CORPORATE & INSTITUTIONAL BANKING

WHAT IS DEBT CAPACITY ANALYSIS?

AND WHY IS IT IMPORTANT TO YOUR COMPANY AND YOUR BANK?

Debt capacity refers to the total amount of debt or additional debt that your company can take on and repay within the terms of the debt agreement.

There are a number of metrics that can be used in making this assessment.

You might incur debt for several reasons, such as boosting production or marketing, expanding capacity, or acquiring new businesses. However, incurring too much debt or taking on the wrong kind may result in damaging financial consequences.

Note that, in some cases, the amount of total debt that a company can take on may be limited by covenants on existing debt that are part of an existing credit agreement. While you certainly don't want to violate these covenants, evaluating your debt capacity still makes sense. Perhaps your company's financial condition has improved since the existing loans were taken out and you can refinance this existing debt at more favorable terms.

Overall, debt capacity analysis can help your company in its future planning. What is the best way to finance ongoing operations? How can you best fund your growth and expansion plans?

This type of analysis is also important to your bank. If you work with a banker on a relationship basis, they can use this analysis to help you decide upon the best type of loan and the best overall financial structure for your company moving forward.

 

The main focus of debt capacity analysis

When analyzing your company's debt capacity, the main focus should be on your company's balance sheet and the statement of cash flows.

EBITDA, which stands for "earnings before interest, tax, depreciation and amortization," is a key metric to understand in assessing debt capacity. This is considered a key descriptor of profitability from operations.

The higher the level of EBITDA, obviously the better in terms of your company's ability to service its debt and the amount of debt that you can assume.

As important as the level of EBITDA is, stability is a key characteristic to consider as well when looking at EBITDA as a metric.

- A cyclical business will inherently have less debt capacity than a noncyclical business. Cyclical businesses have a high degree of sensitivity to the business cycle. When the business cycle is in its favorable phase, these types of companies tend to do well.
  - Conversely, when the business cycle turns downward, these companies might be squeezed financially by lower demand for their product or service. This can have an impact on cash flow, profits and the quality of the balance sheet. Cyclical businesses include those whose product or service is discretionary. An example would be the airline industry as vacations may be cut back during a recession.
- Industries dependent upon technology will usually have a lower level of debt capacity than others. Technology is constantly evolving, and new technologies are constantly being developed. Technology-dependent businesses that don't keep up may find themselves suffering financially.
- Businesses where there is a low barrier to entry by competitors are also considered to have unstable EBITDA. Retailers are a good example, especially with the growth of online retailing. Customers will tend to gravitate to the retailer with the lower prices and the best selection, and who makes purchasing easy.

Some specific metrics involving EBITDA include:

- **Total-debt-to-EBITDA ratio** simply divides the total debt on the balance sheet by EBITDA. This is a common metric in comparing a company's level of operating cash flow to its total debt and provides an indication as to the time it might take to retire all current debt.
- **EBITDA-to-sales ratio** compares the measure of profitability to its revenues. A higher value indicates that the company's earnings from operations are good and indicates a high degree of liquidity.[1]
- **EBITDA-to-interest-coverage ratio** divides EBITDA by the interest payments on the company's debt. This metric helps assess how easily the company can cover its interest payment requirements. If a company's operations do not yield enough profits/cash flow to cover interest payments, this is clearly not a good sign.[2]

Together, these ratios will provide you and your banker with a good picture of your company's capacity to assume more debt. Whether your company's metrics indicate that your company can absorb additional debt must be considered in the context of the business and in comparison to other companies in your specific industry or in comparable lines of business.

The debt-to-equity ratio is a leverage ratio that calculates the weight of total debt and financial liabilities against the total shareholders' equity. This ratio highlights how a company's capital structure is tilted either toward debt or equity financing and the importance of striking the right balance.

If a company's capital structure is weighted too heavily toward debt, it can limit their ability to borrow and fund projects or business operations that require additional capital. Companies in this position may be considered too "leveraged" to justify additional indebtedness. If the capital structure is weighted too heavily to equity, a company might be considered "liquid" and easily be able to cover any outstanding debts, but might be deploying higher cost equity for use in situations where lower cost debt might suffice.

Putting it together

As mentioned above, the amount of debt capacity is a function of a thorough analysis and the type of business involved.

An industrial company might have an extensive balance sheet and require a high level of capital expenditures. Therefore, a loan tied to their assets might be appropriate, depending upon their debt capacity and EBITDA.

A retailer might have different issues, especially with the advent of online retailing. They have inventory to finance, and their business may be quite seasonal and perhaps cyclical. These factors will play into their debt capacity analysis and into the type of financing that is best for their business. Either an asset-based loan or one based on cash flows might be appropriate here.

A healthcare system is faced with its own unique challenges. The technology and data requirements are major and ever-changing. Beside core hospitals, there are smaller urgent care facilities. There have also been mergers in this industry in recent years. Again, these are all factors that will impact their debt capacity and the best financing method.

Conclusion

A debt capacity analysis is valuable in assisting a company in understanding what amount of debt their cash flow and balance sheet might support and, therefore, what to expect when they request financing from a bank.
In some respects, it's like getting a pre-qualification on a home loan: You know what you have to work with.

Armed with this knowledge, companies can scale their financing plans to finance growth, M&A, R&D and other endeavors. The company, ideally with assistance from their bank relationship manager, can create a dynamic debt capacity model that can be used for other scenarios in the future.

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READY TO HELP

Contact one of our relationship managers at PNC to learn how we can help you complete a debt capacity analysis and how our approach to financial services can help your company grow and prosper.

1 https://www.investopedia.com/terms/e/ebitda_to_sales_ratio.asp

2 https://www.investopedia.com/terms/e/ebitdacoverinterestratio.asp

Other sources:

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