

ENTREPRENEURSHIP AND SMALL FIRMS - 4th Edition
DEAKINS AND FREEL

CHAPTER 4: SOURCES OF FINANCE: OVERVIEW OF ISSUES AND DEBT FINANCE

CASE STUDY: RAISING BANK FINANCE

PETERS AND CO.

The following information provides detailed information on the case study, Peters and Co, that has been referred to in Chapter 4. The case study, Peters and Co, involved a business plan for team start but with limited equity investment by the three co-directors. Each of the three committed £10,000 equity and required a bank loan of £60,000 to cover the forecast deficit on the cash flow. This meant a debt to equity ratio or gearing ratio of 2:1; whereas banker's preferred gearing ratios are 1:1.

The case concerns a start-up proposition and business plan involving 3 entrepreneurs seeking to raise bank finance. The case is designed to illustrate some of the issues in raising bank finance.

INTRODUCTION AND BACKGROUND

The following information is based on a real business. The names of the 3 entrepreneurs concerned have been changed but otherwise, all information is based on their actual business, including financial costings and research. The information provided is for a start-up venture that is seeking to raise finance from a bank. You are provided with the following sets of information:

1. Summary of the proposition.
2. Business plan for the following 3 years for Peters and Co.
3. Information on the 3 entrepreneurs who are to be equal directors in the concern.

SUMMARY OF THE PROPOSITION

THE THREE PROPRIETORS

The three proprietors are all qualified as chartered quantity surveyors (QS). 2 of them are working for a major UK QS partnership which has offices throughout the UK. Noel Peters, who is to be the managing director for Peters and Co, has nine years experience with local authorities and seven years experience with the UK QS practice; his qualifications include a B.Sc. in QS. He has been rapidly promoted and is a senior partner. He has worked on schemes up to £100 million in value. Graham Davis is a colleague of Noel Peters with 20 years' experience in the QS industry. He heads up the cost planning unit at the UK practice. Tony Franks has been a chief QS with a local authority and cost centre manager before leaving to be managing director of a company in private practice. He has 30 years' experience in QS and the construction industry. More details are provided on the individual proprietors later.

THE SERVICE

The business would offer traditional cost and auditing control of QS through, for example billing of quantities, which is the traditional costing service of QS. In addition, the business would use its experience to offer project and facility management. Experience in project management means that the business can draw on the skills and expertise of the proprietors to offer this service. The business also hopes to offer an integrated IT construction service. This marks a difference from the standard traditional QS costing and auditing service. The business will offer a bespoke service by applying CAD techniques to the design, construction and costing of projects. This use of information technology offers exciting opportunities to break the mould of traditional QS. A project could be designed, costed and controlled using information technology applications that allow the customer to vary specifications and produce different costings as part of the service.

To develop this service the business will employ an 'automisation director'. This person, Joe Wilcot, has worked with Noel Peters before on developing CAD techniques in the QS industry

and the present employers of Peters and Davis; Gleeds. A section of the business plan is devoted to a 'strategy for growth' which concentrates on the role of IT and new technology in the construction industry. If the business is successful it is likely that Joe Wilcot will be brought in as a full director. The directors are excited about the development of a revolutionary housing product developed by Joe. If this takes off then they have been promised a good percentage of the QS work that will result.

In the first six months that the business is in operation, the proprietors have identified a further service that could offer potential for the growth of a separate service particularly for local authority housing departments and housing associations--the provision and targeting of an energy auditing service.

THE MARKET

Potential clients are to be drawn from both the private and public sectors. Obviously the nature of the recovery means that the business will have to market for clients actively. However, there are some areas that have major growth potential as construction projects, e.g., in hotels and leisure. The development of housing associations also offers major potential. The proprietors believe that the advantages of the flexibility of a small firm could be used to their advantage in the recovery. This ability of a small firm to control costs, react quickly to opportunities, and to be flexible is likely to be an important factor in the success of this proposition.

