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proactive business advice

Investing in your business

Whether you are considering fresh investment in an established business or initial investment in a new enterprise it is important that your investment decisions are thoroughly appraised, timely, and in accordance with your overall personal and business strategy.

Business UPDATE

Need for a strategic approach

Businesses need to keep their investment strategies under regular review, regardless of the economic conditions, and assess potential investments not in isolation but within the context of their overall business objectives.

When the current economic downturn began, many UK SMEs responded by cutting back on investment - putting off, for example, IT and other equipment upgrades. But a recent survey has revealed that as a result of this underinvestment UK SME's lost in the region of £8.3 billion in potential new income or new business opportunities.

There are, of course, many reasons for investing in your business besides replacing and upgrading systems and equipment, but this example does serve to illustrate the importance of taking a strategic approach to investment and making decisions proactively based on long term considerations rather than reactively as a short term response to current economic conditions.

Clearly there is an even greater need for a planned, strategic approach if your proposed investment involves expansion or diversification such as:

- Developing a new product or service
- Entering a new market
- Expanding territorially
- Entering into a joint venture or strategic alliance
- Planning a merger or acquisition.

Getting the balance right

Besides avoiding potentially damaging underinvestment, it is equally important to avoid over investing and thereby placing undue stress on your financial resources, restricting your investment options further down the road, or limiting your flexibility to respond to future changes.

As with many business decisions, investment is a question of balance - and getting the balance right depends in large measure on applying appropriate appraisal techniques during the planning stage.

Appraising potential investments

Investments of any significance should be subjected to a thorough appraisal, which ideally would include consideration of the following:

Financial factors

Appraise the financial viability of the project by considering, for example:

- Availability and cost of funds
- Impact on cashflow
- Return on investment

Alternatives

Before locking onto a particular project, or a specific approach to that project, it can be worthwhile to consider alternatives, for example:

- Not investing capital in the project but using rental or leasing alternatives instead
- Investing in the project but taking a less expensive approach - or perhaps even a more expensive approach - if analysis suggests it might be beneficial
- Investing in a different project altogether

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Timing

Consider, for example:

- Whether to invest now or at a later date
- How long the payback period should be
- To what extent the project can be implemented in phases

Risks

Where possible, conduct sensitivity and risk analyses to assess how the investment might respond to different scenarios such as:

- Possible delays in implementing or completing the project
- Changes in the marketplace, especially competitor activity
- Changes in economic/financial conditions
- Internal changes such as the loss or acquisition of key employees, customers, or suppliers
- Changes to the regulatory regime

Non-financial factors

Finally, relevant non-financial factors should also be included in the appraisal, and where possible quantified:

- The project might, for example result in your being quicker to market with a product or service, improving employee relations, or adding greater flexibility to your operation, or it might cause disruption that could impact on other aspects of your business
- External factors such as regulatory and compliance considerations or company reputation might also be relevant

We have considerable experience advising on the raising of capital and investing in a business, so if you would like help or advice with any of these steps, please don't hesitate to contact us.

Conducting a financial appraisal

The principal purpose of a financial appraisal is to assess the impact of an investment on your cashflow. It enables you in various ways to estimate the return on investment for a proposed project and to compare it with other possible courses of action.

The simplest way to assess an investment is to estimate how long it will take to repay it - a technique known as the Payback Period. Thus, for example, if a project requires an investment of £100,000 and is projected to return £20,000 a year, the payback period is 5 years. If the return is likely to be irregular the calculations might be a little more complex but the same principles apply.

Note that when appraising a potential investment project it is probably advisable to initially ignore any sunk costs - money that has already been spent and cannot be recovered - or any money that would be spent anyway.

For smaller businesses, especially those that prefer to avoid higher risk long-term investments, this is a simple method for identifying projects with relatively short payback periods. However, because it does not take account any returns likely to be made after the initial investment has been returned it is an appraisal that should not be looked at in isolation.

Impact on profits

Another quick method of financial appraisal is the Accounting Rate of Return (ARR), which focuses on potential profit rather than cashflow. Here, you compare the average annual profit you expect to make over the life of an investment project with the average amount you will need to invest. Thus, for example, if a project required an average investment of £100,000 and was predicted to generate an average annual profit of £12,000, the ARR for that project would be 12 per cent. The higher the ARR, the more attractive the investment.

Both these methods can also be used to compare projects to see which are the most attractive, but when doing so it is important to be consistent in the way you make the calculations so that you are comparing like with like.

More sophisticated financial appraisals

There are more sophisticated appraisal techniques such as Net Present Value and Internal Rate of Return that take the time value of money into account by discounting future cashflow. They allow you to account more realistically for factors such as the length of time it will take for a project begin to providing returns or how a longer investment might impact on your cashflow These calculations can be quite complex and we suggest you contact us if you would like help or advice with this.

It is also important to note that the accuracy and reliability of any investment appraisal depends upon the accuracy of the data you enter, such as the size and timing of future cashflows. Again, this is an area in which you might want to seek our help and advice.

Tax considerations

Any time you invest funds it is important to consider the timing from the point of view of both your financial position and your tax position. We can advise on this. Your investment could qualify for the Annual Investment Allowance if you are planning to invest in certain plant or machinery.

There are also other tax mitigation options that might be relevant such as a short life asset election.

Contact us for help and advice

The current economic conditions provide opportunities for business investment and development but the risk element of investing should also be carefully factored in to the decision making process. We would be pleased to help you plan your business investments to ensure they are thoroughly appraised and that your tax position is optimised. Call today for help and advice.