BUSINESS FUNDING – EQUITY OR DEBT

There are two ways to fund any business. You can put your own money or other people's money into the business or you can borrow. Most business have a combination of the two.

There are advantages and disadvantages of both so we thought it would be useful to take a look at them in more detail.

EQUITY
Most businesses are funded initially with your own money. Some business owners may also raise funds by offering shares in the business to family friends, angel investors, venture capital investors or even crowd funding.

This sort of funding, called equity, has considerable benefits.

- The money is not able to be redeemed.
- There are no fixed repayments.
- Profit is higher as there is not interest to pay to a lender.
- Cash flow is easier and so this can lower your level of stress.
- Dividends are only payable as cash flow permits.

However, there's no such thing as a free lunch and equity funding tends to be more expensive than debt funding. Shareholders are taking a much higher level of risk. If the business gets into trouble, debt is always repaid before equity and so investors expect a higher rate of return. In addition, when you pay out profits by way of dividends, the money is not tax deductible to the business (as interest payments are).

The other thing that you should consider is that shareholders will reduce the amount of control you exert over your own company.

DEBT
Debt funding is a very common form of funding a business. It has two very key advantages.

- It is generally cheaper than equity.
- Interest payments are tax deductible.
- Ownership is not diluted.

Debt usually takes the form of a bank loan and the principal and interest will need to be repaid over time. This means that it will place stress on the cash flow of the business. Less cash is available to commit to other areas of the business. This may mean that you can't employ that extra person or develop a new product. Trade offs need to be made. Bear in mind that if the business has too much debt, this will act as a disincentive if you try to raise equity funding as potential investors may view the company as a high risk.

Often bank debt will require security and the most common form of collateral is the family home. We urge caution here. Personal assets should be ring fenced where possible and the use of trusts is recommended.

Prudent directors will ensure that they monitor debt to ensure that it remains at acceptable levels and doesn't threaten the viability of the business.

It is possible to minimise the downsides of both forms of funding. It is possible to shift tax deductions from the company to the shareholders by borrowing to purchase shares.

There is no right or wrong mix of equity and debt. The ultimate decision will come down to the director's appetite to risk, the stage of the business life cycle the company is in and the size of the business in general.

This resource has been kindly provided by

If you have any questions, please call **0800 CHAMBER (0800 242 623)**.

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