SME Financing - Equity vs. Debt

Small and Medium Enterprises (SMEs) may encounter many challenges when raising capital to finance the development of their businesses. These challenges can have the potential to hinder the development of the SME and also stifle economic development. Equity financing and debt financing are two (2) methods of raising capital utilised by businesses. However, because there are distinct advantages and disadvantages associated with each type of financing option, most businesses employ a combination of equity and debt to support their capital needs. This week's article discusses some of the differences between equity and debt financing for an SME.

Equity financing is derived from selling a portion of the SME in return for capital. SMEs can be listed on the small and medium enterprise market of the Trinidad and Tobago Stock Exchange (Stock Exchange). Through this trading platform, SMEs can have a minimum issued share capital of TT$5 million or a maximum of TT$50 million. Investors can become part owners of the SME and can share in the future profitability through the receipt of dividends. For more information on the Stock Exchange's SME market you can visit their website: https://www.stockex.co.tt/.

For the purposes of this article, Debt Financing will include the use of traditional forms of financing, such as loans from financial institutions. It should be noted that while the issuance of corporate bonds is a form of debt financing, SMEs are more likely to utilise smaller loans from financial institutions. Generally, debt financing includes the borrowing of money and repaying the amount, plus interest over a period of time.

The combination of equity and debt shapes the capital structure of an organisation. A major aim of entrepreneurs is to increase the organisation's capital structure to facilitate expansion and growth. However, the entrepreneur must decide how best to alter the capital structure, whether by increasing equity or debt.

Advantages of Equity Financing

- Assuming the Initial Public Offering is successful on the SME market of the Stock Exchange, equity issuers can potentially obtain more financing from the capital market when compared to financial institutions.
- When using equity financing, there is less burden on the SME since there is no debt obligation where monthly payments are required. Therefore, there is a bit more freedom in managing cashflows to pursue growth of the SME.
- Going public establishes the structure to facilitate raising additional capital in the future.
- Due to the level of transparency requirements, when an SME goes public its overall credibility is enhanced, therefore its negotiating power increases with financial institutions.

- Existing shareholders will now have the opportunity to easily liquidate their shareholdings if so desired.
- In some cases, equity financing can cost less that debt financing.

Disadvantages of Equity Financing

- If the SME is listed on the Stock Exchange, there will be some dilution of ownership
- There are both legal and compliance requirements to be meet and adhered to, when listing on the Stock Exchange. The cost of these regulatory compliance requirements will reduce the SME's cash flows. Among other things, these can include legal fees and audit fees.

Advantages of Debt Financing

- Debt payments may be flexible to meet the needs of the borrower.
- Debt has the unique feature of allowing the borrower to potentially walk away from their obligation to pay, in exchange for the assets of the company. Lenders refer to this as default risk where borrowers do not repay their obligations.
- Interest Tax Shield- Tax savings resulting from deductibility of interest payments. Negotiations can be held with lenders to reduce interest rates/cost of debt.
- Ownership in the company is not diluted.

Disadvantages of Debt Financing

- Interest and principal payments must be made, even during periods of low profitability.
- SMEs can face cashflow difficulties when managing debt payments.
- Based on the SMEs credit history or score the cost of debt can be quite high.

When considering debt financing, other factors entrepreneurs should consider are:

- Should the company borrow short term or long term?
- Should the debt be fixed or floating?
- The collateral that is available to negotiate with the lender?

Which is more expensive – Equity or Debt?

If we assume that an SME wants to obtain TT$20 Million, Tables 1 and Table 2 below compares the average cost[1] of the equity and debt financing options.

Table 1: Cost of Equity Financing

Item	**Cost TT$**
Start Up Cost	
TTSEC annual registration fee as reporting issuer	5,000.00
TTSEC Filing of Registration Statement	100.00
TTSEC Filing of Prospectus	10,000.00

[1] Some costs not shown include, financial institution fees and charges, costs associated with the auditing of financial statements and other regulatory and compliance costs that may be incurred if there are changes in the company's operations.

TTSEC Market Access Fee	2,000.00
TTCD Initial Membership Fee	7,500.00
Sub - Total	**24,600.00**
Yearly Fees	
TTSEC annual registration fee as reporting issuer	5,000.00
Sub - Total TTSEC Annual Registration Fee for over 5 years	**25,000.00**
Grand Total over 5 years	**49,600.00**

Trinidad and Tobago Securities and Exchange Commission ("TTSEC")

Table 2: Cost of Debt Financing

Item	**Cost TT$**
Borrowing TT$20 Million - Assuming an Interest rate of 5% for 5 years	
Total Monthly Payment	377,425.00
Total Interest Payment (5 years)	2,645,480.00
Total Payment – Principal and Interest (5 years)	**22,645,480.00**

NB – These costs do not include financial institution fees and charges.

If we compare the aforementioned costs, it appears that issuing equity is cheaper than borrowing when an SME wants to raise TT$20 Million capital. However, it should be noted that other costs associated with regulatory compliance will be incurred by an SME listing on the Stock Exchange . It is important that entrepreneurs are aware of the options available to them when seeking to raise capital for their organisations. In this regard, the TTSEC continues its mandate of public education as it seeks to continue fostering the development of the securities industry of Trinidad and Tobago.

For more information, please visit our corporate website, www.ttsec.org.tt.
You may also visit our Investor Education website at www.investucatett.com or connect with us via any of our social media handles:

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