Types of Financing

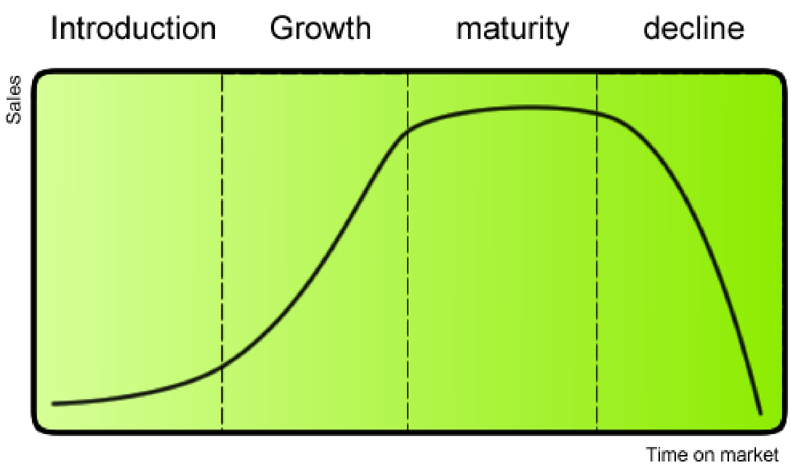
by Sophia

WHAT'S COVERED

In this lesson, you will learn about different types of financing that are appropriate for a business based on its stage of development. Specifically, this lesson will cover:

1. Financing Life Cycle of the Firm

Most businesses pass through a series of well-defined stages based on their level of development. Although businesses differ in size and potentiality for growth, they all experience common problems that arise at similar stages of their development, known as the four-stage life cycle of a firm. Methods of obtaining financial capital may be more or less suitable for a firm, depending on the current stage of its life cycle.



1. *Introduction:* In the first stage, a new company begins with the seed of an idea. Its**external financing needs** (EFN) are high, since it needs money to develop but lacks retained earnings. These young firms are frequently financed through debt, acquiring loans from banks and acquaintances. They may also acquire seed money, a form of securities offering in which an investor (usually friends, family, or angel investors) purchases part of a business. The source of the financing may depend on the perceived riskiness and growth of the business.
2. *Growth:* After the firm is able to acquire external funding and develop its product/service, it enters the growth phase. Once a company has a successful strategy, it attempts to offer its products or services to potential customers – expanding first to other states and regions and then often internationally and globally. Successful companies can turn in increasing earnings year after year, evidenced by the increasingly steep slope in the diagram. Firms may face an increase in competitors. In the growth stage, a

firm's initial EFN is high relative to its current value; it needs significant funds for growth. If it fits the specifications for venture capital (high growth potential, innovative product), a VC firm may agree to finance the firm. It may also raise capital through equity financing. As it progresses through the growth stage, earnings begin to increase less rapidly. At some point, the company may decide to go public, offering its stock to the general public on a security exchange as a means of equity financing.

3. *Maturity:* Eventually, all possible customers have the product or service. They may still buy parts or replace their product with newer models, etc., but growth slows. This is the mature stage of a company's development. If the firm has no new projects in the works, their EFN is quite low and internal funding is high. In fact, the firm may have so much in retained earnings that they cannot put all of it to productive use. They can choose to finance operations by issuing bonds and equity.
4. *Decline:* When the firm has reached the final stage, sales can stagnate or decline due to replacement by a better product or competitor. EFN declines further. They may choose to retire debt or repurchase stock, as significant external financing is no longer necessary.

TERM TO KNOW

External Financing Needs (EFN)
Additional funds needed from sources outside the firm, in order to support firm operations.

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2. Venture Capital

Venture capital, or VC, is an attractive funding option for young companies with high growth potential, most often in high technology industries. These new companies are unable to raise funds in more conventional ways like bank loans. Investors assume a high risk of loss in exchange for a high potential of future growth, significant control over company decisions, and a portion of the company's ownership.

