Choosing between debt and equity finance essay

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In financial decisions, the choice between debt and equity financing is one of the most difficult ones. Both types of financing have its advantages and disadvantages. Debt financing is based on borrowing finance, and incurs debts that should be repaid in a certain time. The obligations of the company include repaying the loan and paying interest on the loan until it's repaid. Debt financing does not impact the ownership of the business, but might cause high debt servicing costs.

On the other hand, equity financing represents the exchange of finance to a part of business ownership; this is commonly done by issuing stocks. Equity financing allows to receive investments without additional payments and does not cause financial concern of investors, like debt financing does. However, since the ownership is shared, the owners have to dilute their decisive power (Grossman & Livingstone, 2009), and might even lose control of the company.

For the companies, the choice of debt or equity financing is based on many factors, such as size of the company, state and dynamics of the industry, perspectives of the company, debt-to-equity ratio, debt servicing costs etc. The purpose of this essay is to consider the decision of American

Superconductor Corporation to shift to equity financing from debt financing, made in 2003.

AMSC case

American Superconductor Corporation is a company providing wind turbine design, electrical control systems, power systems and superconductive wires (Madura, 2008). It operates mostly in Europe, North America and Pacific Asia. Before 2003, the company's investment policy was based on debt financing; however, in 2003, the decision to " forgo a secured debt financing and to adopt an equity financing strategy under current market conditions" (Esposito, 2003) was made. The company experienced recession in 2003; in October 2002, its stock prices have fallen to the record level of $2. 25, and in 2003, they constituted about $3. 36, which was very low compared even to 2002 level of $12. 26 (AMSC Stock, 2010). The company needed financing, and their choice was to issue a public equity offering instead of debt financing.

This decision was explained as strategic solution based on the consequences of 2003 blackouts, and CEO of American Superconductor, Greg Yurek, forecasted an increased need for their power grids and public attention to better voltage support with dynamic reactive power compensation (Esposito, 2003). The results of first six months of fiscal 2004 year seemed to prove the efficient of the decision to pursue equity financing, since no long-term debt was reported, and $17. 4 million revenue in the first two quarters of the year. The company also focused on wind turbines, which were gaining popularity. Wind power in 2007, for example, became the first $30B clean energy industry (Madura, 2008).

Current financial position of AMSC shows that its total revenue and gross profit values have significantly increased during the last years (2008-2010 financial information available); the company's gross margin is 39. 14% compared to 32. 19% in the diversified electronics industry in general (AMSC Stock, 2010). The operating margin is also higher: 14. 70% compared to 5. 71% industry's operating margin, the EPS is also higher (0. 64) than 0. 08 average (AMSC Stock, 2010). Although the financial position of AMSC is weaker than that of main competitor, ABB. Ltd., the company managed to override another major competitor, SatCon Technology Corporation. The industry provides a significant development potential, and the stocks of the company were not priced less than $10 since 2007 (AMSC Stock, 2010).

Analysis of financial decision

The combination of debt and equity financing impacts the company's cost of capital. Debt financing is safer for investors, while equity financing is more risky for investors, but at the same time safer for the company (Grossman & Livingstone, 2009). Since debt financing creates contractual obligations, the companies should carefully consider their ability to repay the debts. Debt servicing incurs higher costs than equity financing, and if the company experiences fast growth, it might suffer from high debt servicing expenses. It has also been shown that companies with consistent profit operating in low-risk and slowly growing industries more often opt for debt financing, while companies operating in risky and rapidly changing industries as well as in volatile ones, should choose equity financing since these companies have more opportunities for investments, and would not suffer from underinvestment (Grossman & Livingstone, 2009).

By 2003, AMSC experienced financial problems and its stocks have dropped in price, but the conditions of the environment indicated the quick growth of interest to AMSC production. It could be forecasted that in some time the company would need significant investments and 2003-2004 was the right time to expand. If AMSC continued debt financing, its growth would be hindered by debt servicing costs and worse stock dynamics. Thus, the decision of AMSC to replace debt financing with equity financing was very appropriate in this situation.

Conclusion

In order to perform the choice of business financing (debt versus equity), it is necessary to consider the perspectives of the company as well as the nature and dynamics of the industry. In 2003, AMSC was experiencing financial difficulties and its stocks have significantly fallen. However, there were many opportunities for development, and the 2003 blackouts increased the interest to AMSC production. Therefore, the company had strong potential for growth, and needed strong financing source without excess cost increase. Thus, American Superconductor Corporation performed a right decision to stop debt financing, and to issue a public equity offering. The correctness of the decision can be also traced looking at further financial development of the company: AMSC is stably growing, creates new products and shows good progress compared to its competitors.