

Money & Machines

The Guide to Successful Capital
Investment in Manufacturing



How Money & Machines Can Help



Identifying and Assessing Capital Investment Opportunities



Capital Investment Appraisal



Selecting the Right Financial Package



Preparing an Application for Funds

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Department of Trade and Industry



“In today’s challenging conditions, investment in the right equipment, technology and management methods is key to the success of the business enterprise and the economy.”

John Battle MP, Minister for Science, Energy and Industry



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“I welcome *Money & Machines* which I hope will contribute to a better understanding between those who supply finance and those who use it to improve the productive capacity of our economy.”

Eddie George, Governor of the Bank of England



Partnership Between Industry and Finance

John Battle MP, *Minister for Science, Energy and Industry*

In today's challenging conditions, investment in the right equipment, technology and management methods is a key to the success of the business enterprise and the economy. Any glance at the international competition suggests the need for increased levels of carefully planned and justified investment - and for a constructive partnership between industry and finance to help bring this about.

Notably a significant proportion of initial applications by firms - particularly SMEs - to financial institutions fail. Of course all investment has an element of risk but manufacturers and financiers can minimise the risk by working together with common structures and guidelines. This is why we have produced *Money & Machines*.

The up-to-date guide is the result of a unique partnership between industry and finance, designed to improve the success rate of applications for finance - and the level of understanding between manufacturing industry and lenders. By encouraging these improvements the guide will also improve the quality of capital investment, and ensure that

investment is, as it should be, at the heart of business improvement.

Its message is simple. If companies are to make the right decision on an investment and secure finance for it, they need to show that they have a business strategy and a plan to take them where they want to go. Lenders need to see that a business is sound and well managed and that the business will be improved if the investment is made.

We want *Money and Machines* to be used both by those running businesses and by financiers. By helping firms to understand what information lenders need and how it can be provided, the guide will improve the success rate of applications. Just as important, it should help financiers think more clearly about their own role in helping business to invest.

I urge you to study *Money and Machines*, understand it and, above all, use it and apply it fully in your preparation or assessment of capital investment opportunities.

With tools like this at our disposal we can all play a part in making sure wealth creating companies remain the driving force behind a growing prosperity into the new millennium.



“Bankers should be partners in the growth process for successful manufacturing businesses and can best add value when we are involved right from the planning stage of development. *Money & Machines* provides a systematic framework for us to work together and so ensure that the right financial package is assembled, whether this involves traditional banking facilities, asset-based forms of finance or equity funding.”

John A Spence, Chairman, British Bankers' Association Small Firms Advisory Panel



HOW MONEY & MACHINES CAN HELP YOU

Capital investment in new equipment and technology is the backbone of manufacturing industry and central to its growth and development. Investment funds are its lifeblood. But when many companies apply to financial institutions for funds their requests are refused. This is not necessarily because of any inherent weakness in the projects themselves. Often, it is because the quality of the proposal is considered so poor that financial institutions find it impossible to evaluate. At the same time, lenders may fail to grasp all the benefits the investment will bring them.

Our aim is to help manufacturing companies and financial institutions understand each other's needs. We also want to provide a common set of guidelines which will help you in industry achieve three things:

- To make sound capital investment decisions;
- To select the most appropriate financial package;
- To prepare applications for funds which stand the best chance of success.



HTEC managers part funded their automated test equipment with an unusual system of pay per use. Full story in related publication, Informed Investment.

Who will find *Money & Machines* most useful?

For all companies planning a major capital investment, there is valuable advice in the guide. In particular, firms with little experience of securing outside funds will find this guide a great help when they see fresh opportunities that require new investment. The guide is primarily aimed at companies with a turnover ranging from around £1 million to about £10 million.

The financial institutions will gain a better understanding of business' needs. In addition, the guide should also prove useful to those advising firms on capital investment plans.

How should you use the guide?

Owners and directors of small and medium sized businesses can use it to check that they are following a logical sequence when reviewing their current business position and identifying investment requirements. These steps take the reader right through to preparing an application for funds.

Second, the guide is structured so that the manager or team working on the investment project can use individual sections as required.

Third, the guide will provide financiers with the basis for a structured evaluation process.

What does *Money & Machines* cover?

The process of making a capital investment varies every time, but, typically, is made up of ten steps, all covered by the guide. These are:

1 Identify the need to invest

Successful companies look regularly to identify areas with profitable capital investment potential. This analysis has to fit with the existing business plan and budget, or financial constraints, and be consistent with the overall situation facing the company.

2 Assess how much capital is required

You need to ensure the proposed investment maximises all possible benefits and that all areas, particularly those offering so-called soft benefits, are included. You must also make sure that costs like training or working capital are not overlooked.

3 Pinpoint resources

Carrying out an investment appraisal and preparing a financial application call for specialist expertise. If this is not available inside the company you must look for it outside. Details of the type of financial analysis that needs to be carried out are in Section 2 on page 16.

4 Manage the investment project

This stage will vary enormously, but in addition to the financial aspects addressed by this guide, you must cover areas such as:

- *Specifications of the equipment or technology involved;*
- *Names of equipment suppliers, plus costs and lead times;*
- *Installation and operational risks.*



5 Carry out the investment appraisal

Section 2, beginning on page 16, shows that, when carrying out an appraisal of the proposed investment, it is important to:

- *Consider the full scope of the investment;*
- *Use the right financial analysis tools and techniques;*
- *Carry out a satisfactory risk analysis;*
- *Make a comprehensive assessment of the capital requirements of the project.*

6 Work out the right financial package

Most capital investments will involve the use of several types of finance. Sorting out the most suitable package is critical. See Section 3, beginning on page 27.

7 Prepare the finance application

This involves understanding what information is required by financial institutions and providing it in the correct form. See Section 4, beginning on page 38.

8 Choose and negotiate the finance

There are many sources of finance to choose from. When assessing the most suitable source and starting negotiations, you will need to have a clear strategy and as much information as possible on typical terms, conditions and interest rates. This may also affect the finance package decision outlined in Step 6. See Section 3.3, page 34.

9 Project controls

With finance in place and the project under way, it is vital to keep track of expenditure and compare it to budget, checking progress against a plan. These measures should prevent any need for extra finance or the renegotiation of the repayment period. Both are common problems.

10 Review results

Carrying out a review of any large or important capital investment is well worth while. Reviews are best conducted about a year after the project has been completed. A track record of investment success, gathered from previous reviews is a great help in selling a proposition to financial institutions.

Figure 1 *Provides a checklist which managers can use to review how well prepared they are to undertake a major capital investment project.*

Figure 2 *Is an example of a typical capital investment project plan.*

At the end of each chapter you will find a list of useful reading material.

FIGURE 1 CAPITAL INVESTMENT MANAGEMENT CHECKLIST

HAVE YOU:	YES	NO	REFERENCE	
Actively reviewed capital investment opportunities?	<input type="checkbox"/>	<input type="checkbox"/>	Section 1.0	Page 11
Checked the investment opportunity against your plan?	<input type="checkbox"/>	<input type="checkbox"/>	Section 1.1	Page 12
Fully assessed the proposed investment to ensure you have maximised benefits, included all costs and minimised risks?	<input type="checkbox"/>	<input type="checkbox"/>	Section 1.2	Page 13
Identified the resources needed to carry out the investment appraisal and apply for finance?	<input type="checkbox"/>	<input type="checkbox"/>	Introduction	Page 6
Made a project plan?	<input type="checkbox"/>	<input type="checkbox"/>	Introduction	Page 9
Carried out a financial appraisal?	<input type="checkbox"/>	<input type="checkbox"/>	Section 2.0	Page 16
Identified and evaluated non-financial benefits?	<input type="checkbox"/>	<input type="checkbox"/>	Section 2.3	Page 21
Carried out a risk analysis and identified the funds needed?	<input type="checkbox"/>	<input type="checkbox"/>	Section 2.4	Page 24
Selected the most appropriate types of finance?	<input type="checkbox"/>	<input type="checkbox"/>	Section 3.0	Page 27
Produced a well-prepared, high-quality application?	<input type="checkbox"/>	<input type="checkbox"/>	Section 4.0	Page 38
Chosen potential finance providers and prepared for negotiations?	<input type="checkbox"/>	<input type="checkbox"/>	Section 3.3	Page 34
Put in place project control measures?	<input type="checkbox"/>	<input type="checkbox"/>	Introduction	Page 7
Planned to carry out a review after the project has finished?	<input type="checkbox"/>	<input type="checkbox"/>	Introduction	Page 7


FIGURE 2 CAPITAL INVESTMENT PLAN OVER 12 WEEKS

ACTIVITIES	1	2	3	4	5	6	7	8	9	10	11	12	TIMESCALES PROJECT DEPENDENT
Review against strategy and business plan													
Set objectives and define business benefits													
Assess capital investment requirement													
Identify project resources													
Define project details													
Carry out investment appraisal													
Select suitable financing type													
Prepare finance application package													
Finance provider selection													
Negotiate with finance providers													Dependent on finance type
Project implementation controls													Throughout project
Post-commissioning review													1 year after commissioning
MILESTONES													
Definition of main areas covered			X										
Detailed project specification					X								
Internal justification							X						
Accept/decline decision							X						
Selection of preferred finance package								X					
Finance application document											X		
Agreement with finance provider													Timescale dependent on negotiations
Formal mid-stage project reviews													Timing and number project dependent
Formal post-commissioning review													1 year after commissioning

SOME SOURCES OF FURTHER INFORMATION

Selecting and building teams

Appointing and managing advisors and providers of professional services: what to do, what not to do and what to look for
 Barrie Woodcock, RBW Associates,
The Chartered Institute of Public Finance and Accountancy,
 3 Robert Street, London WC2N 6BH

