### Equity Financing and Debt Financing

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Company financing is a prior concern for operating any business, and financing is arranged before any business plans are made. Debt financing and equity financing are the two financing options most commonly pursued by companies. Debt financing refers to borrowing funds which must be repaid, plus interest, while equity financing refers to raising funds by selling shareholding interests in the company.

Most companies use a combination of these two different types of financing in the course of their business life. Loan borrowing, bond issuance, and issuance and sale of shares are the main vehicles for company financing. Direct financing from the capital markets (i.e. stock and debt markets) dominates the indirect financing intermediated by banks and finance companies. With this in mind, certain types of bank loans will require that the company maintain a balance of equity and debt (called its *leverage ratio*) that is appropriate for the industry and the stage of business in which it is operating.

#### Typical Uses for Debt and Equity Financing

Equity investment is generally required for funding the start-up plant assets and the company's initial operating expenses, as there is no track record of transactions resulting in cash flows, which the business uses in support of debt and interest payments. Presently, the stock market has been functioning well in Hong Kong, channelling substantial amounts of capital to the corporate sector.

Short-term debt is used to finance current assets that can be quickly turned back into cash; examples of this type of debt are accounts receivable and inventories. Non-current liabilities in the form of long-term debt, or loans, are used to finance long-term assets, such as the purchase of land and the construction of a building or ship.

#### **Debt Financing**

Debt financing refers to the borrowing of loans from other companies, banks, or financial institutions in order to support a business's operations. The loan principal is repaid at a later point in time, with some interest expenses being paid before the debt's maturity.

## Advantages of Debt Financing

The first advantage is <u>maintenance of complete control over the business</u>. The lender charges a company interest for the use of a loan, but the lender does not have the right to say how a company should manage its business. The ownership of the business stays completely in the hands of the corporate directors and shareholders. This also means that lenders will not be entitled to any of the profits that companies make from the business; the borrowing company is merely required to repay the loan within the fixed time period.

Debt financing is appropriate for companies which pursue an aggressive growth strategy, especially when they have access to low interest rates. Though a company may lose some of its assets if it is unable to repay its loans, the company won't lose corporate control or ownership to outsiders. Companies wishing to make use of debt financing are recommended to seek appropriate legal advice from the company's lawyers and accountants for better information on asset protection.

The second advantage of debt financing is related to loan repayment interest. Companies can deduct their interest payments (but not the principal repayments) as a business expense. The interest rate which a company pays is usually based on the prime interest rate, and the interest that the company has to pay on a company loan is tax-deductible. This means that debt financing covers up part of a company's business income from taxes and reduces the company's tax liability.

The third advantage to debt financing is credit maintenance. Continuity of debt borrowing can help to establish a company's record of creditworthiness. This will prove beneficial in the future when a company seeks to obtain bank loans and to achieve competitive company insurance rates from banks.

#### Disadvantages of Debt Financing

The first major disadvantage of debt financing is that companies need to pay back not only the principal of the loans, but also the interest, which may create a financial burden. This financial obligation must be treated as a liability on a company's statement of financial position. Since a company will often choose to borrow funds to pay for its business operations, the company may end up committing itself to large business expenses, thereby forcing it to transfer its holding rights to another company. The company may also be under pressure to repay its loans with cash that it badly needs for some other aspects of its business, and the company's business will suffer as a consequence.

The second disadvantage of company financing concerns the process of securing a loan. If companies borrow from banks or other financial companies, they will often be required to pledge company properties as collateral to secure the loan. This means that if a company does not repay its loans, then the lender can take the properties and sell them on the market in order to recover the value of the loan obligation. Thus, if a company pledges its business assets as collateral for the loans, and it is unable to pay back its creditors, then the company may lose important corporate assets.

Similarly, if a company pledges its personal assets, such as company properties or its stock portfolio, then it may risk losing them to pay back business loans.

The third disadvantage of credit financing is that obtaining business loans can be very difficult if a company does not have a good credit rating and strong track record of loan repayment. Furthermore, if a company carries too much debt, then that company may come to be seen as "high risk" by potential investors; this will limit the company's ability to raise capital via equity financing as well; this constraint can severely limit future cash flow.

The fourth disadvantage of debt financing is that debt can stifle a company's growth because of the high cost of repaying the loan, especially in the case of repaying compounding interest. This in turn increases a company's risk of bankruptcy. Related to this and the previous point, banks will often not accept a high leverage ratio for company, as high leverage ratios can be seen to be very risky. In such a scenario, a company may instead have to resort to the use of equity financing, i.e. issuing share capital, to balance its sources of financing.

# **Equity Financing**

**Equity financing** refers to the issuing of shares to investors in order to support a company's business operations. This mode of financing is especially important during a company's start-up stage. In this method of financing, investors make gains when there is an increase in the share price, as well as through the distribution of dividends by the company in which the investor has purchased a stake.

#### Advantages of Equity Financing

The first advantage of equity financing is that it offers another source of funding besides arranging for loans from banks or other financial companies. A company may use funds from business investors when it begins its business operations to cover the start-up costs. The company can then use the cash flow from its operations to directly grow the company or to diversify into other areas. Related to this is the fact that investors tend to take a long-term view, and typically don't expect an immediate return on their investment. This allows the company to keep more cash on hand to expand the business, rather than having to pay a portion of its profits to repay loans. For this reason, this method of financing is less risky than debt financing because the company doesn't have to pay back its shareholders. This fact also makes equity financing a good option when a company cannot afford to take on (more) debt.

A second, related advantage to equity financing is that equity financing helps to confer legitimacy, by enabling companies to tap into investor networks and thereby to enhance their credibility.

The third advantage of equity financing is that if companies have prepared prospectuses for corporate investors and explained to them that their money is at

risk in the companies' brand new start-up business, then investors will understand that if the business fails, they will not get their investment back.

Finally, equity financing offers additional advantages in terms of management of the company. Some prospective investors may be able to offer valuable business assistance that a company may not be able to provide for itself. Investors provide invaluable assistance in the form of management expertise, business contacts and access to other sources of capital. Quite a number of good investors and Venture Capitals assume the role of business advisors or even come on board fully as part of the management team. This can be important, especially in the start-up period of a new business.

## **Disadvantages of Equity Financing**

The most important disadvantage is that investors must be granted some ownership of the company and a certain percentage of the profits. If the company's business takes off, then the company will have to share a portion of its earnings with the equity investors. Over time, the distribution of profits to shareholders may exceed the sum that a company would have had to pay for loans.

Venture Capitals often request an equity stake of 35–51%, especially when companies are just start-up companies without a strong financial background. The potential for equity financing may be limited for this reason, as company directors are sometimes unwilling to dilute their controlling power through equity financing.

#### **Concluding Remarks**

The decision on the arrangement and combination of debt and equity used to finance a company's growth depends on a number of different business factors, especially the availability of sources of funding, the respective industry in which the company is operating, and the relevant banking requirements.

Finally, companies have to maintain good networks and collaborative relationships with banks and financial companies for the sake of future fundraising, regardless of whether they wish to pursue equity or debt issuance.