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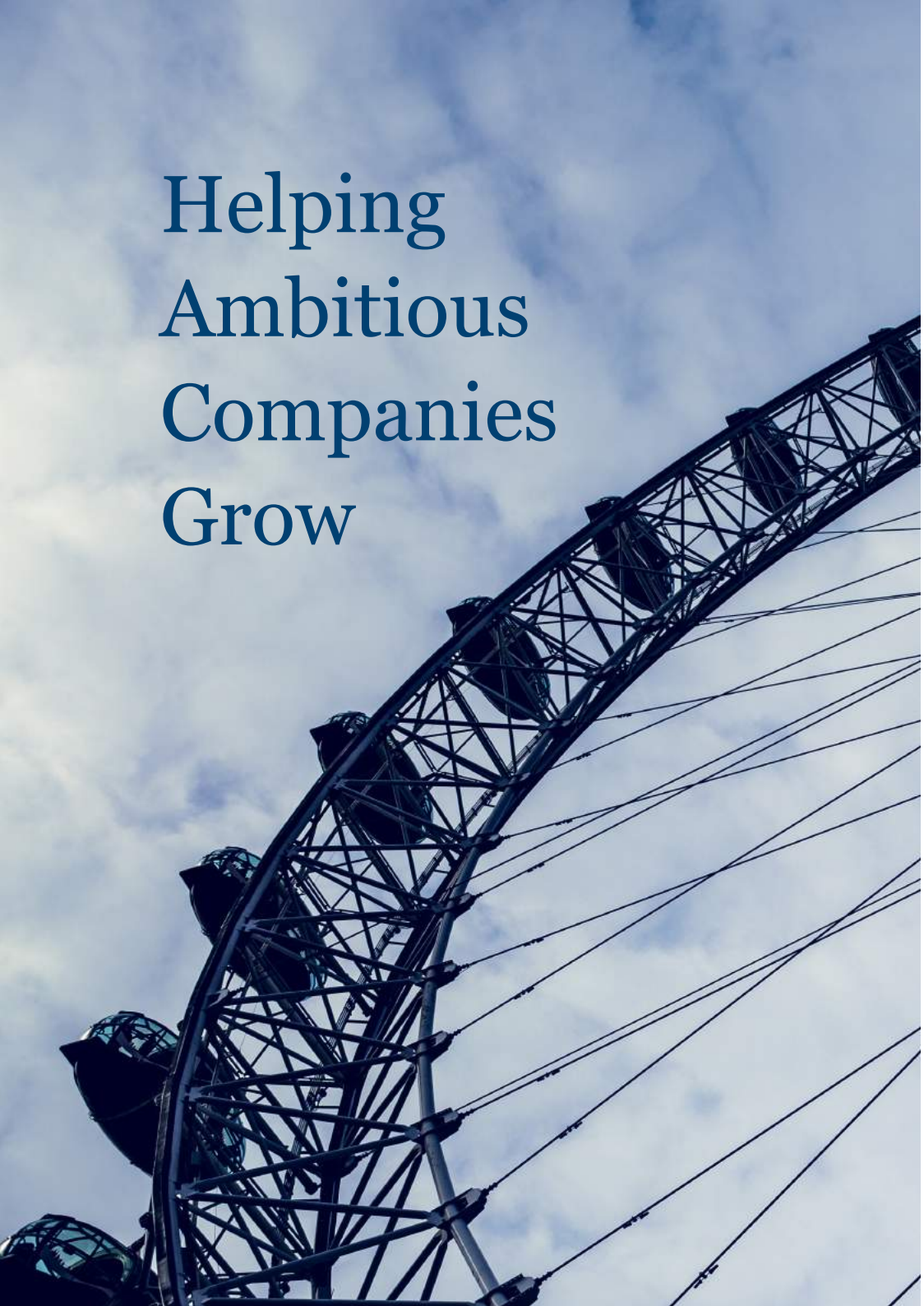
Raising Money for your Business: A jargon-free guide to debt vs. equity



Raising Money for your Business:

A jargon-free guide to debt vs. equity

If you need to raise money to help your business grow, you generally have two choices: debt, or equity. If this is the first time you have started thinking about this question, we have prepared a "back to basics" guide which starts from the beginning to explain what these two financing routes involve, what the jargon means, and how you can decide which route is best for you and your business.

