Debt: You Need It

Executive Summary

Debt, at least in the American construction business, is helpful when it comes to growth. Here's a couple reasons why.

What is debt?

When money is borrowed and then must be paid back, that money which must be paid back is called debt. On your business financials this is carried as a liability on the balance sheet (a balance sheet is comprised of three sections: assets, liabilities, and equity. Assets minus liabilities gives the equity in a business.)

As stated in the executive summary, there are at least two main reasons to carry debt.

What's the 1st reason to carry debt?

Building a *credit history* is important. Because one day you will likely have to borrow money whether it's an operating line, purchase of equipment, or to make a large insurance premium payment. Those that loan you money are going to want to see that you have a history of repaying in a timely manner.

What's the 2nd, and more important, reason to carry debt?

Cash. Taking on debt maintains or allows an increase in cash. And cash is king. Cash serves as the oxygen for your company, and cash, as a number on your balance sheet, usually is a variable in the bonding equation. And bonding leads to company growth and survival.

Give me the 1-minute MBA on this stuff.

Working Capital = Current Assets – Current Liabilities

As stated above, cash is a direct link to bonding. Well, that's not wholly true. Working capital is a more direct link to your bonding and is calculated by subtracting currently liabilities from current assets.

Current assets are expected to be captured in the next year and current liabilities are due and payable in the next year. So, when a surety goes to your balance sheet and sees Current Assets and Current Liabilities (they're listed as such on your financials), they do the calculation above and get a number. This number, call it $600,000, is then multiplied by say 10, or 20, and that becomes your bonding capacity. So, if this number is 15, your bonding capacity is $9,000,000 (15 * $600,000).

Scott Jennings, P.E., is the President of SJ Construction Consulting, LLC (808) 271-5150, sj@sjcivil.com. He is former owner of a heavy/civil construction company and now provides cost estimating and training, litigation support, and efficiency advice to contractors. He is also the founder of Runjob Software, Inc. ***Download our QR scanner app: runjobsoftware.com/mobile/***

Give me an example of how to take on debt.

Say you want to buy a new pickup truck for $60,000. You have two basic options: (1) cash or a (2) loan. And say that your surety calculates your bonding credit at 15 times Working Capital (this is a split between 10 and 20 above).

If you buy the truck in cash, you just lost $900,000 (15 * $60,000 = $900,000) of bonding credit.

If you buy the truck with a four year loan at $15,000 per year, you only lost $225,000 (15 * $15,000). The calculation here is all about the way in which your debt is classified on the balance sheet. Remember that the Working Capital calculation has as a variable called current liabilities which are liabilities due in the next one year. If that truck is bought with $15,000 due this year and the remaining $45,000 due in years 2, 3, and 4, you're only charged for $15,000 of your debt in the Working Capital equation because this is the Current Liability. Listen to the audio, it may be a little easier to understand.

My Story

My CPA was on me about this when I started my construction business. "Take some debt Scott, it's necessary." I didn't like it for the same reason you don't: most people don't like to owe other parties money.

Most companies have hard times. And likely your business is no different. Most company owners have had the tough discussion with their controller about where and how they're going to get enough money to make payroll or pay off vendors.

The 1st reason above to carry debt is cute: "oh, let's have a good credit score down at Dunn & Bradstreet". Yes, that's necessary but the hard knocks reason is that without cash you die. And preserving cash is not a luxury, it's responsible and necessary.

Work Safe!

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