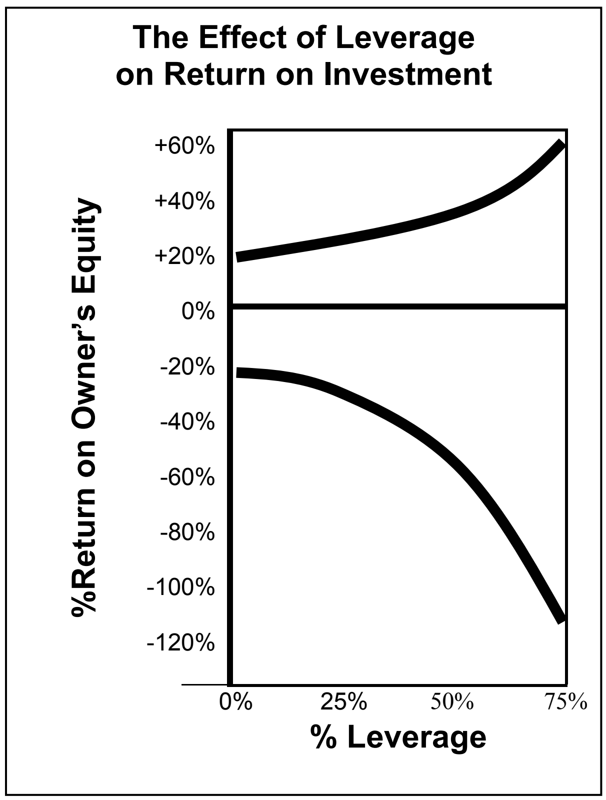
USING DEBT EFFECTIVELY

I just returned from a meeting in which a ranch family member had a fear of debt. His insistence on becoming and remaining debt free is a major obstacle to the growth and profitability of that business. He isn't alone. I often hear ranchers say one of their goals is to be "debt free." It is an understandable comment given sleepless nights and the weight of worry from operating notes that grow a little each year and long term debt of six or seven figures. But I think that we often confuse being "debt free" with "financial security." Improper use of this debt can kill a business. But properly used debt (borrowing) can be a powerful tool to help achieve high economic returns and financial security.

The wise use of debt begins with understanding the difference between economics and finance. In economics the issue is profit. In finance, the issue is cash flow. If economics is the engine of the business, then finance is the fuel that makes the business go.

When the business is economically viable it pays to "leverage" our own money through borrowing. When the business is unprofitable, borrowing only increases the loss. This is best illustrated with an example.



Let's say a business venture is expected to yield a 20% return. If we invest $10,000 of our own money, we'd expect a return of $2,000 at year's end. Not bad. But if we make the same investment using only $5,000 of our own money and borrow the rest at 10% interest, we'd make a 30% return ($2,000 return - $500 interest = $1,500 return on our $5,000 investment). If we only use 25% of our own money and borrow the rest at 10% interest, the rate of return on our capital increases to 50%. Wow! Let me in on this deal.

Unfortunately, there is a down side. Let's say things don't go as well as we had hoped and instead of making 20%, the deal loses 20%. If we had invested $10,000 of our own money we'd lose $2,000. If we had borrowed half the money invested in the deal we would lose $2,500 (a 50% loss on our capital). If we borrowed 75% of the capital invested our loss would be 110% of our original investment.

The greater the degree of leverage (borrowing relative to equity), the greater the potential return (positive or negative) on our own money.

Too Much Of A Good Thing

A little bit of leverage may be a good thing, but that doesn't mean a lot is a better thing. Too much leverage can leave a business too vulnerable to risk. The degree of leverage that is reasonably safe depends on the risk of investment, the drought risk of the environment, the track record of the borrower and several other considerations.

Solvency ratios show the degree to which a business is leveraged and indicate a business's ability to withstand risk and remain solvent. One solvency ratio is the net capital ratio. It is calculated by dividing the total assets of a business by its total liabilities. This ratio generally exceeds 2 : 1 (≥ 2) in a healthy business.

$$\text{Net Capital Ratio} = \frac{\text{Total Assets}}{\text{Total Liabilities}}$$

Another important indicator is the debt to equity ratio. It shows the extent to which a business is leveraged. It is used as a measure of the financial risk carried by a borrower. The debt to equity ratio is calculated by dividing total debt by the equity (net worth). A ratio of less than 1 : 2 (≤ 0.5) is usually considered safe.

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

The moral of the story is: if the business is economically sound, it can be more profitable by borrowing judiciously…but it must be profitable. Economics come first when you are ranching for profit!

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