

Understanding a Firm's Different Financing Options

A Closer Look at Equity vs. Debt

Financing Options: A Closer Look at Equity vs. Debt

Business owners who seek financing face a fundamental choice: should they borrow funds or take in new equity capital? Since debt and equity have very different characteristics, each has a different impact on earnings, cash flow, balance sheet presentation, and taxes. Each also has a different effect on a Company's leverage, dilution, and a host of other metrics by which businesses are measured. Finally, each financing option brings a different type of relationship with the respective financing source. The Company's planned use of funds, desired relationship with the capital source, and type/stage of the company will largely determine the optimal form of financing for a given situation.

Senior Debt

Debt comes in two primary forms: senior and subordinated. Senior debt from a bank is less expensive than subordinated debt but often has more extensive covenants that provide the lender with certain remedies in the event the covenants are not satisfied. In addition, most senior lenders will expect a company to have the debt collateralized by accounts receivable, other company assets, real estate, personal guarantees, or some other secondary source of repayment in the event cash flow proves insufficient to service the debt. In a liquidation event, Senior debt obligations take precedence over all other debt obligations and equity positions; hence the term "Senior Debt". In most cases, Senior debt is the least expensive financing alternative, and most companies therefore look to finance as much of their capital needs as possible using a Senior debt facility, typically with a bank.

However, for most high-growth, emerging growth and balance sheet "light" companies, the financing available through senior debt will prove insufficient for all of their capital needs, leading them to turn to the two most common forms of additional capital: mezzanine debt and equity.

Mezzanine Debt

Subordinated debt, or Mezzanine debt, is a type of debt that typically has both debt and equity characteristics and sits below senior debt in the capital structure. Since the risk exposure is great than senior debt, mezzanine debt carries a higher interest rate and some form of equity "kicker" (an equity interest in the company- typically in the form of stock or warrants) to drive acceptable risk-adjusted returns. Mezzanine debt typically requires that some or all of the related interest costs be paid monthly or quarterly, placing a potential drain on a growing

company's cash flow. And, since mezzanine interest rates are much higher than Senior debt, these payments can be significant. Accordingly, subordinated debt is commonly used specifically for recapitalizations or acquisitions. It is also a good financing alternative for stable, moderate-growth companies with consistent and predictable cash flows and companies that are unwilling to entertain a liquidation event within 7 years (the likely holding period threshold for an equity investor).

Mezzanine debt financing is generally **not** the optimal solution for high-growth companies or emerging-growth companies who have: a) significant strains on cash flow due to growth and reinvestment needs; b) insufficient operating history to demonstrate the stability of future cash flows with the certainty required by lenders; c) high amounts of debt service from an existing Senior debt facility; d) an expected inflection point (new product, service, market, or acquisition) in the business resulting in potential increased volatility in future cash flows, or e) an unsophisticated financial management team. In addition, it is noteworthy that while Mezzanine debt lenders will certainly actively monitor your company's financial performance and covenants, they will likely avoid taking an active role in helping you grow or manage the business. For example, Mezzanine lenders will often ask for observer seats on the Board of Directors, but will typically opt not to take an official Board seat to avoid potential conflicts in the event remedies need to be exercised.

Equity Capital

Equity financing describes an investment of capital into a Company for a share of business ownership, which dilutes the company's existing ownership (although, as stated above, mezzanine debt typically involves some form of equity dilution as well). Typically, equity investors recognize that their capital is needed to fuel growth in the business and, accordingly, don't require monthly or quarterly interest payments. In addition, equity terms are generally more flexible than debt, have fewer covenants, and less defined remedies in the event the Company does not perform in accordance with the business plan. In addition, equity investors will seek to align their interests with those of the management team (not always possible with debt), and then work actively to assist management in maximizing the ultimate value of the business during the investment period (typically 3-5 years). This "value added" element from equity investors is one reason why equity is nominally more expensive than mezzanine debt. The other primary reason is that equity sits below mezzanine debt in the capital structure, and 100% of the return is shifted to the back end of the investment period, resulting in a more risky security. Accordingly, equity investments need to be nominally pricier than debt in order to provide appropriate risk-adjusted returns to the investors.

