Managing and Financing Business Growth

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If you ask ten CEOs or CFOs if they want to grow their business, ten will probably answer with an emphatic "Yes!" After all, a business that isn't growing is either stagnant or, worse, in decline.

But growing just for growth's sake isn't necessarily the best strategy. While reviving a stagnant or declining business is certainly challenging, growing a business to the next level brings many challenges of its own—especially with regard to financing. Growth requires money, and lots of it—for things like equipment, inventory, staff, marketing and sales—which can severely strain a business financially. CFOs who don't carefully plan for the impact that growth can have on their finances can literally grow their companies out of business.

For example, the higher sales that result from growth usually mean that an increase (often significant) in both receivables and inventory will be required to support the additional sales. The main question CFOs must answer is simple: Where will this cash come from? There are only two sources: owner's equity (in the form of personal savings or retained earnings) or outside financing, whether debt or equity.

Pros and Cons of Debt and Equity

There are advantages and disadvantages to both types of outside financing. Debt, of course, must be repaid with interest within a particular time frame. Meanwhile, the lender (usually a commercial bank) may place certain restrictions on a company's financial and other operations (these are known as loan covenants) that may limit moves that can be made and opportunities that can be seized.

Equity, on the other hand, does not have to be repaid—but that doesn't mean it's free. In exchange for cash, equity investors (usually venture capitalists, private equity firms and angel investors) receive a share of ownership in the business.

So which is preferable—debt or equity? It depends on whether you want to "pay now or pay later." Servicing debt may put a strain your current cash flow that equity financing will not impact, at least not right now. But there's no way of knowing now what future equity shares in your business will be worth. For example, imagine if a venture capitalist had secured a 10 percent ownership stake in early-stage Microsoft in exchange for $100,000 in growth capital. That would have turned out to be very expensive financing, given how the value of Microsoft stock has soared over the years since the company first went public.

The hard cost of a loan, on the other hand, is simply the amount of interest paid, which is relatively predictable. Also consider that equity investors expect to receive high rates of return on their investments—usually at least 25 percent per year. Therefore, most financing experts generally believe that debt financing is preferable to equity financing if your business can qualify for a loan.

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Easier Said Than Done
Since the financial crisis, however, it has become harder for many companies to obtain business loans. Most banks have tightened their underwriting standards and lending criteria considerably in order to minimize potential loan losses and meet strict new regulatory guidelines for minimum capital requirements.

Bankers will pay especially close attention to these areas as they consider whether or not to lend money to support your company's growth efforts:

Your personal creditworthiness — Most banks today look carefully at what's referred to as global cash flow—or the aggregate of the business' finances and the owner's personal finances—when analyzing business loan requests. Therefore, you should strive to build and maintain a strong personal credit profile and credit score, as well as a strong business credit rating.

Owner's equity and personal guarantees — Banks generally expect owners to be willing to invest some of their own money into their growth plans. In other words, you should have some of your own "skin in the game." The bank may also require you to personally guarantee the loan, including pledging your primary residence as collateral for the debt.

Your business plan — If the purpose of the loan is to support growth, the bank will want to see a business plan that details how the money will be used to grow your business, how much money is required to achieve this growth, how the money (and interest) will be repaid, and how much owner's equity you will be contributing.

Concluding Thoughts
With signs emerging that the economy may be on the upswing as we head into 2013, many Los Angeles and Southern California CEOs and CFOs are thinking about how they can shift their companies back into a growth gear. As you plan your growth strategies for the new year, be sure to factor in the effects that growth may have on your company's finances. An outsourced CFO services provider can help you plan for the financial impact of growth to help make sure that it doesn't result in unintended—and dangerous—financial consequences.

About CFO Edge
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