

Debt Service Coverage Ratio: What Is It, Formula, and How To Manage It



What is the Debt Service Coverage Ratio and How To Use It In Your Business

If your business carries debt or is looking to take on debt, your debt service coverage ratio or DSCR can be important.

Designed to measure the ability of a business to repay current debt obligations using operating income, the debt service coverage ratio metric is usually used by lenders to determine the company's ability to pay back a potential loan or line of credit and is a mainstay of the real estate industry.

What is Debt Service Coverage?

Debt service coverage shows how much cash your business can generate compared to every dollar owed. Debt service coverage is an amount, where the debt service coverage ratio compares incoming cash totals with current debt

payments.

To determine your debt service coverage or cash inflow total, you'll have to calculate your EBITDA, which is earnings before income tax, depreciation, and amortization.

These totals can be obtained directly from your income statement. For example, if your business has a net profit of \$750,000, interest expenses of \$35,000, taxes of \$115,000, and depreciation expense of \$48,000, you would calculate your debt service coverage as follows:

$$\mathbf{\$750,000 + \$35,000 + \$115,000 + \$48,000 = \$948,000}$$

This means that your business has \$948,000 available to service any existing or new debt.

Keep in mind that to calculate EBITDA properly, you need to obtain your net income from your income statement, and add any interest expenses, taxes, depreciation, and amortization expenses back to your net income.

When Should You Calculate the Debt Service Coverage Ratio?

If you currently have debt obligations or are looking to take on additional debt, it can be helpful to calculate your DSCR.

More importantly, if you're considering applying for a loan, or in the process of applying for a loan or line of credit, take a few minutes to calculate this ratio before completing your application, since it's likely that your lender will be calculating it as well.

Even if you're not planning on taking on additional debt, knowing your debt service coverage ratio can provide some keen insight into current debt levels and if you're getting dangerously close to exceeding the recommended ratio level.

By calculating debt service coverage ratio proactively, you can better manage your outstanding debt and as a responsible borrower, help to ensure an easy road to approval for any debt you may take on in the future.

What is the Debt Service Coverage Ratio Formula?

There are three things you'll need to complete before calculating your company's debt service coverage ratio.

1. Calculate your annual net operating income/EBITDA

The easiest way to calculate your net operating income or EBITDA is by using your cash flow statement. In many cases, your accounting software application will calculate net income on your financial statements, but not always.

First, locate your annual sales revenue, which for this example we'll say is \$700,000. Next, you'll need to add up all of your expenses for the year. For this example, let's use the following expenses:

- Rent - \$50,000
- Payroll - \$125,000
- Postage - \$4,000
- Inventory - \$55,000
- Taxes - \$ 155,000
- Interest payment - \$15,000
- Depreciation - \$40,000
- Amortization - \$22,000

By subtracting the expenses listed above from your sales revenue, your net income is \$234,000.

But to calculate net operating income or EBITDA, you'll need to add back the following expenses:

Taxes - \$155,000

Interest payment - \$15,000

Depreciation - \$40,000

Amortization - \$22,000

Your net operating income calculation would be:

$$\mathbf{\$234,000 + \$155,000 + \$15,000 + \$40,000 + \$22,000 = \$466,000}$$

You'll need to use this number when calculating your DSCR. Though the example above is using annual totals, many larger businesses find it useful to calculate the debt service coverage ratio every quarter or when looking to take on additional debt.

2. Calculate your debt payments for the period

This needs to include all current loans and notes payable. For this example, we'll say that you currently have two outstanding loans with the following payments made annually:

Building loan - \$60,184

Business loan - \$12,550

This makes your annual debt payment total \$72,734. When calculating debt payments, make sure that you include both principal payments as well as interest payments required. And for any new debt, be sure to consider the loan amount, loan payments, and principal repayment required.

3. Calculate your debt service coverage ratio

The DSCR calculation is as follows:

Net Operating Income (EBITDA) / Annual Debt Payments

Let's calculate the debt service coverage ratio using the DSCR formula above:

$$\mathbf{\$466,000 / \$72,734 = 6.40}$$

This result means that the business would be able to cover current debt more than six times, based on their current net operating income.

What is a good debt service coverage ratio?

The debt service coverage ratio is only one of several ratios that lenders typically look at when evaluating the financial health of a loan applicant. But what do your

results mean, and what type of debt service coverage ratio do lenders typically look for?

In most cases, a lender will look for a minimum DSCR of at least 1.15, which indicates that based on current net operating income, the business would be able to repay any loan with interest.

If you're ready to interpret your DSCR, follow these general guidelines.

Less than 1

A debt service coverage ratio of less than one means that your business does not currently earn enough income to completely cover the current debt.

