Introduction to Finance

Determinants of the cost of debt *December 3, 2019*

Based on our analysis of bonds, we see that a company's pre-tax cost of debt depends on:

1. the cost of time (measured in Treasury securities),
2. the company's hazard rate – characterizing its default probability, and
3. the debt's risk premium.

A company can affect only one of these three things – i.e., its hazard rate. Bond rating agencies and lenders use standard credit metrics to assess credit risk. These metrics include:

- Collateral quality,
- balance sheet strength:

  liquidity Lots of cash, reliable receivables;

  low leverage low debt-to-equity ratio;
- stable cash flow (across the economic cycle and product lines),
- experienced management,
- financial transparency,
- competitiveness in industry.

It is not necessarily an optimal strategy to minimize debt costs. As we will see, in many instances, debt is a much cheaper source of capital than equity, and should be used. On the other hand, excess debt can distort managerial incentives, and destroy flexibility by limiting a company's opportunities to take advantage of opportunities. Furthermore, bond ratings can affect a company's operations. Scientists and middle management may be reluctant to work for a pharmaceutical company with low bond ratings. Consumers may be reluctant to buy a durable good from a company with low bond ratings. Suppliers may be reluctant to invest in processes for a buyer with low bond ratings. As already noted, management may be distracted or worse by the need to meet a debt payment and/or refinance.

The main sources of long-term debt for companies are:

1. banks
2. capital markets:
   (a) public market (SEC registered)
   (b) private market (unregistered)

The lines between banks and market debt are blurring as banks often originate loans for sale and hedge funds and other large investors are increasingly involved in direct lending.

Traditionally the size of the loan was a primary determinant of the source of the loan. Large loans would require a public bond offering. However, the private markets have grown since the Global Financial Crisis. In May 2019 Bristol-Myers issued $19 billion in private bonds, as part of its takeover of Celgene Corp. This is the 10th largest bond sale in history– yet it was all private. The company filed no offering prospectus with the SEC. The deal was underwritten by Barclays, Credit-Suisse, Morgan Stanley and Wells Fargo.