THE ROLE OF THE DUTCH COMPANY

A section of the business plan is devoted to the association with a company in the Netherlands that has developed the application of IT and new technological developments to the construction industry on the continent. A number of options are under discussion at the present time. The proprietors have had a number of meetings with representatives of this company and have secured agreement for some investment by it but the deal still has yet to be ratified. The options

at present include cash injection in return for an equity stake, a fee arrangement, or a more loose association with the business using software and technology developed by the Dutch company.

THE BUSINESS RATIONALE

Both Noel and Graham have been frustrated for some time working for Gleeds at their inflexibility and slow progress in adopting new integrated CAD techniques and new technology. They both feel that they have achieved as much as they can within their present environment and feel that the time is right, despite the fragile nature of the recovery in construction, to launch their own business. They are bringing Tony in because he has contacts in the construction industry and also has experience of running a small company himself. They are hopeful that they will be able to take some customers with them when they leave to start up the business. In addition, the role of the automation director will be significant as new technology is adopted in the construction industry. Joe Wilcot has developed a revolutionary housing product that is currently being patented and has generated a lot of interest. Peters and Co. will receive a great deal of work as a result if this new technology and product is adopted in the construction industry. The potential could be huge since the product is ideally suited to the needs of housing associations for low cost housing. Housing associations now have the majority of state funding that is devoted to housing construction.

BUSINESS PLAN: Peters and Co.

SUMMARY OF PROPOSALS

Peters and Co. is being established to provide cost control and management services to the construction industry. The company will focus on four principal areas of service:

- Cost Control
- Project Management
- Facility Management
- Construction Information Technology

These areas will form the basis for the growth and expansion of the business where our expertise in cost control and project management will be the main activity in the initial stages. From this base, growth will develop into the other areas that will then provide a comprehensive construction and property service to clients.

Although the directors are chartered quantity surveyors (QS) by training, they all acquired specialist skills during their careers to respond to the changing demands and needs of their clients. Peters and Co. bring these people together to form a partnership that will be unfettered by QS tradition.

A strong association with a Dutch Company, the Brink Groep, will widen business opportunities for both parties and will also provide advantages for technical development and joint initiatives in other markets.

THE DIRECTORS

The Directors are chartered quantity surveyors as follows:

Noel Peters B.Sc. F.R.I.C.S.

Currently a partner with a national QS practice. He will be managing director with principal responsibility for policy and future business direction.

Graham Davis A.R.I.C.S.

Currently an associate with a national QS practice. He will be the technical director with specific responsibilities for cost control and the integration and expansion of the business in IT areas for both the partnership and the clients.

Tony Franks

Currently employed as managing director of a specialist construction company. He will be responsible for financial matters within the firm and provide expert contractual advice to clients.

All three directors have excellent experience and knowledge of the UK construction and QS industry and have gained a wide range of business contacts.

BUSINESS PHILOSOPHY

The company will offer an exceptional personal service based upon the knowledge, expertise and involvement of the directors. Experience has proved that a commitment to use and develop the most up to date computer technology, including the integration of CAD systems with cost control techniques, will provide the firm with a major advantage over its competitors.

To maintain this philosophy we aim to provide:

1. An expertise that encompasses costing, planning and management, ranging over all aspects of property and construction related activities.
2. The establishment of a working environment which can provide security for all members of the organisation and which will manifest itself into the service we reflect towards our clients.

The firm is envisaged as presenting an image that combines quality of service and personal attention with particular emphasis on standards of presentation. To enhance this image we intend to establish a permanent presence in Bath with easy access to all road and rail links. We are currently negotiating a lease for an office with a prestigious city centre location.

STRATEGY FOR GROWTH

The problem with traditional QS Service

The standard QS appointment provides for a cost monitoring role. This is reactive and not acceptable as it will not be good enough to cope with the demands of clients who want security and certainty of price in their dealings with the construction industry. Clients' concerns are reflected primarily in the growth of the 'Design and Build' sector of the market where over 20% of commercial work is executed in this way. In this area the traditional QS service has a limited role to play.

