ARE YOU STRUCTURED FOR SUCCESS?

A guide for innovative technology businesses

MENZIES
BRIGHTER THINKING

TECHNOLOGY SECTOR
INSIGHTS REPORT

FOREWORD

"To avoid being out-manoeuvred by agile competitors, technology businesses need more than just a great idea and the finance to develop it. They need to know how to get the most value from every pound they spend, for the benefit of the business and all its stakeholders. They need to be structured for success."

Although technology businesses are innovative by nature, fending off fierce global competition can be a risky and costly process. Without the finance required to develop their product or service, and get it market ready, they could end up being little more than a flash in the pan.

Securing the finance needed to invest in product development can be a huge challenge, but it is not the only one. It is also important to make sure the business is structured correctly to take full advantage of any cash being invested and to de-risk its activities as far as possible. Getting the basics right in terms of cash flow management and accurate forecasting is essential.

Stephen Hemmings
Partner and technology sector specialist

CASH MANAGEMENT MATTERS – BUT WHY?

In a fast-growing sector, it is especially important that business managers understand the principles of good cash management and know how to build a business that is structured to deliver rewards for key employees and investors over time.

The UK's digital tech sector is accelerating faster than the rest of the economy, according to Tech Nation 2018, the state of the nation report on the sector.

Turnover of digital tech companies grew by 4.5% between 2016-17 compared to UK GDP which grew by 1.7% over the same period, according to the report. At the same time the number of jobs in digital tech rose at five times the rate of the rest of the economy.

It's not all good news however. About 50% of UK start-ups fail within their first year and the thriving technology sector is littered with examples of businesses that have failed to realise their potential due to financing and/or production difficulties, or a lack of market demand. Whilst many of these failures are unavoidable, a proportion are caused by something quite fundamental – poor cash-flow management. Research carried out in 2017 by Menzies LLP among 111 tech business owners revealed that the biggest risk factor is getting into cash-flow difficulties.

"Investors need to be able to see where returns are coming from and accurate forecasting is essential. It could also guide business managers in protecting value as the business grows."

Stephen Hemmings

In order to manage cash effectively, the business needs access to accurate, real-time information. Due to the proliferation of cloud-based software for financial management applications and the potential to produce integrated data sets, business managers should review the marketplace regularly. To ensure they get maximum value from their investment, they should start by identifying the KPIs of the business and select the right products to ensure this data is readily available. With access to real-time data, business managers will also be able to forecast with greater confidence, minimising the risk of cash flow challenges arising.

Accurate forecasting is especially important for fast-growing tech businesses as it allows investors greater visibility of the returns they might expect to receive over time. This can be useful from a management perspective too, as the business will be able to gauge when further funding might be required to sustain its growth strategy. Too little funding and the project could stall, or worse still, the business could fail. Too much funding and ownership of the business could be diluted more than is required, reducing returns for investors.

"To attract early-stage investment, tech businesses may be able to utilise the Enterprise Investment Scheme (EIS), or the even more attractive Seed Enterprise Investment Scheme (SEIS) but strict rules apply."

Sam Goodsell

With the right cash flow management and forecasting in place, technology businesses will be in a much better position to demonstrate to investors when and how returns will be crystallised. This will reassure them that the business is structured to deliver value over time.

STRUCTURING FOR LENDERS:

Securing finance is often a challenge for technology businesses as the product under development may not have been trialled and market demand is unproven. It is therefore important to structure the business with lenders in mind.

FAMILY & FRIENDS

Without a track record and trial data to accompany their business plan, many tech entrepreneurs struggle to source the finance needed to get their business idea off the ground. Some turn to family and friends for financial support and others take on significant personal debt. Before taking this approach however, it is important to consider how and when the business will reward any third-party investors and put in place a tax-efficient structure to make this possible.

To encourage early-stage investment, tech businesses may be able to utilise the Enterprise Investment Scheme (EIS), or the even more attractive Seed Enterprise Investment Scheme (SEIS). The latter attracts upfront income tax relief of 50 percent for any qualifying investment, whilst those that qualify for EIS attract upfront income tax relief of 30 percent. Both schemes also allow tax-free disposal of shares, provided that they have been held for three years and other conditions met. In a worst-case scenario, if the investor is unable to recover any of their original investment, they could be eligible for tax relief equivalent to 72.5% under SEIS.

