ENERGY CATALYST

Investment Guide: Debt Financing

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Investment guide: Debt financing

Businesses require external financing for a variety of reasons, including launching new products, acquiring new equipment, and maintaining working capital. External financing takes many forms, including grants, equity, quasi-equity and debt, each of which carries benefits and limitations to both the investor and investee. For established businesses with proven cash flows, debt financing may be the most appropriate and readily-available financing source.

Types of business financing

The primary types of external financing for businesses are grants, equity, and debt. Each investment instrument has unique advantages and disadvantages, and may not be suitable for all businesses. Businesses that seek external financing should be familiar with the different investment instruments that may be available to them and evaluate which option is best suited to their needs.

Grant financing provides financing in cash or in kind to a business based on the business' alignment with the grant-providing organisation's values and objectives. Grants are typically awarded based on a competitive application process where businesses' proposals are evaluated against defined criteria for each grant. Firms receiving grants are not typically required to repay the grants; however, the grant-providing organisation will often dictate how grant funds can be used. Further, it may subject businesses to additional reporting requirements to verify the use of funds and monitor the impact of its investment. Many types of organisations provide grants, but the most common are non-profits, development organisations, and governments.

Equity financing provides businesses with cash in exchange for a share of the ownership in the business. Investors realise returns on their investment by receiving dividends from the business, selling their ownership stake to another investor, or realising capital gains when the business is sold. While equity investment requires no up-front payments by the company in exchange for financing, diluting ownership reduces the share of eventual financial returns for company owners and may surrender some control over the company via voting rights given to equity investors.

Debt financing refers to investments where a business borrows money from a lender under an agreement to repay that money (with interest) over a defined period of time.

Matching financing to cashflows

The suitability of each type of investment instrument is largely dependent on the business' stage in its overall growth cycle. A company receiving debt financing should be generating consistent cashflows over the short to medium term to service debt obligations. For start-ups and other early-stage businesses, company income may not be adequate to meet monthly repayments and in such cases, financing from equity or quasi-equity may be more suitable. As a company grows, the cashflows that it generates may enable it to invest in growth and meet debt obligations. Figure 1 below summarises how funding types are matched to the company's development stage.

Early-stage businesses

Start-up businesses typically seek financing to fund pre-revenue expenses including operations, working capital and capital investment. Even post-revenue early-stage businesses may need to direct available cashflow to support overall loss-making operations. In both cases, cashflows are unlikely to be large enough to satisfy debt repayment and interest obligations. These companies may be more suited to patient capital, such as equity or quasi-equity, that does not divert short- or medium-term cashflow from the business.

Growth-stage businesses

At growth stage, companies may prefer to focus positive cashflows from operations on investment into growth opportunities. This may leave little cash on hand to service larger debts. Whilst debt financing may not be the best option for these businesses, more flexible financing options such as quasi-equity may be appropriate. These instruments, detailed in the “Special Instruments” commercialisation guide, can reduce the short- and medium-term cashflow burden on the company.

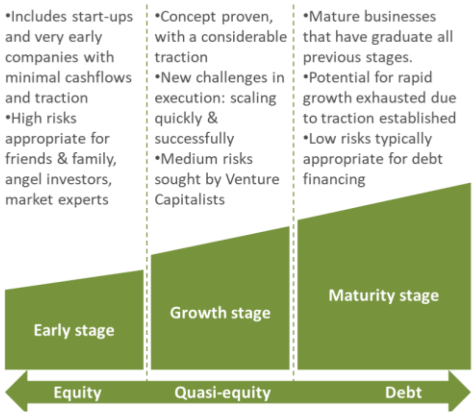

Figure 1: Financing and the business life cycle

Mature-stage businesses

Businesses that reach the mature stage are likely to generate large, consistent cashflows that can service debt. By pursuing debt financing, these businesses may be able to maintain full control of their operations while securing financing at a cheaper rate than alternative options such as equity or quasi-equity.

Debt financing overview

The most common form of debt investment is a **term loan**, which is money borrowed from a lender that is repaid over a predetermined period at an agreed-upon interest rate. Loans are either **secured**—meaning borrowed against collateral (business assets such as property)—or **unsecured**. Debt can also be advanced to a business in other forms such as a **revolving facility**. This enables a company to obtain debt, repay it, and repeat this drawdown process as needed for the period of the contract.

Debt can also be classified by length or **tenor**. **Short-term debt** gives businesses quick access to funds for operational needs and has a maturity of one year or less. **Long-term debt** provides companies with larger sums for long-term financing objectives and typically entails years of repayment.

Debt investments carry a legal obligation for the debtor to repay investors on a pre-determined schedule. As such, debt often carries first rights on claims during liquidation and can be pursued through legal action on non-repayment. In the case that a business is completely unable to service its debts and must be liquidated, seniority dictates which lenders receive payments first. **Senior secured debt** is prioritised for repayment from the company’s liquidated assets. **Subordinate debt** does not have a preferential claim on the company’s assets and is only repaid after all senior debt obligations are settled.