What is debt, and what forms of debt are available?

In a nutshell, debt financing means borrowing a sum of money from an outside source where you commit to repay the money, plus interest, within an agreed time period.

There are several different kinds of debt available. Highlighted below are the primary forms:

Bank debt

This is the most common kind of debt that you are likely already familiar with. Your bank may provide a loan for your business needs, in the same way they provide a mortgage for your house or a loan to buy a car.

The interest rate they set (and therefore how expensive the loan is) will depend on how risky they think your business is; how long you have been established, how visible your future cash flow streams are, whether your revenue is recurring, and so on. The wider economic environment will also have a bearing on the interest rate that you are charged. In general, however, you should expect to pay somewhere between 3% and 7%.

To obtain bank debt you will generally need a certain (higher) level of cash – typically a ratio of 60:40. Some loans will require you to put "collateral" behind them, such as your house, which is where you agree to give up the "collateral" if you fail to repay the debt (which is called defaulting).

Convertible debt

This is where the debt issuer (i.e. the person or institution who lends you the money) may exchange, at a pre-agreed price, the debt for a stake in your company. At that point, you would no longer owe them any money, but they would now be a shareholder in your company.

How many shares they would get in exchange for the debt, if they do choose to convert, is agreed at the time that they lend you the money initially.

Bonds

This is a simply a formal, financial term for debt.
Bonds are a financial security where a (usually very large) company or a government borrows a large sum of money from an institution (such as an investment bank) for a defined period of time at a certain interest rate. The company or government can then use this money to finance a variety of projects, acquisitions or other growth activities.

Debentures

This is another financial term for debt.

The main characteristic which identifies a debenture is that this debt is not secured by any kind of physical assets or "collateral". Therefore, debentures are usually only issued by very low-risk institutions, such as governments, who are perceived by the lenders as highly unlikely to default on their debt.

Promissory notes (or P-notes)

This is another financial term for debt.

A promissory note is simply where the borrower signs a written document stating that they will repay the lender a definite sum of money, either on demand or at a specified future date. It will typically contain all the terms relating to the money being borrowed: the principal amount, the interest rate, the maturity date by which time it needs to be repaid, the date it is issued, and so on.

The key characteristic that identifies a promissory note is that the lender can be any individual or company willing to sign the note and provide the financing. In effect, they allow you to get financing from a source other than a bank.

Venture debt / bridging loans

Typically, when a company raises money, they do this in "stages": the seed stage, right at the beginning, through to Series A, Series B, Series C and so on, with each round usually raising more money as the business gets bigger.

