**What You Should Know About Equity Financing**

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In our last article, we talked about debt as one of the two main ways that businesses can receive an outside cash infusion. The other way is by selling ownership shares in the company to outside investors, which is known as equity financing.

Debt financing is simply a loan, usually provided by a commercial bank, that must be repaid with interest and according to certain terms. Equity financing is very different. Here, investors (usually venture capitalists, private equity firms or "angel" investors) provide money in exchange for shares of ownership in the business.

**Which is Best?**
Neither type of financing is inherently better or worse than the other. Instead, the right type of financing depends on the details of each business situation.

The main benefit of equity financing is that the money does not constitute a loan, so it does not have to be repaid. But this doesn't mean that it's "free" money—far from it. Selling equity in a business divests existing ownership shares. In other words, each share of ownership in your business that you sell to an outside investor is a share that comes out of your pocket, or the pockets of your partners. And these shares have an unknown future value.

Consider Apple, for example. Imagine if an early-stage investor was able to secure a 10 percent ownership stake in the company in exchange for start-up financing. At the time, nobody knew whether Apple would flame out like many other start-up computer companies or become successful. History has demonstrated that giving up a 10 percent ownership share of Apple in exchange for start-up financing would have been a very costly mistake by the owners.

Equity investors look primarily for companies that they believe will achieve rapid growth quickly in order to provide them with a high rate of return on their money—typically, at least a 25 percent return per year. This is because there is also a high degree of risk in equity investing. Investors know that there will probably be some strikeouts along with the home runs they hope to hit.

Investors also want to have an "end game" for the companies they invest in. In other words, they usually 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 seek to take an active role in the management and operations of the companies they invest in. This is something that should be discussed openly during negotiations and agreed upon by both sides before new investors are brought on board.

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**Types of Equity Investors**

There are two main types of 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. VCs, in comparison, may invest millions of dollars in a single company.

How much does equity financing "cost"? This depends on many different factors, the main one being the risk level of investing in a 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 the business plan to try to determine your prospects for future success and the degree of risk involved in the business.

The ultimate type of equity financing is going public—a complex, expensive and time-consuming process that leads to what's known as an initial public offering. In an IPO, shares of a company are made available for the public to buy via a major stock exchange (such as the New York Stock Exchange or the NASDAQ). There is high risk in an IPO, but also potentially high reward, as most of the world's largest and most successful businesses are public companies.

**Concluding Thoughts**

It can be difficult for Los Angeles and Southern California CEOs and CFOs to know which type of financing—debt or equity—is the best option for their company. Bringing in an outside expert can sometimes help, since he or she can look at the situation objectively and through fresh eyes. If you need help determining which type of financing is the best choice, you may want to talk to an outsourced CFO services provider who can offer specific guidance for your situation.

**About CFO Edge**

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