TERM TO KNOW

Venture Capital
Money invested in an innovative enterprise in which both the potential for profit and the risk of loss are considerable.

2a. Obtaining Venture Capital

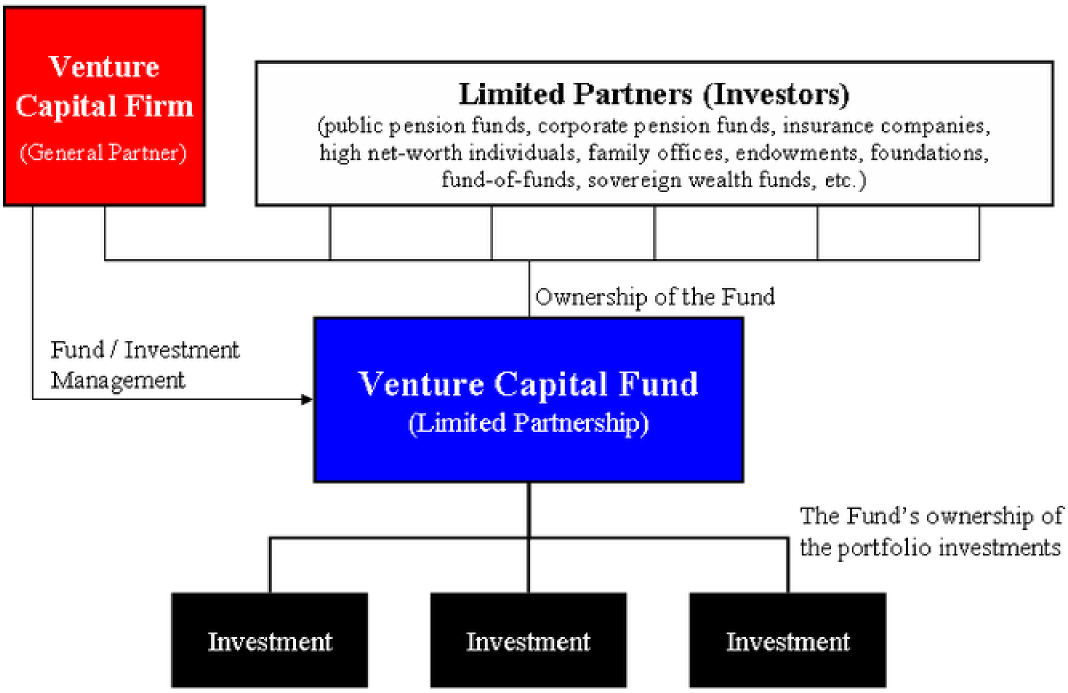
Obtaining venture capital is different from raising debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business. In contrast, the venture capitalist's return is dependent on the growth and profitability of the business. Return is earned when the venture capitalist sells its shareholdings. This happens when the business goes public, issues shares to the general public through an **Initial Public Offering (IPO)**, or is acquired by a third party company.

It is also in the venture capitalist's interest to nurture the companies in which they invest. This increases the likelihood of reaching an IPO stage when valuations give high returns. Therefore, in addition to the initial financial funding, VC firms provide time, expertise, and valuable business connections. As these investments are illiquid and require 3-7 years to reap the full benefit, venture capitalists carry out due diligence, conducting very detailed investigations into the firms prior to investment. This process includes examining the firm's financial records and all aspects of its operations. Most venture capitalists will also require significant detail about a company's business plan.

Venture investors may obtain special privileges that are not granted to holders of common stock, including:

- Anti-dilution protection
- Guaranteed seats on the company's board
- Positive and negative covenants that the company must abide by
- Registration rights, defined as the special right to demand registration of their stock on public exchanges, and to participate in an IPO
- Representations and warranties, which are statements in which the company gives certain assurances to the VC firm as to the operations and financial condition of the company
- Liquidation preferences, meaning in any liquidation event, the VC investors get their money back, often with interest before common stock is paid any funds from liquidation

Initially, VC firms establish a fund which pools money raised from individuals, companies and other interested parties. This pooled investment vehicle is then used for investment in start-up enterprises.



