

How do you know if a company has too much debt?

By Michael Kemp

When you invest in a company there are two important things you're looking for. Firstly you don't want the company to go broke. And secondly you want it to return more than you invested.

Both of these outcomes are influenced by how much debt a company carries on its balance sheet. So let's pose the question: How can you tell when a company has too much debt?

Debt can boost returns

Companies typically fund their operations by a mix of debt and equity. Business debt isn't always a bad thing. Used prudently, it can boost a company's return on equity (ROE). That is, the return shareholders receive on their part of the funding equation. That's because debt is typically a cheaper form of funding than money supplied by shareholders (equity).

But it's important that management gets the debt/equity mix right, because too much debt can place a company in jeopardy when business conditions go sour. That is because, unlike shareholders, lenders demand to be paid in bad times as well as good.

What then is the optimal mix of debt and equity? Investment great, Benjamin Graham, used to say that a company should own more than it owes. It's a simplification, but a good starting point. So let's take a look at a commonly used metric used to measure the debt/equity mix that Graham is talking about.

The Debt/Equity ratio

The debt to equity ratio quantifies the relative proportion of debt and equity used to fund a company's operations. A refinement of the ratio uses net debt instead of total debt. Net debt is calculated by deducting the cash held by the company from its total debt. It's a useful adjustment particularly for companies holding significant cash deposits.

$$\text{Net debt/equity ratio} = (\text{Financial Debt} - \text{Cash}) \div \text{Equity}$$

So relating this back to Graham's rule of thumb, that a company should "own more than it owes", this is the case when the net debt to equity ratio is below "1". It can also be expressed as a percentage in which case you'd be looking for a figure below 100%.

Another way to express this relationship is the percentage of total assets which is funded by debt. For example if the net debt/equity ratio is 1 then it would be expressed (using the formula below) as net debt represents 50 percent of total capital.

$$\text{Gearing} = \text{Net Debt} \div (\text{Net Debt} + \text{Equity}) \times 100$$

Don't forget Leases

Many leases are just a form of debt. This is particularly so with finance leases where the lessee enjoys the benefits and assumes all the risk of the property, plant or equipment. So when calculating gearing ratios it's appropriate to include them as debt.

Some analysts also like to include some off balance sheet liabilities in the calculation. Examples include operating leases and unpaid pensions particularly when they are substantial in size.

Analysing the debt to equity ratio

Contrary to Graham's declaration that it's OK when a company owns more than it owes it is a simplification. What constitutes an acceptable level of debt varies from company to company. And its determination is a mix of analysis and judgment. Let's take a look at some important factors to consider.

1. Volatile Revenue Stream

Lenders demand that interest and principal payments are made on time and in full. But when a firm has a volatile revenue stream its ability to meet these regular payments is less certain. The problem is compounded when a business is burdened with high fixed costs – the costs of simply keeping the doors open even if it's not doing any business. So look out for red flags, for example where a company's debt materially exceeds that of its industry peers.

2. Concentration Risk

When a large portion of the company's business is limited to a few customers then it's prudent for it to carry less debt. Loss of an important customer will impact its revenue stream and jeopardize its capacity to service debt.

3. Start-ups and Young Companies

New companies with a limited track record should carry less debt. Their business models have yet to be fully tested and the reliability of their future revenue stream is often difficult to judge.

4. Debt Structure (debt maturity)

The mix of long and short-term debt employed by a company is important. Long-term assets should preferably be funded out of equity and long-term borrowings, while working capital needs are best funded by bank overdraft and short-term borrowings.

Watch out for companies which rely heavily on the use of short-term debt particularly those with a poor credit rating. These companies are faced with an ever-present need to keep rolling the debt over. Failure to do so could lead to failure of the business.

Maturities of borrowings should also be well spread. If the bulk of a company's borrowings fall due at a time when the availability of funds is limited, such as the recent post GFC period, then refinancing may prove difficult. With a chronological spread of maturities, the need to approach the capital markets for a large refinancing in a depressed period is reduced.

5. Debt Structure (currency of debt)

Check for the currency in which the debt is denominated. A company with overseas assets and/or revenue will often reduce its currency exposure by maintaining a similar level of debt in that currency. If this isn't the case, offshore borrowing is still OK if it's largely hedged/swapped back to Australian dollars. If neither is the case, then the company is likely to be exposed to the risk of currency fluctuations.

6. Look out for loan covenants

A loan covenant is a clause in the lending contract requiring the borrower to refrain from doing

certain things. For example, the borrower might have to maintain the ratio of total liabilities (borrowings and other liabilities) to total tangible assets at a certain percentage, say no higher than 60%. It's very important that companies maintain such ratios. Even if a company is fully servicing its debt on time, the breach of such a covenant may lead to a 'technical breach' of the contract and potential recovery action by the lender. So look out for loan covenants, study how onerous they are, and the likelihood of the company breaching them.

7. The level of secured borrowings in a company's balance sheet

Check the level of security which lenders are demanding. Where risks are high lenders tend to demand more security. This provides an indication of the risk they have attached to that company.

Augment your analysis with other financial ratios

The debt to equity ratio should not be relied upon to the exclusion of other ratios. There are many other metrics which can be used to judge the appropriateness of a company's debt. Another ratio that's commonly used is the Interest Cover Ratio. It shows how comfortably a company can meet its interest payments.

$$\text{Interest Coverage Ratio} = \text{EBIT} \div \text{Interest Expense}$$

Where EBIT is profit from ordinary activities before interest expense and income tax.

The higher this ratio is, the better, but it should be interpreted in a similar fashion to the debt to equity ratio. What represents an acceptable figure depends on a number of factors, including the nature of the company's business, the volatility of its revenues and the composition of its debt. However, as a guide, when an interest coverage ratio falls below 2, concern should be raised.

The balance sheet is just a "Snapshot in Time"

A criticism of the ratio approach is that ratios are static. They are correct at just one point in time: the annual or semi-annual balance date. Yet we are applying them to businesses which are dynamic. The economic factors impacting businesses are ever changing.

Undertaking a debt capacity analysis goes some way towards addressing this issue. It poses a series of "what-if" questions. Take for example a company like Fortescue Metals. A debt capacity analysis seeks to quantify the impact on its ability to service debt under a variety of different scenarios. For example what would happen if:

- The price of iron ore dropped 50 percent?
- Interest rates rose by 3 percent?
- The Australian dollar appreciated by 20 percent?
- Fortescue's capacity to raise new equity was shut down?

Purchasing Shares on Margin

I want to finish on a very important point. In an ideal world a company's debt structure should represent the optimal balance between risk and return for that company.

What then of investors who choose to buy the company's shares on margin? That is with borrowed money. They are effectively throwing the whole risk/reward debt optimization issue out the window, denying the judgment of the company's directors and re-establishing their own gearing

level, in the process dialling up the risks substantially; which is food for thought when you're next tempted to take out that margin loan.

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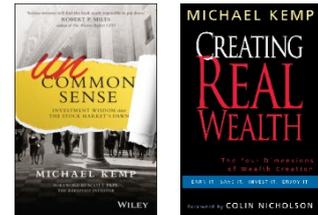
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