

Business financing and the capital structure

[Finance](#)



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In their effort to expand and increase their outputs, firms can adopt various methods of raising capital. These include use of debts and equity among others. Debts includes loan from banks while equity entails looking for investors. Advantages of debt financing
One of the notable merits of using debts is that the bank or the institutions that provides the loan do not control the business. Secondly, the interest accruing on the loan is tax deductible. Thirdly, once the money is paid back the business ownership ends. Fourthly, business owners are aware of the principal and the interest. Thus they are in a position to make budgets. Disadvantages of debt financing
One of the notable demerits is that the loan must be repaid within a fixed time. Secondly, if a business experiences cash flow problems due to heavily relying on debts, it will face difficulties in paying back the loan (Daniel, 2014). Thirdly, when sales decrease during hard times, debt financing can negatively affect a firm. Fourthly, due to high costs of repaying the loan, a firm expansion process may be difficult. Fifthly, the assets owned by the business can be used as collateral by the lending institutions. Advantages of equity financing
One of the major advantages of using equity as source of capital is that it is less risky. Secondly, by involving investors in a business, its credibility improves. Thirdly, a firm will not need to use all its profit into repaying loans. Fourthly, a business will have more cash on its hand to expand its operations. Fifthly, if the business fails, it is not compulsory to pay back the investments. Lastly, since majority of the investors do not expect returns on their investment immediately, the business can maximally use the funds at the initial stages. Disadvantages of equity financing
First, the rate of return may be higher than
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that used to repay bank loans. Secondly, investors are interested with the business and may control the business an aspect that business owners may not be ready to give up (Daniel, 2014). Thirdly, business owners must consult the investors before making any major decision. Fourthly, it takes time for the management before getting the right investors. Based on the many advantages of equity financing, I would advice my client to use equity as the source of capital. It is effective not only by the huge amount of funds that the business is likely to get but also due to improved business credibility. During the selection of an investment banker, I would advice my client to first communicate with them, and note who they will contact as well as their relationship with the banker. Secondly, the investment must understand the client business segment as well significant information about the industry (Rosenbaum and Joshua, 2009). Thirdly, the investment banker must create a solid relationship with the venture capitalists who are involved within the business segment. Fourthly, the management must ensure that the motives of the banker are in line with those of the firm. For example, if the firm want large amount of funds, it must chose an aggressive banker (Fleuriet, 2008). Fifthly, the client must not just choose a banker but a partner also. In this way, the banker will professionally represent the firm. By investing with a stock, one becomes partly an owner in the company. On the other hand, by investing in a bond once becomes a creditor. As a partly owner, nothing is guaranteed since the divided depends on whether the business makes a profit. As a bondholder on the other hand, an investor expects fixed interest as his or her money back. Diversification of portfolio ensures that as the stock market continue to bounce up and down, not the entire portfolio loses value. For example, if the prices of stocks go down resulting to low returns,

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other investment vehicles such as mutual funds, cash and real estate may provide high returns to the investors. If a company in telecommunication industry for example has \$100 million to invest it can invest \$15 million in oil industry, \$25 million in retail industry, and \$30 million in transportation among other industries. References Daniel, R. (2014). Debt Financing - Pros and Cons Managed well, it can be an effective vehicle to help grow your business. Available from <http://entrepreneurs.about.com/od/financing/a/debtfinancing.htm> Fleuriet, M. (2008). Investment Banking Explained: An Insiders Guide to the Industry. New York: Mc Graw-Hill. Rosenbaum, J and Joshua P. (2009). Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions. NJ: John Wiley & Sons.