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Is Debt or Equity Better for Your Business?

By Meghan Daniels, Axial | May 9, 2017

If your business is considering raising capital, one of the first questions to consider is whether to seek equity, debt, or a combination.

We asked four investment bankers to share their thoughts on the most important factor CEOs and CFOs should consider when making this decision.

Stephen Lewis, Headwaters MB

Mike Richmond, Managing Director, The DAK Group

Frank Williamson, Oaklyn Consulting

Davis Rosborough, Progress Partners

Frank Williamson, Founder at Oaklyn Consulting:

"The decision is, fundamentally, between entering into a contract or a partnership. At one extreme, picture bank debt as a pure contract. In a very detailed and conservative way, a business agrees to borrow money today and pay it back in the future, with a set of requirements that give the bank confidence that they will get their money back almost no matter what. In return, the business gets low-cost financing and little interference with their business.

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At the other extreme, an equity investment could be seen as a pure relationship. In a less detailed way, a business agrees to take money in return for the investors having a role in running the business. The equity investors do not have many assurances of getting their money back and they have the hope of sharing in a profitable future. In return, the business gets flexible financing and a partner that will ideally add something to the company's prospects."

"The decision is, fundamentally, between entering into a contract or a partnership."

Mike Richmond, Managing Director at The DAK Group:

"There are several questions a business owner has to address before determining which financing method is better:

- How predictable is my cash flow?
- How much risk can my business tolerate?
- Am I ready to take on a partner?

In general, financing with debt is almost always going to be considerably less expensive than equity, but will require consistent cash flow for the repayment of principal and interest.

Typically, an equity provider will demand a return on their investment that will be considerably higher than comparable interest expense. Furthermore, even a minority equity holder will require some say in the running of the business.

There are situations in which raising equity is better, such as with companies that do not have the cash flow to repay the debt over a relatively short period, or in the case of a company that may not be able to raise debt because of historical losses or lacking an established operating history.

Business owners need to be careful about the amount of debt they take on. Many lenders will target leverage ratios, or the percentage mix of debt and equity, to determine if they will provide additional funds. Having too much debt can strain a company's ability to obtain additional debt at a crucial time or could result in having to divert operating capital towards debt repayment."

"Business owners need to be careful about the amount of debt they take on."

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Davis Rosborough, Vice President at Progress Partners:

"Business owners need to make a careful calculations between the advantages of taking on debt or selling equity. Folks have to evaluate the relative cost of equity in relation to the expected dilution of the company (in this process) by factoring in their size, growth, and available terms. In cases where owners can't take on debt or debt would be too expensive, it's sometimes more appropriate to sell equity if the objective is increased growth.

In other words, the best option (debt or equity) is dependent on market conditions, the company's sector/stage/growth profile, and the use of funds relative to what other options exist today. Many options for short-term, low-cost debt financing solutions exist to give entrepreneurs extra cash on hand to invest in sales or technology growth. Terms on those financings are determined based on current profitability and/or A/R capacity relative to the size of the financing and the expected risks of defaulting on those terms (EBITDA covenants tied to Term Debt placements, for example).

Some companies are strong debt facility candidates, and are smart to pursue those financing sources (incremental growth without dilution). Other companies may be able to take on debt, but the growth objectives and required investment to realize that growth are much better suited for an equity investment of some kind."

Stephen Lewis, Managing Director at Headwaters MB:

"There is not one most important factor when making this kind of decision. This is a decision that has multiple economic and other inputs that must be taken into consideration.

Where is the company in its life cycle? Is it an early stage business in a stage of high growth or a mature business? If the business is in a high growth phase, is that growth most likely going to come via acquisition or organic growth? If the business is a mature business, what is the next step in its evolution?

The owner should also ask him or herself: What is the money going to be used for? Cap Ex? R&D? Product extensions? Working capital? Acquisitions?

Remember to take into account the financial and non-financial costs of dealing with the rights various types of investors will expect/demand for their investment. It is axiomatic that debt is cheaper than equity. However, both debt and equity have hidden costs that should be taken into account."