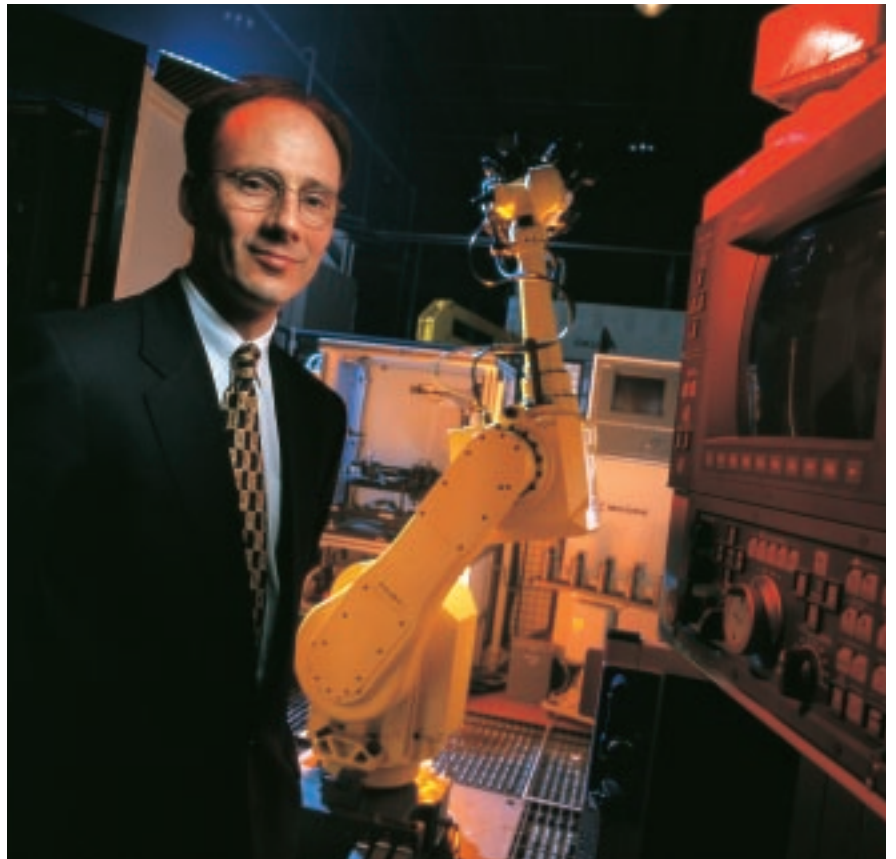
Managing capital investment projects

Capital investment and financial decisions
 Haim Levy and Marshall Sarnat, Prentice-Hall

Post-commissioning reviews/project management controls

Management Accounting Guides, Capital Expenditure Control
The Chartered Institute of Management Accountants,
 63 Portland Place, London W1N 4AB

Alan Purvis of pump maker BOC Edwards. £1.2 million of a £10m per annum investment has gone into this robotic rotor making cell. Full story in the related publication, Informed Investment.



IDENTIFYING AND ASSESSING CAPITAL INVESTMENT OPPORTUNITIES

1.0

The success of any business depends on the strategy it adopts and the way that strategy is implemented (detailed in the business plan). The success of any investment decision will mainly be determined by how well it fits with the strategy, rather than how it is financed.

Companies that are particularly successful in achieving a good return on their investment, and therefore gaining an advantage over their competitors, have a lot in common. For example:

- *When these companies invest, expected performance is achieved because their plans (including risk assessment) have been realistic and their investments have fitted a sound strategy.*
- *Their investment decisions not only stand on their merits, but integrate well with each other. Rarely is there any conflict.*
- *Whenever possible, they buy equipment that can be enhanced or upgraded later.*
- *They are realistic and invest enough to ensure the project's success.*
- *Their project funding covers more than just core equipment. Associated support and services, critical to success, are also included.*
- *These successful companies make both short-term (two to three years) and long-term investments. Long-term investments are vital for sustained competitive advantage.*

STAPLES GROUP

Established way back in 1886, Huddersfield-based Staples Group is a major paper converter and polythene extruder. Exporting to 42 countries, Staples primarily supplies the textile industry, but has recently developed its business to serve other sectors, including automotive.

Chairman Robert Staples, a former president of the Yorkshire Institute of Directors, is a firm believer in planned investment as the best route to sustained competitive advantage. In the last few years, the group has spend hundreds of thousands of pounds buying new machinery and acquiring other companies. "We have recently installed two new paper converting machines at a cost of £150,000 each," he says. "We've also spent £60,000 on ultrasonic equipment for our shoulder pad manufacturing facility, which means we can effectively weld the seams rather than stitch them. This helps us to make our products more quickly and better serve customers."

A cannily-run Yorkshire business, Staples prefers not to

borrow money if possible, opting for retained profits as a source of funds when conditions allow. This does, Robert accepts, mean that a quick return on his investment is critical, though he sees advantages in this: "Today, it's very difficult to plan for the long-term. You choose projects which offer a quick payback wherever possible: it's not short-termism, because faster returns give you more money for reinvestment in other projects." Markets are changing so quickly, he argues, that long-term schemes are more risky. Staples also says he looks closely at the likely margins when assessing an investment project.

Robert Staples' admitted old-fashioned reluctance to borrow money does not blind him to the need for carefully budgeted investment. His firm has a special 'machinery account' with its bankers, which is used to finance larger purchases. Essentially a fixed-term loan facility, this account gives the business stability and enables him to measure the return on his investment.

Seeing capital investment decisions as part of an overall plan

1.1

Companies decide to make a capital investment in one of two ways: either they proactively identify the need to invest during a planning or budgeting process, or the decision is made reactively in response to market opportunity.

Situations that might lead to planned capital investment:

- *Enhancing existing products and services;*
- *Developing new products or offering new services;*
- *Entering new markets;*
- *Replacing or adding to buildings or equipment to increase capacity, to replace worn out machinery or to increase efficiency;*
- *Takeovers and mergers.*

Investment opportunities that require a reactive response:

- *A request or demand from a customer;*
- *Problems with or suggestions from a supplier;*
- *Competitive activity;*
- *Response to legislation such as health and safety requirements;*
- *A good idea from within the company.*

Areas worth considering during the planning process are set out in Figure 3 on page 14. A useful checklist when considering opportunities that call for a reactive response is on page 15 (Figure 4). This checklist will help ensure a close fit with the business plan.

It is also critical to be aware that any significant capital investment exposes a company to risk. Like shares, the value of assets to a company can rise as well as fall, and it is a vital part of the investment appraisal process to determine the potential risk to the business if the project fails to produce its expected returns. This is not to say that firms should be dissuaded from taking bold decisions where the business case justifies such a move, but any investment project whose failure would leave the company in difficulties should be regarded as dangerous, and the greatest care taken to ensure the likely returns and risks have been accurately assessed.



What should capital investment cover?

1.2

One of the most common features of successful capital investment is that the project is comprehensively assessed to determine how it fits with other parts of the business. This includes assessing how the business can adapt to make the most of the investment. Significant benefits often come from investing enough to ensure success, rather than a bare minimum

Enhanced competitive position as a result of:

- Capacity or capability enhancements which are difficult for competitors to match without similar investment;
- The ability to compete on price due to efficiency savings;
- Offering a one-stop shop or full range of services;
- Setting high technological or quality standards;
- Taking processes in-house where strategically appropriate.

Increased sales through:

- Better quality products;
- Faster introduction of new products or design changes;
- Offering development or prototyping facilities;
- Offering additional services such as design or just-in-time delivery;
- Offering a more consistent product;
- Giving customers information on lead times or order status;
- A new ability to offer products or services to new markets.

Operational improvements

For example, cellular manufacturing techniques or Kanban systems which bring reductions in:

- Scrap;
- Rework;
- Disruption of production due to scrap and rework;
- Warranty and service costs;
- Cost of inspection and quality assurance;
- Cost of design changes and documentation;
- Safety stocks.

Meeting legislative requirements and standards in:

- Health and safety;
- Recycling;
- Environmental emissions.

Job satisfaction

Although the concept of creating greater job satisfaction through multiskilling and training is difficult to quantify, there is growing recognition that investment can create high levels of employee confidence and morale, and lead to a more efficient, stable and profitable business.