TERM TO KNOW

Initial Public Offering (IPO)

A type of public offering where shares of stock in a company are sold to the general public.

2b. Stages of Funding

Through informal and formal business networks, VC firms and entrepreneurs will meet to discuss the business plan and investment possibilities. There are different rounds of financing corresponding to different stages of a company's development.

Round of Financing	Description
Seed money round	The entrepreneur must convince the venture capitalist to fund their business vision. The VC firm is looking for a number of qualities including a solid business plan, an effective management team, high growth potential, and high target minimum returns. The VC firm will investigate into the technical and economic feasibility of the venture's idea. If it is not directly feasible, but the investor sees potential, the investor will choose to invest some seed money for further investigation.

Start-up	VC firms provide capital to early-stage firms that need funding for marketing and product development. Organization of the company is formed, with finalization of the management team and establishment of an individual from the VC firm on the company's board. The prototype product/idea is developed and tested. Market research for the idea is conducted, and the VC firm also monitors product feasibility and capability of the management. If, at this stage, the VC firm is not satisfied with the progress from market research, the VC firm may stop their funding and the venture will have to search for other sources of funding.
Second-Round	Early-stage companies that are selling product but not yet turning a profit receive working capital.
Expansion/Mezzanine financing	As the name suggests, VC firms provide expansion money for a newly profitable company.
Bridge financing/exit of venture capitalist	Finally, the company is expected to either "go public" or be bought by a third-party company. The VC firm then exits by selling off its shareholdings of the company. The investor's risk of losing the investment decreases as the company advances from one round to the next of this process.

3. Long-Term Debt

In the most basic terms, debt financing takes the form of short-term or long-term loans that must be repaid over a specified period of time, usually with interest. Money is borrowed, and usually the borrower (debtor) gives the lender (creditor) a promissory note that obligates the debtor to pay back a certain defined amount at a particular and defined time in the future.

With debt financing, the creditor's return is fixed as the agreed upon interest rate for the**debt**, which varies depending on the perceived riskiness of the debtor. Debt financing usually takes the form of bank loans or bonds.

TERM TO KNOW

Debt

Money that the borrowing entity owes or is required to pay to a lender.

3a. Bonds and Interest Rates

Bonds are a debt security under which the issuer owes the holders a debt. Depending on the terms of the bond, the bond issuer is obliged to pay the bondholders interest and/or to repay the principal (also known as nominal, par or face amount). Most corporate bonds are fixed-rate bonds, meaning that the interest rate stays the same until maturity. Some use floating rates to determine the exact interest rate paid to bondholders. The interest rate paid on these varies depending on some index, such as LIBOR. Other corporate bonds, called zero-coupons, make no regular interest payments at all, but investors still receive returns because these bonds are originally sold at a discount, and then are redeemed at par value upon maturity.

The interest that the firm will pay ultimately comes down to one factor: at what rate will investors believe the bonds are a good investment? Riskier investments will require compensation for the lender in the form of higher interest rates. Indicators for riskiness can include individual credit histories (for a bank loan) or bond rating by a credit rating company (for corporate bonds). The difference in yield reflects the higher probability of default and liquidity and risk premium.

TERM TO KNOW

Bond

A documentary obligation to pay a sum or to perform a contract; a debenture.

3b. Capital Structure Theory

The actual effect of the firm's capital structure on firm value is a contested topic in financial theory (see Miller Modigliani Theorem). From a tax perspective, debt financing may have some advantages over equity financing for both investors and the firm. Under a majority of taxation systems around the world, firms are subject to corporate tax and individuals to income tax, leading to double taxation of dividends, if the firm is financed through issuing stock.

> EXAMPLE Imagine a firm that generates a profit based on its operating activities. These profits are then taxed. After this, if the firm then distributes these profits as dividends to owners, these dividends are then treated as income for the owners and thus, taxed again.

