BRIEFINGS

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In the Company of Strangers: Should Your Business Bring in Investors?

Sometimes the difference between a good business and a great business is simply having sufficient capital to execute your business plan. For many businesses, the owners have put everything they have into growing the business, but there is still a gap. Investors offer an opportunity to close that gap, but at what cost?

How Do You Know You Need Investors?

Unfortunately, most businesses seek investment funding at the point it is most critical or for the wrong reasons – seeking funding for a business when it is in financial distress is always going to be hard. Neediness is never a good negotiating position or very attractive. And few will be prepared to invest to save you.

Funding from investors is used to fund growth where a major investment is required – where the business cannot service its growth or capital requirements and these requirements are greater than what the business can fund on its own.

On most occasions, investment is needed to build out scale and take advantage of the potential of the business. In many cases the owners can only afford to fund a portion of what is required, but the scale they need will make the difference between an okay business and a great business.

What Will Investors Expect?

Before seeking investors you need to get your house in order.

Every business operator knows that they should have a business plan in place. Most don't. With a strategic business plan, you can track performance and growth, departures from the plan, etc., and this management information will tell you the point at which you need investment - either debt or another form. A strategic business plan will also inject reality into blue sky entrepreneurialism and flush out many of the issues that investors will inevitably question. It will shore up the business case and demonstrate that the growth path anticipated has been sufficiently thought through - a big issue for many entrepreneurs.

This planning stage is important because there are more ideas chasing capital than there is capital chasing ideas. You have one chance to pitch to investors and often you are competing with a range of unrelated or different opportunities.

Investment Types

Investment can be debt or equity investment. A debt investment is paid back in some form. There are many ways to structure debt investment from traditional interest payments to profit sharing.

Equity investment, however, is what most people think of when they think of investors. Equity investment is where the injection of capital buys equity in the business and often a degree of management participation or control. There are many ways of structuring these arrangements depending on the motivation of the parties involved – everything from a direct injection of cash to the provision of essential infrastructure and knowledge.

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Investor Types

The most common investor for SMEs is family or friends investing out of loyalty and often a belief in the skill set of the business operators. The key problem with family and friends as investors is that often the details of the investment are loose. Trust is high and everyone has a belief, at the beginning, that the other party will act in their best interest. If family and friends are investing, you must put in place the same level of formality to the arrangement as if strangers were investing. It prevents confusion and upset.

Another reason for a high degree of formality is that on some occasions, the person looking to unwind or exit the arrangement in the future will not be the person who entered into it. It's important to ensure that the exit provisions are clear in case someone dies.

Commercial investors come in many forms – angel investors, venture capitalists, private equity, or investment by associated parties. At the SME end of the market, angel and venture capitalists dominate.

Angel investors tend to operate at investment levels between $100,000 and $500,000. Angels are generally individuals looking for a great idea from a start-up that they can capitalise on.

Private equity investors are at the other end of the scale and look to invest tens of millions – generally with established businesses reaching for another level and expectations of high growth. Private equity investors generally look for a compound internal rate of return on capital in excess of 30%. They look for high returns and an identified exit timeline. They want confidence in return on capital and, ultimately, return of capital.

In general, commercial investors will seek a regimented approach – shareholders' agreement, restrictions around what can be done without their consent, and a clear exit path. This is not an area you should approach without expert advice.

Some Things To Look Out For

- Insufficient formality around the agreement – misunderstandings and boardroom battles over direction take the focus off achieving growth.
- The wrong structure at the beginning – a bad deal won't get better.
- Exit clauses – look at what the deal looks like at the end of the investment, not just at the beginning.
- Not being able to fulfil the stated plan – be certain about what you're offering.
- What are you giving away? Often business owners are so keen to secure the investment they forget about what they are giving away.
- Control and how much the investor can achieve over time and the influence they have – you don't want to be voted out of your own company once it's successful.
- The level of management control and influence exerted – in-fighting and debates about direction will only take the focus off the big picture.

The 1 April Salary Packaging Trap

Why a tax on high income earners will disadvantage many with salary packaging agreements.

In last year's Budget, the Government introduced a 2% 'debt tax' on high income earners – the temporary budget repair levy. Unlike many other announced Budget changes, the debt tax bill passed Parliament in record time – 12 sitting days with no amendments.

While the debt tax itself only directly affects those with taxable income above $180,000, there are a number of other tax changes that came in with the debt tax that affect everyone else.

To prevent high income earners planning around the debt tax, the Government increased the Fringe Benefits Tax (FBT) rate from 47% to 49% from 1 April 2015 – bringing it in line with the top marginal tax rate. Like the debt tax, the FBT rate change is temporary, with the tax scheduled to reduce back to 47% on 1 April 2017. The gross-up rate for reportable fringe benefits also increases from 1 April 2015 – 2.1463 for type 1, and 1.9608 for type 2 (type 2 is used for employee payment summaries).

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What Does This All Mean?

In general, the FBT rate change will make providing employee benefits more expensive and potentially less attractive over the next few years.

For those with salary packaging arrangements in place, it is important to review the details of those arrangements and ensure that they still achieve the intended goals.

For employers, you need to review all salary packaging arrangements and any expenses where you have a large FBT exposure.

For employees, it's essential to understand how these rate changes impact on you. Changes to income and fringe benefits tax over the years have made salary packaging less effective in general and, in some scenarios, you might be worse off. Employers may also seek to pass on the FBT rate increase which will increase the amount you are sacrificing and reduce the effectiveness of the packaging.

If you receive family tax benefits or other assistance payments from the Government, it is essential to review salary packaging arrangements as the changes may have a direct impact on any benefits you receive. This is because fringe benefits reported on your payment summary are taken into account for a number of family benefit income tests. The FBT gross-up rate used to calculate these reportable fringe benefits has increased and, as a result, the reportable fringe benefits on your payment summary will also increase.

The FBT rate change will generally not affect not-for-profit entities and other tax exempt entities because the annual maximum value of the capped FBT exemption has also gone up – so employees of these entities should be no worse off than before the FBT rate change.

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