# The Advantages and Disadvantages of Various Types of Financing

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# Introduction

As a business owner, it is often necessary to find resources to raise capital in order to fund growth. Some of the capital raising options available to entrepreneurs include equity financing, debt, and hybrid financing. It is more important to be aware of the advantages and disadvantages of each of these funding options in order to select the one that best meets your business needs.

This e-book discusses raising capital through equity financing.

# 1. Equity Financing

Equity financing can be a very appealing option for funding growth when a company is not yet generating positive cash flow from operations. Unlike debt, equity does not have an amortization schedule that requires the capital to be returned at a specific time. The ability to retain the capital and reinvest it in the company instead of returning it to the lender on a set timeline allows business owners to invest in infrastructure or intellectual property.

When seeking an equity investment, there are several items that a business owner needs to determine:

- How much capital does the business require to grow and over what period of time is the capital needed?
- How much ownership and control is the owner willing to relinquish?
- What type of partner is the owner seeking?
- What is the ultimate goal for this capital raise?
- When is the right time to try and raise equity capital?
- How frequently is the owner willing to invest time in capital raising?
- What impact will that focus have on the ability to focus on the business' growth?
- How many investors will need to be added in order to meet the equity financing requirements of the business?
- What are their investment objectives?

These questions cannot be answered one at a time by the business owner. Contemplating the questions together causes business owners to step back and examine the situation from a holistic perspective.

To begin the process of raising equity, a business owner needs to determine the amount of equity that their business needs to execute its goals. One exercise that helps an owner determine the amount of capital necessary is to project the anticipated cash burn that the company will experience over a given time period. The time period is typically the time that it is going to take the business to start generating positive cash flow or get to the next round of the capital raise. Knowing this number will help ensure that the business owner is able to execute the growth and development desired by the venture capital investor.

Once the amount of equity needed is determined, the owner has to determine the timing of the raise. The timing of the equity raise is important to maximize value for the business owner and to set the business up for success while minimizing equity dilution. A business owner can seek one large investment, or try and space out the rounds of capital raises. If an owner wishes to execute one large capital raise, they will hopefully only have to go through the process once, but will ultimately likely take a larger dilution in ownership and control assuming the company executes it growth

initiatives, and its valuation grows over time. If an owner chooses to instead seek smaller equity investments over a period of time, the owner will take less dilution than in the former situation. This assumes that the enterprise value of the company increases as time lapses. Ultimately, the same amount of capital can come into the business, but the original owner will retain a larger portion of the value and control of the company. There is a considerable amount of execution risk associated with this strategy. The time spent in future fundraising rounds detracts from the owners' ability to focus on the business' operations. A cost-benefit and risk analysis should be performed to see which timing sequence works best for the given situation.

The particular partner chosen by the business owner is equally as important as the amount and timing of the money, and this decision can be a strategic one. Accessing "smart money" from a strategic partner who knows the industry can yield new opportunities and vision for the company. Bringing in a strategic partner has the ability to add credibility to your business, and this additional credibility is beneficial for future financing needs. It can also be beneficial if/when you, as a business owner, decide to sell your business.

### Equity Investment Disadvantages

Equity investments do not come without their own set of disadvantages. Typically equity investors require a rate of return on their investment that is greater than that of a debt instrument. With the equity investment, the business owner is selling off a portion of the future profits and value of their business. The greater the equity investment, relative to the enterprise value of the business, the more control the business owner will be selling. When seeking an equity investment, a business owner needs to be conscious of the fact that they will no longer be the sole decision makers.

These investments also can come with complex regulations by the Securities Exchange Commission (SEC). Most offerings will need to comply with Regulation D unless they are issued under Regulation A, a part of the JOBS Act. In addition to SEC regulations, equity offerings also have to comply with State regulations. As a result of the regulations surrounding equity offerings, the professional fees associated with this type of capital sourcing can become expensive.

Knowing this information, a business owner should spend a considerable amount of time researching and understanding the behaviors and expectations of the potential equity investors. It is important that the new equity investor shares the business owner's vision for the company.

As with most business decisions, the facts and circumstances will dictate the path that the owner takes. It is important for the business owner to evaluate the short-term and long-term needs of the business and the costs associated with each of the options.

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# 2. Debt Financing

Unlike equity financing, debt financing does not require the business owner to sell a portion of the equity in their business in return for the capital. Instead, the capital is provided to the business owner with the expectation that it will be returned on a specific timeline.

There are several key advantages that debt financing affords a business owner:

- **The payments required are predictable in nature.** A business owner that is able to forecast cash flow accurately will be able to assess his/her ability to meet debt service requirements due to the predictable nature of debt payments.
- **The total cost of the capital is often known to the business owner from the onset.** The interest associated with the capital is tax deductible to the business owner, thus lowering the true cost of the capital. For example, if a company is paying 8 percent interest rate, and the marginal tax rate is 25 percent, the true cost of capital is 6 percent.
- In addition to debt having a lower cost than equity, **a business owner often does not have to sacrifice equity in their company to obtain the capital.** Owners that have proven cash flows often find it desirable to hold on to the equity of the company as the business continues to appreciate in value.

