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THE PROS AND CONS OF DEBT VS. EQUITY

Should a growing (and scaling) business seek debt financing or an equity investment? That is the question. Or is it?

Financing a company at various times throughout its life cycle is one of the many critical management challenges faced by entrepreneurs. Indeed, as a company matures and becomes profitable, its financing alternatives change. A company's leverage in the capital markets should improve over time in terms of funding sources, pricing, and terms and conditions. An inappropriate capital structure has the potential for significant shareholder dilution, at best, and ruinous liquidation scenarios, at worst. At birth, a technology concept is likely to be financed by friends and family, credit cards or Connecticut Innovations' Pre-Seed Fund. Years later, if that company has achieved solid market penetration and consistent profitability, it is conceivable that it could ultimately become self-funded. These are two ends of the life-cycle spectrum, but how a company is financed at each stage along the path of development is tricky business.

The scenario that perhaps describes a "typical" late-stage growth company might be a venture-backed technology company that has solidly emerged from its startup phase. Its senior management team is in place; its products/services have been road tested, proven and accepted in the marketplace; it is rounding out its infrastructure; and it seeks funding to quickly acquire customers and market share. While the products/services may be highly profitable from a margin perspective, the company continues to be unprofitable, with negative cash flow because of the required investment in production capability, sales and marketing, and additional research and development and capital expenditures to quickly capture market share. Further, such a company is typically "asset light," meaning that, while the company is rich in intellectual property, there is precious little hard collateral in the form of accounts receivable, inventory, and machinery and equipment to support debt financing.

Before attacking the question of the pros and cons of debt vs. equity in a growth company, one that is scaling, I would pose a larger question: Does such a company have any realistic and practical choice of being able to access institutional debt markets? We know that early-stage companies simply have no access to debt markets, but how about later-stage growth companies? If senior debt is, by definition, the least expensive and gentlest alternative for a growth company, why even consider equity financing? The following will make the case that, in any typical growth company, as defined below, senior debt is often *not* available; therefore, some form of equity financing is the only alternative. Perhaps the latest major league example of a non-bankable growth company is Twitter, which hasn't turned a profit in eight years and just raised equity in a stock offering that valued the company at $31 billion.

For our purposes, let's define debt as senior debt, as customarily provided by banks. Further, let's assume that any such loans would be underwritten predominantly on the strength of the company, without significant reliance on external credit enhancements, such as outside collateral and/or personal guaranties. If we don't purify the definition of debt in this way, then we begin to think of unique and one-off debt alternatives that can be expensive and usually not a complete solution.

When we think of the enormity of the credit risks taken by banks leading to the financial meltdown of 2008, it is perverse but an abiding truth that banks are totally risk averse when it comes to lending to emerging, privately held lower middle market companies. Banks seek collateral security, predictable cash flow, personal guaranties and side collateral to ensure that they get paid back in a timely manner. Emerging growth companies, as described above, usually have none of these credit attributes. So, what is Plan B?

There are a number of debt-oriented financing alternatives that are available in certain circumstances, such as venture leasing, purchase order financing, equipment vendor financing and a variety of grants and economic development-supported programs. Most of these alternatives are provided by non-regulated, non-bank sources that have emerged as banks have tightened credit standards since the financial meltdown. All of these alternatives are unique, sometimes one-off, and often expensive financings. Each has its place and can be valuable, but is usually not a complete funding solution. There are many resources one can use to identify financing alternatives, including the Connecticut Department of Economic and Community Development, Connecticut Innovations and certain members of the Connecticut Venture Group. Each has its own distinct mandate and can be helpful by providing guidance to up-and-coming, Connecticut-based growth companies.

Finally, there are always equity alternatives for any profile company. It is common that the venture capital firm that is an institutional shareholder in the company will play a major role in providing or sourcing the next round of capital. In a growth company, such financings should not be as dilutive as earlier rounds and should provide the financial fuel for the next stage of growth, ultimately leading to that self-funding company that has positive cash flow and will have access to the traditional credit markets.

By Frank Morse

Frank Morse is a managing director of Carter Morse & Mathias, an investment bank located in Southport, Connecticut. You can contact him at fmorse@cartermorse.com.