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# Assess Your Company's Debt Capacity
## Using This Financial Rule of Thumb

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If you are interested to refinance your company's debt or get additional capital, there is a fairly simple rule of thumb that can help you quickly gauge your financing alternatives and make sense of today's lending environment.

We all know rules of thumb aren't 'gospel' but they can provide insight into possible solutions. **The rule of thumb for financing is to look at a company's debt compared to its EBITDA** (or Earnings Before Interest Taxes Depreciation and Amortization). Established, profitable companies have historically been able to borrow up to about 4 times (X) EBITDA.

Using a simple example, a company that generates annual EBITDA of $2 million should have a debt financing capacity of about $8 million assuming a "Debt Multiple" of 4(X) times. So, if, for example, the company had $5 million of existing debt, it would have added debt capacity of about $3 million. [See Figure 1.]

[Figure 1]

| | |
|---|---|
| EBITDA | $2,000,000 |
| Debt Multiple | 4X |
| Financing Capacity | $8,000,000 |
| Less: Existing Company Debt | ($5,000,000) |
| Additional Debt Capacity | $3,000,000 |

While the formula is simple, applying it to real life situations, often requires a closer look at each of the major components: EBITDA, Debt and the Debt Multiple.

**EBITDA (with some adjustments)**

Financial institutions typically look at last year's EBITDA or EBITDA over the last 12 months. EBITDA is supposed to approximate a company's underlying cash flows generated by the business and 'normalizes' the impact of financing, taxes and non-cash expenses such as depreciation and amortization. That said, for companies with significant capital assets, such as manufacturing businesses, on-going capital expenditures should be deducted from EBITDA in order to account for the expense of maintaining the operating assets.

Also depending on the situation, adjustments to EBITDA can be made for significant and non-recurring revenue or expenses. Examples of adjustments could include one-time litigation expenses, moving expenses, discretionary bonuses, or the gain (or loss) on the sale of a building. Probably the most interesting adjustment we've made was for a $750,000 customer appreciation party!

**What are we calling 'debt'?**

Debt obviously includes bank debt but it can also include debt from a variety of non-bank lenders such as commercial finance companies, mezzanine lenders, subordinated debt providers, operating companies, business development corporations, and insurance funds to name a few.

Most companies have limited knowledge of non-bank financing sources but they actually outnumber large bank lenders. In round numbers, there are about 175 banks that have assets of $5 billion or more. In comparison, we have identified over 500 non-bank lending groups, or roughly 3 times the number of large banks.

Equally interesting, unlike traditional banks these groups are actively lending. As a general rule, non-bank lenders tend to charge higher rates than traditional banks but they also typically offer more capital. Non-banks may also provide financing with less restrictive covenants, such as limited personal guarantees, thus lowering the owner's risk when compared to traditional banks.

**The Moving Debt Multiple**

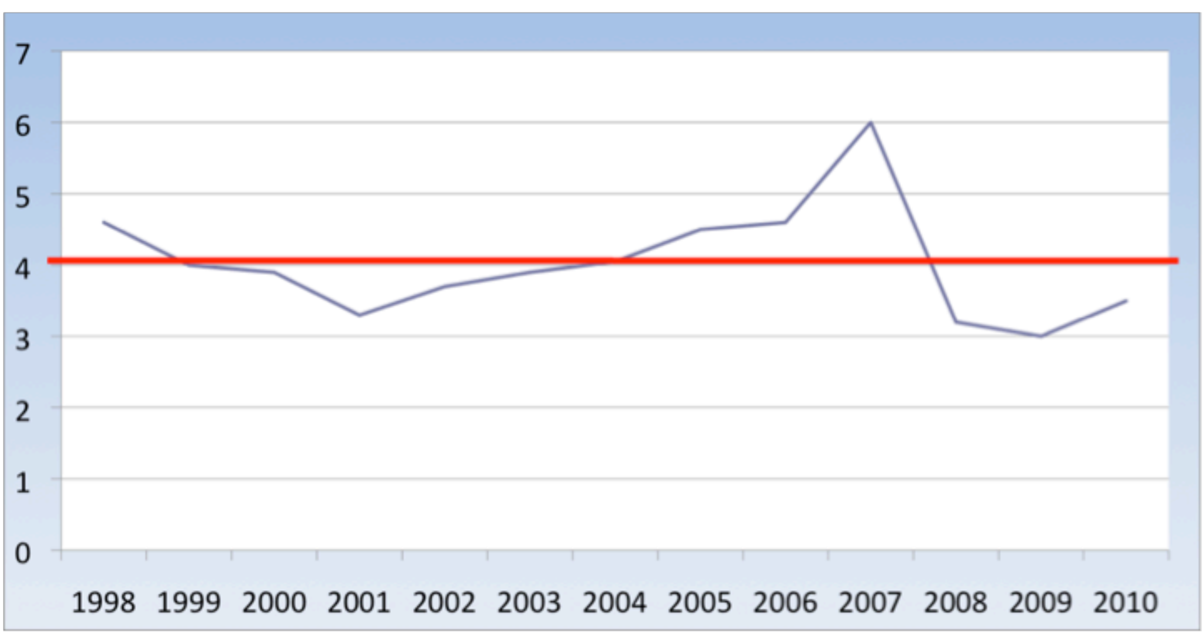
While we have been discussing the debt multiple based on its historical average over the last 10 years, its does fluctuate (which is why this a rule of thumb) [see figure 2]. In our currently poor economy, banks (and some non-banks) are hurting. That 'hurt' is reflected in the average debt levels on new financings. In 2009 and early 2010 average debt multiples for new financings were below 3(X) times. Today, we are seeing debt multiples still around 3X but starting to creep up to 3.5X for businesses with predictable future revenue. [Figure 2 is a chart that summarizes the average debt multiples over the last 10 years.]

