Business financing and the capital structure

Government, Capitalism

Raising Business Capital

As a financial advisor to this business there are two options to consider for raising business capital, equity financing and debt financing. The details, advantages, and disadvantages of both options will be provided. Also information about raising capital by selecting an investment banker will be discussed. To wrap up, the historical relationships between risk and return for common stocks versus corporate bonds will be examined. Equity Financing

In terms of equity financing it is the process of raising capital through the sale of shares in an enterprise (National Federation of Independent Business, 2011). Equity financing is the sale of an ownership interest to raise funds for business purposes. " Equity financing ps a wide range of activities in scale and scope, from a few thousand dollars raised by an entrepreneur from friends andfamily, to giant initial public offerings (IPOs) running into the billions by household names such asGoogleand Facebook" (Kokemuller, 2013).

The equity-financing process is governed by regulations imposed by local or national securities authority in most jurisdictions. The regulations are designed to protect the public from investing with unhonest operators who may raise funds from unsuspecting investors and disappear with themoney. An equity financing is therefore generally accompanied by an offering memorandum or prospectus, which contains a great deal of information that should help the investor make an informed decision about the merits of the financing (National Federation of Independent Business, 2011). Such

information includes the company's activities, details on its officers and directors, use of financing proceeds, risk factors, financial statements and so on.

Advantages

The main advantage of equity financing is that it doesn't have to be repaid. Plus, you share the risks and liabilities of company ownership with the new investors. Since you don't have to make debt payments, you can use the cash flow generated to further grow the company or to diversify into other areas. Maintaining a low debt-to-equity ratio also puts you in a better position to get a loan in the future when needed.

Disadvantages

There are tradeoffs with equity financing, the disadvantage of it is by taking on equity investment, you give up partial ownership and some level of decision-making authority over your business. Large equity investors often insist on placing representatives on company boards or in executive positions. If your business takes off, you have to share a portion of your earnings with the equity investor. Over time, distribution of profits to other owners may exceed what you would have repaid on a loan. Equity financing is different from debt financing, which refers to funds borrowed by a business.

Debt Financings

According to Investopedia, debt financing is when a firm raises money for working capital or capital expenditures by selling bonds, bills, or notes to

individual and/or institutional investors. In return for lending the money, the individuals or institutions become creditors and receive a promise that the principal and interest on the debt will be repaid (Investopedia, 2012).

Advantages

The advantage of debt financing is it allows you to pay for new buildings, equipment and other assets used to grow your business before you earn the necessary funds. This can be a great way to pursue an aggressive growth strategy, especially if you have access to low interest rates. Compared to equity financing, businesses do not have to give up any ownership or control of the business with debt financing. After the loan is paid back the businesses relationship is completed. Other advantages of debt financing are the interest on the loan is tax deductible and if the loan is fixed rate the principal and interest can be planned in the budget (Kokemuller, 2013).

Disadvantages

The main disadvantage associated with debt financing is that you have to repay the loan, plus interest. If a company does not pay back the loan in the terms agreed upon the property and assets can be repossessed by the bank. Debt financing is also borrowing against future earnings. This means that instead of using all future profits to grow the business or to pay owners, you have to allocate a portion to debt payments. Overuse of debt can severely limit future cash flow and stifle growth. Is debt financing is not properly monitored and controlled it can hurt the business. If too much debt is carried the business and owner will be seen as " high risk" by potential investors and that will limit the ability to raise capital by equity financing in the future.

Debt can also make it difficult for a business to grow if the cost of repaying the loan is high.

Investment Bank

Another option for raising capital is selecting an investment bank. They are financial institutions and individuals who assist companies in raising capital, often through a private placement or public offering of company stock. Sometimes investment bankers are referred to as brokers or deal makers. Companies frequently use investment bankers to help identify available financing options and obtain introductions to funding sources (Growth Company Guide, 2000). Investment banks also provide up-to-date advice on the conditions of fundraising for private companies. Because investment bankers make a business of raising money for companies, they can often be quite helpful to a company in analyzing its funding needs, identifying the most likely or appropriate sources for raising money and executing a fundraising strategy (Growth Company Guide, 2000).

An investment bank can help, but the quality of a company's opportunity and the strength of its management team determines the amount of options open for a given fundraising. Investment bankers also vary in quality, resources, experience and contacts. Investment bankers who are experienced with the company's industry and the type of financing it needs, can often help a company raise funds. If they are unfamiliar with the company's industry or the type of financing being sought, they may actually hinder a company's financing efforts. Common Stocks versus Corporate Bonds

It is commonly known and accepted among investors that the higher the returns on an investment, the higher the risks are. Safe investments carry low risk, but the returns are also lower. Different levels of risk apply to common and preferred stock, as well as to corporate bonds. Corporate bonds generally have the lowest level of risk of the three investment types, but also offer lower returns, even with regular dividend payments. Common stocks have the highest risk of the investments and the highest potential returns.

Common Stocks

When you purchase stock in a company during a public offering, you become a shareholder in the company. Some companies pay dividends to shareholders based on the number of shares held, and this is one form of return on investment. Another is the profit realized by trading on the stock exchange, but one must sell the shares at a higher price than paid for. The risks of owning common stock include the possible loss of any projected profit, as well as the money paid for the shares, if the share price drops below the original price

Corporate Bonds

Bonds issued by companies represent the largest of the bond markets, bigger than U. S. Treasury bonds, municipal bonds, or securities offered by federal agencies (Sandilands, T. 2013). The risk associated with corporate bonds depends on the financial stability and performance of the company issuing the bonds, because if the company goes bankrupt it may not be able to repay the value of the bond, or any return on investment. Assess the risk by checking the company’s credit rating with ratings agencies such as

Moody's and Standard & Poor's. Good ratings are not guarantees, however, as a company may show an excellent credit record until the day before filing for bankruptcy (Sandilands, T. 2013).

Risk

Corporate bonds hold the lowest risk of the two types of investments, provided you choose the right company in which to invest. The main reason for this is that in the event of bankruptcy, corporate bond holders have a stronger claim to payment than holders of common stocks. Bonds carry the risk of a lower return on investment, as the performance of stocks is generally better. Common stocks carry the highest risk, because holders are last to be paid in the event of bankruptcy.