AXIAL FOR CEOS

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THE CEO'S GUIDE TO

TYPES OF GROWTH CAPITAL

FORUM

THE GROWTH SERIES

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As a business owner, how should you grow your company?

Many small- to medium-sized business owners rely on their local bank, friends and family, or personal savings for most or all of their company's financing. Some may also use SBA loans from the U.S. government, which provide a financing option for those who are turned down for traditional bank loans. Once they secure initial financing, the company might rely on internal resources to increase revenues; this is known as organic growth.

"The dependency on internal resources can be viewed as either a benefit or drawback for many companies seeking organic growth," explains an article in Axial Forum. On one hand, using only internal resources means a company is growing at a very controlled pace and can quickly navigate through different market cycles and turns. On the other hand, growth contingent on available internal resources means that a business is likely to have slower, incremental growth."

For companies looking for faster, more significant growth opportunities, there are a range of other capital options to consider.

In this guide to types of growth capital, we'll consider the basics of debt vs. equity financing, provide an introduction to capital structure, and help CEOs understand what questions to consider when evaluating their options.

Debt vs. Equity

There are two primary ways to finance a company: debt and equity.

Nearly every individual is familiar with debt, whether from student loans, credit cards, or mortgages. **Debt describes a sum of money borrowed by one party from another to be paid back at a later date.** Like individuals, every company relies on debt financing at some point in its lifecycle. Debt provides owners the ability to transfer their income across time and space — allowing them to use future earnings to finance present-day investments, and pay back their lender later. The question isn't whether your organization will use debt financing — but how you should use it to grow your business most effectively in the short and long term.

Every company relies on debt financing at some point in its lifecycle.

Equity refers to the value of an investment in an organization. Equity financing describes the process of selling ownership stakes in a company in order to raise funds for a business. Rather than pay back the investment over time as with debt financing, you agree to exchange a percentage of ownership in your company in exchange for the capital invested.

In the case of most businesses, this equity will be privately purchased — by friends, family, a private equity firm, a venture capitalist firm, etc. Companies may also go public and sell their shares on the open market; however, this route opens firms up to significant oversight and regulation. The average company going public has a multi-hundred million or billion dollar valuation and high growth rates.

When considering equity financing, it is important to think carefully about your preferred exit plan for your business, as investors look to capitalize on the value on their equity. There are a number of different exit plans for business owners, including sale, IPO, refinancing, or recapitalization.

Equity financing trades ownership for capital.

The Benefits of Debt Financing

Debt enables owners to finance their company's growth without diluting ownership. Once the debt is paid off, the owner maintains his claim to the (hopefully) larger and more valuable business, and the relationship with the lender ends.

Say a demolition company wants to purchase an additional excavator, but can't afford it with current revenues. By taking out a loan, the company can purchase the excavator and use it to increase productivity. If the company can generate revenue at a faster rate than the interest on the loan, the investment can end up paying for itself.

Debt also enables companies to smooth out their working capital. If you have large swings in your accounts receivables, with contracts coming seasonally or in lumps, loans can help you cover payroll and daily expenses until the next accounts receivables are paid.

The Risks of Debt Financing

"Lenders are primarily concerned with managing risk," **writes** Ami Kassar, founder and CEO of MultiFunding. "If they're going to give you a loan, they want to know that you're going to be able to pay everything back on time."

Companies that use debt capital must make regular payments to their lender. While debt does allow you to keep ownership of your company, that's only true if the business stays afloat. Debts have to be paid back eventually and many banks require strong covenants in order to loan you money in the first place. They'll often have access to your full financials, and will be able to mandate that you do certain things in your business or else be in breach of contract on your loan. In some cases, a company may put up assets as collateral against a loan — e.g., manufacturing equipment. In the case that the company can't make its loan payments, it may lose the equipment to its lender and/or be forced to file bankruptcy. Depending on the company's risk profile and the loan terms, a business owner may in some cases be required to guarantee a loan with personal financial assets.

"Debt allows you to keep ownership of your company — but that's only true if the business stays afloat."

"There's money, and then there's smart money."

The Benefits of Equity Financing

Again, equity financing describes the process of selling ownership in your company in order to raise capital. If you fund your business growth with private equity, you don't pay back the investment over time like you would with debt. Instead, you exchange a percentage of ownership in your company for the capital invested. This means that you can continue to dedicate the capital to growth and business activities, without worrying about paying back a loan.

Anyone with an equity stake in your company has a vested interest in its success. They want to see it grow and flourish and as such will leverage their skills, expertise, and connections to help increase the business's value. Investors often work with business owners in an advisory capacity, and their business savvy, in addition to the influx of capital, can help businesses grow in ways that may have been impossible without their support.

