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What is your optimal debt level?

Brad Cherniak | June 9, 2014

Getty Images/Thinkstock *In the 'How much debt should I take on?' debate, there are technical considerations as to what is right for your type of business, and specifically your company.*

In my column last month, I discussed on a big-picture level the world of debt and how it related to small and medium-sized businesses.

The broad implication of increasingly available debt and historically low interest rates, as you may recall, is a developing imperative for business owners to consider increasing both their business and financial risk to better compete in a changing world.

This imperative is classic game theory: If any of your competitors are aggressively borrowing at these low interest rates to expand their operations, hire more staff, or deploy cutting-edge new technologies, they become a more formidable competitor.

Some may not be able to manage all this change and fail, but others may succeed and become stronger than you. Do you stay defensive and try to compete with your existing resource base, or do you enter the arms race and use debt more aggressively?

This is the new dilemma business owners face.

Game theory would suggest you should at least go part way, if not as aggressively as your most aggressive competitor(s). The optimal positioning in the borrowing risk spectrum for most business owners may be in the middle.

Those at either extreme — the most aggressive and the most conservative — may be at the greatest risk in the current business world.

This has clear implications about how business owners manage the new paradigm, how they build value, and how and when they ultimately exit their businesses as risk levels rise.

John Hotson, president of Clearwater Communications and a partner with Sapient Capital Partners in an initiative called *Exit Planning Partners,* looks at this paradigm as a once-in-a-lifetime opportunity.

He says "for those of us who have lived through double-digit interest rates, now seems like the perfect time to be borrowing to invest in your business. Not only will interest rates — by necessity — rise in the future, but it is also unlikely we will see a return to rates like these again in our lifetime."

For many business owners, especially those hoping to sell and retire in the next five years, now may be the optimal time to use the leverage available in their businesses to invest in things that will increase the value of the business and maximize the opportunity for a sale down the road.

You should be looking to invest in "people, marketing and technology. Nothing new here. It's still pretty basic, really," Hotson says.

People Hire the best you can find — people who can replace you. Invest in training them. Add more, and better, sales staff. And then empower them to help you expand the business.

Marketing Develop a greater understanding of the opportunities that potentially lie ahead for your business. Where could your company go with an investment in the right big idea? How could you improve your competitive advantage through capitalizing on what you do best?

Technology The more efficient you become, the more competitive you are, and the more competitive you are the more profitable you become. It's the evolution that is set in motion by upgrading and adding to your technology. Technology is the value facilitator of most businesses, and it has never been cheaper.

However, Hotson concurs that the economy is not all upside. Private companies may be in a bit of a breathing space. That is, a comfortable spot before things get tougher and risk levels come home to roost.

In this scenario, interest rates rise, possibly along with tax rates, coupled with lower growth rates, which could reduce the returns on new business investments. That's the empty end of the glass.

In the '*How much debt should I take on?'* debate, there are technical considerations as to what is right for your type of business, and specifically your company. Generalizations are dangerous: You need to create a financial model and strategic plan tailored to your situation.

Once you have determined the right amount of leverage you can prudently sustain, how you spend the cash comes down to math. In a nutshell, what is the expected five-year return on a strategic investment made today with low-interest dollars, and repaid in the future in inflated dollars?

That is where the opportunity lies.

The result is that business owners will need to increase their focus on managing the increased business and financial risk to build realizable shareholder value.

This ambient level of higher risk also plays into the personal side of the business exit for owners. But the bar is being raised for being prepared well ahead of an exit, and in executing it flawlessly.

But that topic is for future columns.

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