With a multitude of lending institutions, there is a lot of flexibility for the business owner. Generally speaking, the cost of the debt increases as the risk of repayment increases. The way lenders are able to lower their risk of repayment is by evaluating the size and consistency of historical cash flows. A healthy balance sheet, with a manageable debt to equity ratio, is also desirable from a lender's perspective. Depending on the business' specific needs, the business owner can obtain financing based upon many aspects of their financials including, but not limited to, the value of accounts receivable, inventory, and fixed assets, as well as the extent of annual net cash flows and purchase orders. Each has its own cost based on risk of repayment and administrative cost in servicing the various loans.


Additionally, debt can be sourced at a variety of levels. Most commonly thought of is senior debt.

**Senior Debt** is traditionally offered by banks and the all-in cost of capital approximates the sum of the stated interest rate on the note plus any fees paid to issue the debt. The business owner does not take any equity dilution as a result of raising senior debt capital. Depending on the lending environment, the business owner may be required to provide a personal guarantee, but does not have to provide any board representation to the senior debt lender. Often the loan covenants could contain provisions that restrict the company from expending amounts for fixed assets purchases over a threshold amount, executing acquisitions without the prior approval of the lender, and similar significant company transactions that could affect the lender's ability to be repaid. The strongest qualified borrowers can obtain senior debt for around 2 – 3 percent given the current market and prime rates.

There may come a time when a business is no longer able to raise new senior debt due to EBIDTA or cash-flow restrictions. If the business requires more capital to continue growth, and cannot raise more senior debt, mezzanine debt

can be a viable option.

**Mezzanine Debt** is unsecured and is subordinated to the senior debt position held by the original lenders. In the case of bankruptcy, the senior lenders would be paid back their debt before any mezzanine lender would receive funds. The mezzanine lender, as its name implies, sits between the senior lenders and equity contributors. Most lenders require an agreement among all debt holders before mezzanine debt can be issued.

Mezzanine debt is more expensive than senior debt due to its subordinated repayment position. The mezzanine debt has a higher cost of capital due to two separate components, the stated interest rate and either a “paid in kind” feature or a warrant feature. In today’s market, the stated rate on the interest is between 10 – 12 percent, with the preponderance being in the 11 – 12 percent range. Although the interest is paid regularly, the principal on a mezzanine loan is not typically amortized. In addition to the interest rate, lenders will either receive a warrant that upon exercise can be converted into equity of the company, or a paid in kind interest feature that typically accrues and increases the outstanding balance of the debt. Generally the equity rights exercised by the lender are repurchased by the borrower at the time the debt matures, and as a result, at the end of the mezzanine debt’s term, there is typically no equity dilution because of the redemption of the warrant. Mezzanine debt is modeled to obtain an internal rate of return of 15 – 18 percent in today’s market.

### Debt Financing Disadvantages

Like equity financings, there are some negative aspects to debt financing. Because of the fixed payment schedule associated with most debt arrangements, the capital can only be retained by the company for a finite period of time. Before seeking debt financing, a business owner must evaluate the reason they are sourcing new capital and ensure that they will be able to comply with the repayment schedule required.

A lending institution typically creates covenants that businesses have to comply with in order to keep the capital. If the business does not comply with the covenants, as agreed upon from the beginning, the lender can call back their capital. These covenants are important as they may leave a business vulnerable during hard times. If cash-flow dries up for an extended period of time, a business owner may be faced with the lending institution calling the capital. These covenants may also restrict the decisions made by management as it relates to seeking additional debt and/or making distributions to shareholders. When debt financing is obtained, special attention needs to be paid to the covenants as outlined, and the business owners should ensure that their long-term vision is not inhibited by the covenants.

As with most business decisions, the facts and circumstances will often dictate which capital source is best for the business owner. It is important to evaluate the reason capital is needed to ensure the best facility is being used. A business owner should evaluate the short-term and long-term benefits and costs of each option, including the long-term components that require periodic amortization and the short-term components such as annually renewable lines of credit that do not require amortization.

# 3. Convertible Financing

Convertible debt is a short term debt investment that converts to equity at a specific point in time (the "trigger event"). Both the investor and the entrepreneur intend for the debt investment to turn into equity from the onset of the investment. Here are items both investors and entrepreneurs need to consider when using convertible debt to raise capital:

Convertible debt is typically held as debt for 18–24 months before it converts to equity and carries a coupon of 6 percent to 8 percent, with all interest accrued up to the date of conversion. As of the conversion date, both the principal and accrued interest are converted into equity. This means that the owner is able to use the capital provided for 18–24 months before any equity is issued. For the use of their capital, the investor will get a discount on the conversion of their debt to equity. Generally, an investor is able to convert their note to equity at 80–85 percent of the fair market value of the stock as of the conversion date (illustrated later in this article), but in some cases the conversion rate could be as low as 70 percent.