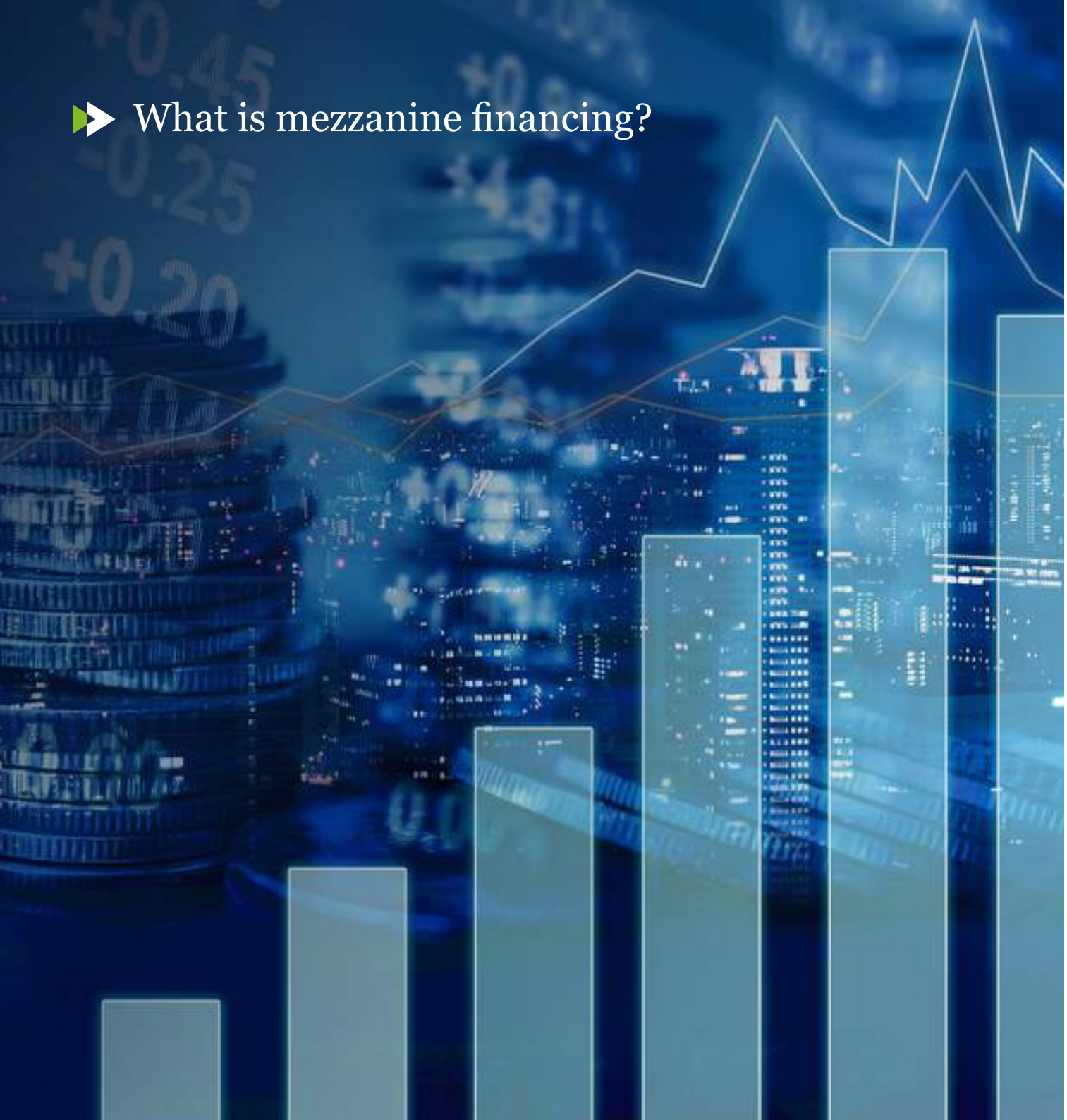
However, sometimes businesses run short of money in between these rounds of raising funds. Venture debt is a form of debt financing which exists to lend money to these businesses that are in this position of being "in between" these rounds, and so can also be known as a "bridging loan".

Bridging loans are more expensive than bank loans – you can expect to be charged interest rates of 10% to 15%.

There are several other forms and sub-forms of debt which we have not covered here but which may be of interest to you:

- Asset-backed finance
- Peer-to-peer lending
- Export finance
- Trade finance
- Royalty financing

What is mezzanine financing?



Mezzanine financing is a hybrid of debt and equity financing. It initially takes the form of debt, but the lender has the right to convert the debt into equity (shares) if the company defaults.

What does this mean in practice? Well, if the business is in the position where it cannot repay its debts (called "defaulting"), the mezzanine debt would convert to mezzanine equity. When the business is liquidated (wound up), lenders are paid first. These are called "senior debtholders". Once the lenders have been paid, the preferred shareholders are paid. If there is anything left over, the mezzanine holders are paid. Finally, if there is any further money left over, this goes to the common shareholders.

