Understanding Debt Financing

Dr. Amartya Kumar Bhattacharya
BCE (Hons.) (Jadavpur), MTech (Civil) (IIT Kharagpur), PhD (Civil) (IIT Kharagpur), Cert.MTERM (AIT Bangkok), CEng(I), FIE, FACCE(I), FISH, FIWRS, FIPHE, FIAH, FAE, MIGS, MIGS – Kolkata Chapter, MIGS – Chennai Chapter, MISTE, MAHI, MISCA, MIAHS, MISTAM, MNSFMFP, MIIBE, MICI, MIEES, MCITP, MISRS, MISRMTT, MAGGS, MCSI, MIAENG, MMBSI, MBMSM
Chairman and Managing Director,
MultiSpectra Consultants,
23, Biplabi Ambika Chakraborty Sarani,
Kolkata – 700029, West Bengal, INDIA.
E-mail: dramartyakumar@gmail.com
Website: https://multispectraconsultants.com

Introduction

Many a time firms need additional funding in order to expand or reach higher revenue levels that would not be possible otherwise. These firms can raise such additional funds by primarily three methods:
Debt Financing
Equity Financing
Hybrid of Debt and Equity

Such external funding allows a firm or a startup to increase its firm value, which is the eventual ambition of every profitable business.

However there are certain factors that influence a firm's decision with respect to the choice of capital structure. These include, but are not limited to, access to capital, taxation norms, agency costs, transactional expenses, etc. This article pertains to Debt Financing and how it affects the firm.

What is Debt Financing?

When a company, in order to finance its business activities takes a loan from an outside entity with a promise to pay back the principal amount along with an interest element, it is said to be financed by debt. The people / institutions that provide such loans, thus, become lenders to the company. However, it must be noted that this is a strictly time-bound activity and, hence, the payment of principal along with the interest must be made within the stipulated time frame. One of the most important features of debt financing and the one that distinguishes it from equity financing is that there is no loss of ownership in this case. Furthermore, such loans can be either secured or unsecured in nature.

A company can indulge in debt financing through fixed income products such as Bills, Notes, Bonds, etc.

Types of Debt Financing

Some of the most commonly practiced types of debt financing for small businesses and startups are:

Unsecured Business Loans: In such loans, no collateral is required. However, the business must have a good credit score in order to get the loan approved. There are usually no restrictions to the usage of money within the business.
Secured Business Loans: This kind of loan requires a collateral. Even a business with a low credit score might still get approved since it is backed by an asset.
Small Business Loans: In such loans, although the money is lent by banks, it is backed by some organisations such as the Small Business Administration (SBA) in the USA. This ensures that you have a greater chance of approval and better terms since the risk to the bank gets reduced significantly.
Equipment Loans: This type of loan can only be used to purchase equipment for business activities. It is profitable for businesses to opt for lease payments instead of buying the equipment outright since that turns out more expensive.

Advantages of Debt Financing

Tax Benefits: The interest paid on debt is tax-deductible since the interest paid is considered as a business expense. This money saved can be ploughed back into the business.
Better Planning: Since the interest rates are pre-decided, it is much easier to account for them when considering future cash flows.
Retention of Control: Unlike Equity Financing, there is no loss of ownership involved. Thus the lenders cannot influence the working of the company. However, depending upon the terms and type of loan, the lender can decide ‘for what’ the money is to be used but not ‘how’ it is to be used (Example: Equipment Loans).

Disadvantages of Debt Financing

Repayment and Timeline: The amount to be paid back involves an interest element as well and not just the principal. The loan must be paid off by a particular date or else fine is levied upon the company. This can get really problematic for companies with unpredictable cash flows. Moreover, you would have to still repay the loan even if the business fails.
Credit Ratings: Debt Financing affects credit ratings of a company. A business with a high Debt to Equity ratio is considered risky and hence in order to attract lenders, it has to offer a higher rate of interest.
High Interest: Despite tax deductions, a business might still face high rates because those depend on a number of factors such as credit score, economic conditions, etc.

Cost of Debt Financing

The company along with the principal, also pays interest to the lenders (usually annually). Such interest payments are called coupon payments and represent the cost of debt. Similarly, the dividend payments made to the shareholders represent the cost of equity. Cost of Debt and Cost of Equity, when combined, make up the Cost of Capital.

The firm's decisions must yield a higher return than the cost of debt, otherwise, the firm would not be generating positive earnings for lenders but will still have to pay them and would hence go into a loss.

Every company that aims to finance itself from external sources faces the issue of Debt versus Equity Financing and hence deciding the apt capital structure can be problematic but the company must consider the overall Cost of Capital (Cost of Debt + Cost of Equity) and should try to minimise it in order to get better returns and thus better profits.

© MultiSpectra Consultants, 2020.