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What is “debt-to-equity ratio” and why do lenders look at it closely?

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The debt-to-equity ratio tells lenders how much debt your business is carrying in relation to the amount of equity or investor capital that is in the business. In other words, it tells lenders how much debt the business has for every dollar of equity in the business. It is a measure of the company’s financial leverage.

As a company grows, it often needs to hire more people, buy equipment, real estate, inventory or even acquire another business. One of the ways that this can be financed is by taking a loan. However, one of the many things that lenders look at before providing the loan is the debt-to-equity ratio of the business.

The higher the debt-to-equity ratio, the more leveraged the company is. Conversely, the lower the debt-to-equity ratio, the less leveraged the company is. Generally, a highly leveraged business is considered riskier in the eyes of lenders since the business has taken on more debt than the amount of the shareholder’s ‘skin in the game’.

How is it calculated?

Debt-to-equity ratio is calculated by dividing the company’s total liabilities by the total shareholder equity.

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Shareholder Equity}}$$

What does the output mean?

Suppose a business has the following:

- Total Liabilities of $1,000, and
- Has total shareholder equity of $800

The debt-to-equity ratio is therefore: = $1,000/$800, which equals 1.25. This means that for every dollar of shareholder equity invested in the business, there is $1.25 of debt.

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A common question asked is: what is a good debt-to-equity ratio to be maintained? Simply put, the lower the ratio, the better it is in the eyes of the lender. The ideal debt-to-equity ratio varies from industry to industry. Industries that are capital intensive tend to have higher levels of leverage vs. other industries, such as service businesses that generally have low levels of debt-to-equity ratio. So, comparing debt-to-equity ratio between companies of different industries is not an “apples-to-apples” comparison.

Key takeaways

- Debt-to-equity ratio is not the only factor that is taken into consideration by a lender when performing their due diligence. They also consider factors such as debt service coverage ratio, tangible net worth ratio, etc.
- In concept, one might think a lower debt-to-equity ratio is always best. However, increased levels of debt can help boost the company’s enterprise value and return to equity. Ultimately, the risk associated with higher debt must be closely weighed against the valuation-related benefits it brings.

At Isaacs Advisory, we have extensive experience in advising on, structuring, and sourcing a wide range of traditional and non-traditional financing solutions from small and medium sized businesses.

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