The interest rate on mezzanine debt, which can also be called "subordinated debt" because it's lower in the hierarchy of the capital structure is relatively higher than on more "senior" debt.

What is equity, and what forms of equity are available?

Equity financing is where you raise money by selling individual shares in your company.

Business owners who choose this method don't repay the money with regular instalments as they do with debt; instead, the individuals or institutions who bought the shares become partial owners (shareholders) who are entitled to a portion of the business profits for as long as they hold those shares.

Like with debt, there are several different terms associated with equity:

Common stock
This is what 'ordinary' shares are called – the most straightforward share class. When you registered your business with Companies House, your shares would be classified as common stock.

Preferred stock (or preferred equity, preferred shares or preference shares)
This, as the name suggests, is a 'preferred' share class. This is because preferred stock has a higher claim on the business' assets and earnings than common stock.

The key difference is usually that preferred shares have a fixed rate of dividend (where some of the profits are paid out each year) that must be paid out before any dividends are paid to common stockholders (shareholders). Also, they typically do not carry any voting rights. It's worth noting that some equity investors will elect to use "loan notes" (a kind of promissory agreement, see above) which bring costs similar to debt.

What is the hierarchy of the capital structure?

Many companies will be financed by both debt and equity. There is a clear hierarchy between these two forms of financing, which is called the "capital structure." We touched upon it when talking about mezzanine financing, but before we go any further, it would be helpful to understand the basic capital structure a little more.

The hierarchy dictates which parties are paid when. This is important in terms of both regular payments (for example, repaying interest on debt, and paying out dividends to shareholders from annual profits) and also if the business is liquidated at any point.

The basic "chain of command," from first priority to last priority, looks like this:

Financing type	Regular payments you need to make	In the event of default or liquidation
Senior debt or secured debt	Either a fixed or a variable rate as interest (agreed at the time you take on the debt)	First in line to have their capital returned (i.e. the principal amount repaid to them)
Preferred shares	A fixed rate as a dividend (agreed at the time the shares are issued)	Second in line to have their capital returned (i.e. what they paid for their shares)
Subordinated debt or junior debt (mezzanine)	Interest (at a higher rate than senior debt as riskier to the lender – they may not get their money back if you default)	Third in line to have their capital returned (i.e. the principal amount repaid to them)
Common shares	Possibly dividends, but often these are not fixed as they are for preferred shares – so you may not choose to pay dividends on these shares	Fourth in line to have their capital returned (i.e. what they paid for their shares)

What are the pros and cons of using debt vs. equity?

Debt	Pros	Cons
	Because the lender does not have any claim to equity in the business, debt does not dilute the owner's stake in the company	Debt needs to be repaid at some point
	The lender is only entitled to repayment of the loan (plus interest), and has no claim on any future profits of the company. This means that if your business is successful, you will reap a larger portion of the rewards than if you had sold shares to investors in order to finance the growth	The interest that you must pay is a fixed cost, which raises your break-even point. Companies that have taken on too much debt can find it difficult to grow because of the cost of "servicing" the debt (paying the interest)
	Interest on the debt can be deducted on your company's tax return, lowering the actual cost of the loan to you	Debt instruments often contain restrictions on the company's activities (which are called "covenants"), preventing management from pursuing alternative financing options and non-core business opportunities
	You are not required to send periodic mailings to large numbers of investors, hold periodic meetings of shareholders, and seek the vote of shareholders before taking certain actions	You are usually required to pledge assets of the company to the lender as collateral, and owners of the company are in some cases required to personally guarantee repayment of the loan

