ENERGY
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Investment guide: Debt Financing

Introduction

Debt financing involves borrowing money from lenders like banks, financial institutions, or public markets, in forms that include loans, promissory notes, bonds, or specialised instruments. Borrowed funds have a specified repayment period and typically contain an interest repayment element. Depending on the life cycle stage of the company, debt financing can be useful for developing new products, meeting working capital needs, acquiring new equipment, or scaling the business.

Key terminologies in debt financing

Term	Description	Business consideration
Amortization	The process of gradually paying off debt through regular instalment payments that include both principal and interest.	Companies should assess their cash flow capacity and align the amortisation schedule with their financial projections.
Covenants	Conditions or restrictions that are included in the debt agreement that the borrower must comply with. These may include financial performance targets, limitations on additional borrowing, or restrictions on certain business activities.	Companies must carefully review and understand the covenant requirements to ensure compliance. Breaching covenants may result in penalties, higher interest rates, or acceleration of debt repayment, adversely impacting the company`s financial position.
Interest rates	The cost of debt is typically represented as a percentage of the principal. Fixed interest rates are constant throughout the life of a debt; variable interest rates are linked to external indices.	Businesses should consider debt terms such as fixed interest versus variable interest rates within a broad macroeconomic context to get the best cost of debt.
Repayment structure	In addition to term loans, which are paid down regularly over a pre-determined period, debt may have other repayment structures, including bullet payment (full balance paid one time at maturity) or a revolving facility (repayment varies with a credit line).	Companies should align repayment terms to their cashflows, for instance, businesses using debt to finance an upfront capital expenditure may prefer bullet repayment terms where payment on the principal is only due once the investment is generating significant cashflows.
Security (Collateral and guarantee)	Collateral is an asset or property offered by borrowers as a guarantee for debt payment. Secured loans require collateral, while unsecured loans do not. A guarantee is a legally binding agreement where a third party assumes financial responsibility for a debt facility if the borrower defaults.	Collateral on secured debt can enforced by lenders if the borrower violates the agreement (e.g., through non-payment), so companies should carefully decide which assets to offer as debt collateral and which guarantees to provide to secure the loan. The loan-to-value ratio is the amount of debt financing the lender can advance against a specific value of the collateral. Companies should assess this carefully when seeking debt

Term	Description	Business consideration
Tenor	The amount of time during which a business must repay a loan. The maturity date is the expiration date for any loan agreement, upon which any remaining debt or obligations must be settled.	Tenor shapes multiple aspects of the debt agreement, including interest rates and repayment structures. Businesses should choose loan tenors that are sufficiently long to create manageable payments.
Seniority	The sequence with which debt facilities are repaid upon liquidation of a company. Senior debt is settled first, followed by subordinate debt.	Businesses may be subject to covenants from senior debt holders that dictate future business activities and may impact the ability to raise further capital until existing obligations have been met.
Restructuring	A negotiation process between the borrower and lender to modify the terms of the debt agreement when the borrower is facing financial difficulties. This may involve changes to interest rates, payment schedules, or other terms to alleviate financial strain.	Debt restructuring is a strategic option for companies facing financial difficulties. It requires open communication and negotiation with lenders to modify the debt terms. It can provide temporary relief, improve cash flow, and enhance the company`s long-term viability.

Benefits of debt financing for a business

Debt financing provides businesses with:

1. ***Immediate capital without sacrificing ownership*** or ***control***,
2. ***Tax benefits*** as interest payments can be tax-deductible,
3. ***Financial flexibility*** with customisable repayment terms, catering to specific needs and cash flow capabilities,
4. ***Predictable repayment schedules*** enabling businesses to plan and manage finances effectively,
5. ***Growth opportunities***, allow businesses to expand, invest in projects, or pursue ventures that have the potential for higher returns on investment.

