Equity or Debt? A Primer for Entrepreneurs

Executive Summary

Clients frequently ask what form of capital is right for their situation – equity or debt? I've gotten this question enough times to put together a basic primer covering the topic for not only my clients but other business owners, entrepreneurs and people who might find this helpful.

The answers range from simple to complex because each company's situation is different and the answer changes at different stages in a company's lifecycle.

Equity is really the only choice for startups and very early stage companies. However, as a company progresses, debt becomes a viable and potentially attractive option. If you have a high growth business, selling an equity stake to investors early in your business' lifecycle could prove to be more costly than debt. This is because the valuation of your business will increase as it grows and becomes more successful. Equity investors who buy a stake at a low valuation get a disproportionate return as the valuation of your business increases.

If you were to borrow the capital rather than selling equity, the loan could cost you significantly less over time. This is because the payback of a loan is a fixed amount with interest whereas the payback of an investor's equity stake will increase as your business grows in value. However, there are many other factors to consider in your decision of whether to raise equity or debt.

A Basic Comparison of Equity and Debt

First, what exactly are equity and debt?

In a nutshell, **equity** represents ownership in business that has no "maturity date" while **debt** is borrowed money that must be paid back over time with interest. Equity provides the most flexibility to founders while debt can be more restrictive.

Startups and early-stage companies typically rely on equity for their initial funding since they generally don't have assets or cash flow to support a loan. As a result, these companies really don't have much of a choice – equity is the only option at this stage.

Equity is raised by startups and early-stage companies in "rounds" which include "Seed", Series A, Series, B, etc. Equity at the seed stage is typically provided by friends and family who know the founders personally and trust them. When a company is just getting started, the risk is high since the prospects of the company are uncertain. Therefore, a company's valuation at this stage is lower than it might be in the future, which makes raising equity "expensive" to the company and its founders (more on this later). In other words, the founders must give up more equity to entice investors to take the risk.

As the company grows, the risks become more well-defined, the valuation generally increases and the amount of equity that must be granted to investors declines. Therefore, the equity becomes less "expensive". In addition, as a company grows and begins to generate profits and cash flow, debt becomes a viable option. Therefore, the choice between debt and equity becomes more relevant at this stage.

Debt is money borrowed from a lender. A business loan carries an interest rate and must be paid back by a certain date, generally within 1-5 years. Debt is typically secured by assets and has various restrictive covenants that a borrower must abide by. If a company loses money, it may trigger debt to be paid off, putting further pressure on a borrower, whereas equity holders simply lose the value of their investment if the company's performance or prospects diminish. While equity provides more flexibility to the company, this comes at an additional financial cost to the founders. The table below summarizes the differences between equity and debt.

	Equity	Debt
Company Stage	Seed stage and later	Generally after seed stage and typically requires revenues, positive cash flow and/or assets
Ownership Stake	Yes	No
Sizing Based On	Valuation of company and percentage ownership stake	Assets and/or cash flow
Required Payback	Potentially never or upon future investment rounds	1-5 years
Operational Flexibility	High	Medium to low
Collateral	Not Required	Generally required
Interest Rate	No	Yes
Dividends	Yes, but generally later than seed stage	No

	Equity	Debt
Timing of Return to Investors/Lenders	Variable and irregular	Fixed and regular
Tax Implications	Dividends aren't tax deductible	Interest is tax deductible
Board Seat	Generally yes	No
Potential Loss of Control	Yes, if shareholders obtain 51% or more ownership stake	No, except in a financial distress situation or bankruptcy
Financial Risk to Founders	Low	Medium to high
Types	Preferred stock, common stock, SAFE[1]	Revolver, term loan, borrowing base loan, cash advance, factoring, equipment financing, lease, mortgage, convertible note[2], bond
Nature of Cost of Capital	Claim on earnings (through dividends) and share of proceeds upon a sale of the business	Fixed interest expense
Overall Cost	High	Medium to low

[1] A "Simple Agreement for Future Equity" of "SAFE", is a simple and fast way for very early stage companies to raise equity.

[2] A convertible note is a hybrid between debt and equity. As the name implies, the debt is convertible into equity under certain circumstances. Many early stage companies can raise convertible debt even before they have significant revenues and/or assets.

To complicate matters a bit, a common form of financing is a "convertible note", which is a hybrid between equity and debt. A convertible note is a loan with a stated maturity and interest rate but that can be converted into equity if certain conditions occur. A convertible note is appropriate in certain circumstances.

Equity vs. Debt: Comparing the Costs

I previously mentioned that equity can be "expensive". Let's walk through a simple example to explain what I mean by that.

Let's assume that you run a small business and need $2MM for a new project you're planning. Your business generates $10MM of revenue and $2MM of earnings before interest and taxes ("EBITDA") annually. EBITDA is generally used as a proxy for the cash flow that your business generates before you pay taxes. Lenders and investors consider this useful since it indicates how much cash flow your business generates and that is available to service a loan or pay dividends to shareholders.