"There's money, and then there's smart money," says James Cassel, chairman and co-founder of investment banking firm Cassel Salpeter & Co. "A million dollars is a million dollars. But if you get a million dollars from the right party, it might be far more valuable to you in helping to grow and advance your business. If you're in the retail business, you might get your growth capital from a fund that has expertise in retail — in which case you're not just getting money, you're getting help you with your supply chain, with your distribution, with selling online. The right partner can open doors that would never have been opened otherwise."

The Risks of Equity Financing

Raising equity financing can be time consuming. The company will have to create a business plan, give a management presentation, and put together a data room with contracts, agreements, and descriptions of intellectual property, among other activities. This can take executives away from core business activities and pose challenges for the company. "It's not a quick process for private companies," warns Cassel. "If the world were perfect, it might take 90 days — but I've never met a perfect world."

CEOs don't always expect the level of due diligence that financial firms do. "I've seen situations where firms come in, and as a result of their due diligence, they may know the company's numbers or business model better than the people who own and run it," Cassel says. "If there are any challenges in the business, we believe in laying them out up front, because they'll be found out in due diligence. It is best to identify the issues and tackle the solution head on."

In addition, while you never have to pay back the money that investors give you to grow your business, you also never get the equity you gave up back. Investors will want to have varying levels of control over the business (depending on the nature of the deal, their reasons for investing in the company, and their ownership stake). At the very least, management will be expected to check in with investors regularly and keep them up to date on any problems or concerns.

Business owners may lose the power to make some or all management decisions unilaterally. "If you own 100% of your business, you can do whatever you want. I try to get people to look in the mirror and be honest with themselves — can they really live with a partner? They may just not be happy having to have a monthly board meeting or a quarterly board meeting or provide periodic information — because they know their business and don't want anyone else to tell them how to run it," says Cassel.

Business owners should also consider how contract provisions will affect their plans long-term. For example, provisions in the contracts negotiated to exchange the equity may give investors preference in the winding down or sale of a business — meaning they'll get one or two times their investment before anyone else gets any of the proceeds.

Capital Structure

Often, a company will use both debt and equity to finance its assets and operations and facilitate growth. **Capital structure refers to the composition of a given company's liabilities** (e.g., equity or debt).

A company's capital structure is arguably one of its most important choices. It influences the firm's risk profile and helps determine the accessibility and cost of funding. It affects the return investors and lenders expect, as well as how insulated the firm is from both microeconomic business decisions and macroeconomic downturns.

For example, one company may be financed with 30% equity and 70% debt, while another is financed with 70% debt and 30% equity. The amount of debt used to finance a firm's assets is referred to as its "leverage"; the latter firm in the example would be considered highly leveraged.

Obligations at the top of the capital structure are low-risk, low-cost, and have the highest seniority in the case of a liquidation event (that is, they must be repaid first in the event of sale, restructuring, or bankruptcy). Obligations at the bottom of the stack have the highest risk and cost, and the lowest seniority. For large corporations, the capital stack typically consists of senior debt, subordinated debt, hybrid securities, preferred equity, and common equity. (See Exhibit A.)

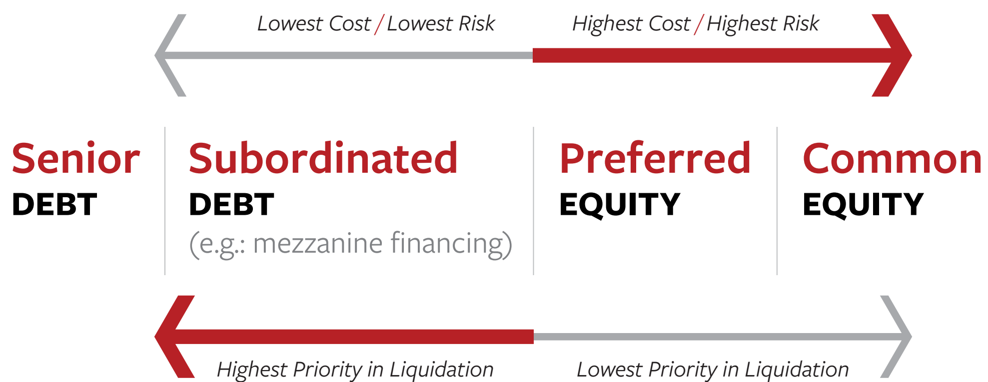

Exhibit A: The Capital Structure

A company's capital structure represents all the claims different players have on your business.