Investor considerations when providing debt

For investors, debt investment carries risk to capital without ownership or control of the business. To offset this risk, investors evaluate a borrower's creditworthiness and use covenants to influence the borrower's behaviour.

Some of the indicators that investors consider when determining creditworthiness include:

1. Ability to service debt

To ensure that their borrowers can consistently repay the debt owed, lenders use metrics such as liquidity ratios (which evaluate a business's ability to quickly repay the debt), debt-to-equity ratios (which evaluate whether a company already bears a high debt burden), and debt coverage ratios (which evaluate whether a company generates enough cash flow to service its debt).

2. Return on investment

The investor will set loan terms (e.g., tenor and interest rate) that ensure the financial returns compensate for the risk of debt invested. Typically, the investor will apply a discount to the schedule of future cashflows from repayment to determine the present value of the investment. Discounted cash flow analysis allows lenders to compare investment opportunities.

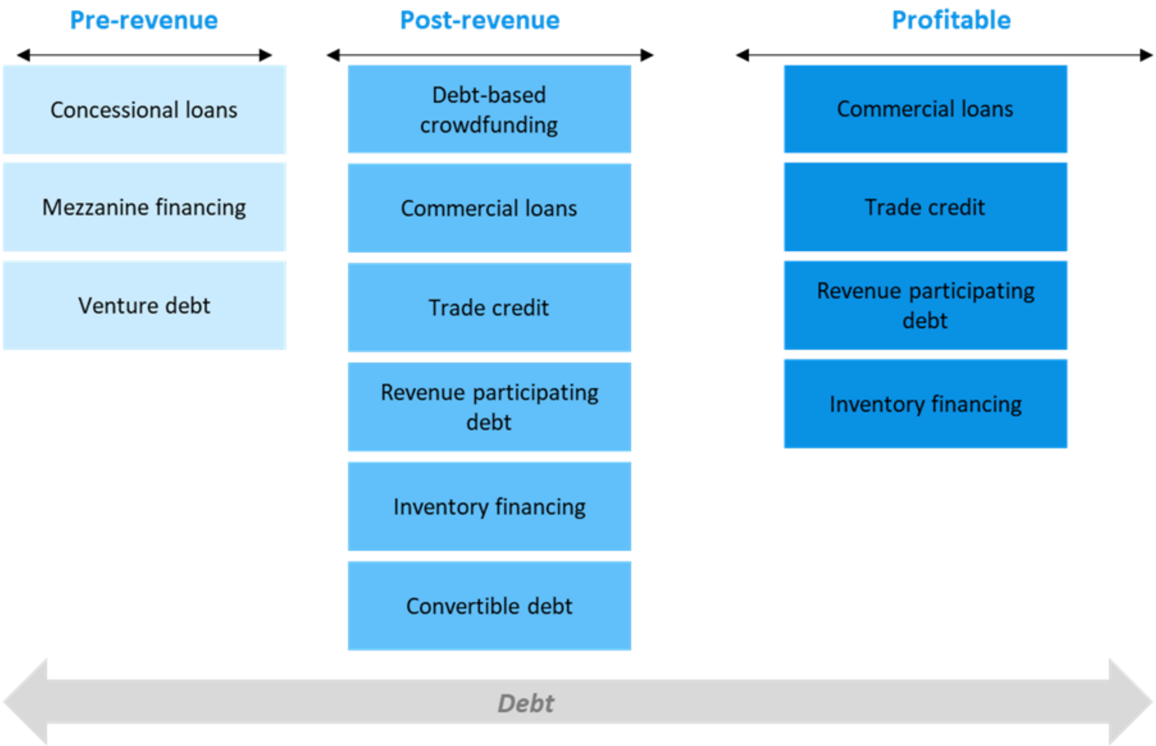
3. Credit history

Investors will also look at a business' borrowing history to see if the business has been able to service debt in the past. Credit history assessments may be standardised (e.g., via credit scores) where established credit referencing bureaus exist, but they may also involve bespoke research in regions without established credit assessment infrastructure.

