Debt Financing

Meaning

When a company borrows money to be paid back at a future date with interest it is known as debt financing. It could be in the form of a secured as well as an unsecured loan. A firm takes up a loan to either finance a working capital or an acquisition.

Debt means the amount of money which needs to be repaid back and financing means providing funds to be used in business activities. An important feature in debt financing is the fact that you are not losing ownership in the company.

Debt financing is a time-bound activity where the borrower needs to repay the loan along with interest at the end of the agreed period. The payments could be made monthly, half yearly, or towards the end of the loan tenure.

Another important feature in debt financing is that the loan is secured or collateralized with the assets of the company taking the loan. This is usually part of the secured loan. If the loan is unsecured, the line of credit is usually less.

If a company needs a big loan then debt financing is used, where the owner of the company attaches some of the firm's asset and based on the valuation of those assets, loan is given. Let's understand debt financing with the help of an example. If a company requires a loan of Rs 10 crores, it can raise the capital by selling bonds or notes to institutional investors. Debt financing is an expensive way of raising funds, because the company has to involve an investment banker who will structure big loans in a systematic way. It is a viable option when interest costs are low and the returns are better.

A company undergoes debt financing because they don't have to put their own capital. But too much debt is also risky and thus, companies have to decide a level (debt to equity ratio) which they are comfortable with.

Characteristics of Debt Finance

1. It is a fixed return finance: interest on debt is fixed regarding less of the profits made by the company.
2. Interest of debt finance is a legal obligation on the part of company to pay and failure to pay it may lead the company into receivership in the extreme.
3. It is usually given on conditions and restrictions except for overdrafts.
4. It carries a first claim on profits and assets before other finances.
5. It does not carry voting rights and as such it does not participate in the decision making process of the company.
6. Its use rises the company's gearing level.
7. It is always refundable except for irredeemable debentures.
8. it is usually a secured type of finance
9. Interest on debt finance is a tax-allowable expense.

Types of Debt

1. Secured Debt

The dealer hands you the keys to a brand-new SUV. You pump your fist in the air and drive home to show off the car you just bought. Except you didn't just buy it—you financed it. The bank owns the car. You just get to pay them to drive it each month. That's secured debt.

With secured debt, any money you borrow is backed by a physical item. In other words, there's collateral. When you finance a car, boat, RV or even a home, the lender looks at your credit to check your borrowing history. That helps them determine your interest rate (money charged just for the act of borrowing). They also place a claim of ownership (also called a lien) on your stuff. If you stop making payments, the lender can take the item back (either through repossession or a foreclosure).

Secured debt is great for lenders because it means less risk for them. They either get their money, or they get the item back to sell. But it also means more risk for you. The moment you don't pay up, you'll be saying hello to the repo man and goodbye to your precious Honda. And with assets that go down in value (like cars), you could end up underwater and owe more than the item is worth.

But instead of paying someone else to use their stuff (because that SUV isn't yours until you finish paying it off), what if you saved up cash to buy that item up front? Not only will that save you a ton of money in interest, but you'll also get a better night's sleep knowing your car (and your mattress) is paid for.

2. Unsecured Debt

So, if secured debt is backed by something that can be taken away, what about unsecured debt? Unsecured debt means there's no collateral for the loan. Think credit cards, student loans, medical bills, payday loans or personal loans. It's money you've borrowed, but it's not directly tied to an item. This makes it harder for the lender to get their money when you don't pay up, so unsecured debt usually has a higher interest rate. And it also means you're more likely to face debt collectors or lawsuits if you miss payments.

This kind of debt can pile up quick if you're not careful. With secured debt, you're more motivated to make payments because you might lose your car, home or something you use every day. With unsecured debt, it's not as easy to see where the money you're borrowing is going, but you still need to pay off the debt ASAP!

3. Revolving Debt

Revolving debt is an open line of credit. It's when you enter into a cycle of borrowing money and paying back—just to borrow more money. It's kind of like the revolving door you use to enter a mall to buy things with your line of credit. You can borrow up to a certain amount (called a credit limit), and as long as you make the minimum payment by a specific date each month, you can keep spending. Revolving debt is your credit card, store card (we're looking at you, Target), or even the tab you've racked up at your local hardware store.

With this type of debt, it's easy to feel like you have your credit under control because the minimum payments you make are usually super small compared to your credit limit. But only paying the minimum each month (or anything less than the full balance, for that matter) means you have to pay interest on the rest of your balance later. And if you miss a payment, you'll owe late fees on top of everything else! No gaming system or pair of shoes is worth the mess you could be in if you use a credit card.

Even if you pay off your entire balance at the end of the month, there's still a period of time where you owe someone else, whether it's a store or a credit card company. That thing you bought technically isn't yours until you've paid off the balance. Time to do a 180 and revolve right out of this debt for good.

4. No revolving Debt

Non revolving debt is a line of credit that can't be used more than once. It's a car loan, a business loan, a student loan or a mortgage. You borrow a specific amount of money and pay it back in installments before a certain date. And your minimum payment each month usually depends on how much you originally took out. Once you've paid the loan off, it's gone, and you don't get any more funds to spend.