The conversion from debt to equity occurs based on a predetermined trigger event. This trigger event can be any sort of milestone, such as the achievement of a revenue threshold, a predetermined time period has lapsed, or the next round of capital is raised. The most common trigger event is the company's next capital raise. The valuation used in the next capital raise is used to determine the amount of dilution the entrepreneur takes when the debt converts to equity.

The initial investment using convertible debt does not require the entrepreneur to value their company formally. Although convertible debt does not require the entrepreneur to value the company formally, typically the convertible debt is issued because the owners do not want to take dilution based on the current value of the company. Instead of valuing the company from the beginning, the entrepreneur receives the capital now, knowing that the investor will take a portion of the equity at a future trigger event. Whenever the trigger occurs, the investor will get its share of the equity based on the valuation at that time (not based on the initial investment valuation).

›EXAMPLE

**An investor may contribute $100,000 of convertible debt to ABC, LLC. The investor and ABC, LLC agree that the debt will convert to equity upon ABC's series A capital raise (the trigger event in this case). In 18 months, ABC, LLC has appreciated to a pre-money valuation of $1M based on the Series A capital raise. At this time, the investor will convert their debt to equity and receive 10 percent of the equity in ABC, LLC. This particular example is oversimplified for illustrative purposes.**

**"Why would an investor agree to this when they could have acquired a larger share of the company when the initial investment was made?"**

To entice investors to make this type of investment, an entrepreneur will have to offer a discount on the conversion to equity. For example, an entrepreneur could offer a 20 percent discount on conversion (80 percent of FMV). In our example above, the investor would receive the equivalent of $125,000 of equity for their initial loan – resulting in receiving

12.5 percent of the equity in ABC, LLC. The discount offered by the entrepreneur sometimes is expressed as a function of time between the initial investment and the time of the conversion. The discount is a method to reward convertible debt investors for the risk that they take by making the initial investment.

One feature that can be found in convertible debt that protects the investor is a valuation cap. The cap ensures that the investor receives at least a certain percentage of the equity in the company when the debt converts. This protects the investor in case the growth of the company is much greater than originally anticipated. A valuation cap sets a maximum valuation that can be used when determining the amount of dilution an entrepreneur takes upon conversion. This feature is investor friendly as it allows him/her to receive a larger portion of the company should the company experience appreciation greater than originally underwritten. In our previous example, the convertible debt investment was $100,000. If there was a valuation cap of $750,000, the investor would have 16.67 percent of equity of the company instead of the 12.5 percent outlined in our original example, assuming the valuation of the company is $1M, as outlined in the example above. It is important that the entrepreneur gives considerable thought to the value of the cap before agreeing to this provision.

Convertible debt is a very attractive capital raising option when the anticipated appreciation in the business' value exceeds the discount conversion rate required by the investor. For example, if a company is able to appreciate in value 50 percent by using the funds from the convertible debt and only has to offer a 20 percent conversion discount rate, they are able to minimize equity dilution while still taking advantage of growth capital. As is the case with any capital raise, it is important that the entrepreneur determine the amount of capital that he/she needs and the anticipated growth in the business that is projected to happen given the capital raise. This will help determine what conversion discount the company can offer to the investor.

Convertible debt is a very attractive capital raising option for the right circumstances. As we outlined above, convertible debt is most attractive to a company that does not want to sell equity at their current valuation and believes they will see considerable growth in value with use of this new capital. If your business is experiencing a need for new capital and you would like to be advised on your different options or would like to learn more about the advantages and disadvantages of various types of financing, contact us.

**If you have questions about financing or capital raising, or would like to learn more about Keiter's Transaction Advisory services, visit keitercpa.com or call (804) 747-0000.**

# About the Author

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Scott works with both large and mid-market clients in the real estate, construction, and manufacturing industries, as well as with private equity firms and emerging businesses. He works closely with his clients to identify tax planning and savings opportunities. His experience includes single and multi-state corporate and flow-through tax planning and compliance, corporate tax provisions (FAS 109 and FIN 48), and individual income taxation. Scott is a member of the Keiter Merger and Acquisition team and Future Leaders group.

# About Keiter

## We are Your Opportunity Advisors

Keiter is a team of experienced accountants and advisors with the knowledge to identify opportunities and the commitment to see them through. We understand that you depend on us to identify, communicate and help shape the financial decisions that determine the success of your business. The Keiter team works with both mature and early-stage, privately-held entities, in the capacity of auditors, business advisors, tax advisors, and valuation experts. Whether performing an audit, preparing a tax return, or providing specialized consulting services, we are always focused on providing fresh insights and creating new opportunities to help our clients grow.

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