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Financing Options For Mid Market Companies

Debt Capital, Equity Capital & Convertible Debt

There are three basic types of funding options for mid market companies: debt, equity and convertible debt. In this article, we will discuss the trade offs of each of these funding options in the context of a mid-market company.

Debt Capital

Debt capital is money raised for a company that must be repaid over a period of time with interest. Debt financing can be either short-term or long-term. Unsecured debt is rare and lenders typically secure debt with assets of the company. This also means that service, technology, and other asset-lite companies have a hard time raising debt capital.

Common debt financers include banks, credit unions, finance companies, and credit card companies.

Advantages of debt capital

- Raising debt capital, for profitable asset intensive companies, can be faster than raising equity capital.
- Debt capital is typically cheaper than equity capital because the financing companies pick only the lowest credit risk companies and further secure their loan with assets.
- The lender does not gain an ownership interest in the business and this allows the business owner to remain in the driver's seat of the company without being answerable to investors.

Disadvantages of debt capital

- The loan amount and the interest payments can saddle the balance sheet and income statement of the company.
- Any downturn in the business or unexpected capital needs can make it difficult to make the interest payments and send the company into a debt induced downward spiral.
- For some debt instruments, the terms can be complex and may onerously burden the business.

- If the debt is personally guaranteed, liability will extend to non-business assets.
- If the company gets into trouble, the debt financier could become adversarial.

Equity Capital

Equity capital is money raised by a business in exchange for a share of ownership in the company. Equity financing allows a business to obtain funds without incurring debt and without having the burden of associated interest/principal payments. For a growing company with cash needs and for companies with an erratic earnings stream, it can be a big advantage to not have to repay a specific amount of money at a particular time.

Equity capital can be public or private. Public equity capital is only available for large companies (revenues over a hundred million dollars). Two key sources of private equity capital for mid market businesses are Private Equity Groups (PEGs) and corporate investors. Other forms of private capital such as angel capital and venture capital, are typically not available to mid-market companies. Angel investors and venture capitalists provide funding to young, nascent private companies.

Equity investors can be passive or active. Passive investors are willing to give you capital but will play little or no part in running the company, while active investors expect to be heavily involved in the company's operations. Investing in a company's equity over a long term without any security collateral is inherently high risk. As a result of that, this form of capital typically comes with an active participation from the investors.

Passive or active, equity investors are typically patient, long term investors. These investors seek to add value in an effort to help the company grow and achieve a greater return on the investment. In return for their risk and participation, private equity investors usually look for a 25% or more return on investment, and put a number of checks and balances on the company's operations to achieve their goals.

Advantage of Equity Capital

- Lack of recurring principle/interest payments makes the business more able to cope with the ebb and flow of the business and increases the margin of safety
- Corporation's risk is shared with investors
- Right investors can add significant value
- Smooth transition option for business owners looking to ease out of the business
- May be the only possible type of capital for rapidly growing and asset-lite companies
- Equity investor is committed to the company until exit. If the company gets into trouble, the equity investor is likely to help with the turnaround

Disadvantages of Equity Capital

- Owner answerable to investors and some loss of control
- Can be more expensive than debt capital (albeit at a lower risk)

- It typically takes longer to raise equity capital than debt capital

- Deal terms can be complex. Without good deal making support, the company may unknowingly allow the investor to undervalue the company and take a disproportionately higher percentage of the company compared to the value of the investment made.

Convertible Debt

Convertible debt is a hybrid of debt capital and equity capital. Convertible debt typically involves favorable interest rates and other terms on the loan in return for the option to convert some or all of the debt into equity at predetermined price levels. Convertible debt instruments are complex and require a substantial amount of work on the part of the deal makers. There are many different variations of convertible debt available depending on the needed trade-off between debt and equity.

Convertible debt is more likely to be seen in distressed or high risk companies, and some investors specialize in distressed convertible debt. However, the flexibility of convertible debt makes it an attractive option in a wide variety of situations. This option gives the management maximum flexibility and is worth considering for larger mid-market companies.

Chak Reddy is a Mergers and Acquisitions Advisor with Elite Mergers & Acquisitions, Inc. Elite Mergers & Acquisitions specializes in selling and recapitalizing businesses with revenues between $5 million and $100 million - Businesses too large for business brokers to adequately handle but too small for the national M&A firms. Mr. Reddy is a business M&A and Marketing expert, and is the chief deal maker at Elite. You can reach Mr. Reddy at 916-220-3052 or by email at creddy@elitemanda.com .

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