Providers of debt financing

Debt financing is typically associated with traditional financial institutions such as commercial or government banks. **Commercial banks** are the primary providers of debt capital to small businesses, and banks typically offer term loans in addition to other debt instruments such as overdrafts. **Government banks** operate much like commercial banks, but they may provide special investment or preferential terms to businesses that support government priorities and initiatives. In addition to banking institutions, companies may obtain debt financing from other investors, as detailed in the “Investment Readiness” commercialisation guide.

Key terminology

Table 1: Key debt financing terms		
Term	**Description**	**Business consideration**
Currency	Loans are denominated in a currency for disbursement and repayment. A **hard currency** (e.g. US dollars) is one with a stable exchange rate, while **soft currencies** (e.g. Kenyan shillings or other local currencies) fluctuate as a result of political or economic uncertainty.	A company collecting revenues in local currency that depreciates relative to the borrowing currency is exposed to exchange rate losses and an increased overall cost of debt. This can have significant implications for developing market borrowers.
Fees	In addition to interest and principal payments, debt investments may include additional fees such as administrative and penalty fees (e.g. for late payments).	Fees add to the overall cost of debt and a business should understand how these fees impact the total cost of the debt to the business.
Grace period	Grace periods are a pre-determined time during which a borrower may not be required to make principal and interest payments. A **static** grace period is typically provided in a loan contract while an **extended** grace period requires the borrower's application to the lender.	Grace periods may be agreed to in the original loan agreement, but borrowers in financial difficulty may also be able to negotiate with the lender for a grace period on an existing loan.
Interest rates	Interest rate is the amount, as a percentage of debt accessed, the borrower must pay to the lender in addition to repaying the principal. **Fixed interest rates** are constant throughout the life of a debt; **variable interest rates** are linked to external indices that may fluctuate over time.	Over the life of a loan, small interest rate differences can make a significant difference in the total cost of debt. While variable interest rates are often lower than fixed interest rates initially, they carry additional risk from economic fluctuations.
Repayment structure	In addition to term loans, which are paid down regularly over a pre-determined period of time, debts may have other repayment structures, including **bullet payment** (full balance paid one time at maturity) or a **revolving facility** (repayment varies with credit line).	Companies should align repayment terms to their cashflows, for instance businesses using debt to finance an upfront capital expenditure may prefer bullet repayment terms where payment on principal is only due once the investment is generating significant cashflows.
Security (collateral)	Collateral refers to assets or property offered by borrowers to lenders as a guarantee of payment for a debt. Loans that require security are referred to as **secured loans** while those that do not are classified as **unsecured loans**.	Collateral on secured debts can be claimed by lenders if the borrower violates the agreement (e.g. through non-payment), so companies should carefully decide which assets to offer as debt collateral.
Tenor	Tenor refers to the amount of time during which a business must repay a loan. The **maturity date** is the expiration date for any loan agreement, upon which any remaining debts or obligations must be settled.	Tenor shapes multiple aspects of the debt agreement, including interest rates and repayment structures. Businesses should choose loan tenors that are sufficiently long to create manageable payments.
Seniority	This term refers to the order in which debt facilities are repaid and explains the treatment for such upon liquidation of a company. **Senior debt** is settled first, followed by **subordinate debt**.	Businesses may be subject to covenants from senior debt holders that dictate future business activities, which may impact the ability to raise further capital until existing obligations have been met.

Pursuing debt financing

Debt agreements involve two parties, each with its own considerations. Businesses seek financing with low overall cost, whilst investors seek steady returns on their investments.

Business considerations

Businesses should consider all investment instruments when determining how to finance their operations and growth. When evaluating debt relative to other financing options such as equity, businesses should consider a few key factors:

Matching cashflows: Companies should pursue financing opportunities that match their cashflows. Debt is best suited for companies that will generate cashflows that can service the interest and principal payment obligations of the financing.

Company control: Debt, unlike equity, does not give the investor ownership of the business. Further, lenders cannot claim any assets in excess of the amount they are owed. Even small businesses that prioritise independence and control may prefer to accept debt with restrictive covenants over loss of control through equity investment.

Cost of capital: While borrowers must pay interest to lenders for debt financing, the total financial obligation for a given loan is clearly defined and time limited. In contrast, selling company shares via equity investment surrenders an undetermined amount of profits for an indefinite period of time. For successful companies that grow quickly, debt is often a "cheaper" form of finance in the long term. In addition, debt financing may come with tax benefits that reduce the overall cost of debt to the company.

Investor considerations

For investors, debt investment carries risk to capital without ownership or control of the business. To offset this risk, investors maintain credit criteria to evaluate a borrower's creditworthiness and implement covenants to influence the borrower's behaviour.

Before signing a loan agreement, investors will complete a credit process to evaluate whether a company is a suitable recipient of investment. Investors look at a few key indicators to determine whether a borrower is creditworthy:

Ability to service debt: To ensure that their borrowers are able to consistently repay the debts owed, lenders leverage metrics such as liquidity ratios (which evaluate a business' ability to quickly repay debt), debt-to-equity ratios (which evaluate whether a company already bears a high debt burden), and debt coverage ratios (which evaluate whether a company generates enough cashflow to service its debts).

