Debt Financing

Meaning

The simplest meaning of debt financing is borrowing money on credit with a promise to repay the amount borrowed, plus interest.

Debt financing can come from selling bonds, bills, or notes to lending institutions, individuals, and sometimes, to investors.

Debt financing takes many forms. The essence of debt is that the borrower must repay the funds along with agreed-upon service charges such as interest and loan origination fees. If the money is not repaid as promised, the lender can start collection proceedings. This process can become very uncomfortable for the entrepreneur, who could stand to lose the business and any non-business assets pledged to secure the loan.

Seeking financing from an outside lender can be difficult. The process is made easier when the entrepreneur understands the lender's concerns. Lenders want to loan money to businesses that will provide a good return. They also want to do business with companies that pose little risk, which is why many technology and life science companies are not able to raise debt financing until they are down the road considerably.

Money should not be borrowed lightly. The borrower assumes a serious obligation. It is a basic lesson of finance that money should not be borrowed unless those funds will earn in excess of their cost. Examples of debt include numerous types of loans:

- SBA-backed loans
- Long-term loans
- Line of credit

Small Business Administration (SBA) Backed Loans

The SBA has a variety of guaranteed loans. They have programs for both start-ups and existing companies; for working capital, inventory, and equipment; for minority or women-owned businesses; and for loans in the nature of lines of credit. The SBA does not make the loans, banks do, but because the SBA guarantees a portion of the loan, the bank's risk is lessened.

Entrepreneurs who might otherwise be unable to find a bank willing to make the loan may be able to obtain an SBA-guaranteed one. The entrepreneur should seek out banks that are not just SBA certified lenders but those that are actively seeking to make SBA loans. SBA loan interest rates are generally slightly higher than conventional loans, but if they are the only available source of funds, they should not be dismissed simply for the additional costs.

Long-Term Loans

A long-term loan usually has a payback period between one and five years. Depending upon the deal negotiated, these loans are normally secured (collateralized by assets) and guaranteed by the entrepreneurs. Rates and terms on long-term loans vary greatly based on the lending institution's policies and the business's age and financial status.

Collateral (personal assets) is pledged by the entrepreneur to offset the loss to the lender should the entrepreneur default on the loan. If a borrower fails to meet the terms of a secured note, the lender takes possession of whatever asset was pledged as collateral and sells it. The proceeds of the sale are then applied to the amount due on the note. The loss of collateral will not release the borrower from all liability on the debt if the collateral sale proceeds are not enough to pay off the loan and the lender's costs of retaking and selling the collateral. If the sale of the collateral is insufficient to repay the debt, the lender may then look to the guarantee provided by the entrepreneur for the remaining unpaid balance.

Line of Credit

When a line of credit is awarded to a business, the funds can be drawn upon whenever needed. Lines of credit are usually only available to entrepreneurs after they have raised equity capital as leveraging funds. Certain venture banks offer lines of credit to companies who have recently secured a round of equity capital. This type of funding is appropriate to cover seasonal fluctuations in sales or regular cash shortages. The amount and terms of the line of credit are determined in advance based on the needs of the business and the policies of the lending institution.

In most cases, lines of credit are due to be paid within a year. Other policies may be imposed, such as not using the line of credit for two months after the balance has been paid. The rate will vary based on the institution and the business. In general, the rate for established companies is often one or two points over the prime rate, slightly higher for new businesses.

Advantages of debt financing:

- Maintained ownership

  It allows the founders to retain ownership and control of the company (in contrast to equity financing).

- Greater degree of financial freedom

  It provides business with a greater degree of financial freedom than equity financing as debt obligations are limited to the loan repayment period, after which the lender has no further claim on the business.

- Easy to administer

  It lacks the complex reporting requirements accompanying some forms of equity financing.

- Tax deductions

  Interest payments can be deducted from business income taxes (lower interest rate).

- Less expensive

  It tends to be less expensive over the long-term than equity financing.

Disadvantages of debt financing:

- Repayment

  Shortages in cash flows may make regular payments difficult (including penalties, taking possession of collateral etc).

- High rates

  Interest rates vary with macroeconomic conditions, the borrower´s history with banks, business credit rating, and personal credit history.

- Impacts borrower´s credit rating

  Debt increases leverage, failure to make payments adversely affects business credit rating and its ability to obtain further financing.

- Cash and collateral

  It is necessary to make sure the business will be generating sufficient cash flows, it is asked to put up collateral on the loan.

- Availability limited to established businesses

  It can be difficult for unproven businesses to obtain loans, the amount of money small entities may be able to obtain via debt financing is likely to be limited, and so they may need to use other sources of financing as well.

Factors influencing the price of the loan:

- Macroeconomic factors

  The level of inflation; the volume of money supply and higher monetary aggregates and politics of money supply regulation; velocity of money circulation; level of GDP and its growth rate; level of investments and rate of savings; discount rate of the National Bank.

- Microeconomic factors

  Creditor's costs of obtaining funds; level of risk of the financed project; period of a loan (maturity); relation between short-term loan sources and long-term sources; amount of a loan; backing of a loan; individual rate of profit (project, business, industry); net present value of investment project.

Conclusion:

This article discussed the debt financing methods companies can use and then argued that their choice depends on the costs and benefits of debt financing and the firm's life cycle.