BUS.AL20 Sources of Finance: Share Capital, Loan Capital and Venture Capital

AQA 7132 · Calculators not allowed · about 75 minutes

Total Marks

Name: ______________________________ Date: ____ / ____ / ______

Answer ALL questions in the spaces provided. Show your working for any calculation. Use the data and figures given in each question's prompt; no prior knowledge beyond what is specified is required. Where a question asks you to apply to the case, use the figures and balance sheet extracts provided in that question's prompt.

1 Match the following finance terms to their definitions for an incorporated business. Terms: 1 Ordinary share capital; 2 Debenture; 3 Venture capital; 4 Business angel; 5 Crowdfunding. Definitions: A A form of long-term loan with fixed interest, often secured, usually repayable at a set date. B External finance provided by many small contributors via an online platform in return for rewards, pre-orders or sometimes equity. C Equity investment from professional investors into high growth companies, exchanging capital for shares and often taking an active role in governance. D Individual wealthy investor providing start-up capital and advice, usually in return for equity. E Money raised by selling ordinary shares to owners or new investors, giving voting rights and a share of residual profits.

Match terms to definitions for an incorporated business, using the letters A to E.

(Total for Question 1 is 1 mark)

---

2 Which one of the following best describes 'ordinary share capital' for a private limited company seeking growth finance?

- ☐ A) A short-term loan from a bank repaid within one year
- ☐ B) Capital raised by issuing shares that give owners voting rights and a residual claim on profits
- ☐ C) A form of grant that must be repaid only if the business makes a profit
- ☐ D) A fixed interest bond secured against company assets

(Total for Question 2 is 1 mark)

---

3 State two features that typically distinguish venture capital funding from a bank loan for an early stage growth business.

(Total for Question 3 is 2 marks)

4 Identify one control implication for a founder if they accept ordinary share capital from outside investors such as venture capitalists, in the context of a private limited company seeking growth funding.

(Total for Question 4 is 1 mark)

---

5 Explain one advantage to a high growth technology start up of accepting venture capital rather than taking a long-term bank loan. Use application to a start up planning rapid expansion that requires cash for marketing and product development.

(Total for Question 5 is 3 marks)

---

6 Explain one advantage and one disadvantage of ordinary share capital for LumiWear Ltd, a private limited company that wants to raise 1.5 million pounds to expand overseas and is concerned about keeping founder control. Use application to LumiWear Ltd in your answer.

(Total for Question 6 is 6 marks)

---

7 Identify one reason an early stage biotech company might prefer business angel funding over venture capital.

(Total for Question 7 is 1 mark)

---

8 State two differences between crowdfunding that offers rewards/pre-orders and equity crowdfunding for a small consumer product business.

(Total for Question 8 is 2 marks)

---

9 Identify one cost-related factor a management team should consider when choosing between issuing debentures and selling ordinary shares to raise 2 million pounds.

(Total for Question 9 is 1 mark)

---

10 Which one of the following is a typical feature of a debenture used by a medium sized manufacturing firm?

- ☐ A) It gives holders voting rights in general meetings
- ☐ B) It is a form of equity that increases founder control
- ☐ C) It is a secured loan instrument with fixed interest payable to holders
- ☐ D) It requires no contractual repayment date

(Total for Question 10 is 1 mark)

---

11 GreenGrow plc, a medium sized agri-tech firm, is considering issuing a 5 year debenture to raise 500,000 pounds at a fixed interest rate of 6% per year. Calculate the total interest the company will pay over the 5 years. Show your working.

(Total for Question 11 is 2 marks)

12 State one reason a founder might accept venture capital despite the likely loss of some ownership.

(Total for Question 12 is 1 mark)

---

13 Case extract for Q13 and Q14: BrightBrew Ltd is a UK private limited company making speciality coffee machines. Balance sheet extracts (simplified) at 31 Dec: Shareholders equity: Ordinary share capital 600,000 pounds; Retained earnings 200,000 pounds. Non-current liabilities: Long-term bank loan 400,000 pounds. Current liabilities: Trade creditors 50,000 pounds. BrightBrew plans to raise 300,000 pounds to fund a new European sales team and asks whether to issue new ordinary shares, seek venture capital, or issue a 5 year debenture. The directors are concerned about gearing and control: current gearing ratio measured as long-term debt / (long-term debt + equity) is useful. Using the extracts, calculate BrightBrew's current gearing ratio (long-term debt / (long-term debt + equity)) as a percentage to 1 decimal place, then calculate the new gearing ratio if a 300,000 pounds debenture is issued (assume the debenture is classed as long-term debt). Show your working and state which option (share issue, venture capital or debenture) would keep gearing lowest, based on your calculations.

