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Equity vs Debt: Understanding the Capital Structure

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Many of us invest in stocks or bonds of companies but may not fully understand the bigger picture of where these investments came from in the first place. Why does a company issue stock and bonds and what are the implications and considerations for each? What is a corporation's capital structure and why does it matter? How does the mix of equity and debt on a corporation's balance sheet impact the value of the company and the investments we make? This article will give a brief overview of a corporation's capital structure and the difference between equity and debt.

The Capital Structure

The capital structure of a corporation is the mixture of equity and debt that it uses to fund its operations and growth. As a company expands – perhaps building a new plant in another country or buying additional equipment to keep up with increasing demand for products – it may require additional capital to fund its expansion. The leaders of the company (e.g. CEO, CFO, Board of Directors) then can decide on which of two different paths to take. They can either raise cash by selling an ownership stake in the company, or equity, to investors, or they can borrow the funds from investors with clear rules for repayments. The latter would be considered debt issued by the company.

Before jumping into the specifics of equity and debt, let us consider why this is important to us as investors. It's crucial to understand the financial wellbeing of a company prior to making any investment. When looking at a company's balance sheet, we see the assets of the business followed by the liabilities or debt the company holds as well as the equity. Unlike being saddled with personal debt like high-interest rate credit card loans and expensive mortgages, debt on a company's balance sheet is not necessarily a bad thing. When interest rates are low as they are in the current environment, it may be advantageous to issue debt at reduced interest rates to fund operations or even pay off older and more expensive debt. In this scenario, debt may be a cheaper form of liquidity than selling equity or ownership in the company, allowing it to retain a higher percentage of profit and control.

But unlike equity, debt must be paid off at some point in the future and usually has interest payments due along the way. And the more debt a company has, the more it pays annually to its creditors in the form of interest and maturity payments, leaving less money to be returned to the business. This could make an investment in the company increasingly risky as a change in its operating environment or sales and cash flow could throw into question the company's ability to pay off its debts, decreasing the value of your investment. So, while it may be prudent for a company to borrow from investors by issuing debt, it is important to see the bigger picture of the business and understand how much risk the company is taking on based on its capital structure and the norm for its industry and peers.

Equity

As mentioned previously, equity represents ownership of a company. Consider it the value of the cash remaining after all its assets have been liquidated and liabilities paid. How does this relate to stock shares sold on exchanges around the world? From an investment perspective, stocks could be considered the current and future earnings potential of the company. Each share represents a small claim to those future earnings. This is why stock prices move up and down when news of the company hits the wire – investors are quick to make a determination if the stock is overvalued (and thus may sell the stock and decrease its price) or undervalued (buying pressure would raise prices).

A company may decide to sell a percentage of its ownership to investors in the form of stock in exchange for cash. Further, there are several classifications of stock; the most prevalent are common stock and preferred stock. Common stock is much more widely followed and the prices of which flash across the screen on your favorite financial news network. It represents a true equity stake in the firm and typically comes with the right to vote in elections determining corporate governance matters. Additionally, common stockholders can receive a share of annual profits – dividends – but only after interest has been paid to bond holders and payments have been made to holders of preferred stock. Preferred stockholders own a fixed claim on future profits, but it is still not a debt that must be repaid by the company. Thus, preferred stockholders have higher claims to any profits and proceeds than common stockholders but lower claims than a company's creditors.

Debt

Earlier in the article I gave the example of a company issuing debt to fund its business as it expands. Just as a home mortgage is a debt that must be paid back at some point in the future, so too is corporate debt an IOU given from a company to an investor. In return, the investors earn an interest rate for a fixed period until the debt is repaid.

Just as there are multiple types of equity, so too are there several classifications of debt in a company's capital structure. There is unsecured debt, which is a general obligation of the company to repay, and secured debt, where a specific asset or cash flow is pledged as collateral to assure repayment. Additionally, there is senior and junior debt, with senior debt having a higher priority over junior debt, though each takes priority over common and preferred equity.

No two debt securities are the same. A company with a higher amount of debt on its balance sheet relative to another company may be deemed riskier, and likely investors would require a higher interest payment to take on that risk. A company may be looking to borrow for three years while another may be looking to borrow for much longer, depending on when the company expects to be able to pay off the borrowing. All these factors come in to play when an investor determines the riskiness of a specific bond offering and if the investment is worth taking.

Debt and equity are pivotal to a company and provide much needed flexibility as leaders determine how best to support the operations and growth of their business. Both means of raising capital have their benefits and costs, but it is likely that a corporation will utilize both to build out its capital structure. As investors, it is important to understand what the implications may be for our investments in stocks or bonds of a corporation and the risks we may be taking on.

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