CFO Success Series: Treasury Part 3 - Equity

In their eagerness to get to market, companies may be rash in selecting financing and take the first solution they come across. A sound financing strategy is one of the most important pillars of corporate growth, and – done well – it can benefit your company long into the future.

Last month, we wrote about capital planning and using debt to finance your business. Here we explain equity financing and when you should consider it.

Broadly speaking, financing is divided into two categories: debt and equity. While debt carries the promise of repayment, frequently with interest, equity provides an ownership stake in a company and the expectation of capital appreciation, as well as possible dividend payments.

Types of Equity

- Common Stock
- Preferred Stock

Hybrid Debt/Equity

- Mezzanine Debt

Equity financing involves selling an ownership interest in a company with no repayment obligations. New equity funding is normally viewed by owners as less desirable than debt, because it dilutes ownership and reduces their control of the company. However, when not enough debt is available to cover capital needs, companies frequently tap into the equity market.

An upside to equity financing is that equity investors can often bring technology, intellectual property or other strengths to a business that debt providers cannot. In these cases, diluting the current ownership stake may be a small price to pay for the benefits a new equity investor brings.

1. Common Stock

Common stock provides buyers with ownership rights (capital appreciation and voting rights) in the company and the opportunity to receive dividends. This is the most common form of equity issued.

2. Preferred Stock

Preferred stock provides an ownership interest and fixed dividend payments, which give it debt-like characteristics. Like common stock, most preferred stock is classified under the “Owner’s Equity” section on the balance sheet.

The Equity Alternative

Generally, the riskier the company and the riskier the investment, the more difficult it will be to raise debt. At some point along the risk spectrum, the only new outside capital available to a business will be in the form of equity. When new equity is added to a company's balance sheet more "default protection" is provided to debt holders, potentially increasing the debt capacity of the company. Because of this, new equity issues are frequently accompanied by new debt.

When considering an equity issue, many topics arise that do not occur with a debt issue. Governance matters, board representation, stock valuation (for private companies) and dividend policy (to name a few) require more detailed documentation than required for most debt financing.

Investors risk more through equity investments than lenders do with loans; however, the rate of return on an equity issue is expected to be much higher than the return on most debt instruments.

3. Mezzanine Debt

Mezzanine debt has characteristics of both debt and equity. On one hand, mezzanine debt is not secured and has a relatively high interest rate. If a company can't repay the debt, the lender may trade its debt or exercise options for an equity stake. On the other hand, like equity, mezzanine debt requires intense documentation. Mezzanine debt is typically classified as a liability on the balance sheet, but special terms and certain market conditions can cause part or all of the financing to be classified as equity.

Use mezzanine debt when you prefer to issue debt but are not able to raise it through traditional means.

Conclusion

Going to the equity market is frequently a last resort for business owners because they do not want to give up control or ownership of their company, and they do not want to be obliged to pay dividends. For these reasons, small business owners often decide to avoid the equity market, even when it means sacrificing growth opportunities. However, equity investors may bring technology and other resources to your company that could be a catalyst for profit and growth. Consider equity financing when you need capital but cannot raise it by borrowing.

Catch up on our CFO Success Series:

Treasury Part 1: Capital Planning

Treasury Part 2: Debt Financing