Debt versus equity: When do non-traditional funding strategies make sense?

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The U.S. produces more new startups and unicorns each year than any other country in the world, but 90% of startups fail, with cash flow often being a major challenge.

Entrepreneurs trying to raise funding for their new businesses are faced with a maze of options, with most taking the common route of equity rounds. There's clearly a lot of venture money to be raised — and most tech entrepreneurs happily take it in exchange for equity. This works for some, but too often founders find themselves diluting their equity to unrecoverable portions rather than considering other financing options that allow them to hold on to their company — options like debt capital.

Even if you're growing quickly, not all founders want to set a valuation for their company. In that case, you can offer investors "convertible debt."

Despite the VC flurries of 2020 creating an ecosystem of seemingly endless equity, it's important for entrepreneurs and founders to understand that there is no one-size-fits-all model for raising capital. Debt capital, which refers to capital raised by taking out a loan, is an alternative route that entrepreneurs should consider.

Understanding the real cost of venture debt and when it makes more sense than the traditional equity route relies on an understanding of what you and your company hope to achieve.

Understanding your goals

We mainly see two kinds of startups today: Those that want to try something new, and the ones that focus on making things faster, cheaper or simpler. Facebook, Twitter and Instagram are good examples of the first kind — social media didn't exist before the internet. Discount airlines, cell phones (not smartphones) and integrated circuits are good examples of the "faster, cheaper, simpler" variety, because they simply displaced familiar incumbents.

Many entrepreneurs are eager to be the next "try something new" success story, and I applaud them for feeling that way. Carving out your own market is a fast-track to entrepreneurial stardom if you're successful. But unless your main goal is to be famous, it's often impractical and distracting.

People tend to think that category creation is less risky than incumbent disruption. However, as long as you're truly faster, cheaper and simpler, patience and strategy can propel you to where you want to be.

Just as there are different market approaches, there are a number of funding strategies that work best for your goals. Landing investments from leading VC firms has benefits and is a good avenue to opt for if you're a young startup carving out a market and in need of validation and experience. These firms bring trusted advisers that are laser-focused on growth and have the resources and experience to navigate the murky waters of category creation.

Entering a well-established market needs a different playbook, however. If you're equipped with disruptive features and pricing, the need for validation goes away because the product speaks for itself. Equity is still a good option here, but I've seen many cases where a VC forces a company to move too fast and ultimately lose focus.

I’m not saying rapid growth is a bad thing, but if it’s not done strategically, it can be. And sometimes it’s simply not the best option.

Depending on the capital needs of your business, debt funding might make more sense. In cloud storage, for example, a company needs the capital to build data centers and the physical assets that come with them, all over the world. Expensive equity is best not spent on such assets, so taking a more stable and reliable route like debt funding makes more sense.

How can debt be stable and reliable? Seems like an oxymoron, but the reality is that while equity investors are looking for growth, debt investors just want to get paid back with interest.

Measuring the real cost of debt versus equity

There is a common misconception that when a company “takes out a loan” from investors, it’s because they are less desirable. Lenders will not give you money to use in the same way as venture capital would. Debt comes with strings attached, but that doesn’t mean it isn’t an effective approach for companies that qualify.

Generally speaking, debt is far less dilutive and less likely to result in founders losing control of the business. It is well suited for funding capital expenditures (CapEx), which are major purchases a company will use over the long term, because they are not meant to drive immediate growth. With debt, an organization doesn’t need to show the immediate value of the investment, they just need to eventually pay it back.

On the other hand, equity is better suited for funding operating expenses (OpEx), the day-to-day expenses a company incurs to keep its business operational. Operational excellence is key to set your company apart from your competition. Any good founder or CEO recognizes that differentiation is vital for fast growth and as long as your business model is sound, these expenses can show the immediate impact that venture capital investors want to see.

The strategic choice

Debt financing certainly has its benefits, but it doesn’t make sense for everyone. So, when should you consider it a viable option, and when should you stick to equity?

Even if you’re growing quickly, not all founders want to set a valuation for their company. In that case, you can offer investors “convertible debt,” which allows you to borrow money from investors with the understanding that if you fail, or if the investor so elects, the debt will convert into equity at a predetermined price.

This can be useful when you’re optimistic about your company’s eventual valuation spike, but you’re not at the point where it would make sense to wait and do an equity round later. Convertible debt can provide you the money you need now while protecting the later value of your equity.

Convertible debt can be treated much like venture capital. You can use it for sales and marketing, R&D and other OpEx. Think about it like real estate investment — builders borrow large sums of cash to finance a new property with the knowledge that returns will come later. In most cases, these investments will increase in value over time. However, developers still have to pay for advertising, architects and other expenses out of their own pockets.

In cloud storage, we have a similar model. My company raised $27.5 million in debt financing earlier this year, which we're using to bolster our infrastructure, including constructing additional data centers in new geographies, to meet accelerating global cloud adoption. This situation was perfect for debt because we knew our new infrastructure would carry us through the long term.

At the same time, we continued to raise venture capital — for example, we plan to use our $112 million Series C venture round to grow our network of resellers, technology alliance partners and distributors, and add team members across development, sales, support, marketing, administration and operations.

Although receiving funding from the biggest VCs is attractive and usually results in fun additives such as media coverage and an expanded network, it certainly doesn't guarantee success. Ultimately, it all comes down to which solution is the best fit for your business and financial needs.

Doing your research, monitoring the competitive landscape and remaining realistic about your business and the funds it needs is key to understanding which source of funding is right for you. Debt and equity funding both have pros, cons and risks, so it's important to recognize what you hope to achieve and how those factors might play into that vision.

Lastly, don't go down certain paths just because it's the common thing to do. Every business is different and non-traditional money sources can be easily overlooked. As a founder and CEO, it's your job to recognize the benefits and drawbacks of each path.