Chapter 5

Where Does the Organization’s Money Come From? Capital Structure

Organizations typically sell goods and services, and get paid for doing so. However, before the first sale is made, they need resources to be able to buy land, buildings, equipment, and supplies. The money needed to acquire these assets is referred to as the organization’s capital. Where does a business get the capital it needs to operate? Once the business is well established, capital can come at least partly from profits. But reinvestment of profits may not provide enough resources for everything the organization wants to do. And during the early life of any business, other sources of capital are essential.

The dominant sources of capital are from the owners of the organization, referred to as equity financing, and loans, referred to as debt financing. The choices made with respect to obtaining resources determine the capital structure of the firm.

**PROPRIETORSHIPS AND PARTNERSHIPS**

For organizations that are owned by one individual, referred to as sole proprietorships, or for partnerships, the prime source of capital is money that the owner or owners put into the organization (equity financing) in exchange for their ownership of the business. If debt financing is needed, it is generally obtained from either family and friends, or from a bank.

A partnership has a number of restrictions which make it cumbersome and complicated. It may be difficult for a partner to liquidate their interest in the partnership. Partners generally may not transfer their ownership shares to outsiders. Further, there are legal limits on the number of partners a business can have, and this can make it hard to raise a large amount of equity-financing.

**NOT-FOR-PROFIT ORGANIZATIONS**

Not-for-profit organizations do not have owners, but still need capital. Initially a substantial portion of that capital comes from charitable donations. Donations are considered to be equity financing because, unlike a loan, they do not need to be repaid. However, not-for-profit organizations often rely heavily on debt-financing because they are unable to generate unlimited amounts of donations. Once the organization is established, reinvestment of profits becomes another primary source of capital to allow the organization to replace facilities as they wear out, adopt new technologies, and expand.

**FOR-PROFIT ORGANIZATIONS**

There are several advantages to organizing a business as a corporation. Corporations provide their owners with limited liability. Limited liability means that if the corporation is unable to pay its bills, creditors may take all of the assets of the corporation, but may not come after the other assets of the owners of the corporation. This contrasts with proprietorships and partnerships. In those organizations, the obligations of the company may be treated as obligations of the owners. If the business fails, the creditors can pursue the owners for payment from their own resources. Because of corporate limited liability, the maximum amount that owners of a corporation stand to lose is the amount they invested in the business. It should be noted that there are some situations where partnerships may be formed in a way that does provide limited liability for the partners.

A second major advantage of corporate form is that owners can readily sell their share of ownership in the company to third parties with very little impact on the organization. This makes it easier to raise capital. And since there can be an unlimited number of owners of a corporation, there is potential to raise a very large amount of equity capital.

#### Common Stock

A dominant source of capital in the early life of most corporations is the issuance of common stock. Common stockholders own a share of the corporation’s assets, have the right to vote to elect the board of directors, are entitled to a proportionate share of distributions (such as dividends), and can freely sell their ownership interest. Common stockholders invest their money, hoping to benefit from dividends and/or increases in the value of the stock.

Once a company is well established, common stock is often issued as a result of mergers (where the acquiring organization pays for the acquired company with shares of the acquiring organization’s stock) or to managers as a result of various compensation arrangements. However, common stock is not regularly used to raise capital at that point because of the potential to dilute the share of the company owned by the current owners.

Dividends are paid to shareholders of common stock if the corporation decides to distribute some of its profits directly to its owners. Alternatively, the corporation may retain some or all of its profits for reinvestment in other potentially profitable opportunities. Hopefully this will result in even greater future profits. If so, the value of each share of stock may rise, and the stockholder will be able to sell the stock for a higher price, resulting in a profit referred to as a capital gain.

A significant advantage the corporation gains by issuing common stock is that there are no requirements to make payments to the stockholders. If the corporation has a bad year, at least it doesn’t have to worry about getting the cash to make required payments to the common stockholders. A second significant advantage gained by issuing common stock is that it creates an equity base. This provides a safety cushion for lenders and makes it possible for the company to incur debt.

#### Debt

Debt is a second major source of financing for corporations. Debt represents a loan. The borrower must pay interest and repay the amount borrowed. In order for a company to be stable, a substantial portion of the firm’s debt will generally be in the form of long-term debt. This avoids the potential problems created if, for example, a building is financed with a one-year loan that it intends to renew each year. What if the lender decides not to renew the loan when it comes due for payment? Long-term debt also eliminates the risk of interest rates being substantially higher when it is time to renew the loan.

