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Article 2 in a 3 part series

In the first article, we discussed the opportunities and caveats of equity financing. When sourcing capital for growth, equity financing is not the only option for business owners. An alternative to equity financing is debt financing.

Unlike equity financing, debt financing does not require the business owner to sell a portion of the equity in their business in return for the capital. Instead, the capital is provided to the business owner with the expectation that it will be returned on a specific timeline.

There are several key advantages that debt financing affords a business owner. One is that the payments required are predictable in nature. A business owner that is able to forecast cash flow accurately will be able to assess his/her ability to meet debt service requirements due to the predictable nature of debt payments. Additionally, the total cost of the capital is often known to the business owner from the onset. The interest associated with the capital is tax deductible to the business owner, thus lowering the true cost of the capital. For example, if a company is paying 8% interest rate, and the marginal tax rate is 25%, the true cost of capital is 6%.

In addition to debt having a lower cost than equity, a business owner often does not have to sacrifice equity in their company to obtain the capital. Owners that have proven cash flows often find it desirable to hold on to the equity of the company as the business continues to appreciate in value.

With a multitude of lending institutions, there is a lot of flexibility for the business owner. Generally speaking, the cost of the debt increases as the risk of repayment increases. The way lenders are able to lower their risk of repayment is by evaluating the size and consistency of historical cash flows. A healthy balance sheet, with a manageable debt to equity ratio, is also desirable from a lender’s perspective. Depending on the business’ specific needs, the business owner can obtain financing based upon many aspects of their financials including, but not limited to, the value of accounts receivable, inventory, and fixed assets, as well as the extent of annual net cash flows and purchase orders. Each has its own cost based on risk of repayment and administrative cost in servicing the various loans.

Additionally, debt can be sourced at a variety of levels. Most commonly thought of is senior debt. Senior debt is traditionally offered by banks and the all-in cost of capital approximates the sum of the stated interest rate on the note plus any fees paid to issue the debt. The business owner does not take any equity dilution as a result of raising senior debt capital. Depending on the lending environment, the business owner may be required to provide a personal guarantee, but does not have to provide any board representation to the senior debt lender. Often the loan covenants could contain provisions that restrict the company from expending amounts for fixed assets purchases over a threshold amount.
executing acquisitions without the prior approval of the lender, and similar significant company transactions that could affect the lender’s ability to be repaid. The strongest qualified borrowers can obtain senior debt for around 2 - 3% given the current market and prime rates.

There may come a time when a business is no longer able to raise new senior debt due to EBITDA or cash-flow restrictions. If the business requires more capital to continue growth, and cannot raise more senior debt, mezzanine debt can be a viable option. Mezzanine debt is unsecured and is subordinated to the senior debt position held by the original lenders. In the case of bankruptcy, the senior lenders would be paid back their debt before any mezzanine lender would receive funds. The mezzanine lender, as its name implies, sits between the senior lenders and equity contributors. Most lenders require an agreement among all debt holders before mezzanine debt can be issued.

Mezzanine debt is more expensive than senior debt due to its subordinated repayment position. The mezzanine debt has a higher cost of capital due to two separate components, the stated interest rate and either a “paid in kind” feature or a warrant feature. In today’s market, the stated rate on the interest is between 10 – 12%, with the preponderance being in the 11 – 12% range. Although the interest is paid regularly, the principal on a mezzanine loan is not typically amortized. In addition to the interest rate, lenders will either receive a warrant that upon exercise can be converted into equity of the company, or a paid in kind interest feature that typically accrues and increases the outstanding balance of the debt. Generally the equity rights exercised by the lender are repurchased by the borrower at the time the debt matures, and as a result, at the end of the mezzanine debt’s term, there is typically no equity dilution because of the redemption of the warrant. Mezzanine debt is modeled to obtain an internal rate of return of 15 – 18% in today’s market.

Like equity financings, there are some negative aspects to debt financing. Because of the fixed payment schedule associated with most debt arrangements, the capital can only be retained by the company for a finite period of time. Before seeking debt financing, a business owner must evaluate the reason they are sourcing new capital and ensure that they will be able to comply with the repayment schedule required.

A lending institution typically creates covenants that businesses have to comply with in order to keep the capital. If the business does not comply with the covenants, as agreed upon from the beginning, the lender can call back their capital. These covenants are important as they may leave a business vulnerable during hard times. If cash-flow dries up for an extended period of time, a business owner may be faced with the lending institution calling the capital. These covenants may also restrict the decisions made by management as it relates to seeking additional debt and/or making distributions to shareholders. When debt financing is obtained, special attention needs to be paid to the covenants as outlined, and the business owners should ensure that their long-term vision is not inhibited by the covenants.
As with most business decisions, the facts and circumstances will often dictate which capital source is best for the business owner. It is important to evaluate the reason capital is needed to ensure the best facility is being used. A business owner should evaluate the short-term and long-term benefits and costs of each option, including the long-term components that require periodic amortization and the short-term components such as annually renewable lines of credit that do not require amortization.

In our third and final article in this series, we will examine the benefits and caveats of convertible debt.

If your business is experiencing a need for new capital, and you would like to be advised on your different options, please contact your Keiter Professional or Scott Zickefoose at szickefoose@keitercpa.com.