Cover all costs

A common problem is failing to invest in support areas and systems and other overheads, so the main investment can be exploited fully. It is worth looking at the following areas:

- *Management information systems;*
- *Recruitment and staff training;*
- *Sales and marketing;*
- *Increasing services and utilities;*
- *Changing working practices;*
- *Adequacy of working capital;*
- *Credit control;*
- *Changes in areas such as stores, factory layout and location in relation to markets and distribution;*
- *Spares and servicing.*

FIGURE 3 PLANNED INVESTMENTS CHECKLIST

Shareholders' objectives and company strategy in the areas of:

- *Growth;*
- *Risk;*
- *Control;*
- *Profit levels;*
- *Exit from the business;*
- *Diversity of products, technologies and markets;*
- *Innovation.*

The resource base of the company and plans for developing it in the areas of:

- *Financial resources;*
- *Skill base;*
- *IT;*
- *Sites and facilities;*
- *Managerial ability and resources;*
- *Technological and operational capability.*

Finance

- *Sources of investment finance;*
- *Levels of borrowing;*
- *Working capital position;*
- *Levels of risk attached to financial strategy.*

Manufacturing and operations

- *In-house manufacture or subcontracting;*
- *Inventory policy;*
- *Jobbing, batch or continuous manufacture;*
- *Specialised manufacturing or flexible cells;*
- *Purchasing and supply.*

Competitive position

- *Products and services;*
- *Markets served;*
- *Customer types and requirements;*
- *Pricing policy;*
- *Distribution;*
- *Promotional policy;*
- *Image.*

The business environment

- *Technology trends;*
- *Environmental, legislative and health and safety requirements.*


FIGURE 4 CHECKLIST FOR REVIEWING NEW INVESTMENT OPPORTUNITIES

	YES	NO		YES	NO
Does the project fit with the company's objectives?	<input type="checkbox"/>	<input type="checkbox"/>	Does the project support the company's marketing approach in the areas of:		
Can existing company resources support the project in areas like:			● product ranges?	<input type="checkbox"/>	<input type="checkbox"/>
● workforce skills?	<input type="checkbox"/>	<input type="checkbox"/>	● customer requirements?	<input type="checkbox"/>	<input type="checkbox"/>
● managerial ability and resources?	<input type="checkbox"/>	<input type="checkbox"/>	● advantages over competitors?	<input type="checkbox"/>	<input type="checkbox"/>
Can you fund the project within the current financial plan?	<input type="checkbox"/>	<input type="checkbox"/>	● pricing policy?	<input type="checkbox"/>	<input type="checkbox"/>
Does the project fit with current and planned:			● marketing policy?	<input type="checkbox"/>	<input type="checkbox"/>
● manufacturing strategy?	<input type="checkbox"/>	<input type="checkbox"/>	Does the project conflict with:		
● site and facilities?	<input type="checkbox"/>	<input type="checkbox"/>	● environmental constraints?	<input type="checkbox"/>	<input type="checkbox"/>
● technological and	<input type="checkbox"/>	<input type="checkbox"/>	● health and safety policy?	<input type="checkbox"/>	<input type="checkbox"/>
● operational capability?	<input type="checkbox"/>	<input type="checkbox"/>			
● purchasing methods?	<input type="checkbox"/>	<input type="checkbox"/>			

SOME SOURCES OF FURTHER INFORMATION

Strategic planning

Exploring Corporate Strategy

Gerry Johnson & Kevan Scholes, Prentice Hall International

Competitive Strategy

Michael E Porter, The Free Press

Marketing Plans, How to Prepare Them, How to Use Them

Malcolm H B McDonald, Heinemann

Capital budgeting process

Accounting and Financial Decisions

D R Myddelton, Longman

Accounting for Management Decisions

John Arnold and Tony Harper, Prentice Hall International

Identifying project size

Machinery Buyers' Guide

Findlay Publications, telephone 01322 222222

CAPITAL INVESTMENT APPRAISAL

2.0



*Nigel Whalley of Delcam. His company will halve the time it takes to make mould tools thanks to a £560,000 five axis machining centre. Full story in the related publication, *Informed Investment*.*

Once you have identified the need to make a capital investment and you are sure it fits your company's business plan, the next step is to make a financial evaluation. This internal justification is vital because it allows you to consider the financial requirements and returns of a project and to choose between alternatives.

The work you carry out on the financial evaluation will give a clear picture of the pros and cons of the investment and serve as the basis of the package you present to your financiers. The internal appraisal is often taken into account by lenders when assessing both the professionalism and the competence of the team making the application.

The level of detail required depends largely on the size of the investment in relation to the total business. It is good practice to use internal justification procedures for most levels of capital investment, including replacement expenditure.

This section considers the financial analysis of an investment and the evaluation of wider, non-financial benefits.

Financial analysis is carried out in two distinct stages.

- Stage 1** Looks at the investment in isolation to determine whether the anticipated return is good enough.
- Stage 2** Evaluates the effect of the investment on the company overall and its financing.



Financial investment appraisal

2.1

A company is planning to buy a new £100,000 machine tool. Although the technical benefits of the equipment are clear, the difficulty lies in deciding if the investment will be worthwhile. Appraisal involves identifying and analysing the way the investment will change cashflow, both negatively (the investment) and positively (the expected returns) and making your best estimate of what those changes will be.

Two common difficulties are associated with appraisals:

- 1 Identifying all the relevant cash flows;
- 2 Forecasting cash flows with some certainty.

All cash inflows and outflows that occur as a result of the investment must be calculated on the day they will arise. Hence, the calculation will need to include at least:

- Capital expenditure and revenue items;
- Increased working capital (stocks and debtors minus creditors);
- The cost of additional training;
- Income from disposal of assets at the end of their life;
- Clean up costs;
- Changes to tax.

To deal with the uncertainty surrounding forecasts, you can make a number of assumptions. Probabilities can be used to determine a best, a worst and a most likely estimate.

Decision-making tools and techniques

Once cashflow forecasts have been produced for the alternative projects and the 'do nothing' scenario, a decision has to be made whether to proceed with some or all of the proposed investments. There are a variety of techniques to help. In order of increasing sophistication, the most common are:

- Payback;
- Accounting rate of return;
- Net present value;
- Internal rate of return.

To help decide which technique to use, here is a brief description of each (simple worked examples using the four techniques are shown in Section 2.2).

Payback

This is the simplest and easiest technique, and involves estimating the time taken for an investment to be paid for. Because it ignores returns made and costs incurred after the payback period and the time-value of money, it tends to favour projects that offer the quickest payback period.

Because of its simplicity, payback is often used as an initial screening technique. However, when using payback, it could be a mistake to discriminate against long-term, strategically important projects (such as product or service development) in favour of rapid payback cost reducing projects which offer a quick, certain return.

Accounting rate of return (also known as return on capital employed)

This widely used method estimates the total profitability of a project as a percentage of the cost of the investment. It is a useful indicator of whether an investment is likely to offer a good margin or profit, and it can be compared with the company's overall return on capital employed to indicate if profitability might increase. The major drawback is that it deals with profits rather than cash, and no account is taken of project size or timing of return.

Net present value (NPV)

NPV, together with the internal rate of return, involves more complicated calculations which take into account the relative timings of cash flows (a discounted cashflow analysis). For long-term projects where short payback is not relevant, this approach of discounting the value of future cash flows according to their timing is an important decision-making tool.

NPV calculations discount all cash flows back to the start of a project to arrive at a single figure which is the cash generated by the project. The general rule is that projects are selected according to the magnitude of the resulting net cash figure. The disadvantage is that it is sometimes difficult to assess risk because the method does not obviously highlight the size of the initial investment and the time taken for it to be repaid.

Internal rate of return (IRR)

This technique is similar to NPV, except that it calculates the percentage return that is required to achieve a nil net present value (that is, it calculates the percentage return generated by the proposed project). Accountants talk about a hurdle rate (or target rate of return) and use an IRR calculation to see if a project meets the hurdle rate.

The calculation is more complicated than the other three methods and will favour projects with the greatest rate of return rather than the size of the return. This may cause problems if a company has to choose between a project with a low IRR and a small project with a high IRR. It is possible the small project will actually generate less cash.

Which techniques should you use?

These brief descriptions show the advantages and disadvantages of each technique. The best course of action is to ask your accountant's advice on the most appropriate method. Here are a couple of useful pointers:

- *For short-term, straightforward projects (up to five years), use payback in the majority of cases;*
- *For long-term, more critical projects, one of the discounted cashflow methods, NPV or IRR, is the best choice.*

Do not put too much emphasis on short, quick-return projects which may favour short-term investments in less productive, poor quality assets, rather than innovative systems which are likely to give long-term competitive advantage.

Appraisal techniques: worked examples

2.2

The starting point for an appraisal process is a clear understanding of the cash flows of that investment. A company can then choose the technique that it feels appropriate. The advantages and disadvantages of each method are addressed separately in Section 2.1. Here we are concerned only with presenting a simple example of the operation of each technique. The example excludes all complicating factors such as inflation, tax, capital allowances and uncertainty over cash flows. You are advised to seek professional advice if required.

EXAMPLE A

		£000
Year 0	Investment	(100)
Year 1	Cash flow	20
Year 2	“	40
Year 3	“	40
Year 4	“	20
Year 5	“	10

Imagine a simple project involving the purchase of a machine costing £100,000 and which generates returns over five years. Example A sets out the costs/revenues.

Payback

Payback

This is the simplest technique and consists of calculating how long it will take before the investment is “paid back”. In our example, payback is three years ($£20K + £40K + £40K = £100K$). The method concentrates on the cash flows generated by the project rather than reported profits.

Accounting rate of return (ARR)

This is also known as the return on capital employed and can be calculated in various ways. However, it normally involves estimating total reported profit on the investment as a proportion of the cost of that investment. In our example, if we assume that the investment is written down (depreciated) over five years at the rate of £20,000 per annum, reported profits are shown in Example B.

ARR is often calculated by dividing the average return (£6K) by the average value of the asset over the five years ($£100K/2=£50K$). Using this method, ARR is 12 per cent.

EXAMPLE B

	£000
Year 1	0
Year 2	20
Year 3	20
Year 4	0
Year 5	(10)
Total	30 (an average of £6K per annum)

Net present value (NPV)

Both NPV and IRR (below) take into account the fact that £1 today is worth more than £1 in the future. Finding NPV involves calculating how much future cash flows are worth in present values by discounting them, using the company's required rate of return for investments. This is done using discount factor tables or by calculation. For example, if the company applied a discount factor of 5 per cent to the above figures (Example B), the present values of the cash flow over the five years would be £113.44K (£19K + £36.12K + £34.28K + £16.30K + £7.74K — see Example C below).

The NPV is thus £13.44K. In theory, any project with a positive NPV can be accepted, but a company will also be interested in other factors such as the size of the final NPV relative to the original investment.

Internal rate of return (IRR)

This method involves calculating the discount rate at which the NPV is zero. Discount factors are applied to the project. In our example, the internal rate of return is approximately 10 per cent. At this point, the real value of the cash flows is £101.13K (£18.18K + £33.04K + £30.04K + £13.66K + £6.21K — see Example C) and NPV is nearly 0.

