VETBIZ RESOURCE CENTER

Equity vs. Debt Financing

Before seeking financial assistance, ask yourself the following:

- Do you need more capital or can you manage existing cash flow more effectively?
- How do you define your need? Do you need money to expand or as a cushion against risk?
- How urgent is your need? You can obtain the best terms when you anticipate your needs rather than looking for money under pressure.
- How great are your risks? All businesses carry risks, and the degree of risk will affect cost and available financing alternatives.
- In what state of development is the business? Needs are most critical during transitional stages.
- For what purposes will the capital be used? Any lender will require that capital requested is for very specific needs.
- What is the state of your industry? Depressed, stable, or growth conditions require different approaches to money needs and sources. Businesses that prosper while others are in decline will often receive better funding terms.
- Is your business seasonal or cyclical? Seasonal needs for financing generally are short term. Loans advanced for cyclical industries such as construction are designed to support a business through depressed periods.
- How strong is your management team? Management is the most important element assessed by money sources.
- Perhaps most importantly, how does your need for financing mesh with your business plan? If you don't have a business plan, make writing one your first priority. All capital sources will want to see your business plan for the start-up and growth of your business.

Not All Money Is the Same

There are two types of financing: equity and debt financing. When looking for money, you must consider your company's debt-to-equity ratio—the relation between dollars you've borrowed and dollars you've invested in your business. The more money that owners have invested in their business, the easier it is to attract financing.

If your firm has a high ratio of equity to debt, you should probably seek debt financing. However, if your company has a high proportion of debt to equity, experts advise that you should increase your ownership capital (equity investment) for additional funds. That way you won't be over-leveraged to the point of jeopardizing your company's survival.

Equity Financing

Most small or growth-stage businesses use limited equity financing. As with debt financing, additional equity often comes from non-professional investors such as friends, relatives, employees, customers, or industry colleagues. However, the most common source of professional equity funding comes from venture capitalists. These are institutional risk takers and may be groups of wealthy individuals, government-assisted sources, or major financial institutions. Most specialize in one or a few closely related industries. The high-tech industry of California's Silicon Valley is a well-known example of capitalist investing.

Equity vs. Debt Financing - Page 2

Venture capitalists are often seen as deep-pocketed financial gurus looking for start-ups in which to invest their money, but they most often prefer three-to-five-year old companies with the potential to become major regional or national concerns and return higher-than-average profits to their shareholders. Venture capitalists may scrutinize thousands of potential investments annually, but only invest in a handful. The possibility of a public stock offering is critical to venture capitalists. Quality management, a competitive or innovative advantage, and industry growth are also major concerns.

Different venture capitalists have different approaches to management of the business in which they invest. They generally prefer to influence a business passively, but will react when a business does not perform as expected and may insist on changes in management or strategy. Relinquishing some of the decision-making and some of the potential for profits are the main disadvantages of equity financing.

Debt Financing

There are many sources for debt financing: banks, savings and loans, commercial finance companies, and the U.S. Small Business Administration (SBA) are the most common. State and local governments have developed many programs in recent years to encourage the growth of small businesses in recognition of their positive effects on the economy. Family members, friends, and former associates are all potential sources, especially when capital requirements are smaller.

Traditionally, banks have been the major source of small business funding. Their principal role has been as a short-term lender offering demand loans, seasonal lines of credit, and single-purpose loans for machinery and equipment. Banks generally have been reluctant to offer long-term loans to small firms. The SBA guaranteed lending program encourages banks and non-bank lenders to make long-term loans to small firms by reducing their risk and leveraging the funds they have available. The SBA's programs have been an integral part of the success stories of thousands of firms nationally.

In addition to equity considerations, lenders commonly require the borrower's personal guarantees in case of default. This ensures that the borrower has a sufficient personal interest at stake to give paramount attention to the business. For most borrowers this is a burden, but also a necessity.

Taken from **http://www.sba.gov**