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Equity finance or Debt finance Part 1

This time, we would like to explain the difference between equity finance and debt finance, which we need to inevitably consider upon M&A structuring.

Equity finance is to acquire the right to participate in the management of the target company, debt finance is to lend money.
Equity finance is the acquisition of shares in the target company. Shares represent the right to control a company and are composed of rights for decision making, such as the right to vote on important matters, and rights for receiving profit, such as the right to receive dividends and the right to receive the distribution of residual assets at the time of company liquidation. In brief, shares represent the right to make a company's decisions and receive profits of a company. So, when you invest money, or acquire shares as equity finance, you acquire the right to make the company's decisions and receive dividends from the company according to your shareholding ratio. In other words, becoming an equity investor means becoming a partial owner of the company.
On the other hand, debt finance is legally defined as entering into a loan agreement with the target company, namely, lending money to the target company. Therefore, when you finance funds as loan, you become a creditor of the target company.

Let us look at those differences in more detail.
(1) Voting rights
When you invest money in a company as equity investor, you become a shareholder, which means you have the right to attend the shareholders' meeting and vote on important matters to be decided at the meeting. On the other hand, in the case of debt finance, you usually do not acquire the right to participate in the management of the company as such.

(2) Dividends and interest
In the case of equity finance, dividends can be received only when there is distributable profit. Therefore, shareholders cannot receive dividends if the company does not generate profit and makes loss. Dividends are paid when there is still distributable profit after the payment of income tax (corporate tax in Japan).
On the other hand, in the case of debt finance, a certain amount of money can be received as interest based on the loan agreement regardless of the company's performance. On the target company (debtor) side, this interest payment is made before the payment of income tax and is recorded as an expense.

(3) Obligation to repay
In the case of equity finance, the target company is not obligated to repay the investment, and the investor cannot withdraw the investment without having a third party or the target company purchase the shares (in the case of an unlisted company, there are usually restrictions on the transfer of shares that prohibit the sale of shares to a third party without the target company's permission, so withdrawing the investment is not easy in practice).
On the other hand, in the case of debt finance, the target company is obligated to repay the principal on the due date. In the case of an equity finance, there is no concept of principal guarantee because the investment is not planned to be returned, but in the case of debt finance, there is a difference that the repayment of principal is guaranteed unless an individual agreement is made.

(4) Order of repayment priority at the time of company liquidation
In the case of equity finance, the return of the investment can be received only when there still remain residual assets after paying all debts to all creditors at the time of company liquidation. On the other hand, in the case of debt finance, the creditors can receive a refund of financing according to the amount of their claims as with other creditors, therefore they are treated in a higher order than equity investors.