Decoding The Value in Fund Raising

Understanding The Fine Print of Capital Structure

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Small and Medium Businesses often overlook the importance of Capital Structure and the value associated with it while raising capital. The value for capital that's optimally structured comes in two folds – a) delivering higher return to the Equity owners i.e., ROE, and b) minimising the cost of raising capital. This makes capital structure the most important criteria in delivering value to the shareholders.

While the Cost of Equity (Ke) is always more than the Cost of Debt (Kd) – and, therefore, optimising the capital structure helps minimising the Weighted Average Cost of Capital – it cannot be seen as plain vanilla when it comes to applying it in the real world since the whole business ecosystem needs to be considered than just doing a simple math.

Debt Does Add Value But For Starters That May Not Be an Option:

While valuing the Equity of a closely held company that's relatively new, risk premiums are added over and above the base Ke (arrived by using the relative valuation method) to arrive at risk-adjusted Ke. These risk premiums may include, but not limited to, country risk, competition risk, liquidity risk, etc. Because of this, the Ke becomes much higher, and, therefore, having a higher proportion of equity in a capital would mean higher cost of capital.

Debt, on the other hand, in simple terms, means doing business with someone else's money at a lower cost. So by adding debt in the capital structure, a company gets two key benefits – i) it reduces the cost of capital from its previous level since Kd is far lower than Ke, and, thereby, ensuring higher capital value to the Equity owners, and ii) it increases the ROE because the company is now less invested in equity due to the introduction of debt, which also means higher earnings per share (EPS).

But in the practical world, the application of this equation is not that simple. For businesses where break-even is longer than usual and the pre-leverage cost is still bleeding, adding debt in this situation would further burden the company with debt servicing cost over and above the bleeding pre-leverage cost. If the uncertainty in the cash flow prolongs, the addition of debt would push the company towards default risk, which, in turn, will significantly increase the risk premium of the capital and will erode the capital value. The value erosion in this situation would be two pronged – a) market value of the underlying security would take a severe hit because of the default risk, and, hence, will erode the capital value, and b) significantly higher cash burn due to leverage cost will erode the EPS and the net worth of the Equity holders.

So when does adding more debt to the capital structure becomes fruitful…

…More Predictable and Certain the Cash Flows Are, More Value Can be Unlocked By Adding Higher Proportion of Debt:

Think of a business that has an ever increasing customer base with Zero or negligibly small client attrition such as an electric supply company. In such businesses, the cash inflow/outflow is highly predictable and certain, thereby leaving enough room to plan and apportion leverage cost. Therefore, it makes a lot of sense to have a significantly higher proportion of debt – a principle on which LBO transactions are based – because with predictable and growing cash flows, the business can start repaying debt at a faster pace and, in turn, keep increasing the proportion of the Equity component in the overall capital. Therefore, with reducing debt levels, the risk premium will keep coming down which will enhance the value for the Equity holders not just from the point of view of capital value, but also from the point of delivering higher ROE and EPS due to decreasing leverage cost.

To Conclude:

When it comes to Capital Structure, logic and vision of the business should take precedence over simple mathematics, since it gives the business an opportunity to carve out value for the shareholders while ensuring higher returns. ◆

'The views expressed in the column are of the author, and may or may not be endorsed by the publication.'

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