Understanding debt

There has never been a more important time to have your business debt structured appropriately. This is a topic which many businesses don't understand and ignore at their peril. We look at the key principles.

Should we have debt?

Very few businesses or people can go through life without having any debt. If as a business you are in the luxurious position of being able to ask yourself the question, the answer will almost certainly be yes. Business debt and personal debt are different. Personal debt beyond an affordable mortgage or car loan is generally bad; business debt is not.

A business which has debt will generally be able to spread the risk of financing its operations, grow more quickly and produce a higher return for its shareholders than a business which is debt free. This may seem counter-intuitive but it is true. A business which has debt should produce higher returns in the good times than a business which is debt free. Conversely, and perhaps more pertinently, a business with debt will produce lower returns than a debt free business when times are tough.

There are a number of parameters we can look at in determining the amount of debt a business should have but the overriding factor for an SME will be the attitude of the owners to risk. Attitude to risk is a personal issue and as such it is not an advisor's role to say if a particular attitude is right or wrong.

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What do we mean by structuring debt?

When people refer to the structure of debt they mean "What type of debt do you have?" and "When does it have to be repaid?" Your business may have an overdraft, a term loan or both. We're all familiar with the fact that overdrafts are generally repayable on demand (i.e. short-term) whereas term loans are for a fixed period of time, usually 3 to 15 years or beyond (medium to long-term).

There are many other forms of finance beyond overdrafts and term loans. For example, your business may also use– trade credit, factoring, hire purchase agreements, preference shares, etc.

What are the security implications of different types of debt?

Irrespective of the term or type of debt, all debt falls into one of two categories. It is either secured or unsecured. As the lender will usually pass any legal and valuation costs on to the borrower, secured debt is more expensive to arrange than unsecured debt. On the plus side, secured debt will generally have a lower rate of interest than unsecured debt as the lender bears less risk. If the borrower defaults, the lender should be able to recoup the funds they've advanced by selling the assets which have been used as security.

A bank may be willing to accept a guarantee from a high net worth individual without attaching any legal claim to a particular asset as security. This is referred to as an uncollateralised guarantee. Normally, lenders will require the security to be asset backed. For the purposes of valuing the assets for determining how much security they require, lenders will normally discount the market value of assets. A bank may discount the value of commercial property by 20%, trade debtors by 50% and stock by 80%. As borrowers generally don't know the discount factors which a bank may apply, they usually feel that the bank has asked for too much security. Banks apply these discounts to the market value so they can be confident of recouping their cash from the sale of assets even in a fire sale situation. As much as discount factors may pain borrowers, the recent developments in the economy, particularly with regard to commercial property values, have only underlined the wisdom of applying discount factors.

What are the cost implications of different types of debt?

Unsecured debt will generally have a higher rate of interest than secured debt. There should be a positive correlation between security and the interest rate. The better the quality and marketability of the security which the borrower provides, the lower the interest rate the bank should charge.

When pricing facilities, banks typically refer to 'the margin'. When they refer to this, they mean the number of percentage points above the base rate or, now more typically above, LIBOR at which they intend to charge you interest. So a margin of 4% would mean LIBOR + 4%. Although the base rate and LIBOR have fallen significantly as banks have increased their margins, many businesses find they are paying interest at a similar level to when the base rate was much higher – so whilst a business may have previously been paying base plus 2%, they are now paying base (or more probably LIBOR) plus 5%.

Although some term loans may have a fixed rate of interest, most overdrafts and loans from banks are offered to borrowers at variable rates. As with many things in life, it is easy to be wise after the event about the merits or demerits of taking a fixed rate loan. As with the absolute level of debt, the decision may depend on your attitude to risk. As a guiding principle I would suggest that it may be better to consider what you could lose rather than what you could gain.

How do we decide the correct structure?

You are probably better able to answer this question than you think. If we look at personal finance – most of us will have financed the purchase of our homes with a 25 year loan, the purchase of our cars with a 3 year hire purchase or lease agreement and perhaps have a mobile phone on a pay as you go contract. So, matching the term of the debt with the purpose of the debt is the key principle in determining how you should structure debt.

Essentially we need to apply the same reasoning to our business finances. Who of us have asked the bank for an overdraft to buy a house or a term-loan to buy a new phone? Yet I've often seen businesses use overdraft finance for everything – buildings, fixed assets and stock. They may get away with this is the short-term but if they use all their overdraft facilities for fixed assets they may find themselves in a tight spot if they find their customers taking a bit longer to pay and their cash resources squeezed.

When should we use short-term debt?

Short-term debt should be used for short-term needs, for example, financing stock and debtors. An overdraft facility is a very effective type of short-term-debt. It is an efficient way to borrow precisely the amount of money you need; you don't pay for the credit you don't use. There is no point in borrowing more money than you need; the interest cost on your debt will exceed the interest income you will earn on the surplus cash so you will be out of pocket.

An overdraft will be subject to renewal on an annual basis. The lender will charge you a fee for the annual review. Typically the fee is a percentage of the amount of the facility. Although many overdrafts are offered to borrowers on an unsecured basis, the lender will use the annual review to assess the sufficiency of their security position as well as considering the interest rate they wish to charge you.

So although an overdraft can be flexible and efficient it is short-term. It is a facility which could be withdrawn at the next annual review. If you have an overdraft which never dips below a certain level of indebtedness you have core borrowings in a short-term facility. If your bank has a change of heart you could find yourself in a tight spot. You should consider switching the core element of the overdraft into a term-loan.

When should we use long-term debt?

Long-term debt should be used for long-term needs, for example, financing fixed assets. Moreover, you should match the term of the loan to the life of the asset. So you may agree a 20-year term for a building and a 7-year term of an item of equipment. This is applying the pay as you go principle.

There will be an arrangement fee which is a percentage of the facility but unlike an overdraft this is not payable on an annual basis. There may be costs associated with putting security in place but as already noted, if your debt is secured you should pay a lower rate of interest compared to an unsecured facility.

Generally term loans can be repaid early without the borrower incurring penalties. Unlike an overdraft, a term-loan is not subject to an annual review. So as long as you keep within the terms of the loan, it is a source of finance which is guaranteed to you, the bank cannot withdraw it from you. You may find it easier to sleep at night if your debt is long rather than short-term. ■

It could be your debt that is keeping you afloat.