In theory, any project where the IRR is higher than the company's cost of capital (or hurdle rate) should be accepted. However, companies may well also take other issues into account such as the total profit.

EXAMPLE C

Application of discount factors

	5 per cent discount factor (NPV example)			10 per cent discount factor (IRR example)	
	£000 x factor = £000			factor	£000
Year 0 Investment	(100)	1.000	(100.0)	1.000	(100.0)
Year 1 Cash flow	20	0.95	19	0.909	18.18
Year 2 Cash flow	40	0.903	36.12	0.826	33.04
Year 3 Cash flow	40	0.858	34.32	0.751	30.04
Year 4 Cash flow	20	0.815	16.30	0.683	13.66
Year 5 Cash flow	10	0.774	7.74	0.621	6.21
			NPV= 13.48		NPV= 1.13

Evaluating and justifying business benefits

2.3

An investment proposal with excellent potential benefits is obviously much more likely to succeed than one with little to offer. However, the reality is that many proposals fall between these extremes and making a good case for the so-called soft benefits may make all the difference.

In making the decision whether to invest, identifying the soft benefits is often as important as the financial evaluation. Typical soft benefits include:

- *Flexibility of production;*
- *Quality;*
- *Greater market share from faster time-to-market;*
- *Reduced scrap;*
- *Better morale and job satisfaction resulting in greater productivity;*
- *Improved company image due to better facilities;*
- *Better decision making as a result of greater availability of management information.*

Quantifying these benefits is no easy task. However, this is an important area, particularly when it comes to preparing an application for funds (Section 4 page 38). So it is well worth trying to define what you will achieve in quantifiable terms.

FAUN MUNICIPAL VEHICLES

When Anglesey-based waste disposal vehicle manufacturer Faun Municipal Vehicles wanted to move to a new plant, it encountered problems raising the necessary finance. But a combination of development grants and a bridging loan facility enabled Faun to cover the shortfall, and the company is now safely ensconced in its new 5,300 square metre premises.

“The new building was budgeted at £2 million, plus we invested £950,000 for capital equipment such as spray booths,” says Faun company secretary Bill Farnell. “We had arranged a commercial mortgage facility with the Bank of Wales, but when the valuation came through, it amounted only to £1.6 million, and so the bank was unwilling to advance us all the funds we needed. Fortunately, with a development grant from the Welsh Office and Regional Selective Assistance, plus a bridging loan from the Midland

Bank, we were able to make up the difference.”

With 12 per cent of the UK market, and recent orders from Hong Kong and Norway, Faun’s business was flourishing. But it was being held back by inadequate facilities. Faun’s move from its original premises — built during the war to house flying boats — to a modern production facility became vital when health and safety regulations made it impractical to continue spraying vehicles in the existing plant. So, says Farnell, the funding gap which resulted from the valuation problem, could have brought Faun to its knees. Solicitors Pinsent Curtis helped Farnell put the financial package together. “Being able to mix different forms of finance made it possible for us to conclude this deal,” says Bill Farnell. “Without that, it would have been very difficult for the company to continue.”

With that in mind, you should consider the following steps:



A technician operates a robotically mounted laser which is being used to weld glass fibre and plastic onto a composite material.

- 1 Identify a potential gain and describe it in general terms;
- 2 Redefine it in quantifiable terms;
- 3 Estimate the approximate size of the saving involved;
- 4 Carry out a provisional evaluation of costs and savings;
- 5 Check if your gains will have a significant effect on the profitability of the project. If so, improve the accuracy of the estimates;
- 6 Make sure the new equipment really will deliver;
- 7 Carry out the final evaluation.

So how does this work in practice? A good example would be to take a general benefit such as better quality and to break it down into more detail, such as:

- Scrap and rework reduced by 10 per cent;
- Less disruption to production due to scrap and rework. Manufacturing downtime cut by five per cent;
- Reduced warranty and service costs. Currently running at £10,000 per annum, this figure is expected to be halved;
- Reduced cost of inspection and quality assurance — QA staff cut by one;
- Reduced cost of design changes and documentation — development costs cut five per cent;
- Safety stock levels down by 15 per cent;
- A six per cent increase in sales of better quality products. This increase is backed up by independent research which shows that quality is the second most important purchasing criterion and that the company is currently ranked fourth among its competitors.

Wherever possible, estimate the financial values of these benefits. It is important.

How to view benefits

As a rule of thumb, benefits that contribute to higher prices or increased sales are more significant than those concerned with cutting costs. Banks and other sources of finance, however, will probably attach more importance to gains directly under your control or that can be validated by an independent source.

It is good advice, therefore, to spend as much time as you can substantiating increased sales forecasts. Wherever possible, support them with market research or other evidence.

Passing the 3M test

Financial institutions are reluctant to acknowledge any benefits that come from a proposed investment unless they pass the 3M test: is the benefit meaningful, measurable and monitorable?

Unfortunately, most soft benefits fail one or more of these tests with the result that you have to think in terms of two categories: hard benefits which pass the 3M test and are included in a discounted cash flow statement; and soft benefits, which are more difficult to quantify, and are stated as side benefits.

Many lenders will need persuading that improvements in manufacturing systems can lead to direct benefits in the market place or the supply chain. Financiers will not normally be experts in manufacturing technology and you should use the minimum technical detail required to make your case. However, be ready to provide more information — ideally from independent sources — if the financier is reluctant to accept your points.

Make sure the benefits are real. For example, although the equipment supplier may guarantee less downtime with a new system, the lender may not be convinced that the extra output can be sold and so might exclude the benefit. A justification should include how that output will be marketed and why customers will buy it. It may also be possible to justify the investment without additional sales if it leads to significantly reduced costs.

Similarly, when techniques like cellular manufacturing release factory space because of low inventory and better plant layout, this will not count in your favour unless the extra room is put to good use, including alternative profitable use of the surplus space and consequent reduction in overheads.

SIMULA ASD

Local development funds from the Northern Development Company helped airbag manufacturer Simula ASD create more than 110 jobs following the opening of its 30,000 square foot facility at Wansbeck Business Park, Northumberland last year.

But the major part of the start-up cost came as a £2 million loan from the American parent company. And, when faced with the need to import a new production line from America, Simula realised it needed to put in place a plan to repay the debt.

Simula has built its reputation upon the technology it had transferred from aviation safety in aircraft and helicopters. It secured a major deal to provide the ITS system to BMW, making the German company the first European manufacturer to offer inflatable restraints for the side impact protection of the head and neck.

As part of the deal — which took a total of two years to

complete — Simula was required to repay the start-up payment, transferring the £2 million in dollars to Phoenix by the beginning of this year.

To provide a more structured repayment period, David Linklater, Simula ASD's finance director, negotiated an unusual lease package with financier Barclays Mercantile. Linklater says: "We had to pay back the dollar loan by the beginning of 1998, so we decided to use lease finance which enables us to extend the payback period to five years." By leasing the new production line, Simula was able to guarantee the payments it would be required to make until the equipment was paid for.

"This is a unique product which required a tailored financial arrangement. We are going to increase production for our customer with other models, and we are also looking to supply other automotive customers in Europe," says Linklater.

Assessing the financial risk

2.4



*Eugene Martinez of Chase Advanced Technologies with games industry and monitor products in whose production Chase has invested £700,000. Full story in the related publication, *Informed Investment*.*

Once you have decided which projects to pursue, the next stage to consider is how they will affect the overall financing of the business.

Financial forecasts, if you do not already have them, must be prepared, including profit and cash flow forecasts and balance sheet projections. The period covered by the forecasts should be the same as in the original financial appraisal. In addition, monthly forecasts should be prepared if there are seasonal variations or significant individual items which cause irregular cash flows.

It is particularly important to work out the level of sales at which the investment breaks even. And it is particularly important, too, to make these calculations in the light of current rather than past conditions. For example, in the past the company may have calculated a hurdle rate by adding a margin of a given number of points to the base rate. If the company is to achieve its objectives, this hurdle rate must be recalculated if the cost of money becomes stable at a different rate, as happened between the early and late 1990s. Too often, the old hurdle rate becomes written on tablets of stone, when what should be written in stone is, not the hurdle rate itself, but the margin between the required return and the base rate to which that margin is added. To make the calculations in any other way is to rule out investment opportunities which could make the difference between success and failure.

Given these strictures, the next step is to work out forecasts in bands which show the effect on cash flow and profitability of variations of 10 and 20 per cent either side in both sales and cost savings. This sensitivity analysis will show whether small changes in these figures make a big difference to the returns proposed. This will help identify critical risk factors that may undermine the project.

Just occasionally a project will present itself which is risk free. Take as an example a company has a full order book and insufficient capacity to meet demand. A competitor then fails, leaving the company the opportunity to either take over the failed premises or, with even less risk, the failure's machinery. Whenever such an opportunity presents itself, it does not make sense to apply the same criteria to it as to a conventional investment, whether in new premises or new plant and machinery, or the development of completely new products or markets. There is no reason to spend expensive accounting time calculating the payback or internal rate of return on such ventures when all that is needed is to work out how the extra capacity can be put to good use and how much extra working capital might be needed to bring in extra raw materials. Similarly, where a cost saving investment is less risky than a new project, you may not wish to apply exactly the same criteria, depending on what method of allowing for risk you employ.

Such cases aside, the forecasts should be used to show the impact on the profitability of the company and the funding requirement. This is important financiers will want to see the full effect on the company and its commitments.



The funding requirement will have a peak amount. Indicate its timing and how long it lasts. Make sure that you seek funds which cope with the peak and define clearly what the funds will be used for (for example, capital costs, other costs and working capital needs). Once this is known, a decision on the most suitable sources of finance can more easily be made.

