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DEBT

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2020 VISION

Understanding Debt

Many people routinely hear that "debt is bad," but it's not if properly managed.

I realize that my column is rarely about something with which all funeral home owners and managers will agree, but my role in this world is to provide an alternative point of view. You cannot imagine the joy it gives me to disagree with more than 10,000 owners and managers on a monthly basis. "When you know you know, you fear no man!" one of my early mentors told me.

Continuing with our preparation for the 2020 Year of Illumination, I have started dissecting 12 key issues of running a business. This month, we examine debt, and I am going to explain why debt is not bad, if properly managed, and then how to properly manage it.

There are seven points to understanding debt.

1. *Who you don't want to owe money to.* Make it a point to never owe money to these three entities: the IRS, any person whose last name ends in a vowel and who has no neck and wears silk suits, and your mother-in-law. All of these entities are patient, but if you ever exceed that patience, a mountain of misfortune will befall you. In the case of the second and third parties, you'll probably walk with a permanent limp as well!

2. *At what qualities of credit does a lender look?* Anyone going to college to be a banker has learned that credit analysis has four qualities, referred to as the Four Cs. The character of the borrower is number one. This profession has one of the lowest credit risks of any Standard Industry Code because it's made up of some of the highest character profiles.

Collateral is the second matter to consider. This is where some lenders don't "get" this business. Collateral is not just tangible assets; rather, the firm's goodwill has a secured value. Unfortunately, most lenders are limited to making loans only on tangible assets.

The third C is credit score. A lender will look for people with solid credit based on previous credit experiences. For the past 30 years, credit experience has been shared among lenders, and if you have a bad credit history, you will not have a good credit future.

Capacity is the last point and refers to the fact that everyone has a limit on what they can repay on any debt. Some lenders are more liberal than others.

3. *Determining the maximum cost of debt.* There are three costs to any debt repayment. Most of you understand principal and interest. However, there's one cost that can be more expensive than interest that you may not be factoring into the cost of repayment – taxes. Interest may or may not be deductible. Principal is never deductible.

Therefore, to pay off the debt, you must factor in the cost of all three, as paying off a $100,000 debt over 10 years at 5% interest (where the interest is deductible) will cost you more than just the $100,000 in principal plus interest payments. For example, the interest on this loan is $29,500. Assuming a 34% tax bracket and 100% deductible eligibility, it drops to $19,500 [$29,500-(0.34x$29,500)]. One may be tempted to stop the computation and conclude that they will owe $119,500. However, the principal payments are not deductible, so in your 34% tax bracket world, you will need to earn another $34,000 in income to pay back the principal of $100,000. A $100,000 principal, plus $19,500 in after-tax interest, plus additional earnings needed to make up the nondeductible status of the principal of $34,000 equals about $153,000.

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The same scenario with non-deductible interest would result in $100,000 principal, plus $29,500 in interest, plus 34% additional income needed to negate the nondeductible tax status on both the principal and interest of $44,000 [$129,500x0.34], equaling about $174,000! The loss of deductibility of the interest adds more than $21,000 ($174,000-$153,000) to the cost of the debt!

4. *Length of debt payments.* I've seen people buy a business and want to pay off the debt early. They heard from someone on the radio that "debt is bad," so they buy a business that is routinely paid for over 15 to 25 years and shorten that to a 10-year term to pay it off early. This can be an operational calamity.

Imagine you're borrowing $1 million to buy a business. Over 10 years, the annual payment at 5% interest is $130,000 per year. At 20 years, that payment at 5% interest is $80,000. The difference of $50,000 is huge. Remember, principal and interest are only two of the three costs you need to pay. Taxes is the other cost that most advisors do not have clients factor in.

If I assume the interest is deductible, over 10 years, the principal, interest and tax cost equals about $1,534,000, whereas over 20 years, the principal, interest and tax cost equals about $1,740,000. That is a $200,000 difference but gives you an extra 10 years on the loan. The annual equivalent payment goes from $153,000 a year for the 10-year loan to $87,000 for the 20-year loan. The $66,000-a-year difference could be the difference between a default and a completed loan.

Too often, I have seen people pay off loans over a lower period and their properties lack complete repairs and maintenance or their marketing programs are deferred as there is no money to invest. These people are debt poor and never understand why.

5. *Fixed versus floating rates?* The question is a matter of risk and logic. Risk is a personal preference. First, understand if you can afford the fixed and floating options. If so, then you can decide which is in your best interest. My experience is too often people choose floating rates because it allows a lower payment (usually), and that is all they can afford.

The logic of the discussion is historical interest rates; from 2008-16, they were the lowest interest rates in the last 75 years. When interest rates are the lowest they have been, which way do you think they are most likely to go? If you can afford fixed-rate financing, I would choose it today.

6. *Types of loan amortization.* Amortizing is the methodology by which loans pay themselves off. Loans amortize three ways. First are the loans that do not amortize, typically an interest-only loan. We see that lines of credit are typically interest only. Borrowers pay back the loan as they see fit.

There are two types of loans that amortize: level amortization and mortgage amortization. A level amortization loan has payments that are equal each year of the loan. Each year, the principal payment is the same, and each year, the interest payment declines. A $100,000 loan for 20 years under level amortization at 5% interest has a payment of about $9,875 in the first year. The principal is $5,000 and interest is $4,875 in the first year. The last year of the loan, the final year payment is about $5,125, with principal at $5,000 and interest only $125.

In mortgage amortization, the loan amortizes with a level payment each year (assuming a fixed-rate interest), and the amount of the principal increases over time as interest declines. This same loan will have an annual payment of about $8,000 in the first and last years. The principal in the first year is only about $3,000, with the interest being about $5,000. In the last year, the payment under mortgage amortization is still $8,000, but the principal portion has increased to about $7,650, with interest at about $350.

7. *Points.* You might hear a loan quote as having two points as an "origination fee," meaning that the lender is going to assess a fee equal to the size of the loan. This is a form of advance payment or, really, advance interest on the loan. It is an added cost of the loan. So, a $100,000 loan with two points is the same as 2% of the loan; each point equals 1% of the loan.

Points are usually paid up-front and usually are a way for a lender to make you think they're lowering the interest rate, while all they're really doing is getting the money up-front. For example, a $100,000 loan with a 5% interest rate and 2% origination fee is almost the same as a 5.4% interest rate with 0 points. It's even more important for the lender to have a client prepay points, as they are not refunded if you pay off the loan early.

So there you have it. The seven things you need to know about borrowing and debt. As we rebuild the financial dynamics of your business, the goal is to make sure you know how to determine when to borrow, how much to borrow and what the terms are within your borrowing capacity.

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