5 FINANCIAL RATIOS YOU SHOULD KNOW WHEN APPROACHING LENDERS

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DISCLAIMER

Lenders may calculate these ratios in different ways and ratios may change over time. Ratios may also vary based on the risk appetite of the lender, the macro and micro economic environment, and your industry. This is for educational purposes only and does not determine or guarantee you or your business' eligibility for financing.

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TOTAL DEBT SERVICE RATIO (TDSR)

Your TDS is the amount of your personal monthly income needed to cover your personal monthly expenses. To calculate your TDSR ratio, add all of your monthly expenses then divide by your total monthly income, before taxes.

FORMULA [monthly expenses ÷ gross monthly income] x 100

Example: You have an annual income of $60,000 hence a gross monthly income of $5,000, and total monthly expense of $1,800 for rent, car loan payments, and your credit cards combined.

TDSR Ratio = $1,800 ÷ $5,000 x 100 = 36% 36% of your salary is used to pay current monthly expenses.

Industry Standards: 44% maximum Given that your TDS is below industry standards, subtracting 36% TDS from industry standards 44% leaves 8%. You can allocate up to 8% or $400 more of your monthly income towards monthly expenses or additional debt, to remain within industry standards.

DEBT SERVICE COVERAGE RATIO (DSCR)

DSCR measures whether or not your business makes enough of a profit to pay its existing annual debt obligations, after operating expenses. Most lenders look to see that your business has a profit of at least $1 for every dollar needed to cover its debts after all operating expenses are paid (salaries, utilities, rent, etc.)

FORMULA [Net Income] ÷ [Annual Debt Payment Requirements]
Net Income = Annual Revenue - Annual Operating Expenses

Example: Your trucking company grossed $350,000 in revenue this year. You have annual operating expenses of $155,000 to cover your rent, utilities, employee salaries, and insurance. Your business pays $92,000 annually for debt obligations to cover its capital lease, truck loan, equipment loan, line of credit and credit cards.

Industry Standards

DSCR = 1 typically means you have just enough cash flow to cover your existing debt obligations
DSCR > 1 typically means you have a good amount to cover your existing debt obligations. A DSCR of 1.5 or above is typically considered great.
DSCR < 1 typically means your company does not have enough cash flow to cover your existing debt obligations. In order to cover your debt obligations you would need to pull funds from elsewhere such as personal finances or savings to cover these obligations.

WORKING CAPITAL/CURRENT RATIO (W/C)

Your business' working capital ratio is a measure of liquidity - the ratio between your current assets and current liabilities i.e, how quickly you can sell your business' assets to pay off what you owe today, and for how much? Current assets include cash, investments, inventory, accounts receivable. Current liabilities include overdrafts, credit cards, lines of credit, pre-sold goods, taxes, or any amounts due to creditors within 12 months.

FORMULA [Current Assets ÷ Current Liabilities]
Current assets and liabilities can be found on the Balance Sheet of your company.

Example: Your construction company put $20,000 from its profits into an investment account and the business has $80,000 outstanding in Accounts Receivable (AR) which you've invoiced to your customers, all due payable within the next 30 days. Additionally, the company has a line of credit of $20,000, a credit card of $10,000 and a mortgage of $185,000.

W/C Ratio = [($20,000 + $80,000) / ($20,000 + $10,000)] = **3.3**

Your company has 3.3x liquid assets as it does debts due payable in the next 12 months. Note the mortgage is excluded as it is a long-term liability that is not due payable in full within the next 12 months.

Industry Standards

W/C = 1 is typically the minimum requirement to meet short-term liabilities
W/C > 1 greater than 1.5 is typically considered good
W/C < 1 your business is running a risk of not being able to meet its short-term liabilities that need to be paid. In some cases, it leads to insolvency or bankruptcy if this is not rectified in the future.

DEBT TO EQUITY RATIO

> Debt to equity measures the ratio between how much debt is outstanding to lenders vs. how much cash has been invested by owners or shareholders into the company to finance its assets.

FORMULA [Total Liabilities (Short and Long Term Debts) ÷ Equity]

Example: Your company's total debt is $300,000 and its total shareholder equity is $100,000,

D/E Ratio = $300,000 / $100,000 = **3:1**
This means that for every dollar invested in the company, three-quarters comes from debt/creditors and one-quarter by shareholders.

Industry Standards
D/E =< 3
As the level of debts taken on by a company can be significantly impacted by its industry and capital requirements, a good d/e ratio varies and depends on industry averages. A debt-to-equity ratio of around 2 or 3 is generally considered good. A company with more debt than the average for its industry is said to be highly leveraged.

Leverage is not necessarily bad. When revenues are growing, additional debt is often acquired to take advantage of market opportunities. However, when revenues are low, a highly leveraged business might fall behind on debt payments and it might not be able to borrow additional money to stay afloat. (Business Development Bank of Canada)

LOAN TO VALUE (LTV)

The loan-to-value ratio is a financial term in percentage form that is used by lenders to express the ratio of a loan to the value of an asset purchased

FORMULA [loan amount ÷ asset value x 100]

Example: A property is valued at $100,000 and you are seeking a loan for $80,000 against the property.:

LTV = $80,000/$100,000 x 100 = **80%**
If a lender finances up to 80% LTV, this means they will finance up to 80% of the value of the asset being purchased.

Industry Standards: LTV varies depending on the asset(s) being financed, industry, and overall risks of the project amongst other factors. Lenders typically shy away from financing 100% of projects as they prefer to see some investment from the part of the borrower, having the risks mutually shared.

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