Return on investment: The investor will set loan terms (e.g. tenor and interest rate) that ensure adequate financial returns to compensate for the risk of debt invested. Typically, the investor will apply a discount to the schedule of future cashflows from repayment to determine the present value of the investment. Discounted cashflow analysis enables lenders to compare available investment opportunities.

Credit history: Investors will look to a business' borrowing history to see if the business has demonstrated an ability to service debt in the past. Credit history assessments may be standardised (e.g. via credit scores) where established credit referencing bureaus exist, but they may also involve less formal research in regions without established credit assessment infrastructure.

Lenders often apply covenants, which are legal obligations on a borrower to protect their investments. **Positive covenants** dictate certain actions, such as financial disclosure, that businesses must take to comply with the loan agreement. **Negative covenants** restrict actions, such as issuing new debt, that a company can take. Whilst covenants may help leaders run their businesses more efficiently, they can also hinder management decision making.

Managing debt

Securing financing is not the final step in the debt financing process. Once a loan agreement is signed, borrowers are legally obligated to begin repaying the debt on the terms set out in the agreement. Non-payment of debt can lead to legal and financial implications that may result in the liquidation of business assets. Such ramifications make it crucial to establish effective debt management strategies to ensure that the business complies with the loan agreement.

There are often early warning signs indicating that a business will be unable to meet its debt obligations. **Negative cashflows** and **declining operating profits** may foreshadow a lack of cash to service the debt. Other indicators of potential delinquency include **defaulting on other debt** or supplier payments, as well as **abruptly changing auditors** or financial advisors. Companies that observe these warning signs in their own business or that are struggling to repay debt should seek to re-negotiate their obligations. This may include:

Grace periods: Companies may be able to negotiate a grace period with their lender to afford time for the company to adjust operations, survive a temporary hardship, or obtain financial relief from another investor.

Renegotiation: Companies may also be able to renegotiate the terms of their loans via a “workout agreement” that restructures the loan to benefit both the borrower and the lender. The borrower may receive lenient terms such as a tenor extension, while the lender will be able to avoid the cost and difficulty of debt collection and repossession.

Refinancing: Borrowers may be able to refinance their loans by taking out a new loan to repay the troubled one. Refinancing may be conducted with the original lender or a new investor.

Consolidation: This involves lumping up two or more debts together to form one large facility. Consolidating multiple loans may allow a company to obtain preferable terms as well as simplify financial planning and budgeting.

Special debt products

In addition to loans provided by financial institutions, businesses may also pursue debt financing through alternative investment products overviewed below and detailed in the “Special Instruments” investment guide.

Revenue-participating debt

Revenue-participating debt allows lenders to collect a share of a company’s revenues instead of a regular debt payment. This arrangement aligns investors with company performance, providing higher returns on company outperformance, and at risk of lower returns on underperformance. Revenue-participating debt is often laid out based on term, revenue share, and maximum repayment. This repayment is determined by income generated by the business and reduces the strain on cashflows on underperformance.

Convertible debt

With convertible debt, investors typically carry the option to seek repayment on pre-defined debt terms, or see their debt investment, inclusive of principal and interest accrued, converted to equity on pre-agreed terms such as company valuation.

Convertible debt enables equity investors to deploy capital faster where the early stage nature of the business hinders the valuation negotiation process. For the company, convertible debt will not require short- or medium-term cashflows, and if conversion takes place, it will not require cashflows at all.

Inventory financing

Inventory financing describes short-term or revolving loans given to businesses to purchase inventory for resale. In these arrangements, the purchased products themselves serve as collateral for the loan. Inventory financing may be provided directly by the vendor or by a third party such as a commercial bank. By helping their own customers grow and succeed, vendors that provide inventory financing may gain long-term benefits for their short-term investments. Such financing is most common for small businesses that do not have adequate cash on hand to purchase all the inventory needed to meet current demand.

Inventory financing reduces cashflow constraints on the business while providing security on the lender's short-term investment.

Corporate bonds

Corporate bonds are debt offered by a business to a pool of investors, who are entitled to repayment over time based on the bond agreement. Corporate bonds are typically issued by a registered underwriter or investment bank that sells the bonds directly to investors. Unlike term loans, bonds are exchangeable instruments that can be traded among investors.

Overdraft agreements

Overdraft facilities allow a business to withdraw money from a bank account after it has reached a zero balance. Overdraft facilities have a predetermined limit and are subject to fees and interest, but they may provide immediate liquidity for businesses with urgent short-term needs.

Trade financing

Trade financing is facilitated by financial institutions that serve as an intermediaries between exporters and importers by providing credit guarantees and short-term lending.

Conclusion

Growing businesses have a variety of financing options to explore, each with advantages and disadvantages. Businesses with steady cashflows and good budgeting practices may benefit from debt financing, which allows them to fund priorities while maintaining control of their companies. However, businesses that pursue debt financing must be sure they have the financial stability to service debts and ensure that the terms and conditions of their debt agreements align with company needs and priorities.

References and further reading

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