A no-nonsense guide to UK startup financing options

Tech startups have plenty of reasons to seek external investment, from boosting growth to accelerating product development. However, in 2023, we've seen a downward trend in the amount of funding being raised by UK startups.

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In the current economic climate, startups are raising less, and investors are becoming more cautious with their valuations to guarantee higher returns. Additionally, investors now prefer management teams that prioritise disciplined capital efficiency and long-term value creation and can offer reliable annual recurring revenues.

In these circumstances, founders are looking for new ways to raise money, beyond traditional equity funding rounds. With that in mind, let’s familiarise ourselves with all the key UK startup financing options, and any legal bear traps they entail.

Equity investment – still a ‘go-to’ option

Though fundraising has no doubt become harder for many UK startups, equity investment is still the go-to option for many early-stage and growing businesses – particularly in the vibrant tech and life sciences sectors.

It's a popular choice because traditional bank loans aren't often available to businesses that have limited tangible assets and little to no revenue. Though there’s no doubt that equity investment enables businesses to supercharge growth while benefitting from investors' expertise, it does also come with 'strings attached'. As founders' equity gets diluted, they must be willing to give up some control over their business. Not to mention handling increased scrutiny over how funds are used and their progress towards pre-agreed strategic objectives.

Typically, businesses that go down the equity investment route raise multiple funding rounds throughout their lifespan. They usually start with a modest amount of seed investment to propel their business to the next phase. At this point, founders can negotiate a better valuation for more substantial funding rounds – A, B, C etc. These are known as "alphabet share classes".

The shares for each successive round typically include a right for that class of shareholder to receive their money back ahead of the holders of earlier share classes. So, C-round investors would get their funds returned before those who invested in B, A and seed rounds. The idea behind this is to encourage management teams to create sufficient value to ensure all investors get their money back by the time an exit happens, while also giving management and founders (who usually only hold ordinary shares) a chance to share the proceeds of the sale or exit return of capital.

Beyond equity fundraising – convertible loan notes and ASAs

Even though equity investment remains popular, founders are increasingly exploring other investment instruments that enable investors to provide bridge financing while deferring the all-important valuation question.

One example of such an instrument is convertible loan notes. These loans can (in certain circumstances) convert into equity, typically during a startup's next funding round. Usually, investors get a discount of 15-30%

on equity.

Another example is advance subscription agreements (ASAs). These work similarly to convertible loan notes. Investors give money to a business, and when a specific trigger event happens (like its next funding round), the funds are used to subscribe for shares. Like convertible loan notes, ASAs can carry a discount on the subscription price for shares.

It’s worth noting that, if structured correctly, ASAs can enable investors to secure tax relief via the SEIS or EIS scheme – more on this below. However, investors in convertible loan notes aren’t eligible.

For later-stage businesses – venture debt funding

For rapidly growing tech businesses that have recently completed or are currently in the process of raising a Series A funding round or later, venture debt funding can present a highly attractive option. It's a great way for later-stage founders to get extra financial support without further diluting the ownership of their business.

Typically, venture debt providers are willing to lend founders an amount equal to 20-30% of the total equity funding they’ve secured so far. Though it doesn’t dilute founders’ equity, venture debt funding often involves an ‘equity kicker’, whereby businesses grant a warrant to lenders, enabling them to acquire shares at a low price. Moreover, venture debt usually comes with higher interest rates and shorter repayment periods of up to three years.

A top consideration – tax-advantaged

investment schemes

Tax relief is a top priority for many UK investors. As such, it's important for startups to gain a thorough understanding of the country's tax-advantaged investment schemes.

The Seed Enterprise Investment Scheme (SEIS), established by the UK Government, has proven to be highly successful in encouraging investors to support high-risk ventures during their early stages. Thanks to SEIS, numerous young businesses have been able to secure pre-seed or seed funding rounds.

Let's take a closer look at the latest data from HMRC, which indicates a promising trend. In 2022, an impressive 2,270 businesses raised £205M through SEIS, compared to 2,105 businesses that raised £176M the previous year. The scheme's recent extension and expansion have further enhanced its appeal, providing startups with an extended period to raise funds.

Alongside SEIS, the UK has several other tax-advantaged investment schemes, such as the Enterprise Investment Scheme (EIS), which caters to later-stage investment opportunities, and the Venture Capital Trusts Scheme (VCT).

Navigating the criteria and conditions to secure relief through these schemes can be challenging, which is why it's essential to consult an experienced advisor. Each scheme comes with its own set of intricacies, and missteps could result in investors losing out on tax relief for all current and future investments in your business. In the case of VCT, there's even more at stake, as it could lead to the potential loss of tax relief for the VCT fund manager across their entire portfolio. So, it's better to play it safe and seek expert guidance.

The outlook for startup financing

The first half of 2023 saw a decline in investment activity in the UK, and discussing valuations has become challenging. However, funding for early-stage businesses remains resilient, particularly in the deeptech, greentech, and life sciences space.

That's because there's still a lot of 'dry powder' in the system in the form of money raised by investment funds over the last two years. In most cases, they are obliged to invest this within a specific timeframe (between five years and a decade). So, opportunities are very much still out there for innovative UK businesses with strong management teams focused on capital efficiency and long-term value creation.

For more top tips on seeking investment please visit *The Fast Growth Secrets of tech founders*.

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