The various types of small business finance for entrepreneurs and when to use them

By Rean Bloem

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SMEs now account approximately for 50% - 60% of South Africa's workforce and contribute around 34% to our GDP making them extremely important to our economic growth. Notwithstanding the tough regulatory and trading environment, especially during the past few years, one of the biggest hurdles for SMEs remains access to funding. This could be either to start, develop or grow the business.

Source: Unsplash

Sufficient working capital is a key aspect of any company's financial health, and not having enough can have a serious impact on the future of any business. Many businesses choose to apply for external funding to create enough working capital to enable them to fulfil their growth ambitions.

The funding can cover short-term funding requirements while giving the business the money it needs to grow or it can bridge the gap between customer orders and supplier payments to help the company meet its funding obligations.

During Covid, many businesses applied for funding to facilitate e-commerce platforms or pivot the business that enabled them to still have their doors open after two years of tough and unforgiving times.

When considering financing there are a couple of options available to SMEs:

Private loans from family/friends

These loans are often unstructured and limited to the amount available. There could be an expectation that they will be paid back within a very limited time at a rate of interest higher through a financial institution.

Bank loans (overdrafts or fixed period loans)

The amount available from bank loans is limited by the security the SME can offer against the loan. This usually takes the form of property, fixed assets, and insurance policies.

Term financing such as hire purchase or leasing

Very similar to bank loans but for term-financing of moveable assets it will be the underlying asset item that is funded.

Private/quasi equity investment

Private investments are offered based on the potential for success in the market as per the presented business plan and the ability or track record of the operator/entrepreneur. The funder has a vested interest in the success of the business venture since it will be sharing in the profits and losses of the business, depending on the structure of the investment.

Merchant cash advances such as from Retail Capital

A merchant cash advance is a type of business funding designed to help businesses gain access to the cash they need in a fast and flexible way. The lender provides the business with funding which it pays back through a percentage of its future turnovers/receivables.

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This type of funding is suitable for a wide range of businesses that need capital for growth. The funding does not require any security like typical Bank loans and is unrestricted meaning it can be used for working capital or asset finance but ultimately it is at the discretion of the business owner what they use it for.

What is asset finance?

Purchasing new equipment or machinery can pose a challenge for SMEs and can potentially cause cash flow issues. Often, businesses don’t have the working capital available to pay upfront for an asset. That’s where asset finance can come in handy.

There’s a range of traditional asset finance products available:

Hire purchase

With hire purchase, you can buy an asset and spread the cost over a set period in monthly instalments. As you own the asset, you are responsible for its upkeep and insurance. The upside is you’ll own it outright once the finance term comes to an end. The asset will appear on your balance sheet.

Equipment leasing

This operates on a rental-like model. The lender purchases the item and you, as the business borrower, pay rent on it every month for a set period. At the end of the term, you can extend the lease, give it back to the lender, get an upgraded version of the asset or pay the remainder and own the equipment outright.

As you don’t technically own the equipment for the lease term, maintenance costs are usually included. Equipment leasing can be ideal if you want to rent equipment on a short—term basis or if you need access to the latest equipment to compete.

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Merchant cash advancest can also be used to fund assets. Its beauty is the transparency and that the payment process is linked to the performance of your business and there are no additional fees, interest, and penalties if the turnovers are under pressure as we have seen due to various trade restrictions in the last two years.

You have the flexibility to decide if you want to pay a variable or fixed % linked to your fluctuating turnover.

What is franchise funding?

Many franchisors require franchisees to make a sizeable, unencumbered upfront payment. This buy-in helps franchises with viability and ensures that the debt is reduced to manageable levels, which will be vital when cash flow is slow during the initial months.

What is cash flow funding?

Capital in cash flow represents itself as working capital and is the difference between your current assets and current liabilities. Working capital, also called net working capital, is the amount of money you have available to pay short/medium-term expenses.

What other types of business funding exist?

Another type of business lending through Retail Capital’s Merchant Cash Advances is where you can pay back the money over a period that suits you. Payment options are flexible, they can be fixed or match the cash flow cycles of the business. Payments are simply a small percentage of turnover.

What is the best type of funding that a business needs?

There are a couple of financing options available to SMEs whether you are in the Business plan/ Idea phase, startup phase, growth/established/expansion phase or in a mature state. Each is vastly different. You should familiarise yourself with the various options in terms of risks and benefits concerning where you find yourself in the lifecycle of your business.

It’s also highly advantageous knowing who can fund you and what you qualify for at all times to be able to act fast on opportunities as they present themselves.

ABOUT THE AUTHOR

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