Long-term debt is often issued in the form of a bond. A bond is a debt instrument in which investors (bondholders) lend money to the company in exchange for the right to receive periodic (usually semiannual) interest payments of a set amount on set dates, plus repayment of principal at a maturity date. Bondholders can sell their bonds to other investors in the same way that stock may be sold. Failure to meet these obligations puts the organization at peril of bankruptcy. Interest payments on debt are tax-deductible. This tax treatment lessens the effective cost of debt to the organization. Bonds are discussed further in [Chapter 14](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap14.xhtml).

#### Preferred Stock

Preferred stock is a hybrid with characteristics of both stock and debt. It is part of stockholders’ equity. However, in most respects it is like a bond. The dividends to preferred stockholders are paid at a predetermined rate, much like the interest rate on a bond. Unlike interest on a bond, the dividends are not tax-deductible to the corporation. Why include preferred stock in a corporation’s capital structure if the payments are not deductible? The dividend payments may be deferred. When a corporation falls on hard times, it still must pay the interest due on bonds. It does not have to pay the dividends due on the preferred stock. However, dividends on preferred stock must be paid before any dividends may be paid to common shareholders. Some preferred stock is cumulative and some is not. With cumulative preferred stock, any dividends that have been skipped in prior years must be paid to the preferred shareholders before dividends may be paid to common shareholders.

#### Cost of Capital

The choice of the relative mix of stock versus debt is an important one. If the business is very profitable, greater amounts of debt result in higher earnings per share of common stock. (This is the result of something called leverage, which will be discussed in [Chapter 9](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap09.xhtml).) However, greater amounts of debt substantially increase risk if profits start to decline. If the company cannot meet its required payments of interests and principal on its debt, its viability may be threatened.

Managers should try to strive for a capital structure that keeps the organization’s cost of capital low. The cost of capital is a weighted average of the cost of common stock, preferred stock, and debt. The cost of debt is the interest. The cost of preferred stock is the required dividend payment. The cost of common stock is the dividend plus the growth in the value of the stock.

A reasonable level of debt tends to reduce the average cost of capital. Not only does it provide the opportunity for increased profits for common shareholders, but also the interest payments, as noted above, are tax deductible. This tax benefit substantially reduces the cost of debt relative to equity financing. On the other hand, one must always keep in mind the increase in financial risk caused by having debt. Further, if debt levels rise too high, lenders will be reluctant to provide further financing and the cost of debt will rise.

#### Other Elements of a Corporation’s Capital Structure

In addition to common stock, preferred stock, and debt, there are several other financial instruments that have a place in the capital structure of a corporation. These include stock options, stock rights, warrants, and convertibles.

##### *Stock Options*

Stock options give option holders the right, but not the obligation, to purchase shares of stock at some predetermined price over some specified period of time. Such options are often issued to key employees in an organization to motivate them to help the organization achieve or exceed its goals. For example, suppose that the corporation’s common stock is currently selling for $50 a share. The owners of the stock would certainly like that value to increase. Employees may be given options to buy shares of stock at $60 per share. The options might expire in three years.

These options give the employees a personal interest in seeing the price of the stock go up. If the stock price fails to exceed $60, the employees will just let the options expire. However, if the stock price rises to $70, they can then pay just $60 to buy a share of stock that is worth $70.

##### *Stock Rights*

At times a corporation will want to raise money through a common stock offering to the public, but avoid the high costs of hiring an underwriting firm to sell the stock. They can achieve this through a rights offering. A stock right gives  the holder the right to buy a share of stock at a stated price. Usually the stated price is somewhat less than the current market price.

Stock rights are usually offered in proportion to a stockholder’s current holdings. For example, suppose you owned 1,000 shares of stock in XYZ Corporation, which has 10,000 shares outstanding in total. That means you currently own 10 percent of the corporation. The corporation now plans to use stock rights to issue another 2,000 shares to raise additional capital. You would be entitled to 200 rights, or 10 percent of the total offering. If the corporation’s stock is currently selling for $50 a share, and the rights allow you to buy stock at $47 a share, you would either exercise the rights, buying the 200 shares, or you could sell your rights to someone else.

##### *Warrants and Convertibles*

Warrants are similar to stock rights, but they generally have an exercise price above the level of the current market. Warrants are often given as an inducement to investors to get them to do something the organization wants. For example, a corporation may have trouble raising debt. As an inducement to lend money to the corporation, warrants may be given to the lender.

Suppose that the corporation’s stock currently sells for $5 a share. Warrants may be issued to a lender allowing it to buy a certain number of shares anytime in the next five years for $10 a share. Lenders do not generally share in the extreme successes of the companies they lend to. They just get earned interest and repayment of the loan. However, if this corporation’s stock shoots up to $50 a share, the lender could use the warrants to buy shares for $10 and join in the success they helped cause by financing the company.

