The Stock Market Vs. The Bond Market: Who Wins?

Every business at one point has to look for capital, whether it's to pay off its initial investors, hire more staff, or expand its reach. This is the biggest headache for most small and medium enterprises' business owners.

There are numerous ways that SMEs and startups can raise the capital they need - besides bank loans. They can look into venture capital possibilities, angel investors, crowdfunding, and of course, the financial and capital markets.

However, most small business owners hardly consider the capital market, i.e., issuing bonds and selling stocks. But the truth is, stocks and bonds are among the best ways to raise capital. Despite bearing certain risks, of course, the opportunity to raise capital (sometimes fairly fast) can be great for both the business and investors.

One important factor to consider when thinking about entering the capital market is this: Your business needs to portray signs of a certain maturity, i.e., growth and profitability. Most investors will only invest in businesses with good financial projections, proper plans, and transparent corporate structures. This means that you should have at a minimum a steady cashflow – independent of new venture capitals and/or other additional financial injections.

With that in mind, let's dive deeper into these two ways to raise capital.

What is the Stock Market?

The stock market is a marketplace that allows businesses and companies to raise capital by selling a part of their ownership (equity). Stocks are ideally, shares of a company or business. Selling stocks means that you're selling a small stake of your company to an investor who believes that it will do well.

What is the Bond Market?

The bond market refers to a marketplace that allows businesses to sell bonds to investors. In this case, a 'bond' is just a fancy word for a loan. So, when a business sells bonds, it's essentially taking loans from several investors who expect regular interest for the lifetime of the loan.

Understanding the Stock Market

The stock market unites businesses with investors through the stock exchange. It facilitates the trade of shares (and related securities) through a regulated platform.

When a business needs to raise capital to expand its growth, it may issue additional shares, and based on its estimated value then sell these to investors through or on a securities/stock exchange: the stock market. Investors who buy the shares then become shareholders of the company. Because the shares are listed and tradeable on the stock exchange the shareholders can later sell their shares back to the market (i.e. other investors who are interested to also buy shares in that company).

Take, for instance, a business that needs $500,000 to expand its operations. The owner may decide to sell 5000 shares at $100 each.

By buying shares (or stock), the investor becomes a partial owner of your business. Depending on the percentage of shares/stock they own and depending on the rights attached to the shares, the investors may get certain voting rights that can influence your decisions. Furthermore, the investor becomes entitled to a small portion of the business profits: dividend. If the business fails, you, the business owner, do not owe the shareholders anymore because they were co-owners with you and stand first in line to absorb losses.

It is important to realize that the value of your stock price is -in principle- never constant if the stock is listed on an exchange. It fluctuates in the market, depending on how other investors and traders project your business's growth. In this evaluation, your performance compared to for instance your competitors can play a very important role.

So, to sell stock/shares of your business to the public market, your business has to so-called “go public”. You literally sell to the wide public. And, of course, that has to be done through a streamlined “going public” process. However, private businesses can also sell their stock, but in a different manner: this we call a private placement or also a private equity investment. In these cases, the shareholders who want to sell their shares must first find a buyer and then often get the business to approve the sale.

Note that most simple investors avoid private stock because (generally) less information on performance is released to the public.

Benefits of raising capital through the Stock Market

- ### Reduced risks

For small businesses and startups, selling a part of your ownership means that in case the business fails in the market, you share the losses with the shareholders. You do not owe your investors because they took a risk as a co-owner by buying your shares.

- ### No new debts

Debt can eat up a lot of the profits for any company. But by using the stock market, investors buy stakes in your company and hence become partial owners. This means that you do not have to pay them interest and are not even obliged to pay them back their invested capital. Only if and when you make a profit you can pay them back a return through the payment of a dividend. **Access to fast capital**

Selling your shares can be a fairly quick and smart way to raise capital for different projects. Based on your valuation, you can sell as little or as many shares as you need to raise the capital for the planned purpose.

- ### Free marketing and visibility

Most businesses that sell their shares often choose to do so by indeed go public. This move puts you in the sight of many investors and customers who may develop an interest in your products and services. New investors, turned shareholders, can also bring in a higher networking power and potential partnerships – which can be good for your business.

Challenges of using the Stock Market to raise capital

- ### Loss of ownership

Selling your stock may bring in the capital you needed, but it can displace you off the majority shareholder seat. This means that your control over the decisions of 'your' company will be limited or under the control of others. Even if you sell small stakes, you still will not have full control over the business. While some perceive this as a negative consequence, it may also be a very positive factor in the sense that you will have to manage your business in such a way that you very conscientiously run your business with your co-owners' interest at heart.

- ### Additional reports and audits

By selling shares in the stock market, your business will be subjected to certain audits and reports to ensure that you use the business' capital well and that your co-owners are properly informed on the "progress" the business is making. Clearly, such audits and reporting will cost money. And, have to be reckoned with in your projections.