We also believe that the presence in the UK of European clients and investors from other countries seeking a marketing foothold in Europe have already affected the attitude and approach of the UK construction industry; the Single European Market has accelerated the pace of this change.

Cost control

We will concentrate on cost control by restructuring the fee arrangement to allow us to maximise the service in areas of value management, project planning and risk avoidance.

Our clients will see budgetary control that will seek to reduce the risk of major cost/time over runs which are the hallmarks of the UK construction process.

Project management

Because Project management is difficult to achieve, the current trend is to appoint a project manager with no direct responsibilities. We believe good project management should be cost linked so that the time frame is viewed at every turn in regard to the cost effects. This requires us to be involved in the auditing of the design process, including the programming of the design input, as well as the more traditional aspects of project management.

Facility management

There is much evidence that many consultant firms are seeking to diversify as the market changes and workload declines. Our growth and expansion into facility management is calculated to maximise our market share and provide a wider base from which to operate and so stabilise our fee income.

This work will provide an extension to our role to form a more general property management service. Facility management provides the opportunity to be appointed for work where major new build schemes are envisaged - this being a natural progression from the facility management role.

IT in the construction industry

Peters and Co. believes that there is dearth of data with which to make key decisions that affect the building process. Thus, the key procedure in all the above areas is to capture,

analyse and store all pertinent information on computer databases. This will be structured in a way that will allow the data to be transferred throughout the cost control and construction process. It is intended to offer this service to clients by expanding into a support role for bespoke applications.

The growth of the firm will see an automisation director, previously identified (Joe Wilcot), who will take a consultancy role in the interim while the market is established. The link with the Brink Groep will also help to support this strategy.

Summary

This range of operations will see a mixture of professional disciplines employed within the firm. The strategy seeks to provide an embracing cost control service to guide clients at any point in their dealings with construction and property.

The potential market is extensive, being in the order of £1500 million to £2000 million of fee income in the UK. We believe that we can establish a share of this market that will see us as a 30 strong practice within 8 years with a turnover of at least £2.5 million.

THE POTENTIAL MARKET

We are confident that our contacts will provide suitable commissions in the following areas:

1. Private sector

- Commercial (offices and retail)
- Industrial
- Hotels
- Leisure

2. Public Sector

- Housing associations
- State schools
- Local authorities
- Central government agencies

We fully recognise the difficulty in launching a new firm and to help us in the launch period we have negotiated agreements with two contacts who will actively market on our behalf. One of these contacts has a detailed involvement with educational establishments where he has extensive contacts both at local and national levels. The other contact already provides general marketing for other organisations and has a proven track record. These people will act on the basis of commission.

ASSUMPTIONS ON CASHFLOW

We expect to receive minimal fee income in the initial 7 months of trading. We hope to secure one medium sized contract and several smaller contracts in the first six months.

As we become more established and growth takes place, we anticipate an increase in our market share in line with that recovery. At the peak of the fourth year of trading we anticipate an income per month of £45,000 and to have secured approximately £22 million worth of work (five or six medium sized jobs). The cashflow shows a consequent increase in staffing levels for this growth.

It should be noted that we expect all Directors to achieve an earnings capacity of £75,000 per head, per annum.

The figures take no account of re-investment to fund other areas of growth such as facility management and the expected increase in automisation.

PROPOSED START DATE

The provisional start date is set for 1st January Year 1. This would mean the funding would need to be in place by 1st December.

One or more of the Directors intends to start earlier than this date in order to concentrate on matters in connection with a business start up and to establish some of the basic procedures needed to allow the firm to run efficiently from the launch date.

PROPOSALS FOR AN ASSOCIATION WITH THE BRINK GROEP, HOLLAND

There are several alternatives that we consider might be of interest to the parties and we outline them as follows:

1. A venture stake in the firm where the Brink Groep becomes a shareholder. We believe that we have much to offer Brink Groep in new areas of research such as value engineering, and risk management. With this closer relationship we would be able to mould a professional service for a European operation using the Brink Groep marketing identity. This would assist the Brink Groep to establish a network of European offices.

