3.2 Sources of finance

Evaluation of sources of finance

Businesses need to choose their finance sources wisely. The origin and type of finance will have a large impact on how a business functions. In Section 1.3.5 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/strategies-and-tactics-id-36521), you watched a video in which Kate Raworth explained how businesses can be designed to be regenerative and distributive. The financing of a business is closely related to the ownership of a business, the business's purpose and objectives, and the networks and governance of the business.

Raworth points out that some investors could demand fast and high growth of the business for the sole benefit of the early equity investors who wish to exit the business with large, quick profits. Some investors, and other sources of finance could represent more patient capital. Patient capital is long-term financing where investors are willing to wait longer to see returns and expect a fair, not excessive, return on their money. Patient capital is especially important for social enterprises that are looking to distribute the value they create more widely.

A business needs to consider carefully where and from whom it sources financing, because those who provide funding may or may not have the same objectives as the entrepreneur and employees. It is important that the business owners and those providing the finance have the same objectives. Financing needs to make sense given:

- the type and size of the business
- the purpose of the business and the objectives of the financing
- the risk tolerance of the business or owners

Exam tip

If you are asked to recommend an appropriate source of finance for a business, you can frame your response by considering the three areas discussed below: the type and size of the business, the purpose of the business and objectives of the financing, and the risk tolerance of the business or owners.

Ownership type and size of business

Not all sources of finance will be available to every business. Sole traders and partnerships, for example, have limited choices. Banks are not likely to loan sole traders and partnerships large sums of money because they are usually small and often have limited experience. Loaning money to such enterprises would be risky for the bank. These ownership types are not able to offer share capital to new investors, without first changing their legal ownership status. Business angels also may not be interested in these small enterprises. Therefore, sole traders and partnerships must often use personal funds for financing new investments.

Activity

Learner profile: Thinkers
Approaches to learning: Thinking skills (critical thinking)

Carry out a quick review of what you learned about different types of businesses from Subtopic 1.2 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-36507).

Using what you know about business types, and about the various sources of finance:

- Download and complete the table below to indicate which sources of finance may be appropriate for the various business types. The columns for sole traders and partnerships have been completed for you based on the information already discussed.
- Share your table with a partner or discuss with the class. It may be that some sources are possible, but not likely or fully appropriate; discussing your thoughts can be helpful to clarify the situation. You could indicate these with a question mark. Note that the solution includes question marks too. These can be areas for interesting discussion.

Download file (https://d3vrb2m3yrmyfi.cloudfront.net/media/edusys_2/content_uploads/3.2.4 tables for download.docx (1).pdf.3b481632d42045fd46c8.zip)

Purpose of the business and objectives of the finance

The sole or main purpose of some businesses is to generate profits for shareholders. These businesses are usually for-profit commercial enterprises. In the case of these businesses, investors may be able to agree with the business to generate large profits as a priority for shareholders including outside investors.

However, in the case of for-profit social enterprises, the choice of finance needs to be made carefully. For these businesses, maximising profits will not be the main objective. It is therefore important for the business to ensure that any outside investors provide patient capital that is in line with the social or environmental purpose and objectives of the business. If these businesses are providing goods and services in a way that is regenerative and distributive, profits (known as surplus) may be lower and take longer to realise. Investors need to be aware of that. There are business angels and venture capital companies, such as the Acumen Fund, that specialise in this kind of patient capital.

Figure 1. Social entrepreneurs need to choose their sources of finance carefully to ensure that investors provide patient capital.

Credit: lisegagne, Getty Images

In order to select the right source of finance, the business will also need to consider the purpose of the finance. A small investment may be funded in a variety of ways, even through short-term finance sources. For example, a small business can free up more working capital through leasing rather than buying equipment, or through negotiating longer payment terms with suppliers. But a large investment may only be funded by sources that are able and willing to provide large sums of money, perhaps over a longer period of time. This will more likely be venture capital, share capital or bank loans.

Risk tolerance

Finally, businesses need to consider their own and others' tolerance for risk when choosing a source of finance. The good thing about having multiple investors, such as business angels, venture capital and share capital, is the ability to share risk among multiple people or groups.

However, when a business borrows money to make capital investments or to grow the business in other ways, the burden of repaying the loan is more concentrated. Loan capital creates large risks for the business, especially where the external environment is uncertain or the business plans are risky. Among other risks, interest rates can change over time, depending on the loan type. This can make the loan more expensive for the business. The benefit, however, is that the business owners do not lose ownership and control of the business through the financing.

Generally, it is best for a business to borrow money only in a lower-risk situation. Where risks are higher, particularly if the possibility of rewards are also higher, then sharing risk with business angels or venture capital companies may be a more appropriate financing option.

