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Capital Versus Debt – What is the Difference?

In the entrepreneurial world of small business, capital, business risk and credit risk can all be easily misunderstood.

One of the reasons companies succeed or fail is due to capital, also known as equity. Whether a business is funded by its owner(s), angel investors or bankers, business risk and credit risk are very different and must be understood to obtain funding.

What Is Business Risk?

According to Jim Hogan, of J. L. Hogan & Associates LLC, a commercial lender with 30 years' experience, business risk is market risk. When a banker considers a loan, a stream of income or revenue is needed to repay the loan. Since cash flow services the debt, a conventional commercial loan is not usually the best avenue for new or young entrepreneurs because their business model is not proven to be viable.

Understanding capital versus debt will take a new business owner far in his goal to success.

For instance, a national company recently sold its local small candy manufacturing division. The buyer was an individual from outside the company. She desired the platform because, in the future, she wanted to convert the candy company into a specialty pharmaceutical manufacturer, an area where she had some experience.

The buyer capitalized the candy company with cash from her retirement fund and money from friends and family. The deal got sweeter because of a seller "take-back note" on machinery and equipment and a rent moratorium for 90 days from the landlord. In addition, some customer accounts were retained, and therefore, the company generated modest revenue from the beginning.

Yet the monthly cash generated was not sufficient to cover the operating costs of the business. As such, the company would have been out of cash in seven months. The company moved quickly to build additional sales, collect on those sales it made and reduce its shortfall. Within months, the shortfall had dropped and the company had sufficient remaining capital (equity) to continue for more than 20 months. But the goal was to become profitable, not just stay afloat. With a few additional sales, the candy company's positive cash flow was within its grasp.

What Is Credit Risk?

Tim Lewis of Chesapeake Corporate Advisors says credit risk is a funding risk that lenders take, intended to cover a timing difference in a business's operating cycle, such as when a company makes a sale and is waiting for payment while it simultaneously has to pay operating expenses.

Credit risk is the timing risk of business assets converting to cash - for instance, accounts receivable. Credit risk should not be the risk of business failure, and credit risk is not rewarded like business risk. Credit risk is rewarded with a reasonable return, but never a large payout to the lender.

A lender will loan on a credit risk, for example, when it knows it has a receivable. The lender then becomes the entity that funds timing differences between the sale of the product and the collection of cash. It might be an inventory conversion cycle in which there is a conversion to a sold product for cash or generating accounts receivable. The business will use all its assets as collateral for funding, and for small businesses, the business owner will also provide a personal guarantee.

The most important thing to remember about credit risk is that capital needs to precede debt. Let's say a local entrepreneur wanted funding for the development, manufacturing and sales of his unique gloves and heated bike riding apparel. He has had some success in the regional biking market, based on his own minor investment, but showed no retained earnings. He wanted to grow his company, and while the finance community could see his business potential, the risk at this early stage was of the business succeeding (business risk), not the risk of the conversion cycle. As such, he was dissatisfied with lenders that were unwilling to finance his marketing efforts to grow his business.

What's the Difference?

Why was the candy manufacturer successful in finding a line of credit while the glove and apparel manufacturer was not successful in finding a loan? The answer again is capital.

In the candy manufacturing deal, the entrepreneur takes the business risk through cashing in her retirement and the investment of her friends and family. She also had cash equity in the game, taking the risk of business success or failure. If the business fails, the entrepreneur, friends and family lose. They may lose all of their investment. But, if the candy company is highly successful, the investors can win many times their original investment. The lender knows that the equity is there and at risk before the loan. The lender takes a credit risk, not a business risk.

The biking entrepreneur failed the business risk test because the lender was being asked to take the equity risk of a successful marketing campaign funded by the lender, not the credit risk of the asset conversion cycle.

Why Does It Matter?

"Business risk underlies credit risk," quips Lewis. "When a business owner embarks on a new venture, he or she is assuming whether or not the business will succeed or fail."

The responsible business owner needs to identify funding sources, and he needs to take his product or service from the concept phase to something that is generating value and profit.

That is when a lender can come in to play. A traditional banker does not take business risk, but does take credit risk. The lender will be there to finance the asset conversion cycle, but not to take an equity level risk or get an equity level return.

Equity should be there to protect the debt and help the business grow. The successful entrepreneur may want to sell his or her business in the future, hopefully for many times his or her equity investment.

Before entrepreneurs go to the bank for a business loan, they should ask themselves, "What kind of risk is this, business (equity) or credit (moving business assets through the conversion cycle)?" The answer is their guide.

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