Borrowing Costs and Capitalization

Borrowing costs are the tangible costs of incurring debt, typically expressed in terms of annual interest paid on outstanding debt or as a stated, annual coupon rate. A firm’s borrowing costs are a function of its credit quality. Credit quality is determined on the type of debt security issued, capital structure, and capital-intensity of the business. Understanding each of the components of credit quality provides a clear picture of the determinants of a company’s cost of debt financing. Borrowing costs also include the expenses incurred to issue debt securities.

Getting Started

The costs of borrowing are primarily made up of interest and issuance expenses. The interest rate assigned to a particular debt instrument is based on the level of default risk assumed by the investor. Several rating agencies assess the default risk of public debt issuances and provide a rating that is indicative of credit quality. The credit quality is greater for secured/collateralized senior debt than for unsecured subordinated debt issued by the same company, and hence the former typically carries a lower rate of interest. Companies that have higher levels of debt must typically pay higher interest rates to investors to compensate them for the increased risk of default. Capital-intensive businesses can usually maintain greater debt-to-capital ratios for the same level of borrowing costs than businesses that are less capital intensive.

FAQs

What are debt issuance costs and are they always incurred when borrowing money?

Debt issuance costs are the underwriting, legal, and administrative fees required to issue the debt. These fees are significant when issuing debt in the public markets, such as bonds. However, other types of debt, such as private placements or bank loans, are cheaper to issue because they require less underwriting, legal, and administrative support. Consequently, the public issuers of debt are typically Fortune 500 companies, while middle-market companies tend to issue debt through private placements.

Do borrowing costs increase or decrease for callable bonds or bonds with detachable stock warrants?

When debt securities are issued with a call feature, the debt can be retired at the discretion of the company until some specified future date. The call feature represents value to the issuing company, much like a call option on equity. The issuer must compensate investors for providing this option. Therefore, the interest rate on callable bonds is typically higher than those on noncallable bonds of the same credit quality. That is, the borrowing costs increase on bonds with a call feature.

The opposite is true of bonds with detachable stock warrants. A stock warrant provides the bondholder with the right to purchase shares of common stock in the issuing company at a specified price during a defined period of time. The warrant’s strike price is typically at, or higher than, the current market price of the company’s stock. Nonetheless, the warrant provides value to the bondholder in the form of a call option on the company’s equity. Because these warrants add to the potential total return on the debt, the stated interest rate is usually lower than that on debt issued without warrants of similar credit quality. Borrowing costs are typically lower on bonds with detachable stock warrants.

Making It Happen

When companies borrow money, they enter a formal obligation to make periodic payments of interest and to repay the principal balance outstanding according to an agreed schedule. The interest payments are typically based on a stated, annual percentage of the original amount borrowed. The interest paid on such obligations represents the cost of borrowing, along with the costs to issue the debt.
The Difference between Funded and Unfunded Debt

The debt can be classified as funded or unfunded. Funded debt is long-term debt or debt that has a maturity date in excess of one year. Unfunded debt is short-term debt requiring repayment within a year from issuance. Funded debt is usually issued in the public markets or in the form of a private placement to qualified institutional investors. Most unfunded debt is commercial paper or bank lines of credit.

Senior and Subordinated Debt

Debt can also be classified as senior or subordinated, based on its preference to assets in the event of default by the lender. Subordinated lenders have a junior claim to assets in the event of bankruptcy and are paid only after senior creditors’ claims have been satisfied.

Senior credit can be secured or unsecured. Much of the corporate debt outstanding is referred to as a bond. However, a true bond is secured by claims against the company’s property, plant, and equipment. For example, many airlines secure their public debt by mortgaging their airplanes. In this example, an airline could be forced to sell its airplanes to pay its public debt if it defaulted on the bonds. Most public debt is secured by the good faith and credit of the issuing company, and is more accurately called a debenture. A company can also pledge certain assets, like accounts receivable, inventory, or property, as collateral for a loan or debt.

Differing Levels of Risk

Even when debt is secured or collateralized, it still does not guarantee repayment by the issuer. A company’s underlying asset value and its earnings may be very volatile, increasing the risk of default in a down business cycle. Because this risk can be different from one business to another, there are several national rating agencies that rate public debt based on the creditworthiness of the borrower. Investment-grade debt securities are securities that are rated in the top four categories of creditworthiness by Standard & Poor’s or Moody’s rating agencies. All debt securities rated below investment-grade are considered to be junk bonds.

Different Types of Interest Rate

Debt can have a fixed or floating rate of interest. Fixed-rate debt pays the same interest rate over its term. Most long-term debt is issued with a fixed rate. Many short-term loans are floating-rate instruments based on the prime lending rate, LIBOR (London Interbank Offered Rate), or some US Treasury security. When the rates on these securities change, the loan rate changes. For example, a line of credit whose current interest rate is 6%, based on one percentage point above the three-year LIBOR rate, will change to 6.25% if LIBOR increases by a quarter of a point. Floating-rate debt is typically used to support a business’s working capital requirements.

The Determinants of Credit Quality

The interest rate and, consequently, the borrowing cost is determined by credit quality. Credit quality depends on the type of debt security, the amount of debt relative to total capital, and the capital-intensity of a company’s business. All other things being equal, a secured or collateralized debt security is less risky than an unsecured obligation. Therefore, investors require a greater return for the additional risk assumed by investing in unsecured debt. Likewise, an investor will require a greater return for subordinated debt than for senior credit.

Credit quality also deteriorates as the level of debt grows on the balance sheet of a company. Intuitively, the greater the debt-to-capital ratio, the greater the risk of default. By continuing to add financial leverage to its business operations, a company increases the risks that in a bad year it may not be able to cover its debt service. In studies on cost of capital, it was determined that companies experiencing debt-to-capital ratios between 25% and 45% saw their cost of capital increase exponentially, indicating greater risk of financial distress.
Debt-to-Capital Ratios

Finally, companies that are more capital-intensive tend to have greater debt-to-capital ratios. For example, automobile and airline manufacturers typically maintain greater leverage than professional services and software companies. The academic explanation given for this circumstance is the degree of industry maturity, lower earnings volatility, and the ability to secure more debt with tangible assets. Consequently, companies in more capital-intensive industries tend to have lower borrowing costs at a given debt-to-capital ratio than those in less capital-intensive industries.

Tricks of the Trade

• The costs of borrowing are composed of interest payments and issuance costs. Interest paid on outstanding debt is a function of the creditworthiness of the borrower. The greater the interest rate on a debt security relative to other, similar securities, the lower the credit quality of the issuer. As credit quality falls below investment-grade, the risk of default becomes ominously greater and the costs of borrowing become more exorbitant.
• A company’s capital structure is another major determinant of credit quality. There is a direct relationship between debt level and default risk. At a given debt-to-capital ratio, incremental borrowing costs increase dramatically as the company’s risk of financial distress reaches its peak.

More Info

Book:


See Also

Best Practice

• Optimizing the Capital Structure: Finding the Right Balance between Debt and Equity

Calculations

• Debt/Capital Ratio
• Debt/Equity Ratio

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