**Where are we today?**

Looking at the chart below helps better explain today's lending problems. The media likes to paint a simple picture that banks have pulled back but that is only half the story. In our bad economy, many businesses are experiencing declining EBITDA and increasing debt levels. This combination creates a quick 'no man's land' scenario where the existing lender pulls back and no other lender is interested to take their place. Here's a simple illustration using our earlier example [from Figure 1].

| | 2 years ago | | Today |
|---|---|---|---|
| EBTIDA | $2,000,000 | (Decline) | $1,500,000 |
| Debt Multiple | 4X | (Decline) | 3X |
| Financing Capacity | $8,000,000 | | $4,500,000 |
| Less: Existing Company Debt | ($5,000,000) | (Increase) | ($6,000,000) |
| Additional Debt Capacity (Deficit) | $3,000,000 | | ($1,500,000) |

**[Figure 2] Historical Debt to EBITDA Multiples**



"Knowing this simple rule of thumb can help CEOs and owners quickly assess their financing options so they can either explore it further, or get back to the business of building value, which means finding ways to increase EBITDA, lower debt, or do both."

This example illustrates how lenders are lending less (which is reflected in the lower current Debt Multiple) but also how a company's current performance can contribute to the problem.

**Other Exceptions**

All this being said, the financing multiple is still not a tell-all indicator. Some companies with significant collateral or assets are often able to borrow larger amounts than the average multiple implies because the bank is comfortable with the collateral (such as accounts receivable and inventory) or the debt on the asset can be repaid over a long period of time (such as a mortgage on a building). This creates more room for free cash flow to service debt.

Ultimately a company's financing capacity is driven by the current economic climate and interest level of prospective lenders or investors. The more a lender falls in love with a company, the more aggressive they will be. Conversely, the more skittish they are of the company (or industry), the less financing they are willing to give. Equally interesting, these opinions (and multiples) can vary between institutions, which is why its good to shop numerous financing sources.

Still, knowing this simple rule of thumb can help CEOs and owners quickly assess their financing options so they can either explore it further or get back to the business of building value, which means finding ways to increase EBITDA, lower debt, or do both!

**ABOUT THE AUTHOR**

Chris Risey is the founder and president of Lantern Capital Advisors, an Atlanta-based corporate financial consulting firm that helps entrepreneurial companies finance growth, acquisitions and buyouts in a way that best suits their company's unique needs and growth potential.

Mr. Risey is a frequent writer and speaker to financial executives and entrepreneurs through out the country interested to learn more about corporate financial planning and how to use it to build greater value in today's financial markets. Mr. Risey began his career as a CPA with Arthur Andersen. Mr. Risey is a magna cum laude graduate of the University of South Florida. He was twice named Academic All-American (Men' Basketball) and is a former Rotary International Ambassadorial Scholar.

**CONTACT LANTERN CAPITAL ADVISORS**

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