Business management: Capital raising

Capital structure optimization is a long-term play: It ought to be thought of that way

SMEs should not wait until they are heavily leveraged to start thinking about optimizing their capital structure. This has a tendency to destroy value for the business owner over the long term.

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As we have time and again observed in the Private Equity space, by the time SMEs are thinking about external equity capital injection, it's normally under great duress. This pressure comes when the balance sheet is already heavily geared or leveraged, and the resulting impact of high debt service is beginning to affect earnings. The business is now forced to survive on overdrafts or other short-term borrowing facilities. By this time, the entire organisation is moving at a very fast pace, trying to make things happen, mostly fighting to meet various obligations as they fall due. In most cases, meeting working capital needs is already problematic at this stage, so the appetite for short term financing is also very high.

As the business continues to operate this way, it becomes increasingly challenging for the founders to strategically think about how best to optimise the company's capital structure, leave alone thinking and planning for organic growth. There is no sufficient time to ensure that the right equity partner is identified and brought on board not just to provide the capital injection, but to ensure that they are the best match for the business both in its current phase and in the long term.

The business is forced to partner with any capital provider that comes along and shows interest because the pressure of piling debt burden is high. Chances of high pricing, poor deal structuring, capital providers mismatch and potentially value destruction overtime is very high. The entrepreneur ends up getting the short end of the stick.

How founders and executives can avoid such costly mistakes

1) **Ensure that an optimal capital structure is part of your growth strategy**: Many SMEs do not have a growth strategy in the first place. The business operates based on what is in the mind of the founders. Proper planning has not been ingrained in the culture of the company. The business should start off by ensuring that it maps out its growth path. In this strategic mapping, the conversation around funding the business from various sources of capital should be included. When this conversation begins early, it will ensure that capital will be raised at the right time, at the right price and from the right partners.

2) **Don't wait until you are in distress to diversify your sources of capital:** Many times this leads to expensive capital and the wrong partners.

3) **Constantly think about a strategic fit in a partner:** When the conversation around the optimal capital structure at specific phases of the business happens early, it becomes clear with time what a 'right' partner would look like. There will be no rush to get any one on board just because they are providing capital injection.

4) **Have a tracking system as the business transitions through the various phases:** It is imperative that the business owner has a 360-degree view of the operations and how things are trending. This helps to determine how best to optimise the capital structure and at what point new/additional equity capital injection becomes necessary. Sometimes founders and business executives think equity capital injection is the single silver bullet to all their business challenges. This is not always the case. Sometimes a simple balance sheet restructuring is sufficient to unlock additional resources. Founders and business operators must have a way of capturing all the dynamics of how the business is performing so that they are able to anticipate challenges that may arise, and thus design the right interventions at the right time.

It is every business founder's dream and desire to grow a sustainable business that continues to create value for generations. This is achievable with the right partners providing capital resources at the right price and at the right time in the life of the business.