Comparison of Financing Options

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The Exceptional Service Grading Company (ESGC), whose balance sheet and income statement we met back in unit 1, requires a capital infusion of $500,000. We are told It is currently a closely held corporation with less than 25 shareholders who, while not blood relatives, view ESGC as a family business. We are asked to evaluate several alternatives available to the company - obtain private debt financing, seek out a private investor(s) who would be willing to share ownership through private transfer of partial ownership, seek out offers for a private buy-out through private transfer of entire ownership, issue public debt or issue public equity (Cremades, 2019).

The most direct way to see the impact of each of these options is to compare them side by side, which I have done in two tables at the end of this paper. As we have been discussing, the most important choice that needs to be made is between equity and debt, with the former requiring relinquishing some control over the business and the latter requiring an ongoing expense (Chron Contributor, n.d.b). We also need to consider the weighted average cost of capital, for which we can generate a rough estimate using this formula (Hargrave, 2026):

$$WACC = (E/V \times Re) + (D/V \times Rd \times (1 - Tc))$$ where:

E = Market value of equity

D = Market value of debt

V = E + D

Re = Cost of equity

Rd = Cost of debt

Tc = Corporate tax rate

using book values to fill in for market values and assuming five percent rate on borrowing and twelve percent as the cost of equity.

The WACC using these assumptions is reduced to 5.97% in the debt financing scenarios but rises to 6.54% in the equity financing ones. This is attributed to the tax shield that results from borrowing (Chron Contributor, n.d). This suggests that debt financing will actually lower the cost of capital while also preserving ESGC's control over their "family" style business, making it the better option. This option will mean dealing with a decrease in earnings while the liability is serviced, but if the twenty-five owners of ESGC are united around doing this, it may make the most sense for them.

A new scenario this week for me at least is the private equity buyout. In one of our readings, *Do Private Equity Buyouts Get a Bad Rap?*, Harvard Business School professor of investment banking Josh Lerner researched data on the effects on a company of private equity buyouts. After the article's author acknowledges the public hostility caused by these buyouts, as exemplified by the name of Senator Elizabeth Warren's 'Stop Wall Street Looting Act' bill, he shares professor Lerner's findings that companies experience a "jolt of productivity" with an annual growth of four percent in the two years after they are purchased. He also acknowledges that these gains are not shared with employees, however, who experience a two percent decline in their wages during the same period (Blanding, 2020).

This contrast does not surprise me at all. I have been watching the financialization of our economy for decades, and ever since Oliver Stone's movie *Wallstreet* made visceral for me back in my youth the impact that corporate buyouts can have on on the lives of working people (1987), I have understood that at the center of the logic of the system lies the extraction of value from working people for the accumulation of power in the hands of those who exploit them.

Table 1: Balance Sheet WACC Comparison of Finance Scenarios

Scenario	Assets (Cash)	Liabilities	Equity	WACC *
Baseline (2018 Actual)	$ 7,025,800.00	$ 4,761,300.00	$ 2,264,500.00	6.15%
Private Debt Financing	**$ 7,525,800.00**	**$ 5,261,300.00**	$ 2,264,500.00	5.97%
Private Investor (Partial Ownership)	**$ 7,525,800.00**	$ 4,761,300.00	**$ 2,764,500.00**	6.54%
Private Buy-Out (Entire Ownership)	$ 7,025,800.00	$ 4,761,300.00	$ 2,264,500.00	6.15%
Issue Public Debt (Corporate Bonds)	**$ 7,525,800.00**	**$ 5,261,300.00**	$ 2,264,500.00	5.97%
Issue Public Common Stock	**$ 7,525,800.00**	$ 4,761,300.00	**$ 2,764,500.00**	6.54%

Table 2: Income Statement Comparison of Finance Scenarios

Scenario	Revenue	Expenses	Net Income
Baseline (2018 Actual)	$9,200,000	$7,862,100	$937,900
Private Debt Financing	No change	**Increase Interest Expense**	**Decrease**
Private Investor (Partial Ownership)	No change	No change	$937,900
Private Buy-Out (Entire Ownership)	No change	Restructuring Costs	**Potential Decrease**
Issue Public Debt (Corporate Bonds)	No change	**Increase Interest Expense**	**Decrease**
Issue Public Common Stock	No change	No change	$937,900

References

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