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Small-Business Financing: Debt vs. Equity

Business owners who seek financing face a fundamental choice: Should they borrow funds or take in new investment capital? Since debt and equity are accounted for differently, each has a different impact on earnings, cash flow and taxes. Each also has a different effect on leverage, dilution of ownership and a host of other metrics by which businesses are measured. The planned use of funds will also affect the choice of financing, with one option more appropriate for certain uses than the other.

Debt

Debt can be a loan, line of credit, bond or even an IOU--any promise to repay borrowed amounts over a certain time with a specified interest rate and other terms. Debt is accounted for as a liability of the company, and interest payments are deductible business expenses. In the event of bankruptcy or insolvency, debt holders take priority over equity holders.

For a small business, debt financing has both advantages and disadvantages. On the plus side, debt can be relatively simple to secure through a bank or other financial institution and is available with a broad range of terms, allowing you to customize the debt to meet your specific needs. Whether you are seeking a three-month bridge loan or a long-term commitment, you can usually find an institution that is willing to work with you. And since most debt entails regularly scheduled payments of interest and often principal as well, debt is easy to plan around. Perhaps most important, debt, unlike equity, will not dilute your ownership interest in your company.

On the negative side, however, financing with debt can be more expensive, and you will have to meet scheduled interest and principal payments regardless of your cash flow. Although loan terms can be negotiated to build in flexibility, ultimately the money must be paid back.

Debt is most often used to fund a specific project or initiative that has an identifiable implementation time frame. It is also used as a cash flow backup in the form of a revolving line of credit. To attract lenders, you will need to have a good personal and business credit history, sufficient cash flow to repay the loan and/or sufficient collateral to offer as a second source of loan repayment. In smaller businesses, personal guarantees are likely to be required on most debt instruments. You also should not be carrying significant debt already.

Equity

Equity differs from debt in that it represents a permanent ownership stake in the company. When you finance with equity, you are giving up a portion of your ownership interest in--and control of--the company in exchange for cash. Equity investors may demand dividends or a portion of annual profits. But most investors in small businesses seek long-term capital gains on their investment, meaning that at some point these investors may look to opt out. This can mean the eventual sale of the business or the need to bring in replacement investors in the future.

The most common sources of equity financing for small businesses are personal savings or contributions from family, friends and/or business associates. Venture or seed capital companies can also be sources of new capital, although they generally deal in larger financings. If your business is incorporated, anyone contributing equity capital would receive shares in the business. If it is a sole proprietorship or a partnership, they would receive an ownership share of the business.

While equity financing can be used for many different purposes, it is usually used for long-term general funding and not tied to specific projects or time frames. The major disadvantage to equity financing is the dilution of your ownership interest and the possible loss of control. Moreover, equity investors in smaller businesses generally look for high returns over time to compensate for the risk they are assuming.

Striking a Balance

In practice, most businesses use a combination of debt and equity financing. The trick is getting the right balance. If you have too much debt, you may overextend your ability to service the debt and can be vulnerable to business downturns and changes in interest rates. On the other hand, too much equity dilutes your ownership interest and can expose you to outside control. The mix that best suits your company will depend on the type of business, its age and a number of other factors.

For a small business, a local community bank may consider an acceptable debt-to-equity ratio to be between 1:2 and 1:1, although debt ratios vary significantly from industry to industry. Startups and newly launched firms will likely be heavily weighted toward equity since they have not had time to establish a credit history and may face negative cash flow in the early years. Whatever your mix, keep in mind that you can often negotiate terms with both lenders and investors.