FACT SHEET

Business Financing – What is the Best Finance Option for your Business?

I need to raise capital for my business. What finance options are available?

At some point most businesses will be faced with a circumstance that requires their business managers to seek capital externally. For new businesses, it may be a start-up capital requirement. For existing businesses, it may be funding required for the replacement of plant and equipment, or be as simple as having a buffer to fall back on due to the cyclical nature of the business.

Regardless of the circumstances creating the capital requirement, there are two broad streams of finance options available – debt financing and equity financing. These are explained below.

Debt Financing

Debt financing involves a loan from a financier, either related to the business (such as the business principal or an associate), or unrelated to the business (such as a bank).

Loans from related parties tend to be informal and unstructured. For example, a company director can lend funds to the company for an indeterminate period with no regular repayments required, and on interest-free terms. Loans from unrelated parties such as banks tend to be more formal and structured, and will usually attract conditions such as:

- Specified repayment term (i.e: loan must be repaid within a set time frame),
- Regular and fixed repayments of loan principal,
- A cost of finance, being borrowing costs and interest, and
- Recourse provisions such as provision of loan security or guaranteeing of loans
- Analysis of business performance to determine credit worthiness

Equity Financing

Equity financing involves an injection into a business (cash or otherwise) in exchange for part ownership of the business. If the business is conducted by a:

- Corporate entity, this would involve an issue of shares
- Fixed / Unit Trust entity, this would involve an issue of trust units, and
- Partnership entity, this would involve adding a partner
- Sole trader, this would involve creating a new structure with the incoming entity to reflect the change in ownership, be it a partnership, company or trust

The following page compares the various attributes of debt financing and equity financing.

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FACT SHEET

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Attribute	Debt Financing	Equity Financing
Business ownership	Unchanged. Control still rests with original business owners	Equity financing introduces an additional business owner resulting in diluted ownership and control. However the additional partner has an equally vested interest in the success of the business
Cost of finance	Interest and borrowing costs which are generally tax deductible. Tax deductibility has the effect of lowering the cost of debt finance by the value of the tax advantage	Dividends or distributions of profits depending on the type of entity, which are not tax deductible
Impact on business profits	• Costs of debt financing are an expense which has the effect of reducing profit. In certain circumstances this can be undesirable • Lenders are only entitled to a repayment of loan principal and interest. They have no ongoing claim against future business profits	• Costs of equity financing are effectively a distribution of profits therefore they have no impact on the determination of profit. This is an advantage when seeking to maximise profits • Equity financiers have an ongoing claim to business profits
Impact on business cash flows	Fixed. Servicing debt finance generally cannot be done on a discretionary or variable basis. That is, fixed payments of loan principal and interest must occur regularly regardless of the cash flow position of the business	Discretionary. That is, business principals can determine if and when equity returns (profits) can be paid out to business owners
Impact on gearing	Negative. Debt financing increases gearing which in turn can increase the risk of insolvency and / or bankruptcy. A highly leveraged balance sheet can concern existing and future stakeholders (eg: lenders and prospective business partners)	Positive.
Ongoing relationship with financier	Lenders do not have an ongoing stake in the business – once the loan is repaid the relationship between business and lender terminates.	Equity financing creates a long-term relationship between the existing business principal(s) and the incoming financier which can be hard to terminate if a dispute arises. Either existing or potential business owners must buy out the exiting principal
Security requirements	Debt financing generally requires collateral, and in the case of loans to corporate businesses, personal guarantees from company directors	None.
Complexity	Raising capital through debt finance is generally easier and less complicated than raising capital through equity finance. In both cases, an analysis of business performance and future success are likely to impact the likelihood of one option over the other.	

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What financing option is best for my business?

If your business faces a need for external capital and both debt and equity financing options are available to you, the decision will depend entirely on:

1. **The circumstances giving rise to the need for additional capital**

In most "business as usual" cases, such as a small-to-medium sized capital requirement to replace some retired plant and equipment, debt finance is likely to be the best fit. In more extraordinary circumstances, such as a large capital investment required to fund business expansion into other states or countries, equity partnering with entities based in those target countries may be a better fit. Business phase could also be a determinant – start-up versus business maturity may sway the business financing decision one way or the other. In all cases, it is important to remember that debt financing will almost always require provision of security.

2. **The individual merits and consequences of the various debt and equity financing options available in your situation**

The situation-specific outcomes under both scenarios should be considered in conjunction with the theoretical comparison of each financing option. If an incoming financier proposes both a debt financing option and an equity financing option, the conditions of one option may be overwhelmingly more attractive than the conditions attached to other. Aside from assessing the financial costs of each option, it is important to give due regard to non-financial outcomes such as tapping in to expertise and opportunities for business synergies and business expansion.

3. **Your underlying preference for either option, based on your perception of both the attractiveness and risks associated with each option**

Regardless of the potential benefits and costs associated with each option, you may have an underlying and unfaltering preference for one type of finance over the other. You may, for instance, object to the idea of introducing further owners to your business as it is not, and never will be, part of your business plan. Hence equity financing will never a consideration.

What if neither of these financing options suit my situation?

If neither outright debt financing nor outright equity financing is the right fit for your business, there may be some hybrid scenarios available for you to consider. For example, if your business is conducted within a corporate structure you could consider an issue of preference shares. Preference shares have the advantages of equity financing but some of the safety features of debt financing, such as having priority over ordinary shareholders in the event that a company is wound up and capital is repaid.

What Next?

If your business faces a need for external capital and a decision between debt and equity financing, contact your manager or partner at Enspira Financial to discuss.