4. Loan covenants

Lenders often apply covenants, which are legal obligations, on a borrower to protect their investments. ***Positive covenants*** dictate certain actions, such as financial disclosure, that businesses must take to comply with the loan agreement. ***Negative covenants*** restrict actions, such as issuing new debt, that a company can take. Whilst covenants may help leaders run their businesses more efficiently, they can also hinder management decision-making.

Types of debt financing



Type of capital	Issuer	Description
		Pre-revenue
Concessional loans	Development partners, government-owned banks	Favourable terms, lower interest rates, and extended repayment periods
Mezzanine financing	Private Equity Firms (PE) / Investment banks	Hybrid form of funding, between traditional debt and equity, offered at higher interest rates and often includes warrants or equity conversion options. Mezzanine financing flexible repayments, so can be used for growth and financial restructuring. Borrowers must consider the cost and subordinate position to decide if it is suitable for their needs.
Venture debt	Venture debt investors, specialised banks	Loans offered to start-up companies that have a track record of raising capital, based on their ability to raise new capital to fund growth and repay the debt; lower cost of capital than equity, typically requires warrants to underwrite the debt
		Post revenue

Type of capital	Issuer	Description
Commercial loans	Commercial banks	Term loans either secured or unsecured loans for a fixed period to support needs such as expansion and working capital management.
Trade credit	Trade finance institutions, commercial bank	Underwriting the purchase of goods by a business. This arrangement is a form of risk management for the supplier who transfers the payment risk to the bank in cross-border transactions.
Crowdfunding	Crowd funding platforms	Debt-based financing from a multitude of individuals, which can be harnessed to expand operations, advance research and development efforts, and construct prototypes for businesses that have already begun generating revenue.

Special debt instruments

Financial institutions have a wide range of special debt instruments that cater to the unique characteristics and needs of businesses. Instruments such as revenue-participating debt involve repayments based on a percentage of future revenue, allowing fast growing businesses with irregular cash flows to access debt financing. Convertible debt originates as a loan but can be converted to equity depending on pre-defined terms, including **conversion price**, **conversion value** (price per share at which the debt exchanges), **conversion ratio** (the ratio of debt to shares), and timing of conversion (e.g., through a liquidity event). Additionally, convertible debt may include a **valuation cap** that limits the maximum valuation of the business at conversion, providing potential upside to investors.

Instrument	Issuer	Description
		Post revenue
Revenue participating debt	Venture capital	Revenue-participating debt can provide the necessary funding without burdening the company's cash flow. Lenders can participate in the company's future revenues, which allows the startup to allocate its cash flow toward expansion activities.
Inventory financing	Banks, inventory finance providers and other specialized lending companies	Short-term loans so the business can purchase inventory to meet customer demand and support business growth without straining their cash flow.
Convertible debt	Angel investors, venture capital	Convertible debt is debt with the option to convert it into equity later when the company's valuation becomes clearer. This enables growing companies to access capital, advance their business, and attract potential future investors.
		Profitable
Revolving credit lines	Commercial banks	Loan facility to use a pre-determined amount of credit and pay interest only on the amount borrowed. Once repaid, the credit line is available for future borrowing.

Managing debt

Non-payment of debt may result in the liquidation of company assets. Therefore, it is crucial to establish effective debt management strategies to ensure that the business complies with the loan agreement.

Risks of debt financing

Key	Risk	Description
	Financial penalties	Failure to meet debt repayment obligations can result in penalties, late fees, or increased interest rates, increasing the overall cost of borrowing.
	Credit risk	Default on debt repayments can negatively impact the credit ratings of a business, making it harder to obtain future financing at favourable terms.
	Bankruptcy risk	Excessive debt or an inability to meet repayment obligations may lead to bankruptcy, potentially resulting in the liquidation of assets or business closure.
	Interest rate risk	Fluctuations in interest rates can affect the cost of borrowing, potentially leading to higher interest expenses and an increased financial burden.
	Collateral enforcement	Failure to pay a secured debt may result in confiscation and auction of collateral assets such as land, motor vehicles, and other assets to facilitate recovery of unpaid debt.