Similarly, convertible debt or convertible preferred stock is debt or preferred stock that can literally be converted into shares of common stock. This convertible feature generally allows the corporation to borrow at a lower interest rate or issue preferred stock with a lower dividend rate. The lenders or purchasers of the preferred stock will take a lower interest or dividend rate because they have the potential for large profits if the common stock rises in value.

#### Dividends

Some companies hold themselves out as growth companies. Growth companies generally retain all or most of their profits to use for additional, hopefully highly profitable ventures. Other companies have a policy of paying dividends to their investors on a regular basis.

Some investors prefer growth companies. By holding stock without receiving dividends, they don’t have to pay tax on the dividends. Later they will sell the stock, hopefully at a higher price, and pay tax at a lower, capital gains rate. And in the meantime, the company has invested the entire amount of retained earnings in ventures that are potentially more lucrative than might be available to the investor. If the investor had received dividends, some of them would have been paid in tax, leaving less for reinvestment.

Other investors, however, need dividends to pay for current living expenses. Although they could sell off some shares of stock from time to time to raise money for such expenses, they prefer to receive a steady, dependable flow of income. As a result, managers must decide on the dividend policy they wish to adopt. The choice will affect the potential buyers of the firm’s stock.

At times, a corporation will issue a stock dividend. For example, there might be a 10 percent dividend, giving the  investor one share for every ten shares currently owned. Or there might be a stock split such as a two-for-one split, in which case the investor gets two new shares in exchange for each old share owned. Such dividends and splits are not substantive. If you own 1,000 out of 10,000 shares, you own 10 percent of the company. After a two-for-one split, you own 2,000 out of 20,000 shares. You still own exactly 10 percent of the company.

Stock dividends and splits are generally done for psychological purposes. First, they make you feel like you have more, even if you don’t. Second, they may bring the stock price down to a more reasonable trading range. For example, if a growth company keeps growing, its shares will get more and more expensive. Some individuals might be tempted to buy a stock, but might decide that its price is so high that they could only afford to buy a few shares. Instead, they buy a less expensive stock so that they own more shares.

This is illogical. They should purchase the stock of the company with the greatest percentage appreciation potential. Fifty shares of a $100 stock are more valuable than 100 shares of a $50 stock, if the $100 stock has the potential to increase by a greater percentage because of the underlying profit potential of the firm. The key should not be the number of shares, but the likely percent increase in the $5,000 investment.

Nevertheless, some companies believe that if their stock is selling for $120 per share, a three-for-one split will be beneficial. It will bring the price per share down to $40 a share. That is a value that seems substantial, but not prohibitively expensive. These companies believe that this may attract more investors, causing the stock to rise by a greater percentage than it would have without the split.

Reverse splits are also possible. If a stock is selling for a very low price, investors might be skeptical of the viability of the company. A reverse split will bring the price back up to a respectable level. For example, a stock selling at $2 a share might have a one-for-ten split that would reduce the number of shares outstanding by 90 percent, but raise the price per share to $20. This latter price might be more likely to attract investor interest.

Some stock exchanges also have minimum dollar prices for the stocks on their exchange. Without a reverse split, a stock might be delisted, substantially reducing the ability of owners of the stock to find a liquid market when they wish to sell their stock.

### GETTING CAPITAL

Understanding your desired capital structure is one thing. Getting the money is another. The capital to run a business is obtained by a variety of means. These include venture capital, public stock offerings, private stock placements, debt offerings, and leasing. Each of these is discussed briefly below.

#### Venture Capital

Start-up businesses must prove that they have a potentially viable business before the general public will be willing to invest in them. However, some investors, called venture capitalists, will put up money called venture capital or risk capital to help a new business get started.

If you can convince these investors that they can make a lot of money by financing your start, they can get money into your firm quickly, without the lengthy and costly process of an initial public offering (IPO) of stock. In return, they generally expect that an IPO will take place within approximately five years.

Businesses often begin with seed capital needed to do market research and product development. Seed money is often provided by the entrepreneurs starting the business themselves, or their friends and families. Businesses may typically raise up to $5 million this way with minimal government registration requirements. After this point, venture capitalists are called upon to provide the working capital needed to acquire supplies and hire workers to start producing the product, and in some cases the acquisition capital to acquire plant and equipment or a going business.

Venture capitalists rely heavily on the firm’s business plan (see [Chapter 7](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap07.xhtml)) in determining whether to invest in the business. Therefore the business plan may be a critical element in determining if the venture ever gets the initial capital it needs to get off the ground.

Be aware that many liken venture capitalists to the devil. The business may be something that you have conceived of and developed. It is your baby. However, not only will the venture capitalists take a substantial financial share of your business in exchange for their investment, but they will take a major share of the control of the business as well.

