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Equity vs Debt: Which Is Better for Your Startup?

Starting and growing a business requires more than a good idea. At some point, most startups need capital to build their products, hire talent, acquire customers, expand operations or enter new markets. For many founders, the question is not whether they need funding, but how that funding should be obtained.

Two of the most common sources of external financing are equity financing and debt financing. Equity financing involves raising money by giving an investor an ownership interest in the company, while debt financing involves borrowing money that must be repaid, usually with interest.

Neither option is automatically better than the other. The appropriate choice depends on the startup's stage, cash flow, growth strategy, risk appetite and the founder's willingness to share ownership and control.

Understanding Equity Financing

Equity financing occurs when a startup raises capital by selling part of its ownership to investors. In return for their investment, investors receive shares or another form of ownership interest in the company. Common sources of equity financing include angel investors, venture capital firms, strategic investors and equity crowdfunding.

One of the biggest advantages of equity financing is that the startup does not have a fixed obligation to repay the capital. This can be particularly important for early-stage startups that are still developing their product, building a customer base or operating without predictable revenue. Instead of making regular loan repayments, the company can use its available cash to focus on growth.

Equity investors can also bring more than money. Experienced investors may provide industry knowledge, strategic guidance, networks, credibility and access to future opportunities. This can be valuable to a founder who needs both capital and expertise to scale.

However, equity financing comes at a significant cost: dilution.

When a founder sells 20% of a startup to an investor, the founder no longer owns 100% of the company. The investor becomes entitled to the rights associated with that ownership interest and may have a voice in important business decisions. As the startup raises additional rounds of funding, further dilution may occur.

Therefore, although equity does not require repayment in the same way as a loan, it is not free money. The founder is exchanging part of the future value, profits and control of the business for immediate capital.

Understanding Debt Financing

Debt financing works differently. The startup borrows money from a lender and agrees to repay the principal, usually with interest, according to an agreed repayment schedule. Examples include term loans, business lines of credit, invoice financing or factoring, business credit cards and other forms of business lending.

The major advantage of debt financing is that the founder generally retains ownership of the company. A lender provides capital but does not ordinarily become a shareholder merely because it provided a loan. Once the debt has been repaid according to the agreement, the financing relationship may come to an end.

Debt can therefore be attractive to founders who have predictable revenue and sufficient cash flow to service their obligations. It may allow them to finance expansion without giving away a portion of their company.

Debt, however, creates a financial obligation that equity does not.

Whether the startup is having a good month or a bad month, the debt generally still has to be repaid. If the startup's cash flow falls significantly, regular repayments can put considerable pressure on the business. Depending on the financing arrangement, the lender may also require collateral, guarantees or compliance with certain contractual restrictions. For this reason, debt can be particularly risky for startups without stable revenue.

Equity vs Debt: The Major Differences

The central difference is simple: equity exchanges ownership for capital, while debt exchanges repayment obligations for capital.

Factor	Equity Financing	Debt Financing
Ownership	Founder gives up part of ownership	Founder generally retains ownership
Repayment	No fixed repayment obligation	Principal and interest must be repaid
Cash flow pressure	Lower immediate pressure	Regular repayments can affect cash flow
Control	May be shared with investors	Generally retained by founders
Investor involvement	Investors may provide strategic input	Lenders generally have no ownership role
Risk	Risk is shared with investors	Repayment risk remains with the company
Best suited for	Early-stage/high-growth startups	Startups with predictable revenue

The distinction becomes particularly important when considering the startup's stage and financial position.

When Is Equity Financing Better?

Equity financing may be more appropriate where a startup is pre-revenue, operating in an uncertain market or pursuing aggressive growth.

For example, imagine a technology startup developing a new product. The founders need ₦100 million to complete development, hire a technical team and launch the product. However, the company currently generates little or no revenue.

Taking a large loan could create substantial repayment pressure before the business has developed predictable cash flows. Equity investment may therefore be more suitable because the investors share some of the commercial risk.

Equity may also be appropriate where the investor brings strategic value beyond capital. A startup may accept dilution if an investor can provide industry connections, technical expertise, distribution channels or access to future funding.

For early-stage startups, therefore, the question should not simply be, "How much equity will I give away?" It should also be, "What am I receiving in return for that equity?"

When Is Debt Financing Better?

Debt may be more attractive when a startup has reliable revenue, predictable cash flow and a clear ability to meet repayment obligations.

Consider a startup that already has a functioning product, a growing customer base and consistent monthly revenue. The founders want ₦50 million to purchase equipment or expand their operations but do not want to dilute their ownership.

If the company's projected cash flows can comfortably support the repayment obligations, debt could allow the founders to finance the expansion while retaining their existing ownership.

Debt can also be useful where the amount required is relatively modest and the founder does not want to sacrifice a meaningful percentage of the company for a smaller amount of capital.

However, founders should not assume that retaining ownership automatically makes debt cheaper. The real cost depends on the interest, fees, repayment period, security requirements and the potential opportunity cost of using future cash flow to service the debt.

What About a Combination of Both?

The choice does not always have to be equity or debt.

A startup² may use a combination of both depending on its financial position and objectives. Investopedia gives an example of a company raising capital partly through an equity investment and partly through a business loan. Such a structure can allow a company to reduce the amount of ownership it gives away while also avoiding excessive debt.

For example, instead of raising ₦100 million entirely through equity, a startup could potentially raise ₦60 million through equity and ₦40 million through debt, provided its financial position and financing terms make such a structure sustainable.

The important point is that capital structure should be deliberate. A founder should understand not only how much money is being raised, but also what that money will cost the business in ownership, repayment obligations, control and future flexibility.

Five Questions Every Founder Should Ask Before Choosing

Before deciding between equity and debt, a startup should consider at least five questions.

1. Do we have predictable revenue?

If the business does not yet generate reliable revenue, taking on significant debt may create unnecessary pressure.

2. How much control am I willing to give up?

Equity financing can reduce the founder's ownership and influence over the business. A founder should understand the consequences of dilution before accepting investment.

3. What will the money be used for?

Financing short-term working capital needs may require a different approach from financing long-term expansion, product development or aggressive market entry.

4. What is the true cost of the financing?

For debt, this includes interest, fees, security and repayment obligations. For equity, it includes dilution and the value of the ownership surrendered.

5. What does the investor or lender bring beyond the money?

The right investor can provide networks, expertise and strategic support.

Similarly, the right debt product can provide flexible working capital without unnecessary restrictions.

So, Which Is Better?

There is no universal answer.

Equity may be better for a startup that is early-stage, pre-revenue, highly risky or pursuing rapid growth and therefore cannot comfortably service debt. It provides capital without fixed repayment obligations, although the founder sacrifices some ownership and potentially some control.

Debt may be better for a startup with predictable revenue, strong financials and sufficient cash flow to meet repayment obligations. It allows the founder to retain ownership but introduces financial obligations that must be honoured regardless of business performance.

Ultimately, the better question is not "Is equity better than debt?" It is:

"Which financing structure is appropriate for the current stage, financial position and long-term objectives of my startup?"

A founder who understands this distinction is more likely to raise capital strategically rather than simply raise money because it is available. The objective should not merely be to obtain funding. It should be to obtain the right capital, at the right time, on terms the business can sustainably live with.

Bibliography

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