Using Debt to Replace Equity Capital in Improving Company Finances

Michael K. Menerey, Partner, CFO Edge, LLC

In the business world and in everyday life, the mention of debt often carries negative connotations. However, in actuality, debt is one of the best methods of managing your finances and increasing your company's wealth. It is not, as many people think, a burden that lowers a business's capacity to function. In many cases, debt can be an extremely useful tool. If the exact reason for incurring debt and the uses for that debt are properly and specifically identified, they can improve the company's financial structure.

In particular, debt can be used as an inexpensive substitute for equity capital (well below the 15 plus% cost of equity capital). Through such uses, it can not only enhance investor returns, but also solve liquidity fluctuations, while enhancing growth of the business. In fact, debt should be considered as part of every company's capital structure and, by taking a few simple precautions, it can be implemented cheaply and effectively.

Locating Debt

The first challenge to implementing this system is locating an appropriate form of debt that will work well for your purposes. Debt can take a variety of different forms, some of which are better than others. It is crucial that you identify a method that will enhance your capital structure and operations, not damage them.

In some cases, useful debt can take the form of a line of credit, either secured or unsecured, that can be used to make further purchases. Also useful is asset-based financing. This involves the provision of structured working capital and fixed-term loans that are then secured by assets. Such assets might include accounts receivable, inventory, equipment, real estate, or other assets owned by the company. In particular, for the uses discussed here, you would want to consider A/R, inventory, or fixed asset financing. A mortgage levied against real estate owned by the company could also serve as a form of secure debt to provide the company with liquid resources.

Regardless, the form of the loan will dictate where such a loan will be found. For more information on identifying and locating useful loans, see one of our earlier articles, The Primary Types of Business Loans. It can also be helpful to consult with a professional who can assess which loan format will be most advantageous for your company, as well as advise where such debt might be found.

Negotiating New Debt to Achieve Success

First and foremost, it is vital that the debt negotiation process is properly managed. Unfavorable terms can cripple a company that is taking on new debt. In particular, it is preferable to avoid agreeing to any kind of personal guarantees. If the business fails and the debt is personally guaranteed, then the obligation to repay would remain in place, leaving the owners of the business personally liable to repay the debt. While some lenders require such guarantees, it is better to either negotiate alternate terms or look elsewhere. It is always better—and far less risky—to secure debt with business assets rather than with personal assets. Such guarantees should only be provided to the lender as a last resort and with full knowledge of the potential ramifications.

 © 2012 CFO Edge, LLC

Furthermore, it is also advisable to avoid incurring any pre-payment penalties when entering into new debt agreements. This is largely because selling or recapitalizing the business could become far more expensive than you anticipate if the company is burdened with such provisions in the debt agreements.

Manage Your Debt

Lastly, and perhaps most importantly, as this stage will last the longest, it is vital that you understand the possible ramifications of taking on new debt and understand how to manage debt to the company's best advantage. This analysis must be completed before taking on new debt and must be based on conservative operating assumptions—not on best-case assumptions.

While borrowing funds through one of the aforementioned loan structures can bring great benefits to your company, it is important that you also understand that such measures also come with a price. Namely, the company may at some stage be required to prepare audited financials, where they may not have been previously required to do so. The additional cost of the audit must, therefore, be factored into any accounting or when forecasting the benefits of incurring the new debt.

When the debt is incurred, there is an accompanying need to forecast the company's ongoing ability to handle the debt, and it may be helpful to engage the services of a qualified professional. The services of such a resource can also address any related covenants as covenant compliance must be part of your forecasting model. An external professional may be able to give a far more detailed and objective assessment of your ability to manage this kind of loan structure. In addition, the situation must be continually monitored and forecasts must be updated on a regular basis to anticipate any problems should the business go off course. All such assessments may similarly be conducted with the help of an outside professional.

This ties into the final point, which is that once incurred, debt must be managed diligently, both in regard to covenant compliance and liquidity requirements, as well as in consideration of repayment plans. In particular, if the debt has been taken in the form of a line of credit that is annually renewable, it must be managed especially closely, and the possibility of it not being renewed must always be addressed.

In Summary

Taking on new debt in the form of lines of credit, loans, or mortgages against real estate (to name just a few options) can be a daunting, but ultimately beneficial means of enhancing investor returns and minimizing liquidity fluctuations. However, it is important that any such measures are approached cautiously and with great consideration of all possible effects that might accompany the debt. In conclusion:

- Before beginning the process, determine what kind of debt will best suit your company's particular circumstances and to locate the best possible source. This is an area where the use of an outside professional may be most beneficial.

- Take care during the negotiation process to ensure that the terms are favorable. In particular, try to avoid any personal guarantees or pre-payment penalties.

- Managing your debt over the long-term is incredibly important. Keep up-to-date forecasts that continually assess how the company will accommodate issues relating to covenant compliance and liquidity requirements. Such forecasts should also determine a healthy repayment plan.

Los Angeles and Southern California CEOs and CFOs looking at debt financing, forecasting and debt management may want to consider working with an outsourced provider of CFO services. An outside professional experienced in securing and managing debt can be helpful in advising on all stages of the process.

 © 2012 CFO Edge, LLC

About CFO Edge
CFO Edge, LLC is a leading Southern California provider of outsourced CFO services. Based in Los Angeles, we are a group of experienced chief financial officers who engage with CEOs and CFOs on demand to address strategic planning, business management, and day-to-day financial operations challenges. Our seasoned professionals deliver services as interim CFOs, part-time CFOs, project-based CFOs, recruitment-to-permanent CFOs and interim-to-permanent CFOs. At CFO Edge, we're passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 626.683.8840.

This publication has been prepared for general information on matters of interest only, and does not constitute professional advice on facts and circumstances specific to any person or entity. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication. The information contained in this material was not intended or written to be used, and cannot be used, for purposes of avoiding penalties or sanctions imposed by any government or other regulatory body. CFO Edge, LLC, its members, employees and agents shall not be responsible for any loss sustained by any person or entity who relies on this publication.