9 Funding growth

About this chapter

This chapter reviews the alternative forms of finance available from equity sources or from borrowing, for funding the development and expansion of businesses in the hospitality, tourism and leisure sectors. Each form of funding is considered in terms of the advantages and disadvantages of the use of that type. The industries in this sector are able to take advantage of a range of alternative approaches for funding investments, based on the separation of ownership from control, including approaches such franchising and management contracts, and the merits and the implications of these will be considered. Selecting which options to pursue and how to fund those options is an important aspect of the strategic process and this chapter and the following chapters focus on the issues relating to effective implementation of strategic developments.

Learning objectives

On completion of this chapter, you should be able to:

- ☐ List the main sources of financing a business
- ☐ Appreciate the factors to be taken into account when selecting long term funds
- ☐ List benefits and disadvantages of each type of financing
- ☐ List the alternative approaches for funding expansion available to the hospitality, tourism and leisure sectors.

Introduction

The strategic direction of a business can take a variety of formats as illustrated by Table 9.1.

A business selecting a strategy based on expansion will certainly need to consider additional sources of finance. The various sources of finance are illustrated in diagrammatic form in Table 9.2.

- **Conservative growth:** An approach to increase sales, profits etc, through the same or related businesses. This is achieved through the development of updated products and/or penetrating the markets for the existing business
- **High growth:** An approach to significantly increase sales by developing further existing or new products and services to be sold in existing or new markets. This approach can be typified by a strategy of acquisition of companies with similar or unrelated products or by buying 'supplying' or 'buying' companies known as 'vertical integration'
- **Maintenance:** An approach to maintain the status quo by maintaining sales and profit at historical levels of performance
- **Recovery:** The purpose of this strategy is to simply survive. This may involve reducing investment in and purchase of new assets, reducing operating costs and attempting to grow sales
- **Reduction:** This approach is to maximise the value of a declining business by salvaging remaining assets and liquidating the business. Alternative approaches might be to sell, negotiate management buyouts or franchise.

Table 9.1: Fundamental strategy goals and approach

Short term	Medium term	Long term
Trade credit	Bank loans	Debentures
Bank overdrafts	Credit loans	Other types of loans
Factoring	Hire purchase	Shares
Bills of exchange	Leasing	

Table 9.2: Sources of finance

There are a variety of sources and methodologies for gaining access to funding business expansion and the choice very much depends on a range of factors including the:

- Cost of raising the finance
- Cost of servicing the finance
- Obligation to pay a return on the capital
- Obligation to repay the finance
- Corporation tax implications
- Effect on the levels of ownership and control.

Risk and return

For many new businesses a variety of sources of investment are required in order to raise the necessary funds to purchase the required noncurrent assets and provide for working capital. The hotel sector within the hospitality and tourism industries is traditionally heavily long term asset based and often considerable sums of investment are required just to get started. Each of the possible sources of funds will have its own cost, that is the return required by the provider of the source of funds, and the size of cost is normally related to the size of the risk as perceived by the lender. In general, research in this area has indicated that investors expect and normally get higher returns in return for accepting increased risk.

For the small business just starting out, the proportions of borrowings to equity can be crucial to survival in the early years of trading. In the past it has been relatively easy to borrow 70% or even 80% of total funding secured against the assets of the business but this creates a burden in terms of the debt servicing costs in the form of interest payments. Experience has indicated that levels of 50% – 60% borrowing against assets can provide a workable level of debt without causing cash flow problems later. The other crucial factor to consider when raising finance is the maximum cost of the finance. In the case of long-term borrowings, such as loans, the cost of servicing the finance is determined by interest rates and the amount of interest to be paid. Changes in interest rates can have a significant impact on a business.

Case example: Impact of interest rates

During 2023 the UK government raised interest rates a total of 14 times to reach a rate of 5.25%, the highest rate for 15 years. This increase impacts all those businesses using debt to finance investments. The hospitality industry was the sector most impacted by the pandemic and many businesses took out loans to survive. The increase in interest rates adds additional costs to the business coupled with inflationary pressures on other costs such as food purchases and energy.

Increasing interest rates raises the cost of capital which means that some businesses are perceived as no longer being viable as the cost of capital exceeds the cash inflows from trading.

Source: Adapted from https://www.thecaterer.com/news/interest-rate-rise-bank-england-4-could-significantly-impact-viability-hospitality-businesses

Alternatively, equity funds are serviced by the payment of dividends which are often flexible in payment and size. However, despite this flexibility, experience indicates that equity investors, that are company shareholders, expect the highest returns in return for being subject to the highest risk. The relationship between risk and return is summarized in the Figure 9.1.

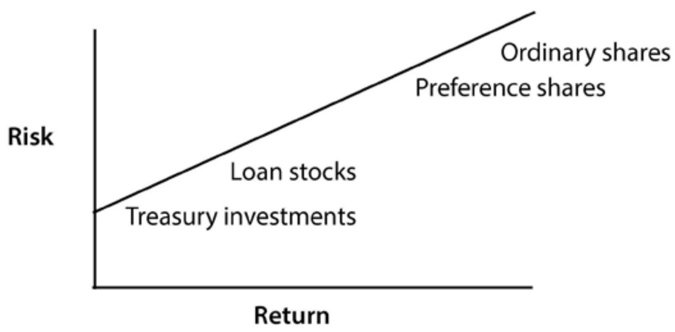

Figure 9.1: The relationship between risk and return