistance need be in the form of cash investment. In some instances it may be available 'in-kind', for example a university or an incubator providing accommodation and other services in return for a shareholding in the company.

FORM OF INVESTMENT

Before investors will commit any investment most will require sight of a business plan and will wish to carry out investigations into the company and its products/services (often referred to as due diligence).

Once investors have decided that funding will be made available it will normally be in one or a combination of the following forms:

- equity - where the investor receives shares in the company. Investors may prefer to hold a different class of shares from those held by the other shareholders that have different/enhanced rights attached to them; or
- loans - which can take the form of a traditional loan repayable over a set period or alternatively in the form of preference shares in the company, which attract a preferred right to fixed dividends but do not usually carry voting rights.

Some investors (eg. some venture capital investors) will require their investment to be staged based on the achievement of certain pre-agreed milestones. Other investors will only make funding available if other third parties provide matched or additional funding (eg. Scottish Enterprise Seed Fund).

Recipients of funding should always bear in mind that most investors will have an exit strategy and will want to invest in a company for a certain period of time (eg. 3 - 5 years for venture capital investors and business angels) so

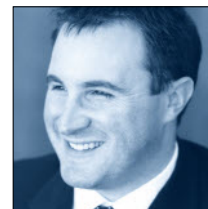
it is prudent for companies to keep their funding requirements constantly under review.

CONTROL OF THE COMPANY

Most investors will expect to have some control over the management and direction of the company, which may include:

- the right to appoint a director and/or observer of their choice; and
- the right to vote on or veto certain actions of the company. Such rights are often found in the investment agreement (the formal document containing the terms of the investment) and/or the articles of association of the company.

This briefing note sets out a summary of sources of funding for spin-out and start-up companies at the time of writing and is for information purposes only. It should not be regarded as legal advice but if you would like further information please contact:



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