Debt management strategies for companies in financial distress

Several warning signs indicate potential delinquency and inability to meet debt obligations such as negative cash flows, declining operating profits, and defaulting on debt payments. In such cases, companies should consider exploring diverse options to renegotiate their debt obligations.

Key	Strategy	Consideration
	Grace period	Companies may be able to negotiate a grace period with their lender to afford time for the company to adjust operations, survive a temporary hardship, or obtain financial relief from another investor.

Key	Strategy	Consideration
	Renegotiation	Companies may also be able to renegotiate the terms of their loans via a "workout agreement" that restructures the loan to benefit both the borrower and the lender. The borrower may receive lenient terms such as a tenor extension, while the lender will be able to avoid the cost and difficulty of debt collection and repossession.
	Refinancing	Borrowers may be able to refinance their loans by taking out a new loan to repay the troubled one. The original lender or a new investor may refinance the debt.
	Consolidation	This involves lumping up two or more debt facilities together to form one large facility. Consolidating multiple loans may allow a company to obtain preferable terms as well as simplify financial planning and budgeting.

Impact of debt on existing equity investors

Key	Impact	Description
	Impact on equity structure	Debt financing affects the capital structure of a company by introducing financial leverage. Higher levels of debt can increase the financial risk and leverage ratio, which is the proportion of debt to equity. A higher leverage ratio can make the company more vulnerable to economic downturns and may impact the perceived risk and valuation of the company's equity.
	Interest payments and cash flow	Debt financing requires regular interest payments to lenders. These payments can reduce the company's available cash flow for reinvestment in the business. Therefore, equity investors should consider the impact of interest payments on the company's ability to generate long-term returns.
	Potential conflicts of interest	Debt financing introduces a new group of stakeholders, the lenders, who have a priority claim on the company's assets and cash flows. This can create potential conflicts of interest between equity investors and lenders. For example, when a company is experiencing financial distress, lenders may prioritise debt repayment over the company's growth and survival which may not align with the interests of equity investors seeking capital appreciation.
	Dilution of ownership	Convertible debt agreements include provisions that give lenders the option to convert their debt into equity. If this conversion option is exercised, it can lead to a dilution of ownership for existing equity investors. This means their percentage ownership in the company decreases, potentially reducing their control and decision-making power.
	Decision making and control	Taking on debt financing may impose certain covenants or restrictions on the company, such as debt-to-equity ratio limits or requirements for lender consent on major business decisions. These covenants can restrict the flexibility and decision-making autonomy of the company, potentially impacting the strategic choices and growth opportunities available to equity investors.

Conclusion

Businesses with steady cashflows and good budgeting practices may benefit from debt financing, which allows them to fund priorities while maintaining control of their companies. However, businesses that pursue debt financing must be sure they have the financial stability to service debt and ensure that the terms and conditions of their debt agreements align with company needs and priorities.

Further reading

A4S Essential Guide to Debt Financing - https://www.accountingforsustainability.org/content/dam/a4s/corporate/home/KnowledgeHub/Guide-pdf/A4S%20Essential%20Guide%20to%20Debt%20Finance1.pdf.downloadasset.pdf

Debt financing- https://www.investopedia.com/terms/d/debtfinancing.asp

Debt Financing: Definition, Types, Advantages & Disadvantages - https://www.wallstreetmojo.com/debt-financing/

OECD – New approaches to SME and entrepreneurship financing: Broadening the range of instruments https://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf

The World Bank – Small and Medium Enterprises (SMEs) Finance - https://www.worldbank.org/en/topic/smefinance

How venture debt works https://www.svb.com/startup-insights/venture-debt/what-is-venture-debt