Financial information required

Financiers may well need certain financial information in order to assess your application. This requirement will vary, but you should ask your accountant to work out the following for the company overall as a minimum:

- *Return on capital employed;*
- *Gross and net margins;*
- *Profit before and after interest and tax;*
- *Gearing;*
- *Interest cover.*

These should be compared with past performance and future trends. Without this information an application is unlikely to succeed.

A useful checklist for the appraisal of a capital investment is given in Figure 5 on page 26. This summarises key actions you should take when appraising the viability of significant capital investment projects.

SYNPROTEC

Manchester-based chemicals company Synprotec is gearing up for rapid growth after being acquired by a team comprising managers and outside investors in an unusually complex buyout deal. The company, which employs 18 people, provides contract research and process development services to specialist organic chemical manufacturers worldwide. As part of the deal, Lancaster-based MDA Chemicals has taken a strategic stake in Synprotec. The buyout, which has valued Synprotec at £2 million, was financed by equity and debt funding from venture capitalist 3i and Bank of Scotland.

During the course of the next year, Synprotec's new management team expects to make major expansions in both its research and manufacturing facilities. Clive Austin of backer 3i says that its involvement with the company demonstrates that investment capital is readily available to businesses with well-structured propositions, particularly in leading edge technology sectors

“Over the last 12 years, Synprotec has built up a reputation with major pharmaceutical and chemical manufacturers for high quality contract research and process development,” says chief executive Dr Rex Clark. “With the injection of new capital, the company will be able to extend this service into full scale manufacture of fine chemical intermediates.”

FIGURE 5 A CAPITAL INVESTMENT APPRAISAL CHECKLIST

Have you identified and quantified all the cash flows for the project, particularly in the areas of:

	YES	NO		YES	NO
● <i>Capital expenditure?</i>	<input type="checkbox"/>	<input type="checkbox"/>	If the project is long-term and more complicated, have you considered carrying out a discounted cash flow analysis?	<input type="checkbox"/>	<input type="checkbox"/>
● <i>Revenue?</i>	<input type="checkbox"/>	<input type="checkbox"/>			
● <i>Resale/scrap values?</i>	<input type="checkbox"/>	<input type="checkbox"/>	Have you identified and described the project's "soft" benefits and, if they are significant, quantified them and looked for "confidence" factors?	<input type="checkbox"/>	<input type="checkbox"/>
● <i>Project "clean up" costs?</i>	<input type="checkbox"/>	<input type="checkbox"/>			
● <i>Tax implications?</i>	<input type="checkbox"/>	<input type="checkbox"/>			
● <i>Additional working capital?</i>	<input type="checkbox"/>	<input type="checkbox"/>	Have you prepared financial forecasts for the business?	<input type="checkbox"/>	<input type="checkbox"/>
If the project is short term and straightforward, it is usual to calculate the payback. Have you done this?	<input type="checkbox"/>	<input type="checkbox"/>	Have you carried out a sensitivity analysis and identified the break-even level of sales?	<input type="checkbox"/>	<input type="checkbox"/>
			Have you identified and quantified the project peak-funding requirement and detailed the purpose of the funds required?	<input type="checkbox"/>	<input type="checkbox"/>

SOME SOURCES OF FURTHER INFORMATION

Investment appraisal tools and techniques

Accounting & Financial Decisions,
D R Myddelton, Longman

Risk analysis and financing implications

Business Finance for Decision Makers,
E J McLaney, Pitman

General

Accounting for Management Decisions,
John Arnold and Tony Harper, Prentice Hall International

SELECTING THE FINANCIAL PACKAGE

3.0

Once the decision has been made to go ahead with a project and the level and timing of funding have been worked out, the next step is to determine the type of finance that will suit your business best.

For small investments, finance will probably be limited to the capital cost alone. But with larger projects, you will need to take other factors into account (as outlined in Section 1.2). For example:

- *Installation and commissioning costs;*
- *Extra funds for training;*
- *Additional working capital.*

There are many sources of funding available. Most are designed to meet specific needs. For large projects, a combination of different sources is probably the best answer. In the UK, small companies have tended to place over-reliance on internal funds and bank overdrafts for their investment needs.

Because of the range of funds available, choosing the right product can be complex, and unless you are familiar with all the possibilities, taking professional advice early makes good sense. Remember one important rule — the finance should match the life of the asset. An overdraft is not the most appropriate vehicle for funding capital investment.



Armitage Shanks's Jeremy Watts. His company has invested £13 million in pressure casting equipment. Full story in the related publication, Informed Investment.

Sources of finance

3.1

In recent years, many of the messages which this guide seeks to convey have made significant strides into the consciousness of UK business people. In particular, firms have become much more aware of the suitability of particular types of funding for particular types of project; fixed-term lending has increased as businesses realise the open-ended overdraft is unsuited to funding a capital requirement. Similarly, equity providers such as venture capitalists have grown massively. Until recently, many business owners were extremely reluctant to hand over equity in their firms, but of late, proprietors have realised that debt must be backed by equity, that over-gearing is a recipe for disaster and that seventy per cent of a cake worth £10 million is preferable to 100 per cent of a cake worth £2 million.

Also growing rapidly are asset-based financial instruments such as hire purchase and leasing. Again, in the past, firms might have felt compelled to buy outright equipment which was crucial to their operations; the modern view is that, as long as you have the equipment available to you, it matters less who is the ultimate owner. And if leasing an item makes it easier to replace when a newer version comes on the market, then so much the better...

It is well worth considering all the options when looking at your investment possibilities. One of the developing forms of finance, not previously entertained, might permit a much needed investment to go ahead.

A list of the sources of finance available for funding capital investments is shown in Table 1 on page 31. Within each category, there is a wide variety of types of product available. It may help to understand the following features of each finance source:

Internal funds

Some firms fund investments almost exclusively from retained earnings — the largest source of investment finance. However, many companies, particularly smaller ones, rely heavily on external finance. For these firms, internal funds may be more relevant for:

- *Working capital;*
- *Fast-decision investments;*
- *Short-term investments (less than two years);*
- *Small investments (less than £100,000);*
- *A deposit on larger investments.*



Debt finance

Bank overdrafts should be used to finance working capital needs. A bank will expect the balance to fluctuate. Facilities normally have a fixed ceiling, reviewed at least once a year and are repayable on demand. Interest rates are variable, but paid only on the outstanding balance.

Term loans offer a repayment period which is flexible and will be related to the life of the project and cashflow projections. Long-term loans are normally for projects with a ten year plus lifetime, and medium-term loans for three to ten year life projects. These periods may vary with different lenders.

Term loans usually have specific default clauses attached: if these are breached, the loan may become repayable on demand. Interest rates can be variable or fixed. In addition, for variable rate loans, a range of products is available to protect against future interest rate rises.

Mortgage loans are for both the medium or long term and are secured against specific assets. They are mainly used for buying property.

Hire purchase and leasing

Capital items can be financed using hire purchase or leasing. The finance term is generally for a repayment period of up to five years.

The availability of hire purchase and lease finance depends on the lender's view of your creditworthiness and whether or not the asset can be sold if you don't keep up the payments. Finance is usually easiest to obtain for a marketable asset with a long life.

This form of finance is extremely flexible. For example, payment holidays may be available. Rental payments can be fixed, variable or arranged to suit you. In addition, some lease contracts are arranged so the hirer only pays rentals calculated on the difference between initial cost and an expected residual value.

Sale and buy-back or lease-back is one way of raising finance from assets that the business already owns. This allows a company to make a quick decision to buy using internal funds and subsequently to finance the asset over the long term from external sources.

Equity and development capital

For a company with major plans for growth or with a high level of debt, reliance on the above financial products can be a seriously limiting factor. The alternative is equity capital, particularly if you want to retain the option of debt finance for future projects.

Equity capital is highly relevant to long-term projects (over five years) that involve high risks and high rewards. Be prepared for this type of investment to take longer to set up than an agreement based on debt.

Equity investments are available from a range of institutions and individuals, including high street banks, merchant banks and business angels (private individual investors). It is important that you and the investor share common goals for the company.

Usually equity investors hold a minority shareholding and take little part in day-to-day management. Business angels, however, often provide both capital funding and management experience.

Equity investment often involves a package of loans/preference shares and ordinary shares. Loans/preference shares will often be repayable over an agreed period.

Other sources of finance

Factoring and invoice discounting are means of raising finance against a company's trade debtors. They can be a means of obtaining quick funding of up to 80 per cent of the value of the sales invoices raised. For a fast growing or a seasonal business, they are a flexible form of working capital. They are not suitable for funding capital investment. In addition, this form of finance can provide insurance against bad debts.

With invoice discounting, a business keeps ownership of the trade debtors and operates its own sales ledger. With factoring, the debts are sold to the source of funds who also collects the debts. Generally, invoice discounting is only made available to larger firms. This approach may not necessarily be suitable for all businesses.

Trade investments by major suppliers or customers are another useful source of money where there is a mutual interest in the business expanding and succeeding. This type of finance can take various forms and you should always seek professional advice on how to structure such an arrangement. In particular, examine carefully the degree of influence over your business a customer or supplier will gain.

Small Firms Loan Guarantee Scheme (LGS) helps small firms with viable business proposals to obtain finance in cases where conventional loans are not available because of the lack of security or track record. The scheme provides banks and other financial institutions with a government guarantee of 70 per cent on loans up to £100,000. The guarantee increases to 85 per cent for established small firms which have been trading for two years or more on loans up to a maximum of £250,000.

