The Debt to Equity Ratio

Ellis Traub eloquently addressed this in the BI Discussion Digest on 11 September 2009.

It would probably help most to understand the concept behind the term. So many of us simply talk of "Debt/Equity Ratio" and look for a value by rote.

The term is used to analyze the degree to which a company's management makes use of debt to enhance the return to the shareholders. In doing so, management walks a fine line between vulnerability and leverage.

A company can be vulnerable, should debt be excessive and the repayment requirements be difficult or impossible to continue during an economic downturn-or should the company's operation be impaired for some reason.

Leverage involves borrowing the money to acquire assets used to bring in additional revenue or to contain costs. By borrowing, they don't have to share the increased income with new shareholders-which they would have to, were they to raise the necessary money by issuing additional shares.

Leverage, of course, increases the earnings per share and management is sometimes tempted to take risks they shouldn't to do that.

It's most commonly calculated as it's expressed: debt to equity; i.e., debt divided by equity. And, there are some rules of thumb bandied about that people apply to judge whether or not the debt level is too risky. I believe conventional wisdom holds that 100% is probably the limit of prudence.

That's to say, if the debt rises about the worth of the company, it's probably excessive.

However, as with all of the balance sheet ratios, I submit that they're really irrelevant to us. At least they are to me!

If a company has had a long enough, solid track record of substantial and steady growth that makes me want to be an owner, I'm not going to try to second-guess management's judgment about how prudent they've been with their debt. Whatever they're doing, they're doing it right (or fooling everyone).

Conditions differ radically from company to company, and industry to industry. For example Philip Morris, arguably one of the most effective debt managers in corporate history, used to run consistently at a debt/cap ratio in excess of 60%. That equates to a 200% debt/equity ratio. We don't have the really intimate knowledge of what goes on inside any company and never will (nor will any professional analyst, for that matter). We can only speculate. And, unless it's a hobby (which it's not for me), it's a waste of time.

When I'm wrong, I'll chalk it up to the "rule of five" and move on, and settle for being right only 80% of the time. But I won't waste a minute trying to try to second-guess those people who spend every waking hour of their stressful days making decisions based on their intimacy with the companies they manage and who risk a whole lot more than I if they're wrong.

(Nor do I ever expect to be able to catch another Enron or Calpine when they cook the books.) And most folks here, if they're honest, would probably acknowledge that they wouldn't make a buy/sell decision based on any of those metrics, all else being equal.

Let me add to this by asking that if this ratio is of concern to you, I ask that you not use an arbitrary upper acceptable limit but rather to compare the company that you are studying to its peers or with others in the same industry.