Making connections

Higher level students will learn about the concept of gearing in Subtopic 3.6 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39311). Gearing refers to the level of a business's debt relative to the equity in the business. A business is said to be highly geared when debts are large relative to the value of equity. Low-geared means that the debt is low relative to the value of equity.

Activity

Learner profile: Thinkers
Approaches to learning: Thinking skills (critical thinking)

For each of the following scenarios, identify and explain an appropriate source of finance for the business. Make sure to justify your choice with evidence from the scenario and your knowledge of business management theory.

1. A small technology company, located in Tel Aviv, has invented a new way of using smartphones to interact with transportation networks. If the idea works, it could be worth billions to its owners. However, the company does not have the large sum of finance needed to fully develop its ideas. Suggest a source of finance it could use and explain your reason.

2. A wholesaler buys food and drink from producers, then sells it on to local retailers. While it is waiting for a large customer to pay, it is having cash flow problems. The customer has been using the wholesaler for years and has never been late paying. Suggest a source of finance the wholesaler could use.
3. A company that manufactures fireworks has highly seasonal demand, with 80% of its sales occurring in the run-up to a major festival. It now needs a warehouse to store the fireworks that it will sell shortly. However, it only needs the warehouse for a few weeks. Suggest a source of finance for the company.
4. A hotel in a mountain resort wants to develop its business in more sustainable ways. It is also concerned about climate change and knows that it might not be able to rely on revenues from winter sports as global warming accelerates. So, it is interested in developing other revenue streams, such as providing cycling, water sports and other summer sports, as well as developing sustainable alpine agriculture and a cooking school focused on regional cuisine. The hotel has hundreds of loyal customers, some of whom have been visiting for twenty years or more. The hotel has previously taken out large bank loans to add more hotel rooms. But the owner of the business is ageing and does not want to leave his children, who will take over the hotel, with unreasonable debt levels. He also does not want to lose control of the business to other owners.

Case study

Figure 2. Students at ToU can study from anywhere in the world.

Tomorrow University of Applied Sciences (ToU) (https://www.tomorrow.university/) is a new, remote-first university specialising in entrepreneurship, sustainability and technology. It offers the following three bachelor's degrees:

- BA in Responsible Entrepreneurship

- BA in Sustainable Product Management
- BSc in Artificial Intelligence and Sustainable Technologies

ToU's digital learning platform makes it possible for students to learn from anywhere in the world. The programme emphasises learning-by-doing, with challenge-based exercises to solve real-world problems. Mentors and a global network of learners to support students through the programme. The degrees are fully flexible. New cohorts are admitted every three months. If students want to pause their learning, for example to complete some full-time work experience, they can simply rejoin the programme with a later cohort.

ToU was set up as a non-profit enterprise in 2022. The founders set up ToU as a non-profit enterprise in order to meet their responsibilities under Sustainable Development Goal 4 (SDG4) (https://sdgs.un.org/goals/goal4) relating to quality education. This is the human need in the social foundation of the Doughnut Economics Model that you learned about in Section 1.1.2 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-doughnut-economics-model-id-36500). Non-profit status was important for the founders because they want to ensure that any surpluses generated by ToU are reinvested in the business to improve and expand education for students. They want to distribute value to a wide range of stakeholders.

However, the founders of ToU realised that, to meet their objectives of growing their programme through advanced digital technologies, they would need large amounts of financial capital. This amount of funding would be difficult to raise for a non-profit organisation. So they founded a second business called Tomorrow's Education, which is a for-profit social enterprise. For-profit status makes the business more attractive to investors, who may be seeking some level of fair return on their investment. ToU is a subsidiary of Tomorrow's Education.

The two founders used personal funds to set up and register Tomorrow's Education. To acquire the finance needed to build the digital learning platform for ToU, the founders sought funding from several other sources. Initially, Tomorrow's Education received 1.1 million euros of 'pre-seed' funding from several business angels and a venture capital company called Emerge Education (https://emerge.education/), which specialises in financing EdTech businesses. In another round of seed funding, Tomorrow's Education received 3.4 million euros organised by a Dutch venture capital company called Mediahuis Ventures (https://www.mediahuis.com/en/activities/mediahuis-ventures/). Both rounds of funding were in the form of equity finance.

So, the founders of ToU have set up both a for-profit social enterprise – with the ability to raise funds from investors – and a non-profit social enterprise – to deliver education for responsible entrepreneurs. By doing this, they are working towards their objectives to deliver quality education to large numbers of students with adequate funding from interested investors.

Questions

1. Define business angel. [2 marks]
2. Explain one advantage and one disadvantage for Tomorrow's Education of using equity finance as its main source of finance. [4 marks]

3. Explain how setting up both a non-profit social enterprise and a for-profit social enterprise helps the business deliver education services on a large scale. [4 marks]