A ratio of less than 1 would make it impossible to qualify for any type of business loan or line of credit, though you may be eligible to acquire short-term debt, particularly if you include any personal income.

= 1

A DSCR ratio of exactly 1 means that you currently have enough income to cover the current debt but not enough cash to take on additional debt.

More than 1

A debt service coverage ratio of more than 1 indicates that your net operating income exceeds your current debt obligations.

The higher the debt service coverage ratio, the more financially stable your company is viewed.

Breaking down the implications of a 1.5 debt service coverage ratio

In general terms, a DSCR of 1.5 means that your business is financially stable, and will be viewed as a good risk for a loan or line of credit.

More specifically, a DSCR of 1.5 shows potential investors and lenders that your company is currently earning 50% more income than is required to adequately

cover repayments associated with your current debt. But that can quickly change.

For example, if your net operating income is \$500,000 and your debt obligations total \$325,000 for the year, your DSCR would be 1.53.

But what happens if you're looking to take on \$125,000 of additional debt? You would need to add that amount to your current debt obligation to view your updated debt service coverage ratio:

$$**\$500,000 / \$450,000 = 1.11**$$

By adding in the potential new debt obligation, your DSCR has dropped from 1.5 to 1.11, still, a decent DSCR, depending on who your potential lenders are. But what happens if your new debt is \$200,000?

$$**\$500,000 / \$ 525,000 = 0.95**$$

By adding this additional debt, you're now able to only cover 95% of your debt obligations and will likely be turned down for any additional funding from lending institutions.

Why are the results of the debt service coverage ratio important?

Taking on additional debt isn't always optional - sometimes it's a necessity, even for a small business.

For example, a small manufacturing company has three of its four machines break down. Even worse, they're unable to be repaired, making it necessary to purchase three new machines.

In addition, it's helpful to know what your current debt service coverage ratio is, allowing you to take any corrective measures immediately.

And keep in mind that potential investors may also look at a company's debt service coverage ratio to better analyze the financial health of a business before investing.

Reasons why your debt service coverage ratio may be low and how to raise it

There are several reasons why your debt service coverage ratio may be low, but in most cases, it's low because of insufficient net operating income.

This could be a temporary situation, particularly if you're calculating DSCR based on monthly or even quarterly income. For example, if you own an ice cream parlor, chances are that the majority of your operating income is earned in the warmer months.

If that's the case, calculating your debt service coverage ratio for December may indicate that you don't have enough operating income to pay for current or additional debt.

However, calculating your DSCR for the entire year will likely result in a better ratio result.

Remember, a DSCR of 1 means a business has enough net operating income to support current debt, but is unable to take on more debt.

But a DSCR of less than 1 means that your income level is too low to support your current debt.

This can be the case for businesses that were able to obtain a loan or line of credit at an earlier time but have since seen revenues drop. If that's the case, there are ways to improve your debt service coverage ratio.

1. **Increase your net operating income** - there are a variety of ways to increase your net operating income. These can include expanding your product line or services offered or increasing your pricing levels.
1. **Lower your operating expenses** - In many cases, it's easier to lower costs than it is to increase income. Some of the ways you can lower your operating costs include seeking out new suppliers, renegotiating existing contracts with current vendors, or eliminating an unnecessary service. Other, more drastic cost-cutting measures include relocating your business to a less expensive facility or reducing staff.

When should you calculate the DSCR for your business?

If you carry any debt, you should minimally calculate your DSCR annually. And for businesses looking to take on any new debt, you should calculate your debt service coverage ratio before applying for a loan or line of credit.

By calculating this ratio proactively, you can better manage your outstanding debt and as a responsible borrower, help to ensure an easy road to approval for any debt you may take on in the future.

What's your goal today?

1. Use PLANERGY to manage purchasing and accounts payable

We've helped save billions of dollars for our clients through better spend management, process automation in purchasing and finance, and reducing financial risks. To discover how we can help grow your business:

- Read our case studies, client success stories, and testimonials.
- Visit our "Solutions" page to see the areas of your business we can help improve to see if we're a good fit for each other.
- Learn about us, and our long history of helping companies just like yours.

[Book a Live Demo](#)

2. Download our guide "Preparing Your AP Department For The Future"

Download a free copy of our guide to future proofing your accounts payable department. You'll also be subscribed to our email newsletter and notified about new articles or if have something interesting to share.

[download a free copy of our guide](#)

3. Learn best practices for purchasing, finance, and more

Browse hundreds of articles, containing an amazing number of useful tools, techniques, and best practices. Many readers tell us they would have paid consultants for the advice in these articles.

Related Posts