A company's capital structure is effectively an overview of all the claims that different players have on the business. The debt owners hold these claims in the form of a lump sum of cash owed to them (i.e., the principal) and accompanying interest payments. The equity owners hold these claims in the form of access to a certain percentage of that firm's future profit.

The capital structure is heavily analyzed when determining how risky it is to invest in a business, and therefore, how expensive the financing should be. Specifically, capital providers look at the proportional weighting of different types of financing used to fund that company's operations.

For example, a higher percentage of debt in the capital structure means increased fixed obligations. More fixed obligations result in less operating buffer and greater risk. And greater risk means higher financing costs to compensate lenders for that risk (e.g., 14% interest rate vs. 11% interest rate). All other things being equal, getting additional funding for a business with a debt-heavy capital structure is more expensive than getting that same funding for a business with an equity-heavy capital structure.

Components of the Capital Structure

Senior Debt

Senior debt is a class of loans with priority on the repayment list if a company goes bankrupt, usually issued by banks and other financial institutions. Senior debt is usually provided by banks and other financial institutions. Holders of this form of financing have first dibs on a company's assets. That is, in a liquidation event, senior creditors are paid in full first, before lenders holding subordinated notes. Because of the minimal risk that accompanies this block of the capital structure, senior lenders loan money at lower rates relative to more junior tiers.

Within the senior debt class, there are different types of debt with different levels of relative seniority. Nearly all organizations will make use of a revolving line of credit provided by a bank or a financial institution; this form of senior debt, which is secured by current assets or inventory, is usually the first to be repaid. Senior term debts, often secured by a company's fixed assets, are repaid next. Any unsecured senior debt will likely to be the last type of senior debt to be repaid in a liquidation event.

Subordinated Debt

Subordinated debt is a class of loans that ranks below senior debt with regard to claims on assets. Subordinated debt is more risky than senior debt, since subordinated lenders have less seniority in the case of a liquidation event. However, subordinated debt also comes with commensurately higher returns, usually in the form of higher interest payments.

MEZZANINE DEBT

Mezzanine debt is a class of subordinated debt that blends equity and debt features. Mezzanine capital does not dilute equity ownership, and is usually paid out at maturity; this allows business owners to direct cash flow into growing the business. Mezzanine capital, which is usually unsecured, receives liquidation after senior capital. Mezzanine capital might be used by a company that can't secure as much money as it wants from traditional lenders. For example, a technology company with little physical asset base that is growing quickly might need some liquidity to grow more effectively (without diluting equity). The founder may want to raise $20M in debt, but the traditional debt markets will only enable it to raise $10M. In this case, mezzanine capital might be used to fill in the gap.

Mezzanine firms lend at higher interest rates than traditional debt providers, and usually attach warrants — giving them the right to purchase equity at some future point.

CONVERTIBLE DEBT

A form of mezzanine debt, convertible debt combines debt and equity features. Convertible bonds are the most common type of this hybrid financing, and usually take the form of bonds that can be converted to equity. The conversion can only happen at certain points in the firm's life, the equity amount is usually predetermined, and the act of converting is almost always up to the discretion of the debt holder.

Preferred Equity

Preferred equity is a class of financing representing ownership interest in a company. Unlike fixed income assets (e.g., debt), equity is a variable return asset. However, preferred equity has both debt and equity characteristics in the form of fixed dividends (debt) and future earnings potential (equity). Correspondingly, it gives the holder upside and downside exposure. Its claims on the company's assets and profits are less senior than those of debt holders and more senior than those of common stock holders. Generally, preferred equity obligates management to pay its holders a predetermined dividend before paying dividends to common shareholders. However, preferred equity typically comes without voting rights.

CONVERTIBLE EQUITY

Convertible equity, another class of hybrid financing, usually takes the form of convertible preferred shares. Preferred shares are preferred equity that can be converted to common equity (see below). Like convertible debt, convertible preferred shares convert into common shares at a predetermined fixed rate, and the decision to convert is typically at the owner's discretion. Importantly, the value of a firm's convertible preferred shares is usually dependent on the market performance of its common shares.

Common Equity

Common equity is a class of financing representing ownership interest in a company. Common equity is the junior-most block of the capital structure and therefore represents ownership in an business after all other obligations have been paid off. It comes with the highest risk and the highest potential returns of any tier in the capital structure.

Capital Structure: Factors to Consider

Business owners must take a variety of factors into account when considering capital structure. These include but are not limited to:

- Cash flow
- Growth
- Return on investment
- Risk
- Dilution
- Taxes
- Relationship with investors and lenders

Can You Live With a Partner?