Like all debt, interest is also involved. But with non revolving debt, you're usually dealing with some larger numbers. So even if you make the minimum payment each month, you're still going to have to pay interest on the remaining balance. These loans are probably going to take some time to pay off (especially a mortgage), which means you will end up shelling out more than you borrowed to begin with. And depending on your interest rate, that can add up to some serious cash. For example, let's say you took out a 30-year $250,000 mortgage at 3.8% interest. When all is said and done, your house will actually cost you almost $420,000 ($250,000 plus about $170,000 in interest)!

5. Sneaky Debt

Cars, motorcycles, couches, computers, dishwashers, even pets—you can finance anything nowadays. You've probably seen the flashing, neon signs: zero percent APR! Or 90 days same as cash! These, friends, are examples of sneaky debt. Salespeople know most folks don't pay off that furniture set or treadmill within 90 days—and the moment your time is up, crazy interest rates kick in with full force. Even credit card points and airline miles are another way to tempt people to spend more money in the hopes of getting a very small reward. Don't fall for these debts disguised as deals. They're not worth it!

There's also another kind of debt you may not even know is debt . . . and it's in your pocket. Yep, cell phones fall into the sneaky debt category because many of us don't think twice before signing a contract and agreeing to pay off our phone every month for the next two years. But it's secured debt. It may not seem like a big deal, but the truth is, you still owe on that device, and it could be taken from you if you don't pay up. Instead of financing the latest iPhone, you'd be better off saving up to pay for the whole thing with cash.

Advantages

- **Maintain ownership:** You become obligated to make the agreed-upon payments on time when you borrow from the bank or another lender, but that's the end of your obligation. You retain the right to run your business however you choose without outside interference.

- **Tax deductions:** This is a huge attraction for debt financing. In most cases, the principal and interest payments on a business loan are classified as business expenses, and they can, therefore, be deducted from your business's income at tax time. It helps to think of the government as a "partner" in your business in this case, with a 30% ownership stake or whatever your business tax rate is.

- **Lower interest rate:** Analyze the impact of tax deductions on the bank interest rate. If the bank is charging you 10% for your loan and the government taxes you at 30%, there's an advantage to taking a loan you can deduct.

Drawbacks

- **Repayment:** Your sole obligation to the lender is to make your payments, but you'll still have to make those payments even if your business fails. And your lenders will have a claim for repayment before any equity investors if you're forced into bankruptcy.
- **High rates:** Even after calculating the discounted interest rate from your tax deductions, you might still be faced with a high-interest rate because these will vary with macroeconomic conditions, your history with the banks, your business credit rating and your personal credit history.
- **Impacts on your credit rating:** It might seem attractive to keep bringing on debt when your firm needs money, a practice knowing as "levering up," but each loan will be noted on your credit report and will affect your credit rating. The more you borrow, the higher the risk becomes to the lender so you'll pay a higher interest rate on each subsequent loan.
- **Cash and collateral:** Even if you plan to use the loan to invest in an important asset, you'll have to be sure that your business will generate sufficient cash flow by the time repayment of the loan is scheduled to begin. You'll also most likely be asked to put up collateral to protect the lender in the event that you default on your payments.

Sources of Debt Financing

1. Loans

Perhaps the most obvious source of debt financing is a business loan. Entrepreneurs commonly borrow money from friends and relatives, but commercial lenders are an option if you have collateral to put up for the loan. If you're just starting out, that may mean pledging your personal assets, including your home. (The "second mortgage" has a rich history of financing startups.) Once your business is established, you may be able to pledge the assets of the company itself.

2. Installment Purchases

A business that takes out a mortgage on a building, buys a vehicle with a car loan or purchases equipment with dealer financing is doing nothing more than acquiring debt financing. Someone -- a bank, finance company or the actual seller of the asset -- is fronting you the money to buy the assets. For new businesses, the ability to purchase assets with debt may depend on the owner's personal credit rating. A mature business that has built a solid credit rating of its own is more likely to be able to access financing independent of the owner.

3. Revolving Credit

Whether you use credit cards for smaller things such as office supplies or miscellaneous expenses or for major spending categories such as inventory and capital assets, they represent a form of debt financing. Businesses can also obtain a line of credit -- a pool of money it can borrow from when needed. As with other kinds of debt financing, access to revolving credit may initially depend on the business owner's personal credit rating. With time, though, as the business demonstrates it is capable of managing its debt, it becomes easier to borrow money on its own. Business credit cards are a good way to start building that credit rating. Many retailers cater to small businesses -- office supply stores, home improvement stores -- offer special credit-card programs specifically for the smaller company.

4. Trade Credit

With trade credit -- "buy now, pay later" arrangements with suppliers -- your vendors are the ones providing the debt financing, even if it's relatively short-term. If you receive an order of inventory with 30 days to pay, you've got a month's worth of debt financing for the cost of that inventory. A business just starting out may not have immediate access to trade credit. It will typically have to prepay or pay on delivery until it demonstrates to suppliers that it has the money to meet its obligations.

5. Bonds

Small business people likely don't give much thought to using bonds to raise money for long-term investment. Even so, it's an option to at least keep in mind for down the road, once the company is firmly established and needs capital for growth. Local governments have bond programs in which municipal bonds can be sold to finance smaller business' capital projects, to be paid off with money generated by those projects. And some small companies raise money by selling bonds themselves -- although because of the risk involved, such bonds typically have to pay a high rate of interest and are saddled with the term "junk bonds."