(Total for Question 13 is 8 marks)

---

14 State one control-related advantage and one control-related disadvantage of BrightBrew Ltd accepting venture capital rather than issuing new ordinary shares to existing owners.

(Total for Question 14 is 1 mark)

---

15 BrightBrew Ltd is deciding between three options to raise 300,000 pounds: (A) issue new ordinary shares to existing investors, diluting founders slightly; (B) accept a venture capital investor who will take 30% of the new enlarged equity and take a board seat; (C) issue a 5 year debenture at 6% interest. Recommend which source BrightBrew should use. Justify your recommendation using the figures and the gearing/control information supplied in Q13 and the balance sheet extracts. Consider cost, gearing, control and suitability for funding a sales expansion. You should weigh the options and reach a clear justified decision.

(Total for Question 15 is 12 marks)

---

16 Explain two non-financial factors BrightBrew Ltd should consider when choosing between issuing shares, accepting VC or issuing a debenture to fund the sales expansion. Refer to relevance to the sales expansion decision in your answer.

(Total for Question 16 is 8 marks)

Mark scheme · BUS.AL20 Sources of Finance: Share Capital, Loan Capital and Venture Capital

Question 1

- **B1** 1-E, 2-A, 3-C, 4-D, 5-B cao
- **Answer: 1 E; 2 A; 3 C; 4 D; 5 B.**

Question 2

- **B1** B cao
- **Answer: B**

Question 3

- **B1** VC provides equity in exchange for ownership and often active management involvement
- **B1** VC accepts higher risk and expects higher returns and an exit via sale or IPO, unlike bank loans which require fixed interest repayments
- **Answer: Any two, e.g. VCs take equity and often join the board; VCs accept higher risk and expect an exit and high returns, while bank loans require interest and repayment.**

Question 4

- **B1** founder may lose some control or decision-making power because new shareholders gain voting rights or board seats
- **Answer: The founder may lose some control because new investors gain voting rights or board representation.**

Question 5

- **B1** identifies an advantage, e.g. VCs provide large amounts of equity finance suited to rapid growth
- **B1** develops the point, e.g. equity finance does not require fixed repayments, so cash flow is not burdened during scaling
- **B1** links to the scenario, e.g. this allows the start up to invest heavily in marketing and product development without the immediate pressure of loan repayments
- **Answer: VCs can provide large equity investments, which do not require fixed repayments, so the start up can spend on marketing and development without immediate cash flow pressure.**

Question 6

- **B1** identifies an advantage, e.g. raises large sums without interest repayments
- **B1** develops the advantage, e.g. selling shares can provide the full 1.5 million without adding debt service costs that would strain cash flow while expanding overseas
- **B1** applies the advantage to LumiWear Ltd, e.g. this frees cash for marketing, distribution setup and currency contingencies during expansion
- **B1** identifies a disadvantage, e.g. dilution of ownership and potential loss of founder control
- **B1** develops the disadvantage, e.g. new shareholders may demand board seats or strategic changes that constrain founders
- **B1** applies the disadvantage to LumiWear Ltd, e.g. if founders give up significant equity to raise 1.5 million they could lose decision-making power over overseas strategy
- **Answer: Advantage: issuing shares can raise 1.5 million without interest repayments, preserving cash for overseas marketing and distribution. Disadvantage: it dilutes founder ownership and may lead to loss of control if new shareholders take board seats or influence strategy, which is a real risk for LumiWear Ltd if large equity stakes are sold.**

Question 7

- **B1** one valid reason, e.g. individual may offer mentoring and industry contacts suited to early stage needs, or smaller, more flexible investments than VCs
- **Answer: An angel can provide mentoring and useful industry contacts suited to early stage biotech needs.**

Question 8

- **B1** reward/pre-order crowdfunding gives backers products or rewards, not ownership
- **B1** equity crowdfunding gives contributors shares, diluting ownership and creating ongoing obligations like dividends or reporting
- **Answer: Reward crowdfunding gives backers products or perks not ownership; equity crowdfunding gives shares, diluting ownership and creating ongoing obligations.**

Question 9

- **B1** compare fixed interest cost of debentures with potentially higher long-term cost of equity via dividends and diluted profits
- **Answer: They should compare the fixed interest cost of debentures with the potential long-term cost of equity in terms of dividends and diluted profit per share.**

Question 10

- **B1** C cao
- **Answer: C**

Question 11

- **M1** 500,000 x 0.06 seen (= 30,000 pounds per year)
- **A1** 150,000 pounds cao (total interest over 5 years)
- **Answer: 150,000 pounds.**