"With money comes strings," warns investment banker James Cassel. In the case of equity, this means giving up some of your ownership in your business. "When you bring in a partner, be it a minority or majority partner, well, you now have a partner."

It's important that owners know what they're getting into. "A partner can be great. They can bring new systems and clarity and require accountability, all of which makes for a better business. But not everyone wants that."

Cassel tries to educate business owners on what it's like to have a financial partner, before they embark on the process of raising equity. "They're not looking to make life better for your employees or worse for your employees, they're looking to make money. They are looking for a return of their money and well as a return on their money because that's what they've been entrusted to do by their investors."

Majority or minority partners come with a number of potential obligations: "They may want preferred stock, board seats, certain blocking rights — in other words, you can't do an acquisition of a certain amount or borrow a certain amount of money without approval."

After walking owners through all the issues that might come up, Cassel says, some owners will realize that they may be better off using debt financing that won't dilute their ownership. But "if after all that, they say they want to go forward with equity, then we start implementing a plan."

To illustrate some of the potential pros and cons of different capital structures on a basic level, consider two fictional companies: Equity Medical and Leverage Corporation. The companies have a lot in common: Each is located in the Midwest, manufactures medical devices, is profitable with opportunities for growth, and has $10 million in capital invested in it.

Equity Med's capital structure consists of 90% equity and 10% senior debt. Meanwhile, Leverage Co is financed with 30% equity and 70% debt. The costs and benefits of each structure are interdependent and can shift depending on market conditions.

Factors	EQUITY MED.	LEVERAGE CO.
Cash flow	Since Equity Med has only 10% debt, it has the majority of its cash flow available to reinvest in the business each month.	The majority of Leverage Co's financing comes from debt, which requires monthly payments. This eats up a large proportion of cash flow each month.
Growth	Equity Med can use its cash flow to invest in the company's growth.	After paying down loans, Leverage Co has much less capital left over each month to invest in growth.
Return on investment	Equity is more expensive than debt and therefore does not provide as high a ROI.	Because debt is a cheaper form of capital, Leverage Co has a higher return on equity.
Risk	Equity Med has no interest expenses, and therefore has less risk in the face of unexpected challenges (e.g., economic downturn).	If the economy is in trouble, or Leverage Co loses a big customer, the company risks being unable to pay its debts. For a highly leveraged company, this is a particular concern.

Factors	EQUITY MED.	LEVERAGE CO.
Dilution	Equity Med has raised financing via a private equity firm; someone from the firm sits on its board and is actively involved in decision-making.	Leverage Co.'s lenders serve as board observers but are not actively involved in decision-making.
Taxes	Equity Med has less interest to deduct and therefore will pay more taxes.	Leverage Co can deduct its interest payments for tax purposes; its taxable income is therefore lower.
Relationship with investors and lenders	Equity Med's investors have significant ownership stakes in the business and expect oversight and involvement in important decisions.	Leverage Co's lenders just want to know that the company will be able to pay back its loans on time.

This highly simplified example nevertheless illustrates the complexity of the decision-making process for any business owner preparing to raise growth capital. Most businesses employ a mix of financing types — including senior debt, mezzanine capital, and equity — dependent on both their risk profile and unique goals.

Conclusion

It's crucial for CEOs to be frank with themselves and with advisors or potential investors throughout the process. As a business owner debating different types of capital, consider questions like:

- → What are my long-term goals for the company?
- → How much control do I want to maintain?
- → How much risk am I willing to take?
- → Do I want to work with outside investors?

According to investment banker Cassel, business owners should be looking to the future. Though debt and mezzanine financing are both less expensive than equity, to grow with equity, "you may have to give up 40 percent of your business to raise three million dollars. You have to look at the numbers and think about five years down the line — are you going to be better off with the 60% you own? Will that be worth more down the road than if you had just kept the business yourself and continued to grow without a partner? Five years from now, is my business going to be worth three times what it's worth today?"

Many companies find debt the best solution to help buy certain types of large assets, to smooth working capital, and to grow faster than they could organically when the risks of failure are low. Debt is also often used to make acquisitions.

Equity investments are used all the time in various stages of business. Some companies start with partners who have different ownership shares in the business, while others raise equity capital from family and friends. Private equity often helps more mature businesses grow by buying a stake in the business — sometimes as small as 10% or as large as 100%. Again, what type of financing you choose will depend a number of factors, including your company's perceived risk profile, your vision for running the business, and your confidence in the company's ability to generate profits in a given time frame.