The Key to Capital

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Without capital-whether it's profits from internal operations, a bank loan or equity financing-most businesses find it impossible to develop products, hire additional employees or invest in new equipment. As the old adage claims, you have to spend money to make money. But before you seek capital, it's important to understand what qualities lenders and investors look for in a company, including key financial ratios.

Capital Sources

There are three basic sources of capital for a business: internal operations, debt and equity. Most companies prefer funds generated from internal operations, or the net profit that results from subtracting expenses-including taxes, interest and depreciation-from sales. This form of funding doesn't involve obligations to anyone outside the company or increased outlays for interest payments or dividends.

Unfortunately, most businesses don't generate enough internally to pay for their growth. When increasing sales or cutting expenses isn't enough, you must decide whether to borrow money or sell partial ownership in your company. Each method has advantages and disadvantages.

Debt vs. Equity Financing

Debt financing, or a loan, can be an expensive source of funds, but it allows your business to remain in the hands of existing shareholders. Most lenders are primarily interested in earning interest and receiving the balance according to the loan's terms. As long as these conditions are met, lenders have little reason to exert control over your business.

Your other option is equity financing, which means selling shares in your company to investors. These could be angel investors-individuals who invest directly in small businesses, often taking a mentoring role. Or they could be investment organizations such as private equity firms or venture capital funds. By selling shares in your company, you get the capital you need, but also surrender partial control of your business. And if you're required to pay dividends to shareholders, that reduces the amount of capital left to grow your business.

Unlike interest payments, corporate dividends paid to shareholders aren't tax deductible, but dividends boast certain advantages compared to interest payments. Dividends generally are lower than interest payments, and they're paid out on a more discretionary basis than interest payments. This payment flexibility can be useful if your company experiences a downturn and you need to reduce or discontinue dividends until conditions improve.

What Key Financial Ratios Say

When evaluating your company for a loan or investment, lenders and investors look at several financial ratios. It's important, therefore, to understand what these ratios tell a prospective decision maker.

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The quick ratio represents cash plus accounts receivable, divided by current liabilities. It shows whether your short-term assets are capable of covering your short-term debts if you need to repay funds in a crunch. The higher this "liquidity ratio," the more likely a lender will approve your loan request.

The times-interest-earned ratio expresses earnings before interest and tax expenses, divided by interest owed on borrowed funds. It tells lenders how much of your company's cash flow is available to cover interest payments. The higher this "coverage ratio," the more creditworthy your company is considered.

The debt-to-equity ratio compares total liabilities to shareholder equity. The resulting number measures a company's leverage-the degree to which assets are financed through debt or earnings and stock sales. The lower the ratio, the more moderate a company's debt is considered and the more favorably a lender will look upon your application.

Unlike the previous three ratios, which are primarily of interest to lenders, the return-on-equity (ROE) ratio is most relevant to investors. This ratio represents after-tax net income, divided by average net worth; it indicates the percentage shareholders are earning on their investment.

The higher the ROE, the better the shareholder return and the more attractive your business will appear to equity investors.

Another test of a company's profitability is the return-on-assets (ROA) ratio. This compares earnings to total assets, rather than to just equity as ROE does. A broader measure of profitability, ROA is of interest to lenders and investors alike - the higher the ratio, the more profitable the business.

Avoid Window Dressing

Whether you decide to seek debt or equity financing, remember that ratios for your company probably will be compared to average ratios for your industry. If your business' ratios are out of line with those of your peers or if they show recent changes, be prepared to explain them.

If you have the time and resources, consider improving your company's ratios before seeking capital. Boosting sales and cutting overhead expenses are common methods of doing this, but they may require six months or more to accomplish.

At the same time, avoid extreme measures that could harm the long-term prospects of your business. Cutting maintenance on valuable production equipment, pressuring valued customers by aggressively collecting accounts receivable or stonewalling vendors by delaying accounts payable may improve your ratios temporarily, but when taken to extremes can backfire. Sacrificing long-term growth for temporary financial window dressing can be self-defeating.

Anticipate Scrutiny

Whichever route you decide to take-debt or equity financing be prepared for intense scrutiny of your financial statements. Understanding key ratios and doing what you can to improve their appearance may mean the difference between getting or not getting the money you need to grow your business.