Equity	Pros	Cons
	Equity does not need to be repaid	Issuing shares means selling part of your ownership of the business
	Common shareholders are not guaranteed a dividend, so there is no fixed cost for you to cover; if you haven't made sufficient profit during the year, you do not have to pay a dividend. Preferred shareholders do have a fixed dividend rate, but if you have not made a profit then you are not obliged to pay it that year (unlike interest payments, which need to be made regardless of profit levels)	All shareholders are classified as investors and are therefore entitled to a portion of the rewards if your business is successful. If you manage to grow profit, they will expect dividends to be paid out consistently with no foreseeable end date (unlike debt which has a "maturity date" by which it must be repaid)
	Equity is likely to be less restrictive than debt, which comes with "covenants" (restrictions on the company's activities)	No tax reduction available akin to what is offered for debt interest, and some share classes will come with conditions or caveats
	No requirement to pledge assets of the company as no "collateral" required	Administrative requirements such as sending periodic mailings to large numbers of investors, holding periodic meetings of shareholders, and seeking the vote of shareholders before taking certain actions
	The equity investor is fully aligned with your business objectives and is incentivised to help you grow	You may not be able to make strategic decisions without consulting them. This is a partnership – which can mean both good and bad elements for you!

Weighing up these pros and cons is usually a challenging process for any company seeking growth capital, and what is right for one business will not be right for another. You should seek impartial, professional advice to help you assess the options available to you and make the right decision for your business.

How do I raise money?

Whether you choose to raise equity or debt, the process is typically a long one, taking several months (take a look at our guide, The Process of Raising Capital: How to Prepare, for more information). Professional, impartial advice is critical to getting the best deal for your business, as your advisors can take you through the different components of the form of capital you're raising. They will have good relationships with the funders and an understanding of their needs, which means you'll have real insight into whether or not they are right for your business. Your advisors will be critical in building competitive tension between various investors and lenders, which is key to optimising the outcome for you.

During economic downturns or recessions, raising debt is not always possible as lenders become reluctant to lend money, or will only lend at very high interest rates.
If you are looking to raise senior or secured debt from a bank, you have the option of going direct to the institution. If you are looking at other forms of debt, or would like to discuss which routes you could take, consider engaging an advisor who can look at your business model and your aspirations and work with you to find the best outcome.

There are generally two options for raising equity: on the private markets, or on the public markets.

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Private markets

Private companies (who are not listed on any stock exchange) can raise equity financing by selling shares to any investor who wants to buy them.

The private investor landscape is incredibly broad; from individuals such as friends, family, and "angel investors" (high-net-worth individuals who invest in very early-stage companies usually at the "seed" part of their journey), to venture capital firms (who invest in early stage, high-growth, scalable companies), to private equity firms (who invest in more mature companies), to large investment management firms.

Venture capital and private equity are sometimes used interchangeably, but there are significant differences between the two:

Venture Capital

Venture capitalists invest in businesses with the potential for high returns – those with products or services with a unique selling point, or competitive advantage. They invest in a portfolio where a significant number of businesses may fail, so those that succeed have to compensate for those losses. They also want proven track records, and so rarely invest at the start-up stage.

Like angel investors, venture capitalists bring a wealth of experience to the business. They are unlikely to get involved in the day-to-day running of the business but will often help focus the business strategy. Securing VC investment can be a complex, costly and time-consuming process. A detailed business plan is a must. And legal fees will be incurred through the deal negotiation, regardless of whether investment is ultimately secured.

Corporate venture capital (CVC) is another growing source of funding for small businesses. It describes a wide variety of equity investment undertaken by a corporation, or its investment entity, into a high-growth and high-potential, privately-held business. CVC performs the same economic role that private venture capital plays – the identification and nurturing of the innovative businesses of the future. This formal and direct relationship is usually three-fold: by making a financial investment in return for an equity stake in the business; by offering debt finance to fund growth activities for an agreed return; by offering non-financial support for an agreed return, such as providing access to established marketing or distribution channels, or knowledge transfer. It is important that the corporation's aims are aligned with those of the business.

Private Equity

PE makes medium- to long-term investments in, or offers growth capital to, companies with high-growth potential. Typically, PE invests in more mature companies in comparison to VC firms. PE investors would usually look to improve the profitability of the business through operational improvements and aim to grow revenue through investment in product lines or new services, or expansion into new territories. They will also typically introduce corporate disciplines and a management structure to the business, to give it a platform on which it can grow further.

