


4C CTG – Debt to Equity Jim Hurt

Debt to Equity




Toolkit 6 Row 2C in Section 2
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 **Classes-To-Go! 4C**

Disclaimer

- The information in this presentation is for educational purposes only and is not intended to be a recommendation to purchase or sell any of the stocks, mutual funds, or other securities that may be referenced.



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Outline of Class

- Where do we see D/E and D/C?
- Define debt and equity.
- Why use debt?
- Debt to equity (Toolkit 6 Row 2C).
- Debt to Capital (Online SSG).
- Relationship Between D/E and D/C.

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Two Related Terms

- Will discuss both:
 - Debt to Equity.
 - Debt to Capitalization.
- These two terms are closely related.
- They both measure how much debt.
- Both appear in Toolkit 6.
- Online SSG uses only Debt to Capitalization.

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Where Do We See These?

- Toolkit (all versions) Top of Side 1 of SSG

Company	3M CO	Price Date	03/04/10
Study by	Jim Hurt	Data Date	03/04/10
Sector	Industrials	Data Source	NAIC Data
Industry	Industrial Conglomerates	Reference	
Preferred(\$M)	0.0		
Common(M Shares)	710.6	% Insiders	0.0
Debt(\$M)	5,817.0	% Institutions	0.0
% to Tot.Cap.	31.3	Quality	A+ (S&P)

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Where Do We See These?

- Toolkit 6 Debt / Equity

Side 2, Section 2, Row 2C

2 QUALITY ANALYSIS		Company 3M CO (IBB)										03/04/10	
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	5	TREND
A	% Pre-tax Profit on Sales	17.9	16.7	19.6	20.6	22.8	23.7	22.3	22.2	21.3	20.9	22.1	UP, DOWN
B	% ROE (Beginning Yr)	26.4	33.8	40.0	37.3	32.0	33.5	36.7	31.2	32.9	33.3	33.3	EVEN
C	% Debt to Equity	14.9	25.0	35.7	22.9	7.7	13.5	11.2	34.8	52.9	40.8	30.6	UP

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BETTERINVESTING NATIONAL CONVENTION

Online SSG Debt / Capital

Tab 2: Evaluate Management

Step 4: % Debt to Capital

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BETTERINVESTING NATIONAL CONVENTION

Definition of Debt

- *Debt* is what the company owes and has to pay interest on, such as:
 - Loans from banks.
 - Company bonds.
 - Preferred stock.
- *Short term debt* has to be paid in the next twelve months.
- *Long term debt* has to be paid later than the next twelve months.

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BETTERINVESTING NATIONAL CONVENTION

Definition of Equity

- *Assets* are everything that the company *owns* at that moment.
- *Liabilities* are everything the company *owes* at that moment.
- *Equity* is assets minus liabilities.
 - Also called *shareholder's equity*.
 - Also called *net worth*.
 - Also called *book value*.
 - Also called *retained earnings*.

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BETTERINVESTING NATIONAL CONVENTION

Why Use Debt?

- When the interest rate is lower than the return on total capital, borrowing money will increase return on equity.
 - This is a good thing.

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BETTERINVESTING NATIONAL CONVENTION

Debt to Equity Ratio

- Compares debt to equity.
- Equals debt divided by equity.
- Also called D/E, Leverage, Risk, or Gearing.
- Indicates what proportion of equity and debt the company is using to finance its assets.
- Toolkit 6 uses Long Term Debt and Shareholder's Equity for row 2C.

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BETTERINVESTING NATIONAL CONVENTION

High Debt to Equity

- A high debt to equity ratio means the company has been aggressive in financing its growth by borrowing a lot.
- This can result in volatile earnings as a result of the additional interest expense.
- In hard economic times, too much debt can lead to bankruptcy.

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BETTERINVESTING NATIONAL CONVENTION

How Much is Too Much Debt?

- For manufacturing and retail companies, we BetterInvestors like to see Debt to Equity below 50%.
- Financial companies run much higher Debt to Equity (e.g. 900%).
- Like to see D/E even or down with time.
- Toolkit 6 Row 2C.

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BETTERINVESTING NATIONAL CONVENTION

What if D/E is Increasing?

- If D/E is increasing, find out why!
- Is the company borrowing the money for valid reasons?
- Valid reasons will increase assets, such as:
 - Acquisition.
 - New products.
 - New factories.

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BETTERINVESTING NATIONAL CONVENTION

What if D/E is Increasing?

- If you do not like the reason(s) the money is being borrowed, drop this company.
 - You do not like the acquisition.
 - You do not think new product will sell.
- Read Annual Reports to find out why company was borrowing money.

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BETTERINVESTING NATIONAL CONVENTION

Definition of Capital

- Capital is the funds that the company can use for financing projects and other operations.
- It is equal to Equity plus Debt.
- Also called Total Capital.
- Banks use a different definition.
- Not to be confused with Market Capitalization!

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BETTERINVESTING NATIONAL CONVENTION

Debt to Capital Ratio

- Comparing debt to total capital.
- Calculated by dividing debt by the sum of debt and equity.
- Measures the fraction of all assets that have been paid for by borrowing.
- Also called D/C or DC.

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BETTERINVESTING NATIONAL CONVENTION

BI Advice on Debt to Capital

- We like to have companies use some leverage.
- But not too much leverage!
- Want DC to be below 33%.
- But compare this debt ratio to that of the company's competitors.
- Banks are special (DC around 90%).

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BETTERINVESTING NATIONAL CONVENTION

Relationship Between D/E and D/C

- D/E is Debt divided by Equity.
- D/C is Debt divided by the sum of Equity and Debt.
- D/E of 50% is the same debt as DC of 33.3%.

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BETTERINVESTING NATIONAL CONVENTION

Questions?

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