Debt Financing

Loading the player...

**What is 'Debt Financing'**

Debt financing occurs when a firm raises money for working capital or capital expenditures by selling debt instruments to individuals and/or institutional investors. In return for lending the money, the individuals or institutions become creditors and receive a promise that the principal and interest on the debt will be repaid.

The other way to raise capital in the debt markets is to issue shares of stock in a public offering; this is called [equity financing](https://www.investopedia.com/terms/e/equityfinancing.asp).

*Next Up*

1. [**LONG-TERM DEBT TO CAPITALIZATION ...**](https://www.investopedia.com/terms/l/longtermdebt-capitalization.asp)
2. [**COST OF CAPITAL**](https://www.investopedia.com/terms/c/costofcapital.asp)
3. [**FUNDED DEBT**](https://www.investopedia.com/terms/f/fundeddebt.asp)
4. [**DEBT SERVICE**](https://www.investopedia.com/terms/d/debtservice.asp)

**BREAKING DOWN 'Debt Financing'**

When a company needs money, it can take three routes to obtain financing: equity, debt, or some hybrid of the two. Equity represents an ownership stake in the company. It gives the shareholder a claim on future earnings, but it does not need to be paid back. If the company goes bankrupt, equity holders are the last in line to receive money. The other route a company can take to raise capital for its business is by issuing debt - a process known as debt financing.

Debt financing occurs when a firm sells [fixed income](https://www.investopedia.com/terms/f/fixedincome.asp) products, such as bonds, bills, or notes, to investors to obtain the capital needed to grow and expand its operations. When a company issues a bond, the investors that purchase the bond are lenders who are either retail or institutional investors that provide the company with debt financing. The amount of the investment loan, referred to as the principal, must be paid back at some agreed date in the future. If the company goes bankrupt, lenders have a higher claim on any liquidated assets than shareholders.

**Cost of Debt Financing**

A firm's capital structure is made up of equity and debt. The [cost of equity](https://www.investopedia.com/terms/c/costofequity.asp) is the dividend payments to shareholders, and the [cost of debt](https://www.investopedia.com/terms/c/costofdebt.asp) is the interest payment to bondholders. When a company issues debt, not only does it promise to repay the principal amount, it also promises to compensate its bondholders by making interest payments, known as [coupon payments](https://www.investopedia.com/terms/c/coupon.asp), to them annually. The interest rate paid on these debt instruments represent the cost of borrowing to the issuer.

The sum of the cost of equity financing and debt financing is a company's [cost of capital](https://www.investopedia.com/terms/c/costofcapital.asp). The cost of capital represents the minimum return that a company must earn on ts capital to satisfy its shareholders, creditors, and other providers of capital. A company's investment decisions relating to new projects and operations should always generate returns greater than the cost of capital. If returns on its capital expenditures are below its cost of capital, then the firm is not generating positive earnings for its investors. In this case, the company may need to re-evaluate and re-balance its capital structure.

The formula for the cost of debt financing is:

KD = Interest Expense x (1 - Tax Rate)

where KD = cost of debt

Since the interest on debt is [tax deductible](https://www.investopedia.com/terms/d/deductible.asp) in most cases, the interest expense is calculated on an after-tax basis to make it more comparable to the cost of equity as earnings on stocks are taxed.

**Measuring Debt Financing**

One metric analysts use to measure and compare how much of a company's capital is being financed with debt financing is the [debt-to-equity ratio](https://www.investopedia.com/terms/d/debtequityratio.asp), or D/E ratio. For example, if total debt is $2 billion and total stockholders' equity is $10 billion, the D/E ratio is $2 billion / $10 billion = 1/5, or 20%. This means for every $1 of debt financing, there is $5 of equity. In general, a low D/E ratio is preferable to a high one, though certain industries have a higher tolerance for debt than others. Both debt and equity can be found on the balance sheet statement.

**Interest Rates on Debt Financing**

Some investors in debt are only interested in principal protection, while others want a return in the form of interest. The rate of interest is determined by market rates and the creditworthiness of the borrower. Higher rates of interest imply a greater chance of default and, therefore, a higher level of risk. Higher interest rates help to compensate the borrower for the increased risk. In addition to paying interest, debt financing often requires the borrower to adhere to certain rules regarding financial performance. These rules are referred to as [covenants](https://www.investopedia.com/terms/b/bond-covenant.asp).

Debt financing can be difficult to obtain, but for many companies, it provides funding at lower rates than equity financing, especially in periods of historically low interest rates. Another perk to debt financing is that the interest on debt is [tax deductible](https://www.investopedia.com/terms/t/tax-deduction.asp). Still, adding too much debt can increase the cost of capital, which reduces the [present value](https://www.investopedia.com/terms/p/presentvalue.asp) of the company.