

# How much debt should a firm have?

Having an optimal balance of debt and equity can help maximise returns, enhance growth and provide a competitive edge

By EUGENE TSE and GENEVIA WIJAYA NG

**H**AVE you ever wondered what level of debt your company should take on? It's a seemingly simple – but integral – question that needs to be addressed in every business. Having an optimal balance of debt and equity can help maximise returns, enhance growth and give a company a competitive edge.

Imagine a young enthusiastic entrepreneur, the owner of a fast-growing private company and the chief executive of a listed company. How do they go about getting the funds needed to finance growth? All three are open to different financing options and are going to adopt different capital structures. There are generally three stages in the life cycle of a company. And the financing available at each stage is quite different (see graph). For example, a start-up is not likely to get bank finance due to its limited cashflow track record.

There are only two generic financing options – debt and equity. Debt financing through bank loans is perhaps the most common way of raising capital. Banks charge interest and the loan is typically secured by collateral with personal and/or corporate guarantees. Sometimes, companies may also take loans from shareholders, directors or other companies.

## Pros and cons of debt

Equity financing, on the other hand, is when investors inject capital into the company in return for an ownership interest in it. While equity financing is more commonly used by listed companies, private companies can use it too. Investors providing equity financing may be personal contacts of the entrepreneur – such as friends and family – or professional investors such as private equity funds and angel investors.

Debt and equity financing each have advantages and disadvantages that should be considered to match a company's needs.

The main disadvantage of traditional bank debt is that it exposes a company to insolvency risk. Banks are in the business of lending, not investing. As most people know, banks typically do not take on risk with shareholders. Banks evaluate the credit risk before approving a loan. And to further reduce their risk, they often secure the loan with collateral as well as personal guarantees from shareholders.

During an economic recession, it is not uncommon to see our fair-weather banking friends withdraw loans to protect their capital, causing companies to run into cash-flow difficulties. This was what happened to quite a few companies during the recent global credit crunch. Fortunately for Singapore, the government stepped in to provide guarantees to make sure banks continued to support local companies.

With the credit crunch still fresh in people's minds, should entrepreneurs and CEOs stay away from debt completely? How much debt is too much? We will try to answer these difficult questions.

Let's start by looking at some of the advantages of debt:

- ◆ It is a more affordable source of funds than equity. Increasing debt gives shareholders more capital and more capacity to generate cash flow and profits, thus increasing profit to shareholders or return on equity (ROE).
- ◆ It acts as a tax shield, as interest is tax deductible while dividends are not. Debt financing can reduce a company's tax liability, which translates into a saving in real cash flow.
- ◆ Because loans often come with debt covenants that companies have to adhere to or risk withdrawal of the funds, debt tends to instil discipline in a company's cash management system and its current ratios.

So if a company needs to raise, say, \$5 million for expansion, should it go for debt or equity financing?

Banks are the most natural choice because they are easily accessible. If the banks reject a loan application, this suggests the company's credit risk may be too high, or the funding nature too risky – for example, overseas expansion. This is when management can approach private equity funds or angel investors. While fees and rates are higher, private equity funds will take risky investments in hope of making large upside gains.

As for "how much debt is too much", we can refer to a study by Aswath Damodaran, Professor of Finance at New York University, as a guide. In this study, data was collected on different industries, including debt-to-equity ratio. From these 2010 statistics, the global average debt-to-equity ratio is 0.8, with the Internet software and services industry having the lowest debt-to-equity ratio of 0.028 and the banking industry having a ratio as high as 20.8. Although the ratio varies across industries, as a rule of thumb, according to the US Chamber of Commerce Small Business Nation, an acceptable debt-to-equity ratio is between 0.3 and 1.0.

Balancing of debt and equity is not a simple matter, so companies should engage professional advisers or use financial and risk models before making a decision.

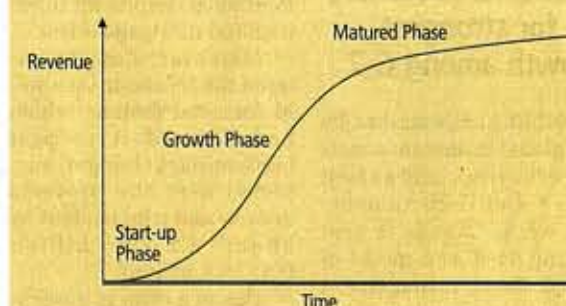
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