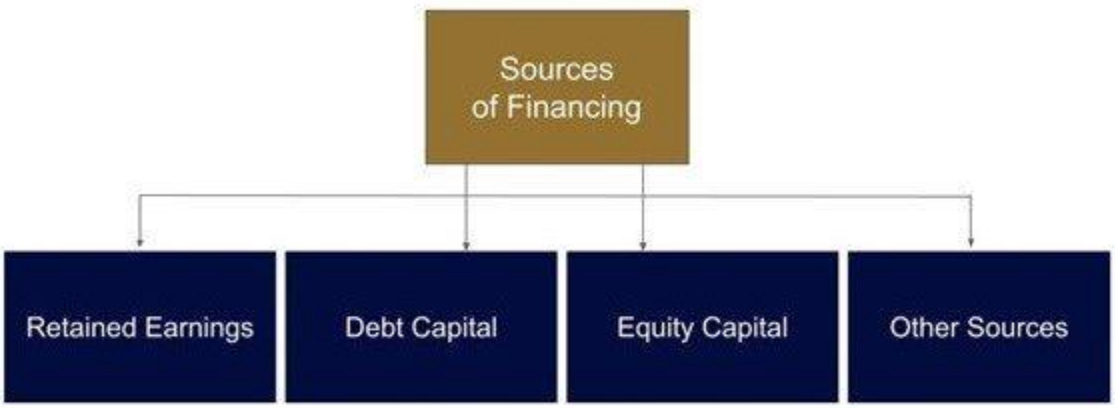
Funding

Companies always seek sources of funding to grow their business. Funding, also called financing, represents an act of contributing resources to finance a program, project, or need. Funding can be initiated for either short-term or long-term purposes. The different sources of funding include:

- Retained earnings
- Debt capital
- Equity capital
- Other sources, such as crowdfunding



Key Highlights

- The main sources of finance are retained earnings, debt capital, and equity capital.
- Companies use retained earnings from business operations to expand or distribute dividends to their shareholders.
- Businesses raise funds by borrowing debt privately from a bank or by issuing debt securities to the public.
- Companies obtain equity funding by exchanging ownership rights for cash from investors.

1/ Retained Earnings

Businesses aim to maximize profits by selling a product or rendering a service for a price higher than what it costs them to produce the goods. It is the most primitive source of funding for any company.

After generating profits, a company decides what to do with the earned capital and how to allocate it efficiently. The retained earnings can be distributed to shareholders as dividends, or the company can reduce the number of shares outstanding by initiating a stock repurchase campaign.

Alternatively, the company can invest the money into a new project, say, building a new factory, or partnering with other companies to create a joint venture.

2/ Debt Capital

Companies obtain debt financing, or debt capital, privately through bank loans. They can also raise capital by issuing debt to the public.

In debt financing, the issuer (borrower) issues debt securities, such as corporate bonds or promissory notes. Debt issues also include debentures, leases, and mortgages.

Companies that initiate debt issues are borrowers because they exchange securities for cash needed to perform certain activities. The companies will be then repaying the debt (principal and interest) according to the specified debt repayment schedule and contracts underlying the issued debt securities.

- Debt financing is also referred to as financial leverage.
- The cost of debt is the interest charged.

*** Debt Financing Options**

1. Bank loan

A common form of debt financing is a bank loan. Banks will often assess the individual financial situation of each company and offer loan sizes and interest rates accordingly.

2. Bond issues

Another form of debt financing is bond issues. A traditional bond certificate includes a principal value, a term by which repayment must be completed, and an interest rate. Individuals or entities that purchase the bond then become creditors by loaning money to the business.

3. Family and credit card loans

Other means of debt financing include taking loans from family and friends and borrowing through a credit card. They are common with start-ups and small businesses.

**** Debt Financing Over the Short-Term**

Businesses use short-term debt financing to fund their working capital for day-to-day operations. It can include paying wages, buying inventory, or costs incurred for supplies and maintenance. The scheduled repayment for the loans is usually within a year.

******Debt Financing Over the Long-Term**

Businesses seek long-term debt financing to purchase assets, such as buildings, equipment, and machinery. The assets that will be purchased are usually also used to secure the loan as collateral. The scheduled repayment for the loans is usually up to 10 years, with fixed interest rates and predictable monthly payments.

- **Advantages of Debt Financing**

1. Preserve company ownership

The main reason that companies choose to finance through debt rather than equity is to preserve company ownership. In equity financing, such as selling common and preferred shares, the investor retains an equity position in the business. The investor then gains shareholder voting rights, and business owners dilute their ownership.

2. Tax-deductible interest payments

Another benefit of debt financing is that the interest paid is tax-deductible. It decreases the company's tax obligations

- **Disadvantages of Debt Financing**

1. The need for regular income

The repayment of debt can become a struggle for some business owners. They need to ensure the business generates enough income to pay for regular installments of principal and interest.

2. Adverse impact on credit ratings

If borrowers lack a solid plan to pay back their debt, they face the consequences.

3. Potential bankruptcy

Agreeing to provide collateral to the lender puts their business assets at risk, and sometimes even their personal assets. Above all, they risk potential bankruptcy. If the business should fail, the debt must still be repaid.

3/ Equity Capital

Equity capital, or equity financing, refers to the funds a company raises by offering ownership stakes, either publicly or privately, in exchange for investment. Compared to debt capital funding, companies with equity capital don't need to make debt and interest payments. Instead, company profits are shared with investors.

Equity finance

Advantages	Disadvantages
• No impact on gearing or financial risk • No repayments, therefore the firm has more cash flow • Does not incur interest charges • Investors (shareholders) are prepared to wait for some time to get a return on their investment	• Proportion of profits go to additional new owners • Dividends not tax deductible • More expensive - shareholders require higher return due to higher risk • Diluted ownership and less control (external equity)

4/ Crowdfunding

Crowdfunding represents a process of raising funds to fulfill a certain project or undertake a venture by obtaining small amounts of money from a large number of individuals. The crowdfunding process usually takes place online and is a common source of finance for startup businesses

Government Grants and Subsidies

Grants and subsidies are examples of financing provided by government agencies to support specific projects, initiatives, or sectors that align with public policy goals. Grants commonly provide funding for research, education, environmental protection, or community development.

Subsidies are financial assistance programs designed to lower the cost of goods or services, making them more accessible or promoting particular industries. Agriculture is an example of an industry that frequently receives government subsidies.

*****What Factors Affect the Need for Sources of Funding?**

For businesses, the most relevant factors influencing the need for funding typically include:

- Growth plans
- Operational needs
- Capital structure, i.e., a mix of debt and equity
- Research and development (R&D)
- Asset acquisitions, i.e., purchasing real estate, equipment, or technology
- Stage of business development
- Economic conditions or unexpected events, i.e., natural disasters