Regional Selective Assistance (RSA) is available in Assisted Areas to all manufacturing industries except where special European Community sectoral restrictions apply and to some service sector industries. The aim is to encourage sound investment and the scheme is open to businesses of all sizes with projects that will either create or safeguard employment. Eligible projects must conform to strict criteria such as proving viability and the need for grant support. There must also be some regional and national economic benefit. Grants are negotiated on the basis of the minimum necessary for the project to proceed.

The Regional Enterprise Grant Scheme is a discretionary scheme available for investment in most manufacturing and some service sectors in areas affected by colliery closure, outside of designated Assisted Areas. The government will pay 15 per cent of expenditure on fixed assets up to a maximum of £15,000. Firms are only eligible if they have under 25 employees and have a turnover not exceeding ECU 5 million.

For further information please contact GO East Midlands (Tel: 0115-971 2593) or GO West Midlands (Tel: 0121-212 5000).



*Walter Hull of Honeyglen, which used an unsecured loan to fund environmental equipment. Full story in the related publication, *Informed Investment*.*


Table 1 MAIN SOURCES OF FINANCE

Some examples	
Internally generated funds	Equity/development capital
Retained cash deposits	Venture capital
Proceeds from sale of unproductive assets	Business angels
Increased working capital from tighter management	Seed-corn capital
	Family and friends
	Stock exchange listing
Debt finance	
Overdraft	Other sources
Term loans	Factoring/invoice discounting
Mortgage loans	Trade investment eg significant suppliers/customers
Hire purchase/leasing	DTI Loan Guarantee Scheme
Hire purchase	Regional Selective Assistance
Finance leases	Regional Enterprise Grant Scheme
Sale and 'lease back'	SMART
	Soft loans

The DTI introduced a new Smart scheme in England during April 1997, following recommendations made in a cross-Government review of support for business during 1998. It combines the previous SMART, SPUR and SPUR-plus schemes and the innovation element of Regional Enterprise Grants. The scheme provides grants to SMEs for feasibility studies into innovative technology and for development up to pre-production prototype stage of new products and processes involving a significant technological advance.

Awards are made on a competitive basis, at the discretion of DTI.

(See also, *Eligibility criteria* on page 33.)

Features of alternative funding

3.2

Table 2 outlines many of the factors which should be borne in mind when considering whether to use a particular form of finance. Investment projects often require a cocktail of finance.

Table 2 ALTERNATIVE FUNDING SOURCES — PROS AND CONS

Internal funds

- Self justification only
- Fast decision making
- Total management control
- Often required by financiers to demonstrate commitment
- No external costs (fees etc)
- Use of internal funds for fixed asset investment reduces working capital flexibility and can restrict further growth

Bank overdraft

This is an appropriate financial instrument for working capital needs associated with the proposed investment

- Flexible and easy to arrange
- Interest only paid on outstanding balance
- Relatively low cost
- No fixed capital repayments
- Wide range of uses
- The overdraft can be inappropriate for a capital investment as it does not match the life of the asset. Its use for fixed asset purchase ties up working capital. In addition, it is:
- Repayable on demand
- Usually requires security
- Normally based on variable interest rates (but interest-rate protection products are available)
- A fixed facility which can be reduced

Term loans/mortgage loans

- Repayments may be matched to asset life
- Not normally repayable on demand
- Fixed interest rates may be available
- Often require asset purchased as security.
- Additional security may be requested
- Breach of contract agreement may trigger on-demand repayment
- Use of funds is restricted to the asset being purchased
- Capital repayment holidays may be arranged to match income earning profile of asset purchased

Hire purchase/leasing

- Flexible and easy to arrange
- Fixed term (not on-demand repayment)
- Fixed or variable rentals
- 100 per cent funding available
- Asset specific — usually no additional security required
- Complex range of options/products
- Use of funds is restricted to asset being purchased
- High-technology assets may require additional security/shorter terms/enhanced deposits
- Asset is secured — requires owner's permission for disposal

Equity and development capital

- Investors prepared to accept risk
- Not normally repayable
- Reduces gearing and may enable faster growth
- May provide access to management expertise
- Trade investors can improve trading opportunities
- More expensive and slower to arrange
- Cost of individual payments
- Problems may arise if investors and management have differing objectives
- May be expensive/difficult to buy out investors at a later stage

Factoring/invoice discounting

This is an appropriate financial instrument for working capital needs associated with the proposed investment

- Flexible source of working capital (which may be associated with the investment)
- Bad debt protection available
- A high proportion of trade debtors can be financed
- Can reduce administrative cost
- Not suitable for funding fixed assets
- Not appropriate for all businesses, products and services
- Factor facilities will vary with sales

Eligibility Criteria

DTI Loan Guarantee Scheme

- *As for term loans, but with reduced requirements for security/track record*
- *Additional cost of guarantee premium*
- *Not all businesses eligible*
- *Proportion of loan guaranteed restricted*

Grant assistance

- *No servicing costs or repayment requirements*
- *No security required*
- *Eligibility is restricted*
- *Application process may take time*
- *Projects cannot normally start until grant is approved*
- *Grant may be recovered/reduced if objectives not met*

Feasibility Studies: Individuals and independent small businesses with fewer than 50 employees may submit proposals for support with feasibility studies. Assistance will be 75 per cent of eligible project costs up to a maximum grant of £45,000. Eligible costs of feasibility studies must be a minimum of £30,000 to be considered for support.

Development Projects: Independent businesses with fewer than 250 employees may compete for support with development projects. The award in this case will be 30 per cent of eligible project costs up to a maximum grant of ECU 200,000 (including any grant already received for a feasibility study). Development projects must be a minimum size of £60,000 to be eligible for support.

Exceptional Development Projects: A very small number of exceptional development projects may receive a higher grant at a variable percentage of total eligible costs (with a maximum rate of 30 per cent). Eligibility is the same as standard development projects (above) except that the award in this case will be negotiable up to a maximum of 30 per cent of eligible project costs up to a maximum grant of ECU 600,000.

Applicants for both feasibility studies and development projects must also meet criteria relating to balance sheet or turnover totals. To find out more, firms in England should contact their nearest Business Link or the National Business Link hotline 0345 567765.

Different arrangements apply, however, in Scotland, Wales and Northern Ireland, where SMART and SPUR schemes remain in existence (Contacts: Scottish Office — 0141-242 5610, Welsh Office — 01222 823543, Department of Economic Development in Northern Ireland — 01232 529577).

Closing dates: There is a regional variation in the number of calls per year — details of regional call closing dates are included with the application form. The current Smart scheme has funding until March 1998 (NB: This does not necessarily mean that the scheme expires at that time, but like all support, it is subject to review under the Governmental Comprehensive Spending Review).

Soft loans from specific European and national agencies are sometimes available in particular regions and areas of the country. Often, soft loans offer either a reduced interest rate or a reduced requirement for security. However, some soft loans may call for security on a par with normal commercial loans. You should seek advice on the availability of such loans from the DTI, lenders and local business support agencies.

A list of useful (mostly free) publications, specifically designed to help smaller businesses, is available at the end of this chapter.

Choosing and negotiating with financial institutions

3.3

Before preparing a shortlist of organisations to approach for funds, first determine the level and type of finance that you want from each one. The main source should be selected before the rest of the package is agreed.

In preparing for negotiations with a financial institution, think in terms of the following pointers:

Sources of advice

Before deciding who to approach, talk to your accountants. They should be able to help you throughout the funding process, creating a package, sorting out the key issues that a financier would want to raise and recommending a list of lenders.

It also makes sense to discuss your plans with your existing financiers and get their input. Finally, check with other companies in the same sector and trade associations.

Number of organisations to approach

When considering a capital investment, only approach a limited number of potential backers. Typically, this will be three to four because it makes good sense to build close relationships with just a small number of sources of finance. This will give you time to help them develop an understanding of your business and your particular strengths, and should also ease future applications for funds. But test the market periodically to ensure that your finance suppliers remain competitive.

Equipment suppliers' lease and HP facilities and schemes are always worth considering. They are flexible and may include easy options to trade up to more advanced machinery at a later date. This is particularly attractive with fast-changing technology.

Presenting a credible case

A detailed, quality business plan (see Figure 7, page 43) will form the basis of your application. It is also a valuable tool which will enable you to monitor your business performance. Do not stint on this plan. A good plan not only enhances your credibility and influences the funding decision, but it is also to be recommended in its own right.

Comparing offers

Offers of finance should always be in writing and compared on a like-for-like basis. All terms and conditions should be considered, particularly:

- *Level of funding offered;*
- *Repayment period;*
- *Interest/dividend rates;*
- *Arrangement fees and ongoing costs;*
- *Security requirements;*
- *Early repayment penalties;*
- *Lending conditions and covenants;*
- *Equity required;*

Other services required.

Offers at this stage are not final or binding and often include preconditions. Third parties may be required to endorse areas such as valuations or there may be a request for an accountant's report. Make sure that the nature and cost of these requirements are clarified early.

Negotiating

Above all, remember you can and should negotiate the best deal you can get. This is accepted practice.

To strengthen your negotiating position, carry out your own background research into finance rates before starting discussions.

Remember, too, that the lowest-priced offer is not always the best and in many situations personal rapport will be a highly significant factor. This will be particularly important where further finance may be required or, as in the case with equity finance, a close working relationship will develop.

Equipment suppliers' lease deals often appear very attractive. However, such offers should always be compared with a cash price and finance from a third party.

A decision on leasing as a means of asset finance may be complex because of the effect of taxation and the wide variation of product. If you are unsure about the details, look for independent advice from an accountant or lawyer.

Indeed, always seek professional advice on offers of finance made by equity investors, including individual investors and trade investors. Investment agreements must be reviewed by your lawyer.

