Smart Investor: how to spot debt danger signs

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Taking on debt can improve a company's returns, but the cost is less flexibility during recessionary periods and a higher risk of default.

How much debt should a company carry? This is a highly subjective question. On the one hand, an accountant will likely tell you that because debt is cheaper than equity, companies should borrow as much as possible. Debt is cheaper than equity because a lender will demand a lower rate of return than a shareholder – partly because lenders are far higher up the pecking order should a company go into receivership.

Others argue that debt is all well and good during the boom part of the economic cycle, when profitability is relatively strong, meaning that interest and repayments of loans can be made easily. However, during recessions (which will inevitably occur) profitability and the ability of a company to service its loans can deteriorate substantially, placing severe pressure on the liquidity and solvency of a firm.

How much is too much?

My own view sits somewhere between the two. I must admit that away from the investment world I have a deep dislike of debt. I am unsure whether this is as a result of my upbringing or whether it is in my DNA, but I cannot stand owing anybody money.

When I consider where to apportion capital I leave this emotion (and the rest of them) at the door. My view is that a company should be free to borrow moderate amounts, so long as they really are only moderate and that, furthermore, they can be adequately serviced by profit.

There are two measures I use to determine whether a company is financially sound from a debt perspective. The first is the debt-to-equity ratio, which measures how much debt a company has relative to its size (in terms of net assets). This is calculated by dividing total borrowing by net assets. My own view is that a company whose debt-to-equity ratio is below 75% is moderately geared, between 75% and 100% is slightly over-borrowed and anything above 100% equates to a substantial negative in my overall analysis.

The debt-to-equity ratio could be substituted for another, similar measure. The key point, though, is that whichever ratio you use, you must use it consistently and resist the temptation to switch between different methods as this will not give comparable figures. The debt-to-equity ratio uses net assets, which are also the denominator for return on equity. As regular readers will know, this is a ratio I also use heavily, albeit to measure profitability.

Serviceable debt levels

Although the debt-to-equity ratio is useful, it is not a sufficient means to decide whether a company is able to comfortably service its interest, meaning that we must also consider interest cover. This is calculated by dividing operating profit by the interest paid on all borrowing. Operating profit is used as opposed to net profit or profit before tax because on the P&L sheet interest is the first figure deducted from operating profit. In other words interest is paid out of operating profits.

To find interest expense you must turn to the notes to the accounts. The P&L will state the specific note to read, which can then be checked and the interest paid on borrowings totalled. The interest coverage ratio tells us how many times interest could have been paid by the company and offers a guide as to how much headroom a firm has when making interest payments. As with the debt-to-equity ratio, the minimum level of cover is quite subjective, but I feel that anything below four is a concern, and anything below three is inadequate.

Of course, it is possible for a company to have a high debt-to-equity ratio and impressive interest coverage ratio; **British American Tobacco** (BATS.L) is an obvious example. It has gearing of 111% and interest cover of 7.4. This is because it pays a relatively low rate of interest on its loans, which is the link between the two ratios. It is also highly profitable, of course.

High reward, high risk

Your view on debt may be similar to mine or completely different, given the highly subjective nature of the topic. Sure, high levels of debt can generate improved returns but also carry the risk of default and lack of flexibility during recessionary periods. An example of a firm that has low debt and high flexibility during difficult economic circumstances is **Kingfisher** (KGF.L), which bought 29 stores from Focus DIY, which had serviced a mountain of debt before finally going bust.

Indeed, companies with moderate debt may well experience subdued profitability when compared with their highly indebted peers. However, being a long-term investor, I would rather sacrifice some profit for financial soundness and have my investments still running at the end of the race. After all, investment is a marathon, not a sprint.

Source: Smart Investor