For both schemes, there are a long list of prescriptive rules, which could easily catch out an inexperienced company and/or investor. For SEIS the company must have gross assets of less than £200,000 and have been trading for less than two years. Both schemes stipulate that the investor should not be connected with the company. This typically prohibits direct employees and some close relatives of the founder from investing under these rules. An example of the importance of understanding the detail is that whilst a grandparent of a founder is classed as a 'relative', a brother or sister would not be, and therefore their investment may qualify for tax relief under the schemes.

It is possible to secure advance assurance of eligibility from HMRC, before an investment is made. To secure this however, the company must have clear plans in place, illustrating how funds will be spent and identifying any early investors.

ANGEL INVESTORS

Many established UK businesses got started with the help of an angel investor. These are private investors who provide finance to early-stage businesses in exchange for shares in the company. By investing early, these investors hope to realise value by selling their shares if the business achieves growth and is sold to a larger corporate in a few years' time.

Keen interest in this form of investing has led to the emergence of 'angel networks', which provide a filter for investors by selecting the best investment opportunities and pitching them at events and via online platforms. In this way, networks provide some reassurance to investors that the business plan of the company seeking finance is robust and well-funded.

Typically, angel investors are likely to qualify for tax relief under the EIS, and an additional benefit is the fact that the scheme's provisions can also allow companies to pay these individuals for their advice at the same time. The discovery of such an angel can therefore be doubly positive for the business.

That said, it is key that the founder identifies someone that they can happily work alongside and learn from. Due diligence on the angel investor can be just as important as the background work they might choose to undertake on the company prior to making their investment.

BANK LENDERS

The Patent Box regime allows UK companies to apply a reduced corporation tax rate of 10 percent to profits arising from the sale of products containing patented technologies.

Traditionally banks have been wary of lending to businesses without an established track record of profitable results and without significant physical assets to guarantee the loan.

This is slowly changing however and banks are increasingly willing to invest in growing businesses where there is a well-structured business plan in place. To tap into this source of finance, business owners should identify a relationship manager with a track record of supporting growing businesses.

As well as looking for evidence of good accounting and reporting practices, banks will expect to see that the business has a tax-efficient structure and can provide accurate cash flow forecasts.

Some high street lenders are now offering the possibility of lending against intellectual property, which is welcome recognition of the challenges facing innovation-led technology businesses. For this reason, where relevant, business plans should include reference to any brand-related IP assets and patented technologies. If the business is already making use of the Patent Box regime, or intends to make use of it, this should also be emphasised.

The Patent Box regime allows UK companies to apply a reduced corporation tax rate of 10 percent to profits arising from the sale of products containing patented technologies. Whilst its calculations can be complicated, this is a valuable relief for established technology businesses with taxable profits.

STRUCTURING FOR GROWTH:

It's all well and good having a plan to grow the business and funding in place, but goals are unlikely to be achieved if the business is not structured in a way that prioritises people and resources. With the right structuring, the business can smooth the way to growth whilst staying focused on tax efficiency and cash management.

BUILDING THE RIGHT BOARD

To help attract and retain the right people, they should consider putting in place tax-efficient rewards such as employee share schemes, which deliver value to both employees and the business.

Many early-stage businesses fail to achieve their potential because their owners are unable or unwilling to put the right people in the right roles to support their growth strategy. In the tech sector, it is not unusual for business owners to be overly protective of what they have created and fail to see the potential that a market specialist or an experienced non-executive director could bring.

To grow successfully, business owners must overcome this protectionist thinking. To help attract and retain the right people, they should consider putting in place tax-efficient rewards such as employee share schemes, which deliver value to both employees and the business.

Growing businesses are unlikely to be cash rich, and so traditional bonus type rewards are typically less competitive than those offered by larger companies. The offer of equity, with a potential large reward at some point down the line, can be very appealing for the business and its employees. Equity incentives can directly align employee rewards to the success of the business, and if well implemented, they can be an effective means of accelerating business growth. They can also help to retain key employees by tying them in to a specific milestone, such as the future sale of the business.

