

FUNDING YOUR BUSINESS GROWTH: DEBT OR EQUITY?

The successful business will almost certainly reach a point where its initial capitalization is inadequate. Ironically, too often the managers of small businesses do not plan adequately for success. Assuming that expanding sales will provide increased cash flow, they expect to finance growth with the anticipated increasing amounts of available cash. But the inevitable happens.

They begin to tie up capital in numerous small capital investments--- increased office equipment and fixtures, expanding physical facilities, affordable additions to manufacturing equipment, an automobile or truck or two or three. Their inventories of raw materials and finished goods increase. Their work in process and accounts receivable grow. As they become more and more successful, they accept larger and larger orders on credit and allow their major customers to extend their payments out of fear of losing them. Before they know it, their “success” has caused a cash flow crisis, and their daily operating expenses cannot be paid for. Enlightened cash management can help in this situation, but it cannot create capital, just make it more available.

Since Murphy’s Law that what can go wrong, will, usually applies in such situations, let us suppose that at this moment an opportunity develops that promises to greatly accelerate the growth of a successful business like the ones in our scenario. Its biggest customer wants to use it as a supplier for a new product. The initial order will be ten times larger than any single order the business has ever received, but the manufacture of this product will require a substantial up front capital investment. The time has clearly come for an infusion of cash. The question is from what source?

The initial capitalization of most small companies is made as an investment, and since this investment usually involves the personal resources of the investors, it is likely to have been as small an amount as the start-up circumstances seemed to require. Typically, the original investors do not have the funds for subsequent investment or they do not want to risk a greater percentage of their personal assets. New equity capital will, therefore, dilute the present owner’s equity, with the potential reduction of the autonomy of present management, if some at least of the current owners are managing the company. In addition new investors will have a proportionate claim on future profits, which a lending institution will not.

However, there are corresponding disadvantages to borrowing capital. The primary one is that borrowed money costs money in the form of interest, and since all borrowed capital must be repaid, it does not become a permanent resource of the company. Consider a hypothetical example.

Suppose that a company has a need for \$500,000 of capital. Its pre-tax earnings are \$45,000. If the \$500,000 were invested capital, there would be no interest. The tax would be approximately \$11,000 so there would be \$34,000 of after-tax earnings.

If \$250,000 of the \$500,000 were borrowed at an interest rate of 12% the interest would be \$30,000: pre-tax earnings would be \$15,000 and the company would have approximately \$12,000 of after-tax earnings.

However, if \$400,000 of the necessary capital were borrowed the company would have a pre-tax loss of \$3,000.

Add to this the fact that if the loan was short term, the \$500,000 would have to be repaid, probably within a 12 month period; and if it were an installment long-term loan a significant percentage of principal would be repaid each year. In both cases in this example, the repayment of principal would significantly exceed the company's after-tax earnings.

If the business is a regular C corporation rather than a Subchapter S corporation, preferred stock with fixed dividends, buy-back provisions and limitations on voting rights might be a viable option for raising invested rather than borrowed capital. This option eliminates some of the disadvantages normally associated with the sale of common stock.

Most businesses partially fund themselves with borrowed capital. When considering the type of loan to pursue, the borrower should be aware that banks are not in the business of providing permanent operating capital. They are lenders, not investors. The fundamental misunderstanding of this fact leads to most of the disappointment and dissatisfaction of potential borrowers.

On the other hand, banks are in the business of lending money--- selling it (or more accurately leasing it) for a price (interest and other compensation). When they can lend with minimal risk and for a competitive return, they will. The refinancing of short-term loans or their conversion to long-term loans can, to all intents and purposes, provide on-going working capital to a business.

There are basically two types of business loans--- long-term and short-term. The successful small business which we are using as an illustration has the need for both types of loans. Assuming that it has positive retained earnings, its original capital has not disappeared. It is simply no longer available to the business to pay for its daily operations. Instead it is "tied up" in receivables, inventory and equipment. A bank can supply its short-term needs by temporarily replacing this "tied up" capital.

One type of short term loan is a "revolving line of credit". Typically, this type of loan has a fixed maximum limit and may be drawn on as needed unless the limit is reached. The borrower pays interest (usually a variable rate tied to the prime lending rate) only on the portion of the line actually used. The borrower may also pay a fee based upon a small percentage of the total line or the unused portion, and he may be required to keep a compensating amount of cash in a non interest bearing account at the same bank.

This type of loan is usually available only to highly credit worthy borrowers. It is reviewed periodically and may not be extended or the limit may be reduced. It may be unsecured, secured by various types of the business' collateral, or even guaranteed by the owners of the business.

Lines of credit are expected to be fully paid back at defined intervals. For this reason they are most valuable to companies with fluctuating needs for cash--- for example, seasonal businesses that may need to create large inventories in preparation for peak seasons.

Another short term option directly related to working capital that has become "tied up" and is no longer available as working capital is the financing of accounts receivable. To do this sort of financing banks will evaluate the aging, collectibility, and diversification of the receivables. The company that does most of its business with one or two customers who are paying slowly will have a problem obtaining this type of loan. Banks or financing companies will often lend up to 80% of the value of solid current receivables. If receivables are reduced, so will be the amount of the loan. But since the reduction of receivables should result in cash to the company, this should not be a problem.

A specialized form of receivables financing is “factoring”. The lender buys the receivables from the borrower and accepts the risk of collecting them. The cost is typically greater than that of a loan secured by receivables, because the lender has the greater risk and the expense associated with collection. There used to be some discredit associated with factoring. Because of the high cost, only companies which were financially unsound and therefore, unable to raise capital less expensively used this type of arrangement. But this no longer applies. Factoring can actually be cost-effective for a small company that cannot afford its own credit and collection department or does not want to tie up the time of key individuals in the collection process.

Another place that the cash-poor-but-successful company actually has its original working capital is its work-in-process and its finished goods inventory. Financial institutions will also resupply a portion of this capital in the form of short-term loans. Because inventory is less quickly liquidable than receivables (and banks do not want to be in the business of selling inventory), they will probably lend only up to about 50% of its fair market value. Banks require frequent inventory reports, when inventory is used as collateral. Under some arrangements, they actually buy and store the inventory.

In our example, the cash-poor-but-successful company also has long-term capital needs for property, plant and equipment. Capital investments of this type are usually financed by term notes, in which principal and interest are paid back in installments over a relatively long period. Such loans typically carry higher interest rates than short term notes.

Do not be surprised if the bank also places certain restrictions on management as a part of the term note contract. Also banks almost routinely require that owners be guarantors of such notes. The reasons are understandable. Not only do the cosignatures provide the bank with added security. They also provide further assurance that the owners will use the borrowed capital responsibly.

Much equipment can be leased, sometimes with the right of cancellation. Lease/purchases are also popular options to outright purchases financed by loans. Lease agreements are generally more expensive than loan agreements, but they usually do not require a down payment. In effect, the anticipated residual value of the equipment at the end of the lease period substitutes for the down payment. And if the equipment utilizes rapidly changing technology a cancellation option is a real plus. If the lease is through the manufacturer, the chances are he will make an attractive “upgrade” offer long before the lease period expires. And, from an accounting standpoint, the tax deduction for the lease payment may be greater than the depreciation deduction, if the asset were purchased.

Whether to borrow or to sell equity? How to structure the sale or the loan? These are questions that will be faced by most small businessmen at some time in their careers. And there are as many different nuances as there are business situations. Just remember that the need for new capital is as often the result of success as it is of setbacks. And lenders like the look of a company whose historical financial statements show growth in sales and profits to support forecasts that this growth can be accelerated during the loan period with an infusion of new capital.