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Optimizing Your Capital Structure

The two traditional methods to finance a business are through debt and equity. Both can be divided further into sub-categories which have different attributes and rights (i.e. common and preferred shares; senior and subordinated debt etc.) And there are instruments that have attributes of both debt and equity; convertible bonds are an obvious example.

The concept of burdening a company with debt (or "levering") is an interesting one in corporate finance. Whereas too much consumer debt (in the form of mortgages on principal residences, home equity loans, credit card debt, etc.) is usually a bad thing, the more debt you use to finance your business, the better – *up to a point*.

The reason for this is that debt is a cheaper financing alternative than equity. The required rate of return for a lender is lower than what a shareholder expects. Plus interest on debt is deductible for income tax purposes.

In fact, using debt in a corporate capital structure actually increases the equity value of a business.

For example: There are two houses that are identical in every way and sit right next to each other on a quiet street. On the first house, an owner can deduct mortgage interest on his income tax return whereas on the second house the owner cannot. Which house would you pay more for?

Clearly you would pay more for the first house since a buyer's after tax cash flow would be greater by using debt to finance a portion of the purchase price. The price of the first house (its equity value) is higher than the second due to interest deductibility.

The above concept applies to the equity value of a business as well.

Taken to the extreme, one could argue that businesses should be financed entirely by debt in order to take full advantage of interest deductibility. However this does not consider the cash flow issues inherent with debt financing. Debt requires ongoing principal and interest repayments whereas equity does not. If these payments become too onerous so that it affects the ability of the company to meet its other cash flow obligations (i.e. accounts payable, payroll etc.), the benefits of debt financing will be exceeded by the costs of distress and of going bankrupt.

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So to conclude, the value of a business increases as you add more debt or "lever up". This holds true as long as the tax savings from interest deductibility on the debt is greater than the costs of going bankrupt due to having too much debt.

The obvious question therefore is: what is the optimal mix of debt and equity an owner should use in order to maximize his business value?

The optimal capital structure differs from company to company. Factors to consider include the size and profitability of the business and the capital intensity of the business. For example, a manufacturer will require more debt to finance equipment acquisitions whereas a professional services company would normally not have this requirement.

One method to determine this is to research the capital structure for companies in the same industry and of a similar size.

Another method is to model the company's forecast for the subsequent three to five years and overlay various capital structure scenarios on top of the forecast. Inherent in this exercise is the calculation of the expected financial covenants that potential lenders will expect the company to meet. These covenants will act as a ceiling for the amount of debt that can be added to the company's balance sheet and should be a good indicator of the optimal debt level a business can service.

Aries Advisory Group is uniquely qualified to perform a capital structure assessment of your business. We will compare and assess the capital structure of your business with companies of a similar size in your industry. We will generate the financial model that determines the optimal amount of debt that can be added to your capital structure. And we will identify and negotiate with the appropriate lender(s) to ensure you obtain the best lending terms on your debt. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

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