Financing 101: Loans

Whether it's a private equity firm looking to purchase the next up-and-coming tech company, or it's a government looking to build a hydro-electric power station in Nigeria, large amounts of debt are required. There are three principal ways companies finance their big deals: loans, bonds, equity.

Here we will drill down into loans as a financing method, looking at the main players in the market, how a loan works as well as evaluating this form of debt.

The basics: loans

The two main players in the loan market are borrowers (companies and governments) and lenders (commercial banks).

The basic structure of such transactions is that a bank lends a sum of money to a borrower who, in return, pays **interest** on the bank as well as paying back the **principal** (the initial sum borrowed). Most loans will also be **secured** – this means that the bank will have assets that it can seize if the borrower defaults (fails to make payments).

The nitty gritty: loans

What are they used for?

City law firms' clients use these loans for two main purposes. The first can be understood as **general corporate lending** and is used to finance day to day activities of a company. The second, is event driven. **Acquisition finance**, for example, is where a company is looking to buy another company and in response to this goes into debt (in the form of a loan) to finance the deal. Other examples of this include project finance and asset finance.

How can loans be structured?

Acquiring a company or funding a large infrastructure projects costs a lot of money, and often a single bank is unwilling to take the risk of lending the whole amount required by the company. This means that the debt portfolio of a company is usually diverse (using loans, bonds and equity) and the loans themselves are given by a number of banks on the same terms – this is known as **syndicated lending**.

Not all loans have the same repayment structure. Most loans involve the borrower making two types of payment at regular intervals (e.g. monthly) – interest payments, and payments towards the principal amount. However some loans may only involve regular interest payments, with the principal being owed in a large bullet payment at the end of the loan's term.

Rather than a simple loan agreement, loans can also be sought through establishing a **revolving credit facility.** Credit is a term used analogously with debt. So this debt facility is revolving in the sense that the borrower can reborrow whatever money it has repaid.

Evaluation: loans

Positives	Negatives
This form of debt is **tax-deductible** – the interest a company pays on its loans reduces the amount of its profit and so reduces the amount on which it pays tax. Compare this to equity, where dividends are paid out after profit is calculated (and so tax has already been paid).	Unsecured loans may have a **higher interest rate** and so lead to demanding interest payments.
Loans can be structured in a **flexible** way to accommodate for the current state of the business (how much existing debt the company has, cash flow considerations etc.)	Larger loans and facility agreements may have **strict and restrictive covenants** which require the disclosure of key financial information e.g. quarterly finances.
Loans are a way to raise money without having to give up **control/ownership** in the company.	Risk of **default** and insolvency proceedings
Loan terms are often long periods of time with **stable and certain** interest payments.	