The PE model of governance consists of the combination of strategic, financial and operational expertise. The provision of non-financial support includes facilitating access to established marketing or distribution channels.

PE investors would actively manage their investment through a period of five to seven years on average. After this they would exit their investment, selling their shares, having seen the value of the invested company grow. A PE firm may sell their stake to another PE firm or a corporate trade buyer. Alternatively, it may publicly list the company via an "IPO" (Initial Public Offering – more on this below).

If your company is eligible for the Enterprise Investment Scheme (EIS) or Seed Enterprise Investment Scheme (SEIS), individuals that buy shares are able to claim tax relief, which is a great incentive for them. It is therefore a good idea to check if you're eligible and apply for the scheme; see finnCap's guide on this.

You have the option of trying to raise equity yourself by going direct to the individuals and institutions. However, particularly when it comes to pitching to institutions such as venture capital funds or mezzanine finance providers, it pays to work with an impartial advisor who knows the full range of options open to you and who will save you time by only asking you to meet firms who are aligned to your business (e.g. your sector, your stage, your growth plans, etc.) An advisor will know exactly what these firms look for in an investment, which avoids you wasting time and effort contacting investors who are unlikely to be interested. They will also be able to help you structure the deal in an optimal way for you, and will manage the "syndicate" of investors if you have more than one party involved in the equity raising process.

Public markets

The first time you raise equity financing on the public markets is called an "Initial Public Offering" (IPO). This process is also called "listing" or "floating" on the stock exchange. In the UK, most growth companies list on the Alternative Investment Market (AIM), which is known as the "junior market" to the main London Stock Exchange.

The decision to list your company is a significant one that is typically only available to relatively established companies with strong fundamentals such as impressive margins, proven profitability potential and a credible, compelling growth trajectory. Joining a stock exchange brings not only prestige but also excellent access to future sources of capital (you can sell more shares at a later date in a "secondary offering"). However, as a publicly-listed company, there are several legal and administrative requirements around disclosure of your financial statements and other information.

The IPO process requires advisors, lawyers and other professionals to be hired to comply with regulations. You can find out more in finnCap's IPO guide.

How to start thinking about what is right for you

What is your current capital structure? Have you previously taken on debt?
If so, you may not be in a position to raise further debt in case this makes your debt-to-equity ratio too high. The level of debt in your company becomes increasingly important if you're looking to go public (i.e. list on a stock exchange). Alternatively, if you have already taken on equity investors, you may not wish to dilute your ownership any further by issuing more equity.

