RISK, RETURN, AND THE COST OF CAPITAL

Debt vs. Equity Financing

James P. Weston
Professor of Finance
The Jones School, Rice University

DEBT VS EQUITY

Simple Balance Sheet

Stuff	Debt
	Equity

DEBT FINANCING

- Non-contingent claim
- Repay principle and interest
- Collateral
- Priority in bankruptcy
- Monitoring / restrictions
- Many different forms

DEBT FINANCING

- Banks
  - Straight loan
  - Line of credit
  - Mortgages
  - Commercial/industrial loans
- Bonds

DEBT FINANCING AND TAXES

- Interest payments are pre-tax
  - Creates a tax shield
  - This is an important cash flow
  - Subsidizes debt
  - Lowers the effective interest rate

EQUITY FINANCING

- Ownership and control
- Contingent claim
- All residual cash
- All the upside
- Wiped out in bankruptcy

MIX OF DEBT AND EQUITY

- Capital structure
- Does not change risk!
- Moves risk between investors
  - Debt: no upside / protected downside
  - Equity: all upside / can get wiped out

SUMMARY

- Equity has ownership and control
- Debt is safer than equity
  - Lower cost
- Mix is called "capital structure"
  - Slices up the risk of the firm