Ever increasing debt?

Debt is currently a very cheap source of funding so what are the risks?

Debt funding is very cheap by historical standards. If you believe central bank forecasts, low interest rates are likely to continue for quite some time, keeping debt cheap into the foreseeable future

There are an increasing number of ways to access debt particularly for SMEs and mid cap companies with the rise of FinTech innovations (such as crowd funding) in addition to traditional bank funding

Debt vs equity funding

Debt funding in nearly always cheaper than equity (shareholder) funding.

Debt holders are always paid before equity holders, have set payments (the amounts and timings) and therefore for the investor is lower risk than equity. Debt costs can be set against profits for tax purposes. Equity returns come from post tax profits

The downside— increased failure risk

Interest and capital payments are pre-agreed and must be met. If not, lenders can seek immediate repayment which often forces the business into bankruptcy and failure. The greater the debt proportion of funding, the higher the interest payments are vs cash generated from profits and therefore the higher the risk of business failure. <u>Debt is not flexible.</u>

For shareholders debt offers the ability to fund the business without diluting equity ownership. Shareholder returns can also be increased as debt is a cheaper source of funding, leaving more profits for shareholder **IF** the business remains successful.

What level of debt is right for your business?

There is no easy answer to this as every business really is different. Comparing yourself to direct competitors is a starting point, as is considering the shareholder’s risk appetite and how they want to earn return.

There are many very successful businesses that have no debt.

Classic mistakes

- Taking on too much cheap debt during boom times and then not being able to manage higher interest payments or refinance in the downturns (Debt becomes more expensive and is less available in downturns)
- Not allowing for unexpected dips or problems with cash flow
- Focusing too much on profit and not enough on cash generation
- Accepting inappropriate loan covenants
- Mismatching funding type/length/features compared to revenue stream features

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