Debt Capital

Debt capital is the capital that a business raises by taking out a loan. It is a loan made to a company that is normally repaid at some future date. Debt capital differs from equity or share capital because subscribers to debt capital do not become part owners of the business, but are merely creditors, and the suppliers of debt capital usually receive a contractually fixed annual percentage return on their loan, and this is known as the coupon rate.

Debt capital ranks higher than equity capital for the repayment of annual returns. This means that legally, the interest on debt capital must be repaid in full before any dividends are paid to any suppliers of equity.

A company that is highly geared (UK), or leveraged (US), has a high debt-to-equity capital ratio. As we already said that debt capital is a loan. This money (which was given to the company as loan) is given to the debt holders first before giving it to preference holder and equity holders. Equity holders (shareholders) have all rights in the business, but the debt holders have no rights on the business.

The team within Debt Capital Markets (DCM) is responsible for providing advice on the raising debt for acquisitions, refinancing of existing debt, or restructuring of existing debt.

A Debt Capital Markets group will work with a client to organize borrowing and to help provide access to a global pool of investors who are looking for opportunities. Debt is often used as it is usually cheaper than financing through equity, and can add diversity to funding.

Equity Capital

The Equity Capital refers to that portion of the organization's capital, which is raised in exchange for the share of ownership in the company. These shares are called the equity shares.

The equity shareholders are the owners of the company who have significant control over its management. They enjoy the rewards and bear the risk of ownership. However, their liability is limited to the amount of their capital contributions. The Equity Capital is also called as the share capital or equity financing.

Invested money that in contrast to debt capital, is not repaid to the investors in the normal course of business. It represents the risk capital staked by the owners through purchase of a company's common stock (ordinary shares).

The value of equity capital is computed by estimating the current market value of everything owned by the company from which the total of all liabilities is subtracted. On the balance sheet of the company, equity capital is listed as stockholders' equity or owners' equity. Also called equity financing or share capital.

Advantages of Equity Capital

It has several advantages:

- The firm has no obligation to exchange the equity shares since these have no maturity date.
- The equity capital act as a cushion for the lenders, as with more and more equity base, the company can easily raise additional funds on favorable terms. Thus, it increases the creditworthiness of the company.
- The firm is not bound to pay dividends, in case there is a cash deficit. The firm can skip the equity dividends (The annual cash flow that an equity investor receives) without any legal consequences.

Disadvantages of Equity Capital

There are several disadvantages of raising the finances through the issue of equity shares which are listed below:

- With the more issue of equity shares, the ownership gets diluted along with the control over the management of the company.
- The cost of equity capital is high since the equity shareholders expect a higher rate of return as compared to other investors.
- The cost of issuing equity shares is usually costlier than the issue of other types of securities. Such as underwriting commission, brokerage cost, etc. are high for the equity shares.
- The cost of equity is relatively more, since the dividends are paid out of profit after tax, but the interest payments are tax-deductible.

Advantages of Debt Compared to Equity

- Because the lender does not have a claim to equity in the business, debt does not dilute the owner's ownership interest in the company.
- A lender is entitled only to repayment of the agreed-upon principal of the loan plus interest, and has no direct claim on future profits of the business. If the company is successful, the owners reap a larger portion of the rewards than they would if they had sold stock in the company to investors in order to finance the growth.
- Except in the case of variable rate loans, principal and interest obligations are known amounts which can be forecasted and planned for.
- Interest on the debt can be deducted on the company's tax return, lowering the actual cost of the loan to the company.

- Raising debt capital is less complicated because the company is not required to comply with state and federal securities laws and regulations.
- The company is not required to send periodic mailings to large numbers of investors, hold periodic meetings of shareholders, and seek the vote of shareholders before taking certain actions.

Disadvantages of Debt Compared to Equity

Unlike equity, debt must at some point be repaid.

- Interest is a fixed cost which raises the company's break-even point. High interest costs during difficult financial periods can increase the risk of insolvency. Companies that are too highly leveraged (that have large amounts of debt as compared to equity) often find it difficult to grow because of the high cost of servicing the debt.
- Cash flow is required for both principal and interest payments and must be budgeted for. Most loans are not repayable in varying amounts over time based on the business cycles of the company.
- Debt instruments often contain restrictions on the company's activities, preventing management from pursuing alternative financing options and non-core business opportunities.
- The larger a company's debt-equity ratio, the more risky the company is considered by lenders and investors. Accordingly, a business is limited as to the amount of debt it can carry.
- The company is usually required to pledge assets of the company to the lender as collateral, and owners of the company are in some cases required to personally guarantee repayment of the loan.