NAC ALLAN

When Tom Jarron was employed by UniRoyal in the late sixties, he became frustrated by how difficult the company found it to source pulleys — required as a component of the timing belts they produced. So, in 1970, Tom decided to produce the pulleys himself and founded his own precision engineering firm — NAC Allan and Company, based in Edinburgh. The company recorded steady growth when, in 1978, with a turnover of £100,000, they were hit with a large tax demand. NAC Allan had a problem — although they had the necessary financial resource, this was in the form of unpaid sales invoices.

Factoring company Alex Lawrie came to NAC Allan's help, providing up to 80 per cent of the total of the company's outstanding invoice value. It proved more flexible finance than a bank loan or overdraft, as it was based on their strong current trading levels, rather than on the company's historic balance sheet ratio.

Initially, Tom had reservations about relinquishing responsibility for such a fundamental part of his business. However, he was soon reassured: "Alex Lawrie was first employed in 1978 to handle NAC Allan's sales ledger for one year. I soon realised that they were running it far more efficiently and effectively than previously. They have been our acting accounts department ever since".

"We are now able to keep the two functions separate. Alex Lawrie deals directly with our customers, to collect outstanding debts, leaving my staff to liaise with the buyers for the next order." Currently employing 35 people with a turnover around £1m, NAC Allan has an extensive client list.

"Without being able to hand over responsibility for NAC Allan's sales ledger, and ultimately for its cashflow, I would have been unable to pursue the more commercial aspects of my business which have led to its success."

The issue of security

When discussing this subject with your financier, it is worthwhile remembering the following:

Security is a secondary source of repayment: the primary source is cash flow;
 Financiers will always look for some form of commitment from the owner of the business. If the funds needed exceed the net value of the tangible assets of the business, additional security may well be required;
 The provision of security may enable a lower price to be negotiated;
 If asked for security, make sure that you have agreed when, and in what circumstances, you can withdraw it.

For a checklist of areas that you should cover when selecting—and negotiating with—sources of finance, see Figure 6, below.

Figure 6 PREPARING FOR NEGOTIATIONS

Have you:	Yes	No	Have you:	Yes	No
Prepared a detailed business plan?	<input type="checkbox"/>	<input type="checkbox"/>	Sought comparable written offers which detail:	<input type="checkbox"/>	<input type="checkbox"/>
Identified the level and types of finance that you will require?	<input type="checkbox"/>	<input type="checkbox"/>	1 All rates expressed in the same terms e.g. APR, flat rate, nominal?	<input type="checkbox"/>	<input type="checkbox"/>
Had initial early discussions with your current financiers?	<input type="checkbox"/>	<input type="checkbox"/>	2 If there are any one-off fees, such as:		
Obtained advice and recommendations on which financiers to approach?	<input type="checkbox"/>	<input type="checkbox"/>	Arrangement fees?	<input type="checkbox"/>	<input type="checkbox"/>
Identified a lead organisation for deals involving different types of finance?	<input type="checkbox"/>	<input type="checkbox"/>	Documentation fees?	<input type="checkbox"/>	<input type="checkbox"/>
Carried out background research on current rates and deals?	<input type="checkbox"/>	<input type="checkbox"/>	Legal fees?	<input type="checkbox"/>	<input type="checkbox"/>
Looked at lease/finance deals from equipment vendors and alternative cash discounts?	<input type="checkbox"/>	<input type="checkbox"/>	Commitment fees?	<input type="checkbox"/>	<input type="checkbox"/>
Selected professional advisors if required?	<input type="checkbox"/>	<input type="checkbox"/>	3 If there are any obligatory additional elements, such as:		
			Life insurance policies?	<input type="checkbox"/>	<input type="checkbox"/>
			Special protection policies?	<input type="checkbox"/>	<input type="checkbox"/>



SOME SOURCES OF FURTHER INFORMATION

Publications marked with an asterisk (*) may be obtained from:
 DTI Small Firms Publications, PO Box 1143, London W3 8EQ
 Telephone: 0171 510 0169

Internal Funds

Accounting and Financial Decisions,
D R Myddelton, Longman

Accounting for Management Decisions,
John Arnold and Tony Harper, Prentice Hall International

*Make the Cash Flow
(providing advice on the late payment of bills) DTI

Debt finance, non-specific

Director's Guide to Finance and Growth,
Institute of Directors, 116 Pall Mall, London, SW1Y 5ED

NB: Individual banks have brochures on sources and types of finance

Debt finance, asset-specific

Finance and Leasing Association Code of Practice and Equipment Leasing Publication,
Finance and Leasing Association, Imperial House, 15-19 Kingsway, London, WC2B 6UN

Equity/development capital

British Venture Capital Association Directory of Members, A Guide to Venture
 Capital, Sources of Business Angel Capital
*The British Venture Capital Association, Essex House, 12-13 Essex Street,
 London, WC2R 3AA*

**Finance without Debt, a Guide to Sources of Venture Capital under £250,000 DTI*

* *A Guide to the Enterprise Investment Scheme DTI*

How to be prepared to meet your Business Angel
Paul Harvey Cantrell, Century Books, Lincoln

Other publications

Business Money

A monthly publication which gives information on the latest bank account charges,
 overdraft charges, addresses for bank lenders, asset finance houses, factors and invoice
 discounters.

Strode House, 10 Leigh Road, Street, Somerset, BA16 0HA. Telephone: 01458 841112

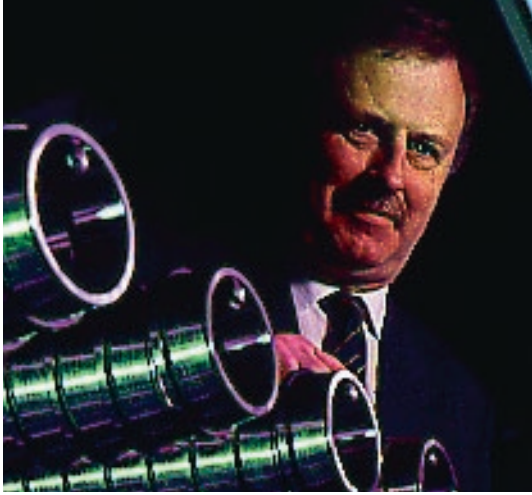
* *A guide to help for small firms DTI*

* *Financing your business, a guide to sources of finance and advice DTI*

Informed Investment in Modern Production Machinery
*Findlay Publications, Hadlow House, 9 High Street, Green Street Green, Orpington,
 Kent BR6 6BG.*

PREPARING AN APPLICATION FOR FUNDS

4.0



With suppliers' help, Stephen LeBeau's Gamet Bearings subsidiary of 600 Group invested in a standard lathe to adopt a ground breaking new process. Full story in the related publication, Informed Investment.

To be successful, applications need to be high quality and well prepared.

Yet the single most common complaint that finance providers make is that many of the submissions they receive are well below standard.

If a company has followed the steps in this guide, preparing a good quality application is all that remains. But before preparing your submission, ask yourself: what are finance providers looking for in an application?

An application should be less than 20 pages long.

In 1991 Elizabeth Vann and Mike Thrasher ran a successful new product development consultancy for blue-chip clients. However, spotting a new opportunity in the baby-food market, Vann decided to put her money where babies' mouths are. She joined with Jane Dick, a qualified microbiologist who had been working as UK Sales Manager for Exxon, and invested £50,000 of their own money to launch an organic baby food in 1992 called Baby Organix. By the end of 1994, they had expanded the range to over thirty products. The company's turnover had grown to £600,000 and the products were listed in over 2,000 UK supermarkets, including the five largest chains. Baby Organix had found a perfect niche. None of the baby food companies could launch a competitive brand without undermining their own non-organic products. Organix were using a German manufacturer to provide their wet meals. However, the company calculated that they could increase margins 50 per cent by transferring the

manufacturing to the UK. They found a local company prepared to set up an exclusive manufacturing line for them. What they needed now was £260,000 in equity finance to enable them to go ahead with UK manufacturing and then promote the brand based on their improved margins and capacity.

Several trade investors were interested — but the ability of 3i in Southampton to provide the most attractive terms won the deal. The company has since gained many new customers, including Boots and Children's World. It has expanded its range to include pasta and pasta sauces, and has relaunched the infant cereal range. With the help of 3i, the company has achieved the momentum it wanted, and has now firmly established itself as the brand leader in the organic baby food sector which is worth over £9 million. "We'd invested our own money to prove our idea could fly. But what we needed now was the money to keep the idea flying all the way to our destination," says Vann.



What do financiers look for when assessing applications?

4.1

1 Credibility, competence and track record

What is the competence of the management team running the business? Is it already known to the lending institution and is it reliable? Does it have a good credit rating and a good repayment record?

What level of experience does the management team and its financial advisors have? How long has the team been running the business? What are the results? Has the lender any experience of the company? Do other lending institutions know the company?

2 Financial accounts

These will be required covering at least the last three and preferably the last five years.

3 Current management accounts

Well-prepared and detailed management accounts create confidence that the business is well-run and professional.

4 A business plan

For a significant investment, draw up a business plan covering the areas shown in Figure 7 on page 43.

5 Key risk areas and contingency plans

Contingency plans are important and many financiers will want to know:

Where are the risk areas?

What contingency plans do you have to deal with risks as and when they arise?

How will we get our money back if it all goes wrong?

6 Funds required and their purpose

How much is required and how does it compare to the cashflow forecast? In manufacturing, every £100,000 of additional sales may need up to £25,000 of extra working capital.

7 How much money has the borrower put into the project?

Does the business have an adequate base of risk capital or equity, provided by the owners?

8 Repayment — how does the financier get his or her money back?

What information is provided that will give the lender confidence in your sales projections?