Equity capital is a good solution for companies looking to finance shareholder liquidity -- allowing business owners and other investors to take cash out of the business. Equity is also typically the preferred solution for: a) companies at an inflection point of increasing growth; b) companies looking for additional management support and board-level guidance; c) companies

wishing to sell within 3-7 years; d) companies looking to do a “roll-up” or industry consolidation, e) companies with unpredictable, erratic, or uncertain future cash flows; f) companies who are looking to shore up their balance sheet; or g) companies looking to do a management buyout.

Equity is typically **not** the optimal source of financing where: a) the company has limited senior debt and a history of stable, predictable and growing cash flows; b) the Company does not see a problem in servicing the debt; c) the reduced dilution is more important than the added management involvement and oversight; and d) the company is not willing to entertain an IPO or company sale within 5-7 years to provide the equity investors an exit from their investment , or e) the Company is reluctant to allow “outsiders” onto their Board of Directors.

Equity vs. Debt: Assessing the Differences

DEBT	EQUITY
Debtor / Creditor Relationship	Equity Partner Relationship
Lower Cost of Capital	Higher Cost of Capital
Funding Amount Based on Current Cash Flow	Funding Amount Based on Expected Future Value
Periodic Interest Payments	Interest Accrued, but not Paid
Fixed Maturity Date	Defined Range of " Exit" Dates
Financial and other Covenants	Less Restrictions; More Collaborative
Retired through Operating Cash Flow	Redeemed through IPO, Recapitalization, or Sale of the Business
Board Observer	Board-level Participation
Little Involvement	Active Involvement, as Appropriate

Partners/Creditors – Whoever provides a company with funding will, to some degree, become involved with the management team. However, there is a fundamental difference between equity and debt investors - equity investors become partners while debt investors become creditors. Since equity returns depends on a company’s growth and success, equity partners have greater incentive to help the owners grow the business, while a creditor (even with some equity participation) is primarily concerned with ensuring the business can cover its periodic interest payments. This economic and structural difference can affect the investor’s tolerance of risk and what they will allow management to do with “their” money. Typically, equity investors have a higher risk tolerance than debt investors, as lender covenants may restrict certain types or levels of investment.

Cost of Capital – Given the different risk profiles between the two investment structures discussed above, equity will understandably be more expensive than debt on an absolute (but not necessarily on a risk-adjusted) basis. Equity partners will likely expect a firm to generate annual returns of 25-30 percent on their equity investment. By comparison, mezzanine debt investors usually expect a return of 15 percent to 25 percent, including both the debt and equity portion of their investment. Of course, while equity may be “more expensive” in the long run, debt is more restrictive on cash flow as the business grows, potentially making debt “feel” more expensive and potentially limiting realized growth along the way.

Funding amount – Equity partners can provide emerging firms with more up-front capital to enable the company to fund all the projects necessary to achieve strategic growth objectives. In contrast, a lender’s funding limit is based solely on a firm’s ability to make loan payments, which will likely be relatively small at the early stages of a Company’s life. In other words, the funding capacity available to a firm will be significantly less in a debt structured deal.

Payments – Unlike debt financing, equity does not get “paid back” each month or each quarter. Equity investors do not look for near-term cash-flow from their investments, but rather prefer to have companies reinvest profit dollars into additional growth objectives in an attempt to maximize the long-term equity value of the business. By contrast, lenders are typically more cash-flow oriented, requiring some form of current-pay return on their investment, even shortly after closing. Even though this payment is recorded as an expense on the company’s income statement, creating tax benefits, this continuous outflow of cash may not only constrain the growth of the firm, but may also raise the required level of initial funding (since some of the Company’s capital will be required to fund the debt service).