Question 12

- **B1** one valid reason, e.g. access to large sums of growth capital, or industry expertise/contacts that can accelerate growth
- **Answer: For access to large sums of growth capital that would otherwise be hard to raise.**

Question 13

- **M1** calculates current gearing numerator and denominator: long-term debt 400,000 and long-term debt + equity = 400,000 + (600,000 + 200,000) = 1,200,000
- **M1** computes current gearing as 400,000 / 1,200,000
- **A1** 33.3% cao (current gearing to 1 dp)
- **M1** shows new long-term debt = 400,000 + 300,000 = 700,000 and new long-term debt + equity = 700,000 + 800,000 = 1,500,000
- **M1** computes new gearing as 700,000 / 1,500,000
- **A1** 46.7% cao (new gearing to 1 dp)
- **B1** concludes which option keeps gearing lowest with reasoning, e.g. issuing shares or taking VC would increase equity and so lower gearing, whereas a debenture increases debt and raises gearing
- **B1** applies recommendation to BrightBrew, e.g. share issue or VC keeps gearing lower, and choice between share issue and VC depends on control implications
- **Answer: Current gearing = 400,000 / (400,000 + 800,000) = 400,000 / 1,200,000 = 0.3333 = 33.3%. With a 300,000 debenture: gearing = 700,000 / (700,000 + 800,000) = 700,000 / 1,500,000 = 0.4667 = 46.7%. Issuing shares or taking venture capital would keep gearing lowest because they increase equity rather than debt; issuing a debenture increases gearing.**

Question 14

- **B1** advantage: VC may bring professional governance that improves strategic decision-making; disadvantage: VC will take equity and expect influence, reducing founder control
- **Answer: Advantage: a VC can bring professional governance and strategic support; disadvantage: the VC will take equity and likely demand board influence, reducing founder control.**

Question 15

- **Level 1** (1-4): Makes simple statements about one or two options with little use of the provided figures and provides no clear, justified recommendation.
- **Level 2** (5-8): Gives a developed comparison of at least two options using some of the figures (gearing, cost) and begins to weigh pros and cons, but the recommendation is not fully justified or lacks clarity.
- **Level 3** (9-12): Weighs all three options using the provided figures and contextual issues (gearing impact, cost, control, suitability for expansion), shows clear analysis of trade-offs and reaches a justified recommendation supported by evidence.
- **Indicative content:**
    - Use the gearing calculations from Q13: current gearing 33.3% and debenture option raises gearing to 46.7%, increasing financial risk.
    - Cost: debenture interest at 6% creates fixed payments and total interest cost over 5 years, increasing pressure on cash flow during expansion; issuing shares or VC avoids fixed interest costs.
    - Control: issuing new shares to existing investors may be least disruptive to control if founders retain voting majority; VC taking 30% and a board seat would reduce founder control significantly.
    - Suitability: sales expansion benefits from partners offering industry knowledge and contacts; VC might add expertise and networks but demands high returns and control; share issue keeps decision-making with current owners but may not add expertise.
    - Gearing and investor appetite: if directors prioritise low gearing and keeping control, issuing shares to increase equity is preferable; if rapid scaling and external expertise are critical, VC could be justified despite higher control cost, provided founders accept dilution.
    - Judgement examples: recommend issuing new ordinary shares if keeping gearing low and control is top priority; recommend VC if rapid pan-European scaling needs active investor support and founders accept dilution; argue against debenture if directors worry about higher gearing and fixed interest burdens during expansion.

Question 16

- **B1** identifies factor 1, e.g. availability of investor expertise and contacts
- **B1** develops factor 1, e.g. VC or an angel could provide market knowledge and distribution contacts vital for European sales expansion
- **B1** applies factor 1 to BrightBrew, e.g. VC involvement might speed market entry and improve sales team effectiveness
- **B1** identifies factor 2, e.g. impact on corporate governance and decision-making speed
- **B1** develops factor 2, e.g. more external shareholders or VC board seats may slow decisions due to more stakeholders to consult
- **B1** applies factor 2 to BrightBrew, e.g. slower decision-making could hinder quick local market responses in Europe
- **B1** identifies an additional non-financial factor or further develops either factor, e.g. reputational signals to partners and customers of having a reputable VC
- **B1** applies this extra point to the sales expansion context, e.g. a reputable VC could reassure distributors and speed negotiations
- **Answer: Possible non-financial factors include access to investor expertise and contacts, which could directly help BrightBrew establish a European sales network and train a sales team; and the impact on corporate governance and decision speed, since more external shareholders or VC board seats may slow strategic responses needed during expansion. A third relevant factor is reputation: partnering with a reputable VC could reassure distributors and customers, aiding market entry.**