How to feed the funding life-cycle of a small business

By Dov Girnun

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For most South African small businesses, the difference between shooting the lights out and failing dismally lies in access to the right funding at the right time.

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We all know about the SME sector's potential to reduce unemployment, raise South Africa's GDP, and basically save the economy from itself. But for this to happen, we need a lot more successful SMEs – and to do that, we need to find a way to fill a R60 billion funding gap in the sector.

How do we get to that figure?

According to South Africa's National Treasury, the country has an estimated 2.8 million SMEs, of which 1 million are formally registered. A 2016 Finscope study suggested that 40% of that 1 million has access to finance, which leaves 600,000 formally registered SMEs still looking for finance. They typically borrow around R100,000 - which works out to a R60 billion funding shortfall.

Why is that a problem? The biggest reason that small businesses fail, or can't scale up their businesses, is a lack of funding. The average venture cycle for SMEs spans around 10 years, through various stages of growth. In that time, the only constant is the need for working capital.

Why small businesses need funds

SMEs tend to need working capital for anything that will drive the growth of their business: hire more employees, buy new equipment, refurbish their stores, buy more stock, even do some marketing. They don't necessarily have to be elaborate plans, but each funding step is crucial to the next. And, according to funding life-cycles, this is often a 10-year plan. But instead of being locked into a 10-year loan, working capital should be flexible because it's the 'air' small businesses need to breathe during their transition and growth stages.

Stage 1: Seed and start-up (1-3 years)

Not surprisingly, this is the stage where failure rates are the highest. Typically, the sources of funding here are the business owner's own bank account, friends and family. As a start-up, you've probably under-estimated the amount of money you need, and been optimistic around your time to market.

Your challenge here: don't burn through the cash you have. Along with establishing your customer base and building a presence in the market, you need to keep a laser-like focus on your cash flow, and constantly check to see that your business is on the right track.

Stage 2: Establish and build (3-6 years)

You've survived the first three years – but you're not out of the woods yet. This phase can be equally tough. As you build your customer base, you're growing your employee numbers, which means paying more salaries and possibly even funding new developments.

Your main challenge in this stage is prioritising where you spend your time and money, and staying on top of market and broader economic conditions. As a small business, one bad patch can easily drain your cash flow and wipe you out.

Stage 3: Expand and grow (7-10 years)

By year seven of any small business, you'll often see a greater focus on seeking sustainable funding and finding more opportunities. This is the phase that really builds the ecosystem and economy. Here, you'll be actively looking for funding to help grow market share and find new channels – possibly through joint ventures and partnerships, although many SMEs don't want to give away equity when what they actually need is working capital.

The bottom line

At every stage, it's vital to align with funders that connect with your business and understand the needs of an SME. The working capital needs of a small business vary from industry to industry, and it's important to find partners with the same vision and values. It's not just about finding a financial investor: you need strategic investors who can provide access to networks and mentorship to help your business grow. If we can do that, we'll be well on the way to creating a more vibrant and sustainable SME sector in South Africa.

ABOUT DOV GIRNUN

Dov Girnun is the CEO at Merchant Capital.

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