Let's assume that you can sell $2MM of equity for a 20% stake in your business. In this case, the profit before taxes in year one that you as an owner would collect is $1.6MM (80% of $2 million).

Let's further assume that instead of selling equity you are able to obtain a $2MM loan at a 10% interest rate, which would be typical for a company of this size. The interest expense on the loan for one year is $200,000 which would imply that profit before taxes on your $2MM in EBITDA would be $1.8MM ($2MM less $200,000 of interest expense).

Therefore, **the additional cost of selling equity in year one would be $200,000**.

The difference in cost can potentially be more pronounced when you sell your business. To demonstrate this, let's assume that you choose to sell your company in three years since your business has done well. Revenues in year three are $20MM and EBITDA is $5 million.

Businesses that achieve $5MM of EBITDA are generally valued more highly than those below that threshold. It is common for such companies to command a 7.0x EBITDA multiple or greater in a sale, while smaller businesses might sell for a 4-5x multiple.

Let's assume that a buyer pays 7.0x EBITDA, or $35 million, for your business. If you had sold the $2MM of equity for 20% of your business in year one, the <u>net proceeds to you as the owner would be $28.0MM</u> ($35MM less the 20% share that your shareholder owns).

If you had chosen to take a loan in year one rather than selling equity, then the <u>net proceeds to you as the owner would be $32.4MM</u> ($35MM less the $2MM loan less the $600,000 of total interest you paid over the three year period).

See a comparison of the two scenarios below:

($ in millions)	Year 1	Year 2	Year 3
Revenues	$10.0	$12.0	$15.0
EBITDA	$2.0	$3.5	$5.0
EBITDA Multiple	4.0x	6.0x	7.0x
Valuation	$8.0	$21.0	$35.0

($ in millions)	Equity Financing	Debt Financing
Transaction in Year One	$2MM of equity for 20% Stake	$2MM Loan at 10% Interest Rate
Allocation of $35MM Sale Proceeds in Year Three:		
To Founder	**$28.0**	**$32.4**
To Equity Investor	$7.0	$0.0
To Lender (including interest)	<u>0.0</u>	<u>$2.6</u>
	$35.0	$35.0

Therefore, **the additional cost of the equity over the three year period is $4.4MM** (or $32.4MM - $28.0MM).

There are two reasons for this large difference: 1) the <u>growth in EBITDA</u> from $2MM in year one to $5MM in year three and 2) the <u>growth in the EBITDA multiple</u> from 5.0x in year one to 7.0x in year three. This second phenomenon is sometimes referred to as "multiple expansion".

When you sold $2MM of equity in your business for a 20% stake in year one, the investor "paid" a 5.0x multiple. In other words, a $2MM investment for a 20% stake implies that your company was valued at $10MM on a "post-money" basis at that time, which is 5.0x year one EBITDA of $2 million.

When you sell your business in year three at a 7.0x multiple, the buyer is paying a significantly higher price than the initial investor did. Said another way, selling equity in year one at a 5.0x multiple turned out to be very expensive to you as the owner when you consider how much more valuable your business is three years later.

Even if there was no multiple expansion over the three year period, the equity would still have cost more than debt because the EBITDA generated by the business grew during the three year period. If you sold your business for a 5.0x multiple of EBITDA in year three rather than 7.0x, the additional cost of the equity would be $2.4 million.

However, the additional <u>financial</u> cost of the equity has to be weighed against other factors. You may place a high value on the operational flexibility and lack of a maturity date that equity provides. Or an early investment from an equity investor may represent "strategic" value to your business. That investor might have operational know-how or relationships that could greatly benefit your business, so bringing that investor on board could be worth more than just the financial investment.

Debt does increase the financial risk of your company. If your business falls into financial distress, you may not be able to repay the debt obligation when it comes due. You could potentially lose control of your entire business to the lender. In this case, selling equity in year one would have been preferable in hindsight.

In many cases, a combination of equity and debt may be either preferable or necessary. You may choose to raise a combination of equity and debt in order to better balance operational flexibility, cost and financial risk. Or lenders may require that a portion of the financing be in the form of equity to reduce financial risk. Therefore, determining the mix of equity and debt requires not only an assessment of your business and long term goals but also an understanding of the requirements that lenders and investors have.

Conclusion

Founders must take many factors into consideration when choosing between equity and debt financing. The right choice for you is based on the prospects of your business, your tolerance for risk and confidence in how fast your business can grow. There are other issues to consider such as:

- How much equity or debt <u>should</u> you raise?
- How much equity or debt <u>can</u> you raise?
- What are your plans for future acquisitions?
- When do you plan to sell your business?

In addition, lenders and equity investors have their own preferences and requirements that may not align with yours. These are all subjects for further discussion. However, understanding your options as well as the economic and strategic impacts of those options is the first step in a process that better positions you to make the decision that is best for you and your company.

About the Author

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