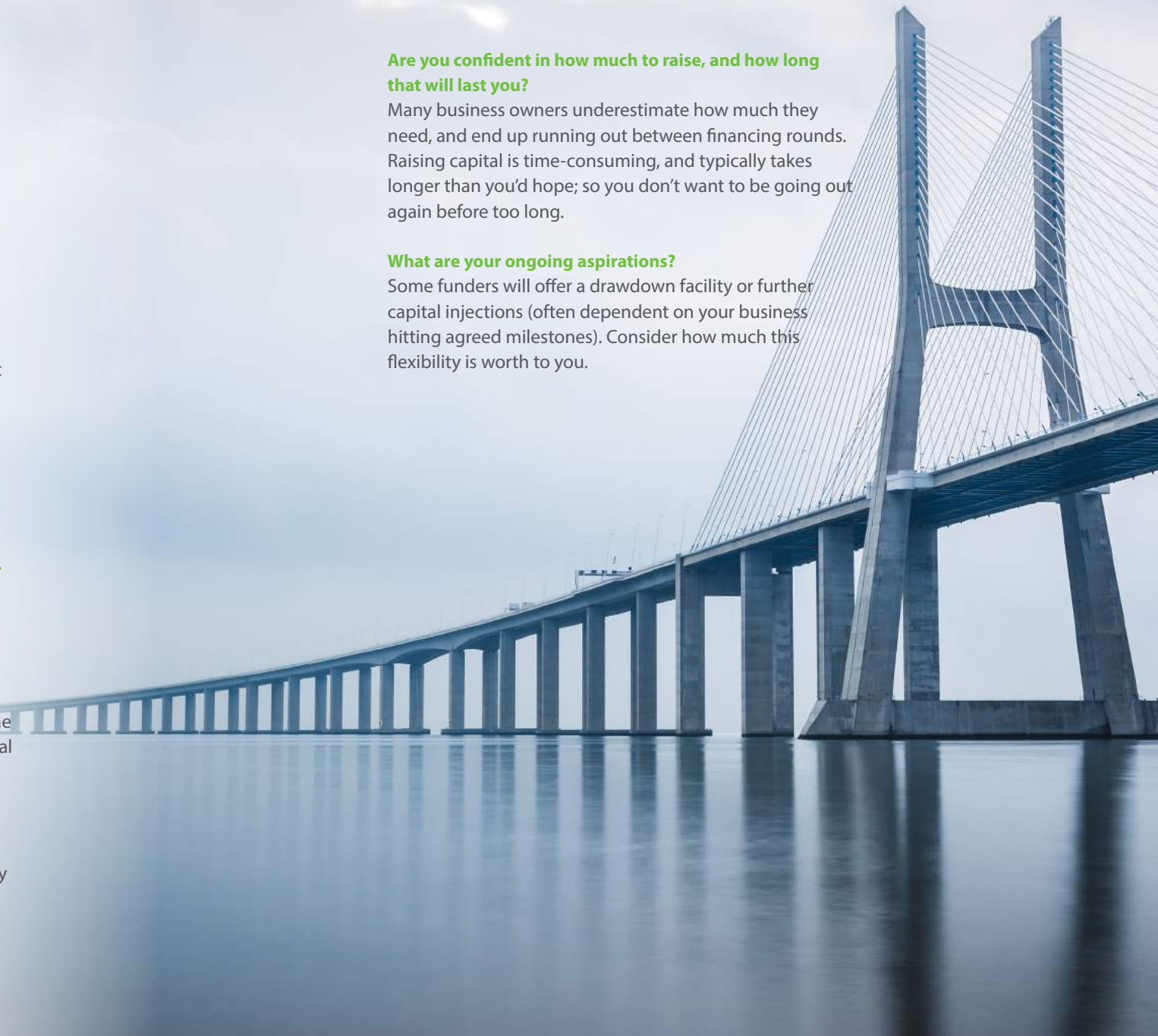
Do you simply need capital, or are you looking for wider support in growing your business?
Lenders of debt will, typically, provide the capital and not be involved any further. Some equity investors, however, will look to take a more active role in the businesses that they back, and have a lot to offer in terms of help and advice. Preserving enough equity for yourself and your team is very important, but the right investor can be game-changing in accelerating your growth.

What factors other than capital will help you realise your strategy?
Linked to the last point, it's worth thinking about your strategy and what role a lender or investor could play in helping you achieve it. Each party will bring something different to the table. For example, if you're looking to expand internationally, an equity provider with links in the countries you're targeting is likely to prove more beneficial than a large lender who does not offer a similar network.

Where are you in your business' lifecycle?
Have you considered whether raising a small round of debt now might allow you to raise equity at a significantly higher valuation down the line? Alternatively, is debt sustainable at this stage; do you have sufficient recurring cash flow to make the interest payments without hampering your growth?

Are you confident in how much to raise, and how long that will last you?
Many business owners underestimate how much they need, and end up running out between financing rounds. Raising capital is time-consuming, and typically takes longer than you'd hope; so you don't want to be going out again before too long.

What are your ongoing aspirations?
Some funders will offer a drawdown facility or further capital injections (often dependent on your business hitting agreed milestones). Consider how much this flexibility is worth to you.



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