What proportion of the repayment is covered by:

- Profits;
- Sale of assets;
- General cash flow.

At this stage, financiers will be looking at the cash flow for the repayment period. They will want to identify clearly the source of repayments and carry out a sensitivity analysis to check that you can still make them even if the investment does not generate the savings, sales or profits you expect.

9 Security

Security is viewed as a secondary source of repayment and is not always required. Even when it is necessary, financiers will generally be much more concerned about whether the business is able to generate the cash flow to service the debt. They will also need to satisfy themselves on how easy the asset is to realise.

10 What charges can you expect?

- *Interest rates;*
- *Arrangement fees;*
- *Expenses associated with the funding.*

To sum up, the financier is looking to see if:

- *You have thought through the investment proposition;*
- *You can justify the top line (any additional sales or soft benefits);*
- *The company can monitor and control its business. (Does it have a proven track record?);*
- *The company can demonstrate the viability of the proposal;*
- *A full appraisal of risks has been made.*

Level of detail

If the money is only needed for a limited time, is well secured or is only required for a less significant investment, less detailed information may be needed.

If a more substantial investment is being made, the prospective lender is likely to want to make a careful evaluation of the management of the business and its financial position. The company's future prospects and the business environment will also come under scrutiny.

When preparing an application for funds, you have two options open when stating your funding requirements:

- *You can prepare financial statements which assume that you get the funding you propose on the terms you expect;*
- or*
- *You can prepare financial statements which show the funds you need but do not specify the source or finance rates. The funding structure is then proposed separately from the balance sheet and profit and loss statement.*

The second is the better option because it does not weaken your negotiating position by giving away what you anticipate in respect of the interest rate.

For a thorough checklist that can be used in compiling a written plan, see Figure 7 on page 43.



*Renishaw's Ben Taylor, whose company funded surface mount technology from internal funds. Full story in the related publication, *Informed Investment*.*

Financiers always scan funding applications for evidence that they are dealing with a well-run company. At times, demonstrating effective management controls — and convincing the financier of the overall soundness of your business — can even overshadow the details of the particular project at issue.

But companies seeking funding that might be vital to their future wellbeing, and by extension that of all the people they employ, cannot afford to lose sight of the strategic goals which the investment project will help them to achieve. Backers who claim to protect you from the risk of insufficient returns by withholding their money expose you to other risks, not least from competitors with deeper pockets.

Backers will tell you they are keen to build long-term relationships with clients, relationships which extend beyond a single deal. It is true that your ability to offer proof that the company is generally sound will be important to such a relationship. And it is also nearly always true that those with a financial background will make you aware of issues you had not considered before. They may even convince you either that some of your confidence may have been misplaced, or that you have to approach your problem in a different but equally fruitful way.

But none of this means that the financier knows more about your business, and its place in your market, than you do.

The secret of building the right relationship with a backer is, first, to know your own case inside out and, second, to be aware that the backer needs your business too. What has changed most over the last few years is that, if one backer remains unconvinced, you can nearly always find another who sees your point of view. If you can't, go back to your sums.

When you do, you may find a downside risk to your project that you had not considered. All financial packages specify the measures that can be taken if the borrower fails to meet his obligations, and, although this will be the last of the financier's concerns — he or she will tell you that he fervently hopes your project will succeed, that they make a good return, and that you both establish a profitable relationship — he or she will generally demand a safety net.

As the principal of a borrowing business, you may well be putting your own assets on the line if you cannot repay the debt. This is no reason not to borrow where a good case exists, but do keep the downside in mind, if only to prevent enthusiasm for a good idea getting in the way of practical calculation. There is usually an alternative to putting the family home at risk.

Post-investment activity

4.2

Once the funding has been secured and the investment made, it is vital that you do the following three things:

- *Make the payments;*
- *Maintain contact;*
- *Carry out a review.*

Maintain contact

Always keep in contact with whoever is supplying your funds and make sure that high-quality, detailed management accounts are supplied on a regular basis. This will increase the financier's confidence and allow any potential problems to be identified and tackled early.

It will also help you to identify and secure any additional funding you need and avoid cashflow difficulties.

Post-project review

It is well worth carrying out a review of large or important capital investment projects. These are generally done about a year after the project is completed. A track record of investment success, gained from previous reviews, will make a major difference in selling your proposition because it adds credibility.

*Ben Gostelow of Stoves, which used a term bank loan to fund an investment in hydroforming. Full story in the related publication, *Informed Investment*.*




FIGURE 7 AN OUTLINE BUSINESS PLAN

Cover page

- Company name and address with contact names and telephone numbers
- Name and address of professional advisors including accountants, auditors, solicitors and bankers

Introduction

- Summary of the business (what it does, brief trading history, current size and profitability)
- Summary of the project (what it is, the objectives, commercial benefits, how it fits with the company strategy, the project timescale, key milestones, why and how much additional finance is needed)

Background of the management team

- Roles and responsibilities together with qualifications, track record and any experience relevant to the proposed project
- Staff organisation chart
- Description of internal management accounting system with scope and frequency of reports
- Outline of budgetary control system

Background of company products and markets

- Overview of the market for the main products/services
- Total current market size, its growth rate, and projections of future demand
- Dependencies on third-party suppliers or distributors/agents
- Current customers, potential customers and market share
- Competitors both actual and potential
- Competitive advantage for own products (innovative design, reliability, pricing, availability)
- Pricing, promotional channels and future strategy including organisation of sales effort
- Distribution channels (retail, distributors, exports)
- Marketing and product strategy
- Project details

(This section will use information from the investment appraisal)

Description of the project

- Capital investment required (function, life, quotations to support cost, installation charges)
- Flexibility of the plant for other products
- Detail the key implementation milestones and timescales
- Ability to operate and maintain the new plant
- Costs of restructuring, disruption and retraining
- What contingency plans are available
- Any environmental, safety or legislative issues

Financial Aspects

- Analysis of past trading results and comments on key changes
- Detailed current balance sheet and management accounts
- Detailed and summary forecast (profit, cash flow and balance sheets) together with all major assumptions
- Sensitivity analysis (assuming, for example, a 20 per cent rise in interest rates, costs increasing by 20 per cent and sales falling by 20 per cent)
- Breakdown of finance sought and its application, ie capital equipment, working capital, installation costs, training, sales and marketing activity

Funding and security

- Details of existing funding (lender, terms and amount)
- Further finance required to finance the new project and structure
- Repayment plans and effect on cash flow
- Contingency provisions assuming the worst possible situation
- Current security and assets available for security (but not their value)
- Proposed exit routes for equity investors (if appropriate)

SOME SOURCES OF FURTHER INFORMATION

Financiers' evaluation of applications

Corporate Performance Evaluation in Bank Lending Decisions
The Chartered Institute of Management Accountants, 63 Portland Place, London, W1N 4AB

Preparing a business plan

The Business Plan Workbook,
Colin and Paul Barrow, Kogan Page

Business Planning: a quick guide
DTI M90s Publication
Orderline tel. 0171-510 0144

Business Plans: a compendium
The Chartered Institute of Public Finance and Accountancy, 3 Robert Street, London WC2N 6BH

Guides to preparing business plans are available free of charge from most large accountancy firms and banks.

Members of the steering group

Money & Machines is produced by a steering group of trade associations brought together by the DTI to produce a best practice guide for capital investment in small and medium sized manufacturing firms with turnover in excess of around £1 million. Its members are:

British Bankers' Association
 Confederation of British Industry
 Engineering Employers' Federation
 Finance & Leasing Association
 Mechanical & Metal Trades Confederation
 Machine Tool Technologies Association

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Consultant to the steering group

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Information and advice on business support, including financial investment, is available locally through Business Links in England, Business Connect in Wales, and Business Shops in Scotland. Details of these organisations, and support in Northern Ireland can be accessed through the Business Link support line: **0345 567765**

Copies of the guide may be available free of charge from the following organisations:

DTI

ADMAIL 528, LONDON SW1W 8YT.

Telephone: 0870 1502 500. Fax: 0870 1502 100. Minicom: 0870 1502 100

British Bankers' Association

Pinner's Hall, 105-108 Old Broad Street, London EC2N 1EX.

Telephone: 0171-216 8853. Fax: 0171-216 8811

Finance & Leasing Association

Imperial House, 15-19 Kingsway, London WC2B 6UN.

Telephone: 0171-836 6511. Fax: 0171-420 9600

CBI

Centre Point, 103 New Oxford Street, London WC1A 1DU.

Telephone: 0171-379 7400. Fax: 0171-836 1972

Engineering Employers' Federation

Broadway House, Tothill Street, London WC1A 1DU.

Telephone: 0171-222 7777. Fax: 0171-222 2782

Mechanical & Metal Trades Confederation

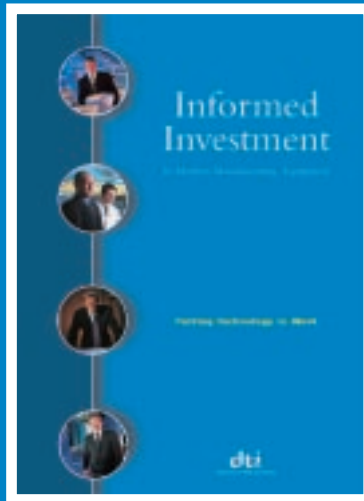
Carlyle House, 235 Vauxhall Bridge Road, London SW1V 1EJ.

Telephone: 0171-233 7011. Fax: 0171-828 0667

Machine Tool Technologies Association

62, Bayswater Road, London W2 3PS.

Telephone 0171-402 6671. Fax: 0171-724 7250



This related publication and further copies of Money & Machines are available from:

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ADMAIL 528, LONDON
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