This degree of involvement would heavily encourage the Brink Groep to market Dutch clients who may wish to work in the UK and would create a stronger drive to establish an automisation arm earlier than would otherwise be possible. Under this scenario the suggested cash involvement of Brink Groep would be £40000 in return for a 20 per cent shareholding.

2. The Brink Groep to secure fee earning work for Peters and Co. A pre agreed commission rate for this work would be paid by Peters and Co. in the form of a shareholding up to an agreed maximum with cash arrangements thereafter.

3. The Brink Groep become a minority shareholder of Peters and Co. with, say, a 5% share of the equity for a direct capital injection of £10,000.

4. A more loose association with Peters and Co. promoting the software of the Brink Groep with us providing general or bespoke databases to be used in conjunction with such software.

GENERALLY

We are currently arranging our finance for the venture through major banks or venture capital companies.

The proprietors are also injecting £30,000 into the business and accepting the risk of leaving well paid jobs to set up this venture.

THE THREE DIRECTORS

Noel Peters

Experience

1980-81	Trainee	Worcester County Council
1981-85	Four year sandwich course,	B.Sc. in QS
1985-89	Assistant QS with QS partnership	
1989- 93	QS and cost planner,	Gloucester County Council
1993- 97	Cost Planning Group Leader at	Hackney Borough Council
1997 to date	Partner with Gleeds,	one of UK's major QS partnerships.

In the last 5 years Noel has been rapidly promoted at Gleeds. He has been prepared to take on and develop IT applications in the QS field. He has enjoyed direct managerial responsibility for the securing and execution of major commercial work, working on schemes ranging in value from £1million to £100million. He deals with the main clients at both local and national level.

His personal details are that he is married with two teenage sons, he owns his own property, currently valued at £250,000 with a mortgage of £100,000.

He is well paid at Gleeds with an annual salary in excess of £50,000 excluding expenses and perks. Thus he is giving up well paid, secure employment to take the risk of launching this company. He believes that the only way to make further progress in the application of IT is to develop applications with his own business.

Graham Davis

Experience

1981-91 QS with 3 firms in private professional practice

1991-97 Senior QS

1997 to date Associate partner at Gleeds

Graham currently heads up the Cost Planning unit at Gleeds and has concentrated in recent years on developing fast track contractual procedures in the commercial sector, together with developing computerised systems to reflect the changing climate of the industry and to assist in the preparation of cost control and tender documentation. Graham has good contact with both local and national clients and has generated a high fee income in recent years.

His current salary is in excess of £40,000 excluding perks.

Graham has worked closely with Noel on a number of projects to develop IT applications and both have been involved in a number of demonstrations to important major clients.

Graham is married with two teenage daughters and owns his own property valued at £200,000 with a mortgage of £80,000.

Tony Franks

Experience

- 1971-79 Junior partner in family building company
- 1979-85 Commercial manager with masonry sub-contractor
- 1985-88 Senior QS with QS partnership
- 1988-2002 Chief QS, Dorset County Council
- 2002 to date MD of private construction company.

Tony is a regular lecturer in law to the industry and also lectures at Bath University. He has extensive practical site management experience and has a wide circle of public sector contacts. He was for many years responsible for strategic and project cost planning advice. As chief QS and cost centre manager he assumed responsibility for the whole range of QS functions as well as fee accountability for the department. He was responsible for selection and vetting of contractors and consultants.

Tony has close links, professionally, with Noel and Graham and has worked on a number of contracts with them. He has some very good administrative and small business experience and understands company and commercial law.

Tony built the bungalow that he presently lives in some 20 years ago and has paid off any outstanding debts. The bungalow has been valued at £300,000.

CASH FLOW PROJECTIONS FOR YEARS 1, 2 AND 3 ARE PROVIDED AS A SEPARATE EXCEL (SPREADSHEET) FILE

[See cashflow projections year 1]

[See cashflow projections year 2]

[See cashflow projections year 3]