FINANCIAL POST

A comfortable debt

Chris Hondros, Getty Images Files

Choosing the right financial structure is key to the survival of Main Street businesses.

Brad Cherniak, Financial Post · Sunday, Jun. 6, 2010

These days there is a lot of debate and discussion about when to raise capital and how-- and about the frightening lack of its overall availability.

There is less discussion about what kind of capital to raise and why. But in my experience, the type of capital is nearly as critical as the amount and timing to the success of growing private companies. Too often, I've seen companies effectively strangled by their capital structures. The bottom line is a bad balance sheet will almost always trump a good business.

Here are some scenarios and how to raise capital for them:

HIGH GROWTH COMPANIES

Whatever stage your company is at, if it is increasing annual sales more than 20% or 25% a year, particularly if it is not yet generating profit from operations, you need straight, simple common equity. Debt is generally bad -- particularly subordinated debt, which tends to masquerade as equity in the market -- but also senior-term debt, assuming you can get it. Preferred shares are trickier and a topic for another day.

Growing businesses consume capital in unpredictable ways, so adding interest charges and principal repayments to your obligations only makes your business harder to manage, tightens liquidity and increases the risk of an operational calamity, as well as a financial one. Debt service is just another chainsaw to juggle while on a unicycle pedaling around the circus tent that is the world of entrepreneurism.

Senior bank loans, or operating lines of credit, are a whole different kettle of fish. They are not a source of capital, but rather a source of liquidity and a way to reduce the overall cost of capital. This is one of the most misunderstood fundamentals of private business. For most growth firms not yet reporting profit, this is a moot point, as few will qualify for an operating line of any magnitude.

COMPANIES WITH CONTINUING OUTSIDE CAPITAL REQUIREMENTS

Your company may be larger and more mature, and may or may not be profitable, but is looking to grow beyond the confines of regular organic growth. You may be a serial acquirer looking to roll up or consolidate in your industry, or have a growth arc so high you cannot generate the profits to fund your growth -- many technology firms fall into this category. You should be under no illusion your most recent capital raise is your last.

It behooves you to raise equity aggressively, not debt. You need to keep your balance sheet as simple as possible. The minute you raise significant amounts of term debt, you may have put your strategy at risk, because that debt must be serviced, and existing creditors will not welcome additional rounds of debt the way equity investors will.

There are sticky issues of security and covenants and risk preferences and priorities. It is not impossible to raise multiple subsequent rounds of debt, but much harder to do than equity.

And SMBs do not need to make financial transactions any more difficult, complex and fragile than they are now. It is much easier to raise debt to pay a dividend or leverage up your equity down the road when you are a much bigger, more profitable and robust company.

You may be thinking, "I am not being offered equity capital, only debt with covenants and service requirements, so what should I do?" There is no question investors will usually prefer the relative safety of a debt instrument over a share certificate with few special rights. And this may be your only alternative.

Clearly, the theory and market realities must mesh. If you can't obtain straight common equity capital, the limitations and risks of debt can be balanced by its lower cost in shareholder dilution, and against the alternative of having no additional capital to work with.

Still, the analysis of whether you are better off with debt versus no additional capital is not a slam dunk. This is one of the most critical decisions companies must make, and they had better do their analysis comparing apples to apples and choose the option that is truly the best for them.

The right decision may be to step off the growth accelerator until market conditions improve -- stay smaller, but maintain operating flexibility and retain control of your company. To make the right decision, you need to consider what your business is today and for the next five years and honestly determine what capital structure is best for it. Never assume one dollar of investment is as good as another.

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