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Analyzing Borrowing Costs and Capitalization

By BNET Editorial

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When a company borrows money, there are essentially two costs involved: the issuance expenses, which are fees charged to issue the loan, and the interest payments on the debt. If interest is added to the principle balance of the loan—rather than paid off—it's known as capitalization.

Interest rates are usually based on an agreed annual percentage of the sum borrowed, and on the level of "default risk" taken on by the lender—in other words, the likelihood a company will fail to keep up with payments. Default risk is evaluated by rating agencies who assign a grade that indicates a company's creditworthiness or "credit quality." Credit quality will be lower for unsecured subordinated debt—which is riskier for lenders because they have a lesser claim on company assets in the event of liquidation—than for secured/collateralized senior debt. Lower credit quality translates into higher interest rates. The debt-to-capital ratio shows the relationship between a company's debt and its capital. Companies requiring heavy capital investment tend to have higher debt-to-capital ratios than less capital-intensive companies with similar borrowing costs.

What You Need to Know

How do issuance expenses affect debt?

The cost of issuing a debt includes underwriting, legal, and administrative fees—which can be substantial in relation to public debt (for example, bonds). Therefore, public debt tends to be the preserve of top ranking companies. Private funding and bank loans are less expensive because the associated issuance costs are much lower, and are therefore more attractive to smaller companies.

If a bond has a call feature, or detachable stock warrants, how is the cost affected?

A callable security is a debt—such as a bond—which the issuer is entitled to buy back (call) before its maturity date. Typically, the issuer might want to call a bond when market interest rates are low, and then refinance the debt at more favorable rates. Bond holders are compensated for this possibility by receiving a higher rate of interest than for an equivalent non-callable bond; making borrowing more expensive for the issuing company.

On the other hand, for bonds with detachable stock warrants, the cost of borrowing tends to be lower. Stock warrants give bondholders the right to buy a certain amount of the issuing company's common stock at a set price during a specified period. The strike price (the price at which this option may be exercised) is typically equal to or more than the stock's current share price. Even so, because a warrant is effectively a call option on the company's stock, it adds to the value of the bond and to its

potential return—which means the interest rate tends to be lower, and it costs the issuing company less.

What to Do

Know the Basics

When a company arranges to borrow money, the contract drawn up with the lender will set out how much interest is to be paid and how often, and the terms for paying off the principal balance. The exact details of the agreement will depend on factors like the type of debt taken on and levels of risk involved, as well as the rate of interest itself.

Funded and unfunded debt

Funded debt is long-term debt that matures more than one year after it is issued, while unfunded (short-term) debt matures within a year. Funded debt is usually issued as a bond or long-term note in public markets, or to qualified institutional investors who are permitted under SEC rules to trade private placement securities. Most unfunded debt tends to be in the form on lines of credit from a bank, or commercial paper (CP)—which is an unsecured promissory note issued by the borrowing company.

Senior and subordinated debt

Debt may be further defined as senior or subordinated; referring to its status in the order of preference to assets should the lender default on payments. A subordinated lender would only be able to claim assets after more senior creditors had settled their own claims.

Senior credit—higher in the order of priority—may be secured or unsecured. Outstanding corporate debt of either type tends to be generally termed a "bond," but strictly speaking it's only a true bond when secured against assets such as equipment, plant and property. In the case of public debt, the more accurate term is "debenture" because the debt is secured against the company's integrity and its credit—although certain assets can also be pledged as collateral, including inventory and accounts receivable.

Define Risk

Although a secured debt, or a debt with collateral, offers investors some protection against default, it is by no means a guarantee that the issuing company will repay its debts. If the value of a company's assets and income fluctuates unpredictably, it could become very vulnerable during a downturn. Rating agencies try to define the actual level of risk involved—which can vary dramatically between companies. Public debt is rated according to the credit quality of the borrowing company: "investment

grade" being the least risky—and accordingly offering lower returns. "High yield" or "junk" bonds are rated below investment grade and carry the highest levels of risk, but may attract speculators by their high rates of return.

Understand Interest Rates

Interest rates on a debt may be fixed (the same level throughout the term), or adjustable ("floating"). Fixed rates tend to apply to long-term debt, while floating rates often apply in the short term. Floating rates may be based on LIBOR (London Interbank Offered Rate), which is widely used as a benchmark, or on a U.S. Treasury security. For example, a loan may be offered at a certain percentage above or below the benchmark, and will change accordingly when the benchmark itself goes up or down. Companies will often raise working capital through debt with a floating interest rate.

Assess Credit Quality

Interest rates available to a particular company will be affected by their credit quality—and so will the cost of borrowing. Credit quality is affected by factors like how much debt a company has in relation to capital (debt-to capital ratio), how the debt is secured, and how capital-intensive the business is. On the whole, unsecured and subordinated debts carry the most risks, so investors will expect higher yields to compensate.

A company that relies increasingly on debt to finance its business operations may find itself unable to service that debt during a downturn. Therefore, as a company's debt-to-capital ratio increases, the risk of default is deemed to be greater, and its credit quality declines. Studies investigating the cost of capital found it accelerated dramatically in companies with debt-to-capital ratios of 25% to 45%—suggesting an even higher risk of financial difficulty.

Understand Debt-to-capital Ratios

An "acceptable" debt-to-capital ratio will vary between sectors and companies. Capital-intensive industries like metal or chemical production are expected to have a higher ratio than a software company for example. The difference is explained by factors like how steady a company's earnings are, whether it can secure debt with tangible assets, and the maturity of the industry is as a whole. Therefore debt-to-capital ratio by itself cannot determine the cost of borrowing—it needs to be set in context.

Know the Tricks of the Trade

- Borrowing costs consist of interest payments and issuance expenses.
- The credit quality of the issuer is reflected in the level of interest paid.
- If credit quality falls below investment-grade, the cost of borrowing rises to reflect the increased risk of default.
- Credit quality also reflects the capital structure of a company.
- As the risk of financial problems—and therefore default—is directly linked to the level of debt, borrowing costs go up exponentially above a certain debt-to-capital ratio.

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