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Finance for Entrepreneurial Companies: Financing Instruments

Introduction

Despite today's growing attention to bootstrapping and the use of customer funding in the financing of new ventures, many new ventures, be they a startup or a plan to grow an existing business, will require some initial injection of capital to finance the fixed assets, working capital, and operating expenses needed to pursue the opportunity. Although the entrepreneur will make projections of such costs and of future cash flow and profitability, these forecasts will be uncertain. Any proposed method of financing needs to allow for these uncertainties.

The providers of both debt and equity finance require a return on their capital, but they have different expectations regarding the level and certainty of the return. Accordingly, accepting finance in the form of a bank loan or equity investment places different types of obligations on the business. The pattern of obligations represented by the mix and type of debt and equity should suit the business's projected operating returns.

The financing package must also suit the entrepreneur. The entrepreneur is key to realising the opportunity, so the package must offer them suitable incentives, in terms of both potential financial gain and freedom to grow the business. Therefore, the central issue in financing an entrepreneurial business is to determine the optimal financial structure. How can these be matched to the business's requirements, while retaining appropriate incentives to motivate the entrepreneur?

Understanding financial structure and the appropriate financial instruments is important. First, an awareness of the sort of financing that will be required will make it easier to raise money. Time will not be wasted in chasing the wrong people. Second, getting the structure right at the outset can avoid a lot of problems later on. A business can get into difficulty through simply having the wrong sort of financing. Renegotiating financing can involve a significant amount of management time – time that could otherwise be spent on developing the business – and can also be costly in the end.

The financing package effectively divides the returns of the business into a set of different income streams. These streams, packaged as different types of instrument, are tailored to suit different types of financier. The entrepreneur, therefore, needs to be aware of the different types of instrument and how they relate to one another.

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This technical note was first written in 2004 by Steve Pesenti and Robert M. Johnson, and was updated by John Mullins in 2021.