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RAISING FINANCE - COMPANIES

Raising finance without giving away control

You've found someone who wants to invest in your up and coming company. They want shares so that their return is based on profit, but you're not keen on them having any control of the business. Is there a way to keep you both happy?

Business angels

When your business is still in its fledgling stage, you probably know that it's hard to convince banks to give you a loan. Increasingly, young businesses are turning to private investors. If you're lucky enough to find one who believes in your business plan, this can be a perfect alternative to traditional borrowing. Sometimes the particulars of how the investment actually takes place can be a stumbling block though.

A growing business

Let's suppose you have been running your business through a limited company for three years, and profits have been steadily increasing. You now want to expand your operation to a second premises, but need a cash injection to do so.

You approach a business angel network, and are contacted by someone who is willing to provide the funds. However, there's a snag - they want to do this by buying shares rather than making a loan. They say that this is for protection if the company fails and they lose their money, and so that they can enjoy a share of the profits if it's successful.

Why shares?

It's likely that your investor will have some tax knowledge and business experience. The reason they want shares rather than a debt arrangement (for example loan notes) is that, in the event of the business failing, the capital loss on shares can be converted to an income loss, but if it continues to be successful they will share in the growing profits. If the investor simply lent you the money, the best they could do with the loss would be to offset it against capital gains, if they have any. As the highest income tax rate (45%) is higher than the top rate of capital gains tax (20%), your investor's downside risk, i.e. the amount they stand to lose, is lower with shares because the income loss would compensate them.

Example. An investor (additional rate taxpayer) buys shares in Acom Ltd for £50,000. Unfortunately, the company goes bust. The investor loses their money, but they can offset this loss against their income which reduces their tax bill by £22,500. In cash terms, they only lose £27,500.

Losing control

This presents you with a problem. Issuing new shares to an investor means giving away some control over company affairs, which you don't want. Fortunately there's a way you can let your investor have their cake and eat it.

Tip. The best way to resolve this is to use variable rate redeemable preference shares. These don't have to carry voting rights, but you can specify that the dividend entitlement is directly dependent on the profits of the company. What's more, they provide the loss protection of ordinary shares because the variable dividend right means the shares count as ordinary share capital.

Convertible shares

You and your investor both get what you want. What's more, the shares can be redeemed later on at their subscription price, meaning no taxable gain arises. Alternatively, they can be converted to a loan later on, making it easier for the investor to recover their investment.

You can avoid giving away control whilst giving the investor a share of profits by using redeemable preference shares which have no voting rights but do carry a dividend entitlement. Make sure this right is variable, dependent on profits. If it's fixed, your investor won't be able to claim share loss relief if things go badly.