Maturity – Equity investors tend to target companies with a 5-7 year horizon to a liquidating event, such as a sale, a subsequent round of take-out funding or an IPO. Most mezzanine lenders will conform their terms to an equity investor’s time horizon if an institutional equity investor is also invested in the Company. Mezzanine debt can be interest-only, thereby minimizing the near-term cash drain on the Company, or fully amortizing over a 4-7 year timeframe to allow the Company to pay off the debt without a subsequent replacement financing.

Warrants – In a typical mezzanine debt funding, warrants are usually issued as a part of the investment “unit” to boost the interest and fee-driven returns. This warrant coverage can range from just a few percentage points of the funding amount to 100% of the amount raised. A warrant is an option that gives the holder the right but not the obligation to buy an underlying security at a certain price, quantity and future time. In another words, a warrant allows mezzanine creditors to have no downside risk yet still benefit from the future growth of the company. Warrants can be issued with exercise prices ranging from \$.01 (penny warrants) to prices well above the current fair market value of the Company.

Restrictions – Both debt and equity can require contractual terms that limit the use of funds and the types of policies implemented, but creditors typically have broader and more stringent

loan provisions than equity investors. Equity investors generally do not impose financial covenants, but will restrict the Company from undertaking any action that could adversely impact their position within the capital structure. Given the objectives and structure around senior and mezzanine debt, companies should expect a comprehensive list of covenants to protect the lender (this is appropriate given their lower risk tolerance and associated cost of capital), as well as a variety of operational restrictions. Typical **covenants** would likely include:

- ❖ Minimum EBITDA levels
- ❖ Minimum Interest coverage
- ❖ Minimum Fixed Charge Coverage ratio
- ❖ Maximum Leverage ratio
- ❖ Minimum Book Net Worth
- ❖ Restrictions on:
 - Dividend distributions
 - Additional loan agreements
 - Joint ventures
 - Employee compensation changes
 - Change in officers
 - Creating or changing employee benefit plans
 - Mergers or acquisitions
 - Other Investments
 - Debt retirement
 - Changing any business agreements

Putting It All Together: Finding the Right Fit For Your Business

While there is no exact formula for calculating the optimal capital structure, companies utilizing debt or equity generally fit these typical profiles:

Equity: Companies that are good candidates for equity investment are those companies in the development stage, or those who are at an inflection point for accelerated growth. These companies are generally building and scaling the company's infrastructure and working capital and require all available cash to be directed towards supporting the Company's growth instead of towards servicing debt. These Companies often have tremendous prospects for long-term capital appreciation but have yet to establish the large, stable cash flow patterns required by senior lenders. Since these businesses are often breaking new ground (through new product introductions, increasing scale, geographic expansions, etc.), cash flow is understandably often choppy and unpredictable. Furthermore, these Companies are usually positioned to benefit from the relationships, oversight, and support that equity investors often provide.

Debt: Debt is most often used to fund a specific project or initiative that has an identifiable implementation time frame. However, a good business credit history is needed, i.e. sufficient cash flow to repay the loan and/or sufficient collateral to offer as a secondary source of loan repayment. Therefore, companies with a strong and stable cash flow often attract mezzanine debt capital on attractive terms. In smaller businesses, personal guarantees are often required on debt instruments, including some mezzanine debt vehicles. In many cases, mezzanine debt can be effectively paired with a private equity sponsor to provide an optimal balance of pricing, flexibility, cash flow, and management support.

Final Words

In selecting the right financing source, Companies need to consider all of the factors described above. However, after choosing the most appropriate financing instrument, it is equally as important to select the most appropriate financier, or investor, for that instrument. Companies should select an investor that they feel comfortable with, who has relevant experience that can add value, and has a good reputation among its previous and current investments, especially the portfolio CEOs (who you should ask to interview). As a practical matter, the pricing difference between a private equity investor and a mezzanine debt investor is fairly immaterial on an absolute basis (as opposed to a percentage) in most scenarios. At the end of the day, accepting an investor into your business creates a delicate and intimate relationship, and relationships will ultimately be the most important determinant of your satisfaction level. Choose wisely, and good luck.