- ### Undedicated shareholders

Just like you may have success-oriented investors, you may also have shareholders who do not really understand the business. In a case where such investors get too much power, they can (in the worst-case scenario) drive your business to the ground with bad strategies and policies. A very careful consideration of how you structure a sale of shares is therefore an absolute must.

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Understanding the Bond Market

Compared to the stock market, the bond market is quite sizeable. This is because bonds are (sometimes in a somewhat unrealistic way) associated with significantly lower risks for investors.

In this market, businesses get to issue bonds to investors for their money. The bonds act as a certificate acknowledging that the business owes an investor, the bond principal amount. Bonds are common among large corporations, municipalities, and governments, but they can also work for small businesses.

Once a business issues a bond, it becomes obliged to pay interest to the investors for the agreed time until bond maturity. It will also have to repay the face value, (principal amount) they borrowed from the investors when the bond expires.

For instance, if the business requires $5 million for development, it can issue 5000 bonds to 5000 investors worth $1000 each. The business will then have to agree to a predetermined interest rate say, 10%, that will be paid annually until the bond term expires. In this case, the business will pay an estimated $100 to investors in interest annually, and finally, pay back the $1000 to each investor once the bond matures.

The bond duration can last anything from a year to long-term credits of up to 30 years. However, long term bonds usually demand higher interest rates to attract customers because the “risk period” is so long, of course.

Unlike the stock market which mostly uses some international stock exchange platform, the bond market is much more decentralized. Yes, there are exchanges where a lot of fairly standard Government bonds are traded, a lot of trading though happens “so-called” over the counter (OTC). Over the counter means nothing else that there are, in principle, no full transparent publicly verifiable prices, and other information being provided; but sellers and buyers agree on the pricing among themselves. Once bonds are issued, they are bought and sold by participants in the secondary market, through specialized bond brokers/trades, just like stocks.

However, bonds are usually not traded in high volumes by individual investors. Instead, investment banks, asset management firms, and hedge funds, take up this role.

This model is attractive to businesses because it can offer significantly lower interest rates for loans compared to banks. Moreover, bondholders have no ownership in the business - they do not affect any decisions you make.

In some rare instances, some corporate bonds are structured in a way that they can be converted into shares (equity) after some time. These are the so-called “convertible bonds”

Benefits of raising capital using the Bond Market

- ### Full control of the business

When issuing bonds, you retain 100% ownership and control of your business. Bondholders do not gain equity in your firm, and neither do they have a direct voice in how you run the show.

- ### More flexibility

Issuing bonds can give a business more control over exactly how much they need to borrow, what the tenure (term) should pay it, and several other terms of payment. Bonds can also be structured to enable convertibility to stocks. This makes it easier to incorporate this into your operations.

- ### Bonds are ‘callable’

Depending on the bond agreement, your business can decide to repay the bond earlier, forcing the bondholder to “resell” (actually accept repayment) the bond to the business.

- ### Bonds are term loans

Regardless of the bond's maturity term, once they are repaid, your business has no further obligations to the bondholders. You will not have to share profits from the returns or repay more interest after the expiration and full repayment of the bonds’ principal amount/face value.

- ### Interests are tax-deductible

Depending on the jurisdiction, when filling in your company tax returns, the interest rates paid to the bondholders is tax-deductible as a business expense. This cuts down the tax you will pay and hence saves back some cash to assist in ongoing operations.

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- ### Access to more investors

A business has the freedom to issue the bonds to as many investors as they wish. This is good as it may foster partnerships with other businesses and help improve your marketing and visibility.

Challenges of using the Bond Market to raise money

- ### Bonds increase debt

Some say "debt is never good for a business, even in the form of bonds" This is of course not true, but the realization has to be that the debt is something you will have to pay back. Period. You will be obliged to repay the agreed-upon interest rates to your bondholders, and later, the principal value, even when if your business is going through a difficult period and the cash flow may not be sufficient to service the interest payments. Failing to repay the debt as a whole may force you to bankruptcy, and the bondholders can demand to liquidate your assets to repay their loans.

- ### Capital limitation

In cases of high-value risky bonds, investors may place a cap on how their money should be used in the business. The money has to be utilized solely for the purpose it was intended for. Normally, a bond agent will be appointed, who has to monitor certain expenditures. This way, the investor can be a bit surer that the business will not use the funds for non-approved expenditures. This limitation means that you will have to issue other bonds or seek an alternate source of capital whenever anything else comes up. You are not at liberty to use the funds "as you see fit".

Final Thoughts

Both the stock and bond markets can be excellent places to raise your capital. However, whichever model you choose has its own perks and cons. You can also choose to use both models to finance your business. But keep in mind, for SMEs and startups, these models demand that you have an already profitable business, preferably with a demonstrable cash flow from operations so that investors can "evaluate" the investment opportunity better.

That said, small businesses can greatly benefit from both the bond market and the stock market. As always, you will need to prove that you are worth the investment with good papers, plans, projections, and strategies!

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