Contrastly, if a firm chooses to finance with debt, and the firm must then pay interest on the debt it owes, for tax purposes this protects the firm, as these interest payments are then written off as tax deductible, thus reducing the taxable liability of the firm.

It is also postulated that debt makes management more disciplined, forcing them to work harder to ensure that they will make enough to cover their interest payments. These benefits are applicable to both bonds and bank loans. However, costs of debt can outweigh these benefits, depending on the firm. In the event of inability to repay debts, firms go into bankruptcy which is a costly process in itself. Furthermore, the more debt a firm takes on, the more uncertainty it will have about future financing needs: if a firm is already taking on a considerable amount of debt today, where will it get financing for its operations in the future?

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4. Common and Preferred Stock

Equity financing occurs when ownership stakes in a particular firm are exchanged for financial capital from investors. These investors may be all types of people, from friends and family of the business, to wealthy, "angel" investors, to venture capitalists. The main advantage of equity financing is that the business is not obligated to repay anything since the individual investors are assuming a certain amount of risk in return for the possibility of making money in the future. However, because equity financing involves trading funds for ownership in the company, these new investors do gain some decision-making power in the company, and the managers lose some autonomy.

Typically, firms obtain their long-term sources of equity financing by issuing common and preferred stock. Holders of **common stock** (also known as a "voting share" or an "ordinary share") often have voting rights on corporate policy and have a say in electing the firm's Board of Directors. They also receive dividend payments if the firm offers them. That being said, in the event of liquidation, **preferred stock** is considered more senior than common stock, in terms of rights awarded to particular investors. If one investor has preferred stock, while another holds common stock, that first individual has more rights to their share of assets, in the event of a liquidation. After bondholders, creditors (including employees), and preferred stockholders are paid their full share, and common stock investors receive any funds that still remain. Thus, it is clear that common stock investors have the riskiest investment, often receiving nothing in the event of a bankruptcy.

Preferred stock is another type of equity security. However, it has properties of both an equity and a debt instrument. The holders of this type of security typically do not have voting rights as opposed to common stockholders. In exchange, preferred stockholders receive a previously agreed upon dividend payment.

Generally speaking, there are four varieties of preferred stock:

- *Cumulative preferred stock:* Provides for dividends to accumulate over time if not paid.
- *Non-cumulative preferred stock:* Does not provide for this accumulation in the event that dividends are not paid.
- *Convertible preferred stock:* Provides the ability to exchange for a predetermined amount of common stock shares.
- *Participating preferred stock:* Provides a set dividend but also the possibility of additional dividends in the event of reaching predetermined financial goals.

There are capital costs associated with equity financing, including accounting and legal costs, as well as underwriting and filing fees. For new issues of stocks, there are flotation costs that must be taken into consideration before choosing equity as a method of long-term financing.

TERMS TO KNOW

Common Stock
Shares of an ownership interest in the equity of a corporation or other entity with limited liability. Holders of this type of stock are entitled to dividends. Importantly, the financial rights for holders of this type of stock are junior to preferred stock and liabilities.

Preferred Stock
Stock with a dividend, usually fixed, that is paid out of profits before any dividend can be paid on common stock. It also has priority to common stock in liquidation.

SUMMARY

In this lesson, you learned that businesses follow a **financing life cycle** that moves from introduction and growth to maturity and decline. The type of financing sought by a company depends in part on where the firm is in its life cycle. **Venture capital** is an option for companies in their early stages who have strong potential for growth. **Obtaining venture capital** can be difficult, and companies who receive it typically give their investors an increased role in oversight and operations. You also learned that there are different **stages of funding** for venture capital, from seed money rounds to bridge financing.

Long-term debt is an alternative method of financing a company. Long-term debt typically takes the form of **bonds with interest rates**, which is preferable to equity financing from a tax perspective, according to **capital structure theory**. However, **common and preferred stock** may be issued if a company prefers to raise capital through equity financing rather than debt.

Best of luck in your learning!

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