Choosing the Right Capital Structure for Your Business

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Los Angeles and Southern California business owners and entrepreneurs often find themselves in situations where they need to raise business capital for one reason or another. Maybe they want to grow their companies and need a capital infusion to purchase more inventory, add more employees or expand their operations. Alternatively, they might simply need additional working capital to cover monthly cash flow shortfalls.

Owners have three main options when it comes to raising and obtaining business capital: debt, equity and retained earnings. Determining which option is the best one depends on the specific business and financial circumstances your company is facing and your specific financing need. This often requires a high level of financial sophistication to properly analyze the options and make the right choice.

In this article, we will describe these three capital acquisition strategies and explain some of the pros and cons of each one.

Debt: Traditional Bank Loans and Lines of Credit
The most common source of debt financing for most businesses is a commercial bank. There are five main types of bank business loans:

1. Line of credit — This is a common type of bank loan. It enables your business to borrow up to your credit limit whenever you want, without having to reapply when money is needed. It's often a good idea to establish a line of credit before you actually need to borrow money so it's readily available when you do.

2. Term loan — These are amortizing loans typically used to finance the purchase of fixed assets like plant, property and equipment. Unlike lines of credit, term loans are longer-term in nature and should match the depreciable or useful life of the asset being financed. Term loans may also be used to finance permanent investments in accounts receivable or inventory.

3. Commercial mortgage — These are used to finance the purchase of new or existing commercial property, including office buildings, warehouses and retail space. In addition, banks may offer construction loans to finance the purchase of land and construction of owner-occupied plant and buildings. Commercial mortgages and construction loans may be amortized for a period of up to 15 or 20 years.

4. Lease — Leasing is sometimes an attractive alternative to buying equipment, especially assets with built-in obsolescence (like computers and other high-tech equipment). At the end of the lease term, you can easily upgrade or replace equipment that is outdated. Leasing may also offer tax benefits and help free up cash flow, since 100 percent of the cost of equipment can be financed.

5. SBA loans — The U.S. Small Business Administration (SBA) offers several types of loans that are designed specifically for small businesses. These include 7(a), 504 and SBA*Express* loans. The SBA guarantees a portion of the loan, which enables banks to make loans that they might otherwise consider to be too risky.

Keep in mind that bank loans typically include strict conditions, such as a fixed repayment term with minimum payment amounts, required submission of detailed financial reports, and covenants that require the company to meet certain levels of performance and/or restrict certain types of business activities. They may also require the owner to personally guarantee the debt by pledging personal assets as collateral, including his or her personal residence. If a business cannot qualify for a loan from a commercial bank, there are a large number of alternative lending sources. While some of these may be relatively expensive, they can often be more flexible than the banks. It is important, however, to fully understand the terms of such loans and to seek advice from qualified professionals when considering such options.

Equity: Bringing in Outside Partners
With equity financing, outside investors provide money in exchange for shares of ownership in your business. Unlike debt, equity does not have to be repaid with interest. However, selling equity shares in your business divests existing shares — each share you sell to an outside investor is a share that comes out of your or your partners' pockets.

Equity investors look primarily for companies that they believe will achieve rapid growth in order to provide them with a high rate of return on their money. They usually want to have an "end game" for the companies in which they invest. In other words, they want to know that they can cash out their ownership within a certain period of time in order to realize their return. Some equity investors also seek to take an active role in the management and operations of the companies in which they invest.

The cost of equity financing depends on many different factors — mainly, the risk investors perceive of investing in your business compared to the potential reward if the business is successful. The higher the perceived risk, the more ownership investors will expect in return for financing. Investors will scrutinize your business plan to try to determine your prospects for future success and the degree of risk involved in the business.

There are two main types of minority equity investors: venture capitalists (VCs) and angel investors. Angels are usually wealthy individuals looking primarily for early-stage and start-up companies or entrepreneurs with whom they have a personal connection, or that are in industries that they personally believe in and want to support (like green energy, for example). Angel investments are usually smaller than VC investments — typically between $25,000 and $35,000 per company, although it is not uncommon for a group of Angel investors to collaborate for a larger total investment. VCs, in comparison, may invest millions of dollars in a single company.

Retained Earnings: Best of Both Worlds
If your business is generating enough cash from operations, it might be possible to meet your financing needs with earnings that are retained in the business. This is obviously the least costly way to raise capital — you don't have to pay interest on a bank loan, nor do you have to give up equity shares to outside investors. Increasing the cash flow from your retained earnings is primarily a matter of increasing your sales and improving your cash management practices. For example:

- Are you negotiating with vendors to receive the best possible payment terms?
- Are you aggressively managing your receivables by staying on top of collecting past-due accounts and minimizing bad-debt losses?
- Are you prudently managing your inventory by using such techniques as just-in -time inventory management techniques?
- Have you considered factoring your invoices in order to shorten your cash flow cycle and accelerate funds availability?

Reliable Financial Statements and Forecasts
While there are many different factors that go into determining which capital acquisition strategy is best for your business, there is one thing that is constant regardless of the option you choose: the need for credible and reliable financial statements and forecasts. Lenders will want to see current financial statements and projections when evaluating your loan request, while investors will want to see detailed financial data as they perform due diligence on your company's finances and operations. And generating financing internally via retained earnings requires accurate forecasts in order to project future cash flow and funds availability.

Many small and mid-sized businesses do not possess the financial sophistication necessary to analyze their capital acquisition options and make the right decisions. An outsourced CFO services provider offers this level of financial sophistication, as well as contacts in the investing and lending communities, and is able to help owners and entrepreneurs choose the best option for their business, given its particular circumstances and financing need.

Concluding Thoughts
You have three main options if you need to raise capital for your business: debt, equity or retained earnings. Determining which option is the best one depends on the specific business and financial circumstances your company is facing and your specific financing need. Regardless of which option you choose, you will need to be able to generate credible and reliable financial statements and forecasts. If you do not possess the financial sophistication necessary to properly analyze your capital acquisition options, consider hiring an outsourced CFO services provider. This professional will bring a high level of financial sophistication to the table to help you choose the best capital structure for your business and negotiate fair terms with chosen lenders or investors.

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