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What Is Debt Service Coverage Ratio (DSCR)?

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What is DSCR?

The Debt Service Coverage Ratio ("DSCR") is one of the most important ratios considered by majority of lenders while approving a loan. This formula is often debated, and each lender looks at it slightly differently. For the purposes of this article, we have based it on a simple corporate finance perspective.

Simply put, debt service coverage ratio tells the lender the ability of the borrower to repay the loan (interest and principal) on time. In general, the larger the ratio, the better it is for a lender.

It is not dissimilar to when one applies for a mortgage to purchase real estate. Banks look at your ability to pay the mortgage based on ratios that look at your income and how much of it you are already committed to for ongoing loans.

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How is it calculated?

DSCR is calculated by dividing the total operating profit of the company by the total debt obligation. Lenders usually calculate this on a monthly basis on the forecast, depending on the frequency of the debt payments. If debt payments are to be made on a monthly basis, DSCR will be calculated on a monthly basis. Most lenders define operating profits as Earnings Before Interest Taxes Depreciation and Amortization (EBITDA). Total debt service is the total of the Interest and Principal payment obligations of the company. The total debt service should include all types of existing business debt, as well as the proposed new debt.

$$DSCR = \frac{EBITDA}{TotalDebtService}$$

Some lenders deduct capital expenditures (CAPEX) from the EBITDA so that CAPEX is also considered. Additionally, most traditional lenders also take personal net income and liabilities of the business owners into consideration while computing the DSCR.

What does the output mean?

Suppose a business has:

- Debt payments (principal + interest) of $100 next month and
- Expects to generate EBITDA of $150 next month

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The DSCR calc is therefore = $150/$100, which equals 1.5x.
This indicates that the business has enough funds to pay 1.5 times of the debt payments.
In other words, after payment of the debt obligations, it will have positive cash flow.

On the flip side, if the EBITDA was less than the monthly debt payments, then the resulting ratio would be below 1x. This implies that there is an inability of the business to generate enough funds to cover debt payments and results in negative cash flow.

And finally, if the EBITDA is equal to the total debt payments, then it would result in a ratio of 1x. This would imply that the business generates just enough funds to cover debt payments.

Typically, lenders require a minimum DSCR ratio of 1.25x to provide them with necessary 'cushion'.

Key takeaways

- Having just enough money to cover the loan payments is generally not enough. Typically, lenders require a minimum DSCR ratio of 1.25x to provide them with necessary 'cushion'.
- DSCR is one of the 3 most important ratios considered by a cash flow lender. The others are Debt to Equity Ratio and Debt to Total Assets Ratio, which I will cover in later articles.
- It is important to note that not all lenders consider DSCR important for their underwriting process as it mainly depends on the type of lending they do.

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For more information on raising financing solutions for a start-up, early stage, growth, or in-transition business, or a business in distress, please contact Dheeraj Nair at 647-673-4969 or dnair@isaacsadvisory.ca.