Entrepreneurial funding - equity or debt?

By Gerrie van Biljon

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Entrepreneurs should be cautious of the amount of finance they apply for, as the wrong amount could jeopardise their business' success. However, when securing funding, many are not aware of the pros and cons associated with asking for either too much or too little finance or whether they should consider debt or equity to fund their business.

Applying for too little funding may not satisfy the financial needs of the business but securing funding in excess of what is required will put additional pressure on the cash flow of the business. This debt needs to be repaid to the lender and the more debt the business is in, the higher the repayment will be.

Too higher funding raises alarms

There is also the risk of the business owner being tempted to utilise the additional funds for private use. Obtaining too much money suddenly could lead to the improper use of the additional funds that become available, which could be spent on unnecessary items that will not necessarily improve the position of the business.

Asking for too much funding can also hinder an entrepreneur's approval rate for finance. Should an entrepreneur apply for an amount that the financier believes is unjustified, the possibility exists that the application will be rejected. This could be for a few reasons, such as the financier not being confident that the entrepreneur is familiar with his/her financial position and the needs of the business, or that the applicant is not fully transparent on the proposed application of funds.

The financial needs of a business stem from either its current position, or the proposed plans for the business, such as expansion, increasing capacity, acquisitions or capital to develop a new product range.

When applying for finance, an entrepreneur should be very clear on the position and strategy of the business as this will determine what type of funding is appropriate for the business. For example, is short or long-term financing more suitable or should the finance be in the form of debt or equity.

Equity requirements

Bringing an investor into the business usually implies that equity will be introduced and that the investor will obtain a shareholding in the business. Although this format of funding has the advantage of no fixed repayment terms, in the process the entrepreneur parts with a portion of ownership of their business. When opting to go with this finance option, selecting an investor should be done with caution and both parties should agree on what their expectations are.

Businesses with high growth potential should not take more funding that is required. Investors may offer the entrepreneur more funding than what is necessary, which will result in the investor obtaining a larger shareholding in the business. Introducing this equity may be a very expensive exercise should the entrepreneur decide to buy the investors' shares at a later stage, as this figure could be inflated due to the growth that the company has experienced.

"During the process of establishing what type of funding is appropriate, professional advice is recommended, as not all entrepreneurs are financially orientated or familiar with the financial principles. Sound, professional advice will guide and steer the entrepreneur to the most suited solution for their particular needs.

ABOUT THE AUTHOR

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