Funding an Expanding Recruitment Business

Today's recruitment market is generally strong with public and private companies alike reporting healthy results. In this climate, many businesses are planning for growth and some employees are taking the leap to set up their own businesses. Whatever the size of business, expansion requires an essential ingredient – cash.

The objective of this paper is to explore the options for funding expansion, highlighting key features and characteristics of each. It must be appreciated that each business will have its own specific set of circumstances which will impact on determining the most appropriate funding solution and advice should be sought when evaluating options. This paper is intended to be informative and offer general guidance, but nothing stated here should be interpreted as being formal advice, nor should it be relied upon in taking financial decisions.

Funding Options – Debt or Equity?

Funding can take one of 2 principal forms – debt or equity.

Debt

Debt comes in more than one form. The most common options for recruitment businesses are:

1. Bank Loan or Overdraft
2. Factoring or Invoice Discounting

Equity

There are a number of potential sources of equity, including:

1. Friends and family
2. Private investors (business angels)
3. Private Equity
4. Existing recruitment groups
5. Stock market (eg AIM)

Each of these options has its place and is most suitable for businesses at different stages, but the underlying principle is the same in each case – buying shares in a business with a view to the value of that investment increasing.

Using Debt to Fund Expansion

The principal basis for recruitment businesses to raise debt (borrow money) is by offering security against debtors. Debt most commonly takes the form of:

1. Bank loan or Overdraft
2. Factoring or Invoice Discounting

1. Bank Loan or Overdraft

This form of lending is reasonably common but loans are for a fixed sum and an overdraft has a prescribed limit. Whilst these may both be capable of change, costs will be incurred and it is a time consuming process. We would characterise this as slightly inflexible and not designed to grow alongside an expanding business.

2. Factoring or Invoice Discounting

This form of lending is the most frequent in the recruitment industry as it provides working capital as required to fund temp and contractor books and, subject to agreed limits, has the flexibility to grow alongside an expanding business. There are many things to look out for when entering into an arrangement and understanding the terms is essential to avoiding nasty surprises, which can take the form of:

- Fees
- Restrictions on lending
- Personal guarantees
- Difficulty in leaving the arrangement

What are the key considerations in taking on debt?

Pros	Cons
• Existing shareholders retain full ownership of the business	• The cost of interest on borrowings and the need to repay loans
• No outside parties can interfere with the running of the business	• Debt will be deducted in arriving at a valuation for sale
	• The worry of owing money to a third party

It is strongly recommended that advice is sought before signing up with a lender. Aside from the major High Street Banks, there are a number of independent and innovative lenders who have tailored offerings which may be more flexible and suitable than the largest lenders.

For more established and profitable businesses, banks may offer a cashflow loan which is an unsecured loan to be repaid out of future profits. Whilst this was fairly commonplace before the financial crash of 2008, cashflow loans are still hard to secure at present and the qualifying criteria remain high.

Using Equity to Fund Expansion

Although there are exceptions to all rules, it is a general principle that equity is best suited to finance growth. Equity investors require a stake in the business on the basis that its value will grow, delivering a return on their investment. The risk associated with equity investing demands a higher return that a debt provider, whose risk is relatively low given that they will seek security – usually in the form of debtors – and possibly personal guarantees too.

Equity investment can take many forms:

1. Friends and family
2. Private investors ("business angels")
3. Private Equity
4. Existing recruitment groups

5. Stock market (eg AIM)

1. Friends and Family

This is a common way for micro businesses to launch, gaining financial backing from those closest to the person starting the business. This is typically a less formal way of raising finance than the others addressed below and the sums involved are typically relatively modest.

2. Private Investors ("Business Angels")

There are a number of private investors who have enjoyed success from recruitment and will consider investing in other recruitment businesses. It would be impossible to list the criteria which would make a business attractive to an investor as different investors have their individual preferences, but the crucial issues which any investor will consider include:

i. Can management demonstrate that they have the ability to make the business successful?
ii. Are management committed to making the business successful?
iii. What is the timeframe for selling the business and are there likely buyers?
iv. Will the investor be able to make a healthy return on the investment?

Private investors will buy some of the equity in the business and in addition to the cash, some may also bring experience and skills which can help to develop and grow the business. Selling part of the business to an investor is a complex, technical and regulated activity and owners should seek expert professional advice before even commencing the process to avoid the commercial and legal pitfalls. Two main considerations for an owner in assessing a deal are:

i. Do they like and feel comfortable with their investor?
ii. Do they feel that their reduced share of the larger business will ultimately have greater value than retaining full ownership of the business as it stands?

If the answers to these questions are both "yes", a deal would be worth exploring in more detail.

3. Private Equity

Private Equity is a more formal style of equity investment. There are a number of Private Equity houses which have a long history of investing in recruitment and many others who are happy to have one or two recruitment investments in their portfolio.

A Private Equity investor will be rigid in their due diligence and will usually be seeking an exit from their investment in a 3 – 5 year range, although there are exceptions to this. They will usually require Board representation and will seek to assist with growth both in terms of financial and commercial support.

Investment from Private Equity can help to support growth as well as enabling founders to take some cash out of the business to de-risk their personal positions. Management Buyouts (MBOs) are popular with Private Equity given the relatively low risk associated with the existing team looking to take the business in which they work to the next level of growth.

There are a range of Private Equity houses which will invest in businesses of various sizes, so approaching the correct parties with suitable information is crucial. Their principal focus will be on the quality of management and whether they are capable of delivering the growth which will provide a return on the investment.

4. Existing Recruitment Groups

There are a number of recruitment groups offering similar options to private investors, but in addition they have an operational infrastructure into which the smaller recruitment business can be absorbed to achieve savings through economies of scale. That said, there may well be charges raised by the recruitment group for providing such services.

A deal with a recruitment group may be similar in many ways to a deal with a private investor, although branding and becoming part of a larger group require some thought. There are a number of potential benefits as well as possible risks. A deal of this nature will be just as complex, technical and regulated as a deal with a private investor, if not more so, so professional advice should be sought.

5. Stock market (eg AIM)

It would be an oversight to exclude the possibility of the use of a Stock Market such as AIM to raise funds for expansion, but in reality no recruitment business has floated on AIM and raised finance for over a decade. In reality this is no longer an option for growing recruitment businesses and it is generally felt that unless there is a significant shift, no recruitment businesses valued at less than £100m would receive a warm reception on a public market.

It has been said that owners should only sell their business if they are happy with the amount of cash they receive on the day the deal completes, but a well-structured earnout can be an integral part of a deal and should not be discounted.

What are the key implications of a business taking an equity investment?

Pros	Cons
• Potential ongoing source of funds for expansion (subject, of course, to investor terms)	• On sale of the business, sale proceeds are shared between all shareholders
• Shareholders may bring additional skills and contacts, and have a vested interest in the success of the business	• Loss of autonomy as shareholders are likely to want some involvement in the running of the business
• No need to repay the funds invested	• The worry of owing money to a third party

Some business owners have an aversion to debt and have a strong preference to raise finance in exchange for equity, preferring not to have the mental and financial burden of borrowings, whereas others jealously guard equity and prefer to fund expansion using debt, seeking to maximise their ownership. There is no right or wrong, and personal preferences can be the deciding factor.

In summary there are a variety of options to fund an expanding recruitment business. All options should be carefully considered and professional advice should be sought before any decisions are taken to ensure that any decisions taken are informed, based on knowledge of all of the options and that the funding structure is capable of supporting the expansion plans rather than constraining them. Poor decisions can prove costly.

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