The Enterprise Management Incentive (EMI) scheme is a great way for business owners to offer equity to incentivise key employees in a tax-efficient way, without diluting control of the business at that point. Such schemes are typically set up on an exit-only basis, meaning that the employee can only convert the options to shares immediately before a wider sale, which means they benefit at the same time as the business owner, and also that there is no real cash outflow for them on the exercise.

EMI schemes also allow the reward eventually received by the key employee to be taxed at a 10 per cent rate of capital gains tax, provided that they hold the options for a two year period (for disposals pre-April 2019 this requirement is just a one year period). If they received the incentive as a bonus they could be subject to income tax at up to 45%, plus National Insurance Contributions for both the company and employer would arise.

MAKING THE MOST OF INNOVATION

SMEs can effectively get 230% tax relief on qualifying expenditure. This would mean tax relief worth £44 for every £100 that the business invests in R&D.

If the business is investing in innovative software or systems, or developing new products, it may be possible to offset this expenditure against its corporation tax liability by claiming R&D tax relief.

R&D tax relief is a very positive example of the Government's attempts to encourage innovation. SMEs can effectively get 230% tax relief on qualifying expenditure. This would mean tax relief worth £44 for every £100 that the business invests in R&D.

For early stage businesses, who are often running at a loss, it is also possible to claim this relief as a cash tax credit and improve the company's cash flow.

Qualifying R&D expenditure includes investment in the design and development of something innovative, which requires time to be spent to address an area or areas of uncertainty, and a person or persons with sufficient expertise to undertake this work. The largest area of qualifying expenditure is typically salary costs, although a reduced rate is available in cases where external developers are utilised by a business.

IMPORTING SOFTWARE & SYSTEMS

Many tech businesses have lean management structures and it is especially important that the most efficient software and systems are used to ensure things run as smoothly as possible. Access to advisors with experience in supporting growing businesses can help them to develop streamlined processes that are easy to use and provide access to integrated data sets and the insights required to aid sound decision making.

Our outsourcing team can help technology businesses to select the right software platforms to meet their needs. All the large software providers, such as Xero, Quickbooks and Sage have cloud-accounting systems, and each of these has an app store of compatible software that can be integrated directly in real-time. For example, 'Expensify' can be used for maintaining staff expenses via a mobile app, 'Unleashed' can be used for managing stock and 'Workflow Max' can be used for project management. Forecasting software, such as Futrli is also available. If the business is using market-leading software, there should be an established link to assist the business in producing integrated data sets. Should this not be the case, all is not lost, and third-party providers can link software, or enable data to be imported.

CREATING A FLEXIBLE & INCENTIVISED WORKFORCE

At a time when many businesses are concerned about skills gaps and talent shortages, growing tech businesses will need to work harder to attract the best people away from the likes of Google and Amazon. Being small and agile can be an advantage when dreaming up staff incentives or creating rewards that enable the business to show how much it cares about individuals who perform strongly or who go above and beyond. Drawing on the advice of experienced advisers, tech businesses can create an employer brand that will attract and keep talented people.

HOW CAN MENZIES HELP?

Tech entrepreneurs can choose from a range of services to assist them at every stage of business development.

STARTING OUT

- Business planning and strategy
- Cash-flow modelling and forecasts
- Presentations for investors
- Introductions to investor platforms
- Establishing an Enterprise Investment Scheme (EIS) and/or a Seed Enterprise Investment Scheme (SEIS)
- Tax-efficient structuring

UP AND RUNNING

- Efficient cash management
- Managing accounts efficiently
- Tax compliance and tax planning advice
- R&D tax relief
- Employee share schemes (EMI schemes)

TRADING OVERSEAS

- Advice on structuring the move
- Access to an international network of advisers (HLB)
- Employer responsibilities
- Tax planning - sales tax and transfer pricing arrangements
- Cultural awareness

PLANNING AN EXIT

- Developing an exit strategy
- Adviser support for managing a disposal

CONTACT

To speak to tech sector advisors or to outsource services in areas like HR, payroll and accounting please contact the firm's technology group.

Stephen Hemings
Partner, Head of Technology
SHemmings@menzies.co.uk
0207 4651968

Sam Goodsell
Director, Technology specialist
SGoodsell@menzies.co.uk
01784 497154

Rob Kruppa
Associate Director, Technology specialist
RKruppa@menzies.co.uk
01489 566727