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MANU		VINU
	CONVERSATION BETWEEN MANU AND VINU <u>ABOUT</u> <u>DEBT EQUITY RATIO</u>	

Manu	Hi Vinu! You look puzzled! What's the matter?
Vinu	I would like to know more about Debt Equity Ratio – Banker's says that our fundamentals are very weak due to Higher Debt Equity Ratio – can you explain me what does that convey?
Manu	Sure Vinu. Let's assume you start a business with an investment of Rs.10 Million.
Vinu.	Ok.
Manu	Now the question is how you are going to fund this investment of Rs.10 Million. You have choices in selecting funds right?
Vinu	Yes! Funds can be raised through i) Owners Funds (Equity); ii) Outsiders Funds (Loan / Debentures)
Manu	Good! If you raise more funds through Owners funds and less funds from Outsiders funds, then your business is said to be more stable one.
Vinu	How is that?
Manu	Let's have a look at this balance sheet:

Liabilities	Amount	Assets	Amount
Equity	**90**	Fixed Assets	**75**
Debt	**10**	Current Assets	**25**
Total	**100**	Total	**100**

	In this balance sheet, the role of debt funds is only 10% total funds. Equity shareholders have contributed 90% of the funds.
Vinu	Agreed!
Manu	Can you calculate the Debt Equity Ratio for this scenario?
Vinu	Ya! Debt - 10 Equity – 90 Debt to Equity Ratio = Debt / Equity = 10 / 90 = 0.11:1
Manu	You are right. In this case, Debt is only 11 Paise for every One Rupee of Equity. This means, this company is not dependent on the outsiders for running its show.
Vinu	True.
Manu	Let's assume, this company defaults in repayment of its debt of 10. The lenders need not worry a lot, because this company has got assets worth 100. Even if you take distressed sale value of saleable assets at 50%, it is 50, and so the lender's interest is protected because his loan is only 10.
Vinu	Very True. In the event of default, lenders have fall back in case of low debt equity ratio borrowers.
Manu	Yes. Now, let's change our Balance Sheet:

Liabilities	Amount	Assets	Amount
Equity	**20**	Fixed Assets	**75**
Debt	**80**	Current Assets	**25**
Total	**100**	Total	**100**

Did you noticed the equity and debt amount?

<table>
<tr><td>Vinu</td><td>Ya. Now Equity is only 20 whereas Debt is 80.</td></tr>
<tr><td>Manu</td><td>It means, 80% of funds for this business comes from lenders and only 20% were contributed by equity shareholders.</td></tr>
<tr><td>Vinu</td><td>So their Debt Equity Ratio should be like this:
Debt - 80
Equity – 20
Debt to Equity Ratio = Debt / Equity = 80/20 = 4:1</td></tr>
<tr><td>Manu</td><td>That’s correct – D/E Ratio is 4:1. If your company’s Debt Equity Ratio is in this range, then don’t expect banker to support you.</td></tr>
<tr><td>Vinu</td><td>Why?</td></tr>
<tr><td>Manu</td><td>Ratio of 4:1 indicates Debt is 4/5= 80% and Equity is 1/5=20%.
You are running the business mainly with the support of Bank Funds.</td></tr>
<tr><td>Vinu</td><td>So what?</td></tr>
<tr><td>Manu</td><td>Let’s say, this company defaults in loan payment – what was the loan amount?</td></tr>
<tr><td>Vinu</td><td>It is 80.</td></tr>
<tr><td>Manu</td><td>Assets available?</td></tr>
<tr><td>Vinu</td><td>100</td></tr>
<tr><td>Manu</td><td>So, now lenders have fall back on assets worth 100 for a loan of 80. Bankers should be comfortable right?</td></tr>
<tr><td>Vinu</td><td>Yes.</td></tr>
<tr><td>Manu</td><td>But Banker’s cannot be. Generally, market reacts negatively when Bankers try to sell possessed assets.</td></tr>
<tr><td>Vinu</td><td>How?</td></tr>
<tr><td>Manu</td><td>If the realisable value of asset is 100, but if it is getting sold by Banker through possession on account of default, then buyers in the market will try to take advantage of it and will pitch for least possible price. It will be technically called as forced sale value.</td></tr>
<tr><td>Vinu</td><td>Oh….</td></tr>
<tr><td>Manu</td><td>In this case, it is possible asset with Realisable Value of 100, may get sold in the market at Forced Sale Value for just 50 (i.e., 50% Forced Sale Value)</td></tr>
<tr><td>Vinu</td><td>Oh..So the Bank will suffer loss of 30?</td></tr>
<tr><td>Manu</td><td>Yes! They have given a loan of 80 and what they are going to recover is only 50 and eventually suffer a loss of 30. So they try to stay away from companies with high debt equity ratio.</td></tr>
<tr><td>Vinu</td><td>But, what is the problem in that, if I honour my commitments regularly?</td></tr>
<tr><td>Manu</td><td>No problem if you can honour your commitment regularly. But the point you have to keep in mind is Bank Funds are liabilities that comes up with Fixed Cost. i.e., Interest and Principal repayment should be as per repayment schedule.</td></tr>
<tr><td>Vinu</td><td>So?</td></tr>
<tr><td>Manu</td><td>Just visualise what will happen to your profit, if your sales drops by 5%.</td></tr>
<tr><td>Vinu</td><td>My Profit will also fall by 5%</td></tr>
<tr><td>Manu</td><td>That will happen only when all your costs are variable costs. (i.e., Costs should move along with sales.)</td></tr>
</table>

Vinu	Correct!
Manu	No business will have only variable cost. For sure there will be certain element of Fixed Cost (like Salary, Rent, Power, Interest, etc.) and in this case Interest on Debt is a Fixed Cost.
Vinu	Agreed!
Manu	It may so happen, when your sales drop by 5% and if you have more fixed costs, your profit can fall by 25%. If you are in thin Profit margin business, then small change in sales will erode all profits and result in losses.
Vinu	Understood.
Manu	Now let's go back to Banker's point of view. Banker's understand more debt means more fixed cost and small variation in sales would make your company as loss making company.
Vinu	Very true.
Manu	And if your company suffers loss, the immediate impact is going to be on bankers. Their cash flows dependent on your company is affected.
Vinu	Correct!
Manu	So, Bankers won't create this situation for themselves and eventually suffer loss. Rather they try to stay away from these kinds of companies.
Vinu	Oh…that's why they are avoiding companies with high debt equity ratio?
Manu	Yes! It's actually good for both.
Vinu	Do they have maximum level for Debt Equity Ratio?
Manu	It varies from Bank to Bank. Theoretically Debt to Equity Ratio of 2:1 is considered as maximum.
Vinu	i.e., Debt 2/3=67% and Equity 1/3=33%
Manu	Correct! But in practice, the maximum level practiced by bankers are 3:1
Vinu	Oh…Debt of 3/4=75% and Equity 1/4=25%
Manu	Yes! In Banking language Debt Equity Ratio is also called as TOL / TNW and they refer it as Leverage.
Vinu	What was that?
Manu	TOL – Total Outside Liabilities TNW – Tangible Networth
Vinu	So, in Debt Equity ratio, debt means Total Outside liabilities?
Manu	It depends upon the context. If you are calculating Debt Equity ratio for the company as whole, the Debt means Total Outside Liabilities.
Vinu	Ok!
Manu	If you are calculating D/E Ratio for a Capex Project, then Debt would mean only the long term funds that comes into the project.
Vinu	Ok! Got it. Thanks Manu for detailed Insight.
Manu	Welcome Vinu.

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