Funding your business with debt/loans versus equity capital

Before you try to raise funds for your business, it is important to determine whether debt or equity financing is more appropriate for your needs. The first step is preparing a thoughtful business plan that identifies the opportunities for growth and outlines the financial costs of pursuing such opportunities. You will need to consider your company's operating history and the degree of ownership you wish to maintain in order to determine what kind of capital is right for your business. You can then choose among various sources of funding and decide which would be the most efficient way to capitalize your company. It's important to analyze debt-financing options. If your company has a solid operating history and ample assets, you may be able to secure a bank loan. When interest rates are low as they are currently this can be a cost-effective way to finance business growth. When you borrow money your cost is known and you don't relinquish any ownership over your company.

Senior debt is usually available only to companies with assets that can be pledged in case of default. Collateral might include business property, real estate or even accounts receivables. You also may use personal assets such as securities portfolio to support a loan made to your company. Most young businesses will not qualify senior debt. Lenders generally require a history of cash flow generation that will be sufficient to pay the interest on the debt and eventually repay the principle. When you would prefer to finance growth with debt rather than with equity but additional senior debt is no longer available to your company you might consider mezzanine financing.

Mezzanine financing is a form of "junior" or "subordinated" debt that fills the gap between equity issuance and senior debt loans. The appetite for mezzanine financing has risen in recent years because of a conservative senior debt market. Mezzanine financing which is repayable only after senior debt has been repaid, carries a higher interest rate than senior debt to compensate lenders for assuming greater risk. Those high interest rates pose more operating risk than equity capital, which doesn't require regular payouts. Frequently subordinated debt is used for recapitalizations and acquisitions.

If you are leading a start-up that will not qualify for senior debt, equity capital may be the only practical way to finance growth. With equity financing, other parties purchase stake in your business. Equity financing can come from non-professional investors such as friends, family or industry colleagues or from professional venture capitalists.

Other reasons might lead you to favor equity capital over debt. Even when interest rates are low, taking on debt increases operating risk because interest must be paid in bad and good times alike. In addition you might be reluctant to become over-leveraged by taking on large amounts of debt.

It's important to note that lending institutions are more cautious with their loan approval process. You might find that you are unable to borrow more than three times your company's cash flow. If a company reached a ceiling on borrowing, raising equity capital may become necessary. Keep in mind that debt and equity capital can work together. Raising sufficient equity capital may strengthen your company's balance sheet and allow access to senior debt. On the other hand once you have reached certain levels of debt you may find that raising equity capital is the only feasible way to finance additional growth.
Selecting the optimal mix of funding sources can be difficult. Your business financial advisor can help develop an integrated plan based upon your unique circumstances to most efficiently raise the capital you need to support a growing business.

LOITA CAPITAL PARTNERS INTERNATIONAL

1st Floor, River Court, 6 St. Denis Street,
P.O. Box 1079, Port Louis, Mauritius
Tel: (230) 208 9022 - Fax: (230) 208 9033
Website: www.loita.com