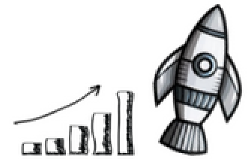

Debt-To-Equity Ratio

Solvency measures the ability of a company to pay off its debts. The debt-to-equity ratio (D/E) is a solvency ratio that takes a company's total liabilities and divides them by its shareholder equity. D/E is an important metric when analyzing a company, as it measures a company's financing through debt versus other funds from shareholders. This metric is imperative to use in times of uncertainty. If a company has a high D/E ratio in times of economic uncertainty, it could worry shareholders as the company may not be able to fulfill its debt obligations.

All of the information needed to solve a debt-to-equity ratio is found on a company's balance sheet. As we stated before, the higher the debt-to-equity ratio, the higher the balance sheet risk most of the time. This shows that a company has been financing its projects and operations through debt. Investors need to be wary of the company's debt-to-equity ratio. If the cost of financing through debt outweighs the amount of income the company generates, share prices may decline. Long-term debt and assets typically have the most significant impact on the debt-to-equity ratio because they are usually larger than short-term debt and assets. Other ratios may be used to evaluate a company's short-term solvency that must be paid within a year, such as the cash or current ratio, which we will cover in another week's excerpt.

Debt-to-equity ratios can also be used for personal financial statements. A personal D/E ratio can be used for individuals or small businesses when applying for a loan or measuring financial health. But it’s also important to consider someone’s income in combination with his or her individual debt picture. For example, Freddie Mac recommends that someone’s total monthly debt payments, including housing expenses, should not exceed 33 to 36 percent of the person’s gross monthly income.

Comparing D/E should be industry-specific. Industries such as banking will typically have higher debt-to-equity ratios than other industries. The higher the D/E ratio is for a company, the higher the risk is that the company may default on its debt all else being equal. However, there can also be a negative D/E ratio which tends to be another weak signal for a company. A negative D/E ratio shows a firm is not using debt financing to grow. During a period like today's monetary policy where interest rates are rising, investors may like companies with no debt.

It's important to consider D/E in combination with other factors. For example, a company that has strong competitive advantages that has shrunk its equity base through buybacks may have very little equity and a high debt-to-equity ratio but have plenty of cash flow to cover its debt obligations. So, while D/E is one of the more important metrics to consider, one should also look at both the earning power of the business and interest-coverage ratios before trying a definitive conclusion on the riskiness of a company’s balance sheet.