#### Public Stock Offerings

A public stock offering is one in which shares of a corporation are sold to a broad range of investors to secure capital for the organization. Issuing stock to the public is costly, time-consuming, and complicated. At times, general economic conditions or stock market conditions will have a bigger impact on the success or failure of your offering than the underlying worth of your company will have. On the other hand, to raise significant amounts of capital without incurring an unreasonable level of debt, a public stock offering may be required.

The first time a public stock offering takes place for a company, it is referred to as an Initial Public Offering (IPO). Subsequent offerings of stock to raise additional capital are referred to as secondary issues. Whether you are considering an IPO or a secondary offering, stock offerings to the public are expensive. The costs include payments to lawyers, accountants, printers, and underwriters.

Underwriters are firms that act as general contractors. They coordinate with all of the accountants, lawyers, and brokerage firms that will initially sell the stock to investors. They help prepare all of the documents that are legally required before stock can be sold, including a prospectus and registration statement. Underwriters have access to potential buyers of your stock through their networks of stock brokers.

Once you have “gone public” your organization has an equity base that makes it easier to borrow, provides you with broader public recognition, and results in increased personal net worth for the original owners of the business. On the other hand, there are ongoing reporting expenses, loss of control, and potential liability of officers for failure to comply with a complicated set of rules and regulations.

#### Private Placements

Given some of the complexities of public offerings, sometimes businesses issue stock through a private placement. The money received from venture capitalists is one type of private placement. Even when the amounts of capital to be raised are substantially higher—perhaps hundreds of millions of dollars or even several billion dollars—a private placement is sometimes possible. Selling stock directly to a few large investors avoids much of the cost of a public offering, and avoids the need to file certain elaborate documents with the government. Large insurance companies often participate in such placements, putting perhaps $50 million or $100  million into a company in exchange for stock.

Private placements can also raise funds much more quickly than a public offering can. However, in most cases the amount of money that can be raised from a private placement may be substantially less than the business might raise from a public offering. It should also be noted that, because of the risks involved to the investor, government regulations tend to prohibit all but sophisticated investors from participating in such placements.

#### Bond Offerings

Bonds can be issued through private placements or public offerings in the same way as stocks are. As with stocks, private placements are simpler and less expensive, but don’t have the ability to raise as much money as a public offering.

Bonds are a particularly good alternative to bank financing because they can be for large amounts of money, they can extend for long periods of time (typically thirty years), providing stability, and they eliminate the bank intermediary. For example, a bank might pay 4 percent to a depositor and then lend the depositor’s money to a corporation for 9 percent. The 5 percent difference represents the bank’s costs and profits. If the corporation issues a bond at an interest rate of 6.5 percent, it will pay 2.5 percent less than the bank charges, and the ultimate investors will receive 2.5 percent more than they would have received from the bank. The investors have more risk than they would if they deposited their money in the bank. The corporation has greater costs and legal compliance issues than it would if it borrowed the money from a bank. For a large loan, it is worth paying these higher costs to get a lower interest rate. Bonds are discussed further in [Chapter 14](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap14.xhtml).

#### Leasing

Another source of financing is leasing. Someone buys an asset, such as a building, and rents it to a business that wants to use that asset. The business using the asset is a lessee and the owner of the asset is a lessor. Leasing is very similar to having borrowed money and purchased the asset directly. Therefore leases are generally considered to be a form of debt financing. Management and tax issues related to leasing are discussed in [Chapter 14](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap14.xhtml).

### KEY TERMS

Capital—the money needed by the firm in order to acquire resources.

Capital structure—the mix of debt and equity used to finance the firm.

Equity financing—capital provided in exchange for an ownership interest, typically through the issuance of stock.

Debt financing—capital provided in the form of loans.

Stock option—security that gives the holder the right to purchase shares of stock at some predetermined price, usually above market value.

Stock right—security that gives the holder the right to buy a share of stock at a stated price, usually below market value.

Sources of capital—venture capital, public stock offerings, private stock placements, debt offerings, and leasing.

### QUESTIONS FOR REVIEW

1. What are the two major sources of capital for an organization, aside from reinvestment of profits?
2. Where do sole proprietorships generally get debt funds from?
3. What is the major capital source for not-for-profit organizations, early in their existence?
4. What are two main advantages that the corporate form has over partnerships?
5. What are several advantages of common stock?
6. What is a bond?
7. What are the key characteristics of preferred stock?
8. What is the cost of capital?
9. Why would an organization issue stock options, stock rights, or warrants?
10. Do stock splits provide a direct benefit to stockholders?
11. Many companies need to get funding from venture capitalists to get their business going. What are the major negatives of using venture capitalists to finance a business?
12. What is an IPO?