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A Refresher on Debt-to-Equity Ratio

When people hear "debt" they usually think of something to avoid — credit card bills and high interests rates, maybe even bankruptcy. But when you're running a business, debt isn't all bad. In fact, analysts and investors want companies to use debt smartly to fund their businesses.

That's where the debt-to-equity ratio comes in. I talked with Joe Knight, author of the HBR TOOLS: Return on Investment and cofounder and owner of www.business-literacy.com, to learn more about this financial term and how it's used by businesses, bankers, and investors.

What is the debt-to-equity ratio?

"It's a simple measure of how much debt you use to run your business," explains Knight. The ratio tells you, for every dollar you have of equity, how much debt you have. It's one of a set of ratios called "leverage ratios" that "let you see how —and how extensively—a company uses debt," he says.

Don't let the word "equity" throw you off. This ratio isn't just used by publicly traded corporations. "Every company has a debt-to-equity ratio," says Knight, and "any company that wants to borrow money or interact with investors should be paying attention to it."

How is it calculated?

Figuring out your company's debt-to-equity ratio is a straightforward calculation. You take your company's total liabilities (what it owes others) and divide it by equity (this is the company's book value or its assets minus its liabilities). Both of these numbers come from your company's balance sheet. Here's how the formula looks:

$$\text{Debt-to-equity ratio} = \frac{\text{total liabilities}}{\text{shareholders' equity}}$$

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Consider an example. If your small business owes $2,736 to debtors and has $2,457 in shareholder equity, the debt-to-equity ratio is:

$$\frac{\$2,736}{\$2,457} = 1.11$$

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(Note that the ratio isn't usually expressed as a percentage.)

So, of course the question is: Is 1.11 a "good" number? "Some ratios you want to be as high as possible, such as profit margins," says Knight. "In those cases higher is always better." But with debt-to-equity, you want it to be in a reasonable range.

In general, if your debt-to-equity ratio is too high, it's a signal that your company may be in financial distress and unable to pay your debtors. But if it's too low, it's a sign that your company is over-relying on equity to finance your business, which can be costly and inefficient. A very low debt-to-equity ratio puts a company at risk for a leveraged buyout, warns Knight.

"Companies have two choices to fund their businesses," explains Knight. "You can borrow money from lenders or get money from equity." Interest rates on business loans tend to come with a 2-4% interest rate (at least at the moment), and that interest is deductible on your company's tax returns, making it an attractive way to fund your business, especially when you compare it to the returns that an investor might expect when he or she buys your stock that shows up as equity on your balance sheet, which can be 10% or higher.

So you want to strike a balance that's appropriate for your industry. Knight gives a few rules of thumb. Technology-based businesses and those that do a lot of R&D tend to have a ratio of 2 or below. Large manufacturing and stable publicly traded companies have ratios between 2 and 5. "Any higher than 5 or 6 and investors start to get nervous," he explains. In banking and many financial-based businesses, it's not uncommon to see a ratio of 10 or even 20, but that's unique to those industries.

There are exceptions within industries as well. Take Apple or Google, both of which had been sitting on a large amount of cash and had virtually no debt. Their ratios are likely to be well below 1, which for some investors is not a good thing. That's partly why, says Knight, Apple started to get rid of cash and pay out dividends to shareholders and added debt to its balance sheet in the last month or so.

How do companies use it?

The calculation is most often used by bankers or investors deciding whether to give your company money. It helps them understand how you're paying for your business. They want to know, says Knight, "Does the company have the ability to develop revenue, profit, and cash flow to cover expenses?"

If the debt-to-equity ratio goes up, the perceived risk goes up. If you don't make your interest payments, the bank or lender can force you into bankruptcy.

"Bankers, in particular, love the debt-to-equity ratio and use it in conjunction with other measures, like profitability and cash flow, to decide whether to lend you money," explains Knight. "They know from experience what an appropriate ratio is for a company of a given size in a particular industry." Bankers, Knight says, also keep and look at ratios for all the companies they do business with. They may even put covenants in loan documents that say the borrowing company can't exceed a certain number.

The reality is that most managers likely don't interact with this figure in their day-to-day business. But, says Knight, it's helpful to know what your company's ratio is and how it compares with your competitors. "It's also a handy gauge of how senior management is going to feel about taking on more debt and therefore whether you can propose a project that requires taking on more debt. A high ratio means they are likely to say no to raising more cash through borrowing," he explains.

It's also important for managers to know how their work impacts the debt-to-equity ratio. "There are lots of things managers do day in and day out that affect these ratios," says Knight. How individuals manage accounts payable, cash flow, accounts receivable, and inventory — all of this has an effect on either part of the equation.

There's one last situation where it can be helpful for an individual to look at a company's debt-to-equity ratio, says Knight. "If you're looking for a new job or employer, you should look at these ratios." They will tell you how financially healthy a potential employer is, and therefore how long you might have a job.

What mistakes do people make when using the debt-to-equity ratio?

While there's only one way to do the calculation — and it's pretty straightforward— "there's a lot of wiggle room in terms of what you include in each of the inputs," says Knight. What people include in "liabilities" will differ. For example, he says, "some financiers take non-interest bearing debt such as accounts payable and accrued liabilities out of the liability number and others might look at short-term vs. long-term debt in comparison to equity.” So find out what exactly your company counts in its calculation.

Knight says that it’s common for smaller businesses to shy away from debt and therefore they tend to have very low debt-to-equity ratios. “Private businesses tend to have lower debt-to-equity because one of the first things the owner wants to do is get out of debt.” But that’s not always what investors want, Knight cautions. In fact, small—and large—business owners should be using debt because “it’s a more efficient way to grow the business.” Which brings us back to the notion of balance. Healthy companies use an appropriate mix of debt and equity to make their businesses tick.