Title:
What Kind Of Capital Is Appropriate For Your Business?

Word Count:
1803

Summary:
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Keywords:
money, business, humor,

Article Body:
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Debt
Debt is money borrowed, which must be repaid at a set time period and generates income for the lender over that time period. Lending sources include not only banks, but also leasing companies, factoring companies and even individuals.

Lending sources look primarily at two factors: how risky the loan is; and whether the company can generate sufficient cash to pay the interest and repay the principal. The growth potential of the company is secondary; the primary considerations are the track record and asset base of the company. Usually the debt must be secured against the assets of the company and very commonly must also be secured against the assets of the owner of the company, also called a personal
guarantee.

Assets of the company are not usually given full book value in securing a loan.

In other words, if your inventory has a book value of $50,000 (or it cost you $50,000 to produce that inventory) a lending source will only give you 50% to 75% of that value. The reason being is that the lending source is not in your business and would have to quickly liquidate the inventory, rather than selling it at market prices.

Accounts receivable, or money that is owed to you from customers who have previously purchased your product but not paid for it yet, are also discounted. Using the same example, $50,000 worth of accounts receivable may only be worth 60% to 70% of that value to the lending source. Customers may not pay the full amount owed, or feel they have to pay for the product at all, if an outside lending source is demanding payment. And so on…with equipment, land, buildings, furniture, fixtures and what ever other assets the company has, the same general rule applies.

The lender often requests that the personal assets of the owner of the company are pledged as a contingency and as a gesture of faith by the owner. Obviously, if the owner of the company does not believe in his/her own company's ability to repay the loan, why should the lending source?

Equity

Equity capital is money given for a share of ownership of the company. Equity can be provided by individual investors, sometimes known as "angels", venture capital companies, joint venture partners, and the sweat equity and capital contribution of the founders of the company. Equity providers are more interested in the growth potential of the company. Their objective is to invest an amount now and reap the rewards of a 5 to 1, or even 10 to 1, payoff in three to five years. In other words $100,000 now will be worth $1,000,000 in three years if invested in the right company.

Since the objectives of investors are different from lenders, the factors they evaluate in determining whether to invest are different from lending sources. Investors like to put money in companies that have the potential for rapid growth. Growth potential is based on the quality of management of the company, product brand strength, barriers of entry to competitors and size of the market for the product.

So Debt Or Equity Capital?

The answer is dependent on the answers to several questions: Why does the company require additional capital? What stage is the company at? What is the financial condition of the company? How much capital is required? What constraints will the financing source put on the day-to-day operations of the company? And finally, what impact will the financing source have on the ownership of the company?

Why Does The Company Require Additional Capital?
The reasons funds are required, or how they will be put to use, may lend themselves more to debt than to equity or vice versa. Debt is often a source of funds for the day-to-day operations of the company or to refinance a current loan. Expansion capital can be debt or equity. Start up funds most often come from equity sources. A turnaround situation, refinancing a delinquent loan, covering a deficit in revenues, could be either, but in these cases the financing will come with a high price.

What Stage Is The Company At?
Companies grow through several different stages: seed, start-up, first stage, and second stage. The stage of the company can be an indicator of the risk involved. While neither debt nor equity would be prohibited at any stage, the older and more established the company is, usually the less risky it is.

Seed Stage--the idea for a product or company is in the mind of the founder, but there is still substantial research and development necessary to determine whether the idea is viable.

Start-up--the company has a business plan, a defined product, and basic structure, but little or no revenues are being generated. The product may still be just a prototype.

First Stage--the product is either ready for market, or is generating some revenues. The structure of the company is in place.

Second Stage--full scale production. The company's product has been selling and accepted by the marketplace. The company is ready for a major national introduction of the product or introduction of a second product.

Established--the company has been operating successfully for at least three years.

Turnaround-- the company has been operating for a number of years but is underperforming. A hard turnaround refers to a company that is not only underperforming, but has been in a cash deficit position with little hope of returning to a positive position without major restructuring.

What Is The Financial Condition Of The Company?
In certain situations the company's financial condition will suggest one kind of capital over the other. If the company needs all its cash to fund its growth,

then a loan is not feasible, because the company could not afford interest and principal payments. If the company just needs a line of credit to fund a cyclical increase in orders, then it doesn't make sense to bring in an equity investor.

A lender looks at the asset base to secure a loan, and the cash that has been generated to pay the interest. They also look at what other debt or liabilities the company has and very often the debts and liabilities of the owner(s). The old adage that it's easiest to get a loan when you don't need one is close to the truth. A strong balance sheet, top heavy on cash, and light on the side of liabilities is easier to finance.

Investors look at how healthy the company is by reviewing trends in the operating statements and the balance sheet. A company that has demonstrated a positive trend in the past is looked upon favorably. However, the future outlook for the company's product and market is just as important to an investor as the past performance. A company with a somewhat shaky past in a currently booming industry is probably preferable to an equity investor than a great performance in the past in an industry that's on the downslide.

But what if your company is a start-up and doesn't have much, if any, history? Then other factors will be reviewed such as:

How much money the owners contributed to the company.

How strong is the management team.

How dedicated to success is the management team.

What other proprietary assets might be available such as   patents, trademarks, goodwill, etc.

What barriers to entry to the marketplace are there?

While both debt and equity come at a price, the company must generate enough cash to repay the principal of the loan and the ongoing interest expense. Equity does not have to be repaid according to a fixed schedule. Equity investors are seeking long-term returns.

How Much Capital Is Required?
A small amount of capital required for a short time is not often an attractive situation to either traditional debt or equity sources. Lenders are not interested in loans that cost them as much in processing as in the income that

can be generated. Investors feel that the due diligence required to fund a small amount of capital is nearly the same as that to fund a much larger amount.

On the other hand a very large amount of capital may only be obtainable if broken into stages that are funded based on achieving performance levels. For example: you have an idea for a diagnostic test that would be a medical breakthrough and revolutionize the treatment of all disease as we now know it. But you need $3.5 million to get the product ready to market. The initial funding may be as little as $50,000 to perform a literature and patent search to see if anyone else is working on the same idea and to determine the size of the market demand for the product. If the search shows that no one else is working on the idea, and the market is every doctor's office worldwide, the second stage of $500,000 could be available to acquire lab equipment, hire lab technicians for six months, and hire consultants to develop a business and marketing plan. If the lab technicians develop a prototype test apparatus by the end of the six months, then $1,000,000 more could be available to develop a working prototype and patent it. When the working prototype is patented then $750,000 would be available to obtain FDA approval and independent tests.

What Constraints Will The Financing Source Put On The Day-To-Day Operations Of The Company?

You must consider how the financing source may limit the company's operations. Loan covenants often restrict what the company can do with excess cash. They can also put limits on how much the company can spend, and on what type of expenditures, as well as demanding that the company maintain certain balances in their accounts, collect their receivable within certain limits, even determine the credit policies that the company extends to its customers. The company may not be able to take advantage of some opportunities because of these restrictions.

Equity investors can demand the same restrictions and in addition require that they have veto power in certain instances, or expenditure approval, even if they are in a minority ownership position.

What Impact Will The Financing Have On The Ownership Position?

The last issue and probably the most important one is, how will the owners react to having their ownership and management control diluted. An investor can often contribute experience and management expertise, as well as money, and has a vested interest in the success of your company. A lending source has no impact on the company (other than any loan covenants discussed above); its primary objective is to be repaid.

So Debt Or Equity? The choice is yours.