



CONSULTING SCOOP



Debt and Equity Issues

[By Mo Aiken]

The most basic means of evaluating a business is the balance sheet. This organized and standardized presentation of the assets, liabilities, and equity reveals the most fundamental capability of the business to conduct business. Reviewing static balance sheets over time reveals a great deal about the dynamics that the business is going through. Of course, the balance sheet is neither the defining view of a business nor is it the only thing that you need to analyze a business, but it usually gives you a clue as to which issue you may want to look at next.

Growing assets are surely a good sign, but they cannot tell the whole story. Debt and equity combined make up the “other side” of the balance sheet. Debt (liabilities) is relatively well understood. In our personal finances, we have *only* assets and liabilities, and all liabilities are essentially debt issues. Equity is often calculated as assets – liabilities = equity.

Getting funding through debt is akin to personal debt, such as a mortgage. The critical issues include the following: reliability of debt repayment (credit score); amount of debt to the value of the collateral; and income sources to provide the payments. Some other attributes are involved in business debts that wouldn’t be involved in personal debt. For instance, a seemingly great business profile with less than three years of taxed operations will very likely not be funded by normal banking institutions.

Funding through equity is not anything like personal debt! These funding sources are very different than those in the debt area. A few banks will use equity (stock) as a collateral device, but that is still a debt issue. Equity funding involves a huge variety of options!

The reason for the multiple options is that the risk-to-reward options and models expand when you open those options. Firms specialize in different risk-reward areas. Private equity firms, investment bankers, venture capitalists, and “angels” are the more recognized names in the area of equity financing.

The equity funding organizations have a varied set of “terms” that they can offer — far more and with greater flexibility than bank or other debt lenders. There are a number of possibilities in these areas including debt instruments that can be turned into equity (convertible bonds), options for stock, option money for the right to purchase equity under a certain condition, and so on.

In order to get financing of any kind, a few basics *must* be there, and several other issues must also be addressed. Anyone seeking funds from others must be able to demonstrate the following in their business plan: a comprehensive knowledge of the delivery of the product/service to the target market; a profitable business model; an understanding of the marketplace; a realistic customer acquisition proposition; and proven relevant experience. The experience factor may overcome some weaknesses in other places, but it doesn’t work the other way around.

When seeking debt financing, a business needs to demonstrate that it has the following: assets; alternate cash sources; personal or committed collateral; ability to pay; and proven payment history. Equity financing has less consistent criteria, but they almost always include (in addition to the above) a significant growth factor to yield an approximately 10-to-1 return within a reasonable time (three years), a pledge of any IP, and certain management oversight.

There are several advantages of debt funding, but the major one is that it will be paid off and leaves the ownership in the hands of the owners. The advantage of equity financing is that while you give up some ownership, you have more working capital (no additional cash flow servicing debt payment) to expand and grow the business.

About the Author

Mo Aiken has spent his life solving problems, the bigger the better! In 1992 he founded Barra Gwynn Enterprises, an operations and strategic planning consultancy, to formalize his delivery of technical insight, leadership, consulting, and executive coaching to transitioning businesses seeking improved productivity, efficiency, and bottom-line profitability. As he says, “I do have some right answers, but I *always* have the right questions to make things work better!” A thirty-five-year veteran and skilled communicator, Aiken effectively interacts with all organization levels to successfully integrate key business functions and best practices for profitable problem resolution. He is dedicated to Consultant’s Link, as he believes it is the best business model to serve the emerging and mid-level market with great results! For more information, please call 714-961-0413 or visit www.barragwynn.com.

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