DEBT and EQUITY for starting a business

When you start a new business, you need to figure out how to finance the business. This is especially critical through the launch period, before the business is actually bringing in any money.

In general, you can raise money for your company through either debt or equity. Debt means taking out a loan, which will need to be paid back in a certain amount of time, and with a certain percentage of interest. Equity means giving up a portion of the ownership of your company in exchange for an investor's money, or some other contribution. Most companies use some combination of equity and debt, but it is good to know the differences, and when you might want to use or the other.

DEBT

Financing your business through debt means taking on loans. The loans will need to be repaid, sometimes beginning immediately, and will have some amount of interest paid on top of the principle. While debt provides a large infusion of cash to the business, it simultaneously constrains the business' cash flow. This is because the repayment schedule requires the business to account for additional money flowing out to make the payments.

Most businesses utilize debt during initial stages of investment, or to bridge a gap in funding. Basically any time that the company needs a large infusion of cash to get over a hump or to enact a specific aspect of the business plan.

Debt can also be used to lessen the dilution that happens when new shares of equity are issued. As new shareholders gain equity in the company, the shares already held become diluted and slightly less valuable.

You may also consider "convertible debt." Convertible debt is similar to a loan, because it has a repayment schedule and interest rate. The difference is that at the end of the term, the lender can convert the debt into an agreed amount of equity. This arrangement is complicated, and not all lenders are interested in issuing convertible debt. Similarly, you may not want to have to dole out any more equity than is necessary (to avoid diluting existing equity).

EQUITY

Financing your business with equity means getting money from investors in exchange for some stock or other security representing an ownership interest. Say you expect your business to be worth $1,000,000 once you get it up and running. You might accept $150,000 from an investor in exchange for a 15% ownership stake in the ongoing business. Though 15% seems like a large chunk of ownership to give up, you may not even get the business off the ground without the investor's money. If you have already decided that debt is not the best option, or is unavailable to you, then this might be a good deal for you.

Issuing equity has some advantages over debt, because allocating equity allows your business to control more of its own resources. Issuing equity means the business receives cash investment directly, without having to pay it back. When you finance your business with debt, cash flow is restricted by the payment schedule for the loan. If your company has limited cash flow, or you expect to have limited cash flow at some point, issuing equity can entice investors and let you move forward with your business without worrying about short term liabilities to lenders. However, for every share of equity you issue, it dilutes slightly the existing shares. Issuing equity also takes longer, and has greater legal costs associated than taking on debt.

Investors in your business will usually want equity in the form of preferred stocks, which give them a percentage ownership in the company, and certain attractive rights if they want to cash out, or if the business ultimately fails. If you do not want to offer preferred stocks, you might still be able to attract investors, but they might invest less.