DEBT

Mini Investment Class by the OKI Tri-State Chapter

Courtesy Cincinnati Model Investment Club
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Companies have three ways to raise money in order to grow.

They are:

1. **Retained Earnings**
2. **Sell additional shares of stock**
3. **Borrow money**

We are going to take a closer look at borrowing money as a way of raising capital.

Guidelines

- As a general rule, BetterInvesting suggests that having about 33% of capitalization come from debt is about the maximum amount you would like to see in most industries.

- There are some industries that operate with higher debt levels such as banking and some that have lower debt levels such as high tech companies.

Why is debt a concern?

- Interest on debt has to be paid regardless of the economic conditions.
- When the economy is booming it is easy for companies to pay the interest and still continue to grow.
- When the economy is in a recession, companies with little or no debt will have more money to continue growing while companies with debt have to pay interest.

Is borrowing money a bad thing to do?

- Not necessarily.
- If the company uses the money to increase shareholder equity it can be to our (the shareholders) advantage.
- What we have to determine is whether or not they are using the money wisely.

How do we determine if they are using the money wisely?

- One way is to use Value Line numbers to compare their

- <u>Return on Total Capitalization</u>

  to their

- <u>Return on Shareholder Equity.</u>

Return on Total Capitalization

- This is a percentage the company earns on its shareholders equity and long term debt.

- When the return on total capitalization goes up, there should be an increase in the return on shareholder equity.

Return on Shareholder Equity

- **This is the amount that has been earned (in percentage terms) every year for the stockholders.**
- **The stockholders include both the common and preferred stockholders.**

Comparing these numbers

- **If the Return on Total Capital is increasing and the Return on Shareholder Equity is not increasing, it means that the company is borrowing money and paying interest but not earning more for the stockholders on their equity in the company's assets**

Target

8.7%	8.2%	8.2%	6.3%	9.0%	10.9%	11.8%	13.1%	12.0%	10.4%	*10.0%*	*10.0%*	**Return on Total Cap'l**	*11.0%*
14.8%	13.0%	13.4%	9.0%	14.5%	17.3%	18.0%	20.2%	19.4%	18.1%	*17.5%*	*17.5%*	**Return on Shr. Equity**	*17.5%*

Wal-Mart

15.8%	13.3%	13.4%	12.2%	12.6%	13.8%	15.6%	14.6%	14.5%	13.5%	*14.0%*	*14.5%*	**Return on Total Cap'l**	*15.5%*
22.8%	21.7%	21.1%	18.6%	17.8%	19.1%	21.0%	22.1%	20.1%	19.1%	*19.5%*	*19.5%*	**Return on Shr. Equity**	*20.0%*

Kohl's

15.2%	18.6%	16.3%	14.6%	13.4%	12.1%	13.8%	12.5%	13.2%	13.5%	*18.5%*	*18.5%*	**Return on Total Cap'l**	*17.0%*
19.0%	21.2%	20.5%	19.7%	19.8%	14.8%	16.5%	15.3%	16.9%	17.8%	*18.5%*	*18.5%*	**Return on Shr. Equity**	*19.0%*

***Representations made in this mini class are historical and should not be used for any current evaluations.**

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