Entrepreneurship finance

Competitive market, in classical economics theory, rests on a number of assumptions, among which is the notion of perfect knowledge of market conditions.

- The market place of entrepreneurial finance on the other hand, is not so perfect
- because it only provides us with an understanding of market operations and its efficiency (Storey & Greene, 2010).
- Storey and Greene (2010) point out that, if the market works well, good borrowers will get funds and bad borrowers will be denied.
- They further explained that the skill to differentiate good borrowers from bad borrowers determines the finance supplier's success in entrepreneurial finance market place.

- Three characteristics differentiate entrepreneurial finance from corporate finance (that is associated with large business).
- 1.Entrepreneur's personal characteristics, in terms of his personal wealth play a role in accessing finance
- 2.There is a greater emphasis on the risk associated with business closure that can result into loan default
- 3. Lack of information about the business or their owners, referred to as opaque.

- These identified characteristics are the themes that run through discussion of entrepreneurial finance theories like:
- agency theory;
- information asymmetries;
- bootstrapping finance;
- And pecking order hypothesis.

- **1 The Agency Theory**
- The agency theory is applied in a context where there is mutual beneficent relationship between two parties, the principal and the agent.
- The framework is based on three assumptions:
- (i) that the principal engages in actions that will benefit the agent in which the principal expects a payback;
- (ii) that the principal has an imperfect knowledge on the activities of the agent and that the agent objectives are not congruent with that of the principal;
- (iii) that it is costly for the principal to monitor the activities of the agent and ensure compliance. The theory

- **Information Asymmetries**
- Asymmetric information explains the reason why SMEs may not have access to finance because of their high information opacity.
- Information asymmetries arise out of the fact that not only is information imperfect, it is also unequal
- Entrepreneurs know a great deal more about the business than the banks that will advance credits or any potential investor and they use the information advantage to their own benefits
- Potential lenders apart from the banks are even more disadvantaged.
- The exception to the advantage in information asymmetry will be at the start up stage, when the banks may be better informed about the developments in the sector from the past experiences of lending to the sector

- **Bootstrap Finance**
- Bootstrap finance approach is hinged upon developing a variety of creative financing techniques without resort to traditional commitments or market obligations.
- The bootstrap finance approach is meant to focus outside of institutional and traditional approaches.
- The techniques encourage owners of businesses:
- to exploit personal resources;
- to utilize personal short-term borrowing;
- to request funding from relatives;
- to barter for services;
- to negotiate for client-based funds; to lease equipment;
- to outsource production;
- to seek subsidies or incentives or grants .

- **Pecking Order Theory**
- The framework argues that business with good future prospect, will avoid situations where they have to sell share to outsiders for fear of dilution of the ownership and control.
- They would rather seek alternative sources of financing and the most favored will be internal financing in that pecking order on the basis that it requires no repayment.
- Where the owners of business are sure of success, they are unlikely to share ownership with others.

- Pecking order theory with the following hierarchy from most preferred to least preferred source of finance:
- (i) Reinvestment of profits (including long working hours and below market salaries of owners-managers);
- (ii) Short term debt financing (trade credit, and personal credit card financing);
- (iii) long term financing(possibly beginning with long term loans from existing owners and owners-managers, their families and friends);
- (iv) New equity injections from existing owners and owners-managers (perhaps including their families and friends, with acceptance of low or zero dividends); and
- (v) New equity from hitherto uninvolved parties, including private equity.

- **Sources of Finance**
- Two broad categories of financing sources available to small business entrepreneurs and they are, the external and internal sources of finance
- The results of Afolabi's (2015) study describing the prevailing financing practices of entrepreneurs in small and medium enterprises in South West Nigeria also show engagement in both internal and external financing practices.
- The analysis of the data shows that the prevalent financing practices amongst others are:
- Retained Earnings with 78%; Personal savings with 76%; Bank and other financial institutions with 58% and Term loans with 52%.
- These are closely followed by the less prevalent practices of: financing from state owned Bank and government agency with 48%; Overdraft facility with 45%; Non Bank financial institution with 45%; Mortgage on homes with 41%; Borrowing from informal sources with 38%; fresh equity from Business angle with 35%; Asset financing with 35%; Asset-based financing with 34% and fresh equity from venture capitalists with 33%.
- With these financing practices, this study has established that SMEs financing are by no means limited to internal financing as can be seen from the foregoing.

- Storey and Greene (2010), comprehensively treat sources of financing available for businesses, without classifications.
- The two scholars identified twelve main sources of finance.
- (i)Overdrafts, is a facility provided by a bank, with a flexibility to borrow up to an agreed limit whenever needed.
- (ii) Grants or subsidized loans, is generally non-repayable payment that is usually provided by a public organization. Subsidized loans are repayable unlike grants, but at an interest rate below the commercial rate. .

- (iii) Term loans, are provided by banks and other financial institutions repayable with a given period of time, normally at an agreed intervals for both interest and principal not exceeding three years.

- (iv) Asset finance is an alternative to term loans for acquisition of assets. Using asset finance, the firm can engage in hire purchase or leasing.

- (v) Credit cards provide access to cash to purchase assets or for working capital. It attracts no interest if repaid within time otherwise the interest rate are prohibitive.

- (vi) Equity finance is a stake or share of the ownership of a business. This often happens when an owner cede part of their business to others in return for cash. There is no interest payment. The disadvantage of this form of financing is that full control will be diluted.

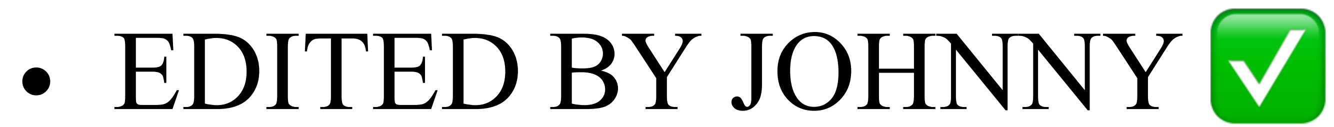
- (vii) Personal savings, these are cash and other assets of the owner.

- (viii) Mortgage on home, provides borrowed funds based on the collateral value of property. This is usually the owner's own house.

- (ix) Gifts from friends and family, these are normally assumed to be non-payable.

- (x) Loans from family and friends, these are assumed to be repayable. If it incurs interest rate at all, they are often minimal or zero.

- (xi) Asset-based finance, involves either 1. factoring of invoices to a third party for a proportion of the yet unpaid invoices
- or 2. stock finance which raises finance against the stock a business holds.
- (xii) Trade credit, the owner may be able to acquire use of an asset without having to pay for it until some point in the future.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