Optimizing a company's equity ratio
A report by JW Morris
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Why would you need to increase Equity or optimize your Equity Ratio?
Here is an example: A Power project seeks to be awarded a PPA from a Government. To qualify, you are required to evidence a certain percentage of equity. If your equity ratio is sufficient, your local bank will provide a loan of possibly up to 70% and the Government provides the PPA. A high equity ratio can open opportunities and is always associated with a high credit rating. It enables financing and also offers a certain buffer for times of crisis. And this stands for any kind of a business sector.

Let's start with some basics
How is the equity ratio actually calculated? As with all ratios (fraction times one hundred), "what is involved" is placed in the numerator. The numerator contains the equity capital. Equity is also the partial mass. Also typical for a ratio: The denominator contains the total mass, the total capital. This is the formula for calculating the equity ratio.

How can you increase the equity ratio?
First you will have to understand the structure of a balance sheet.
A balance sheet has an asset side and a liability side.
The liabilities side shows the source of funds. The equity and the debt and both make up the total capital.

The assets side shows fixed assets and current assets and this results in the total assets. Total assets (assets) is equal to total capital (liabilities). Both values are the same, only derived from the consideration of different perspectives.

On the liabilities side is the source of funds on the assets side is how the funds are used. You can only use what has come from somewhere at some point. Either it is your own money or someone else's money. Since both sides balance each other out, it is also called the "balance sheet".

How can you then increase the equity ratio? In the direct way you increase the equity ratio by increasing the equity value. The second way is indirect, in which the equity capital remains the same, but the borrowed capital is reduced. This also increases the equity ratio.

This is clear maths. Let's now take a closer look at the first, the direct way. How can we increase the equity ratio? In the case of a corporation, this is relatively easy, but in principle, a limited liability company can also increase its equity.

Here we have the direct way of the capital increase.
This is the first possibility: The capital increase happens de facto by taking in new shareholders or existing shareholders acquire additional shares. In the case of a stock company, these are new shareholders, or existing shareholders buy additional shares. This is the direct way that brings up the value of the equity ratio.

Here is the second option (the direct route):
The second way to directly increase the equity ratio is to retain profits. This is also called “retained earnings” which is nothing more than another word for profit retention.

Example: A company has achieved net profits in a certain year or in other words, a positive result. The reserves are now "allocated" from this annual surplus. This can also be called: Retention of profits and allocation to reserves. It means nothing more than the addition to retained earnings, which in principle represents an increase in equity and thus an increase in the equity ratio.

If we deduct the “allocation to reserves” from the “annual surplus”, then the retained earnings remain, which are paid out to shareholders as dividends. Dividends are what is distributed from “what is left over”. Before that, the reserves are "endowed" and the result is that the equity capital increases and thus also the equity ratio.

So these are the two ways to increase the capital. The easiest way to do this in a corporation is to retain profits. "Retaining profits" or you can also say "simply retain more of the annual net profit and distribute less to the shareholders".

But you can also release capital on the assets side.

If you want to free up capital, take a closer look at the fixed assets. For example, there is an unused warehouse and a plot of land. If a building or a piece of land is no longer needed, it can be sold and turned into cash. However, this does not initially increase the equity ratio. It only increases liquidity in the first step.

This is a process on the asset side, i.e. nothing more than an asset swap.

The company has correspondingly less in fixed assets because the warehouse and the associated land disappear from fixed assets and at the same time the company has more liquid funds in the bank due to the receipt of the sales proceeds. So the fixed assets decrease, the current assets increase. The total assets remain the same. Consequently, the total capital on the liabilities side also remains the same.

But this process offers the possibility of indirectly increasing the equity ratio.

If, in a second step, a loan is repaid with this money, then we are on the indirect path of increasing the equity ratio and thus reducing the debt capital. The indirect way is for example a loan repayment, in our example using the proceeds from the sale of the warehouse.

Through the loan repayment
debt capital becomes lower
equity capital remains the same,
total capital decreases and thereby the equity ratio increases!

All measures that reduce “the balance sheet total” - increase the equity ratio. Keeping equity the same and reducing the balance sheet total is therefore the indirect way to increase the equity ratio.

So how can you reduce “the balance sheet total”?

For example by optimizing inventories in current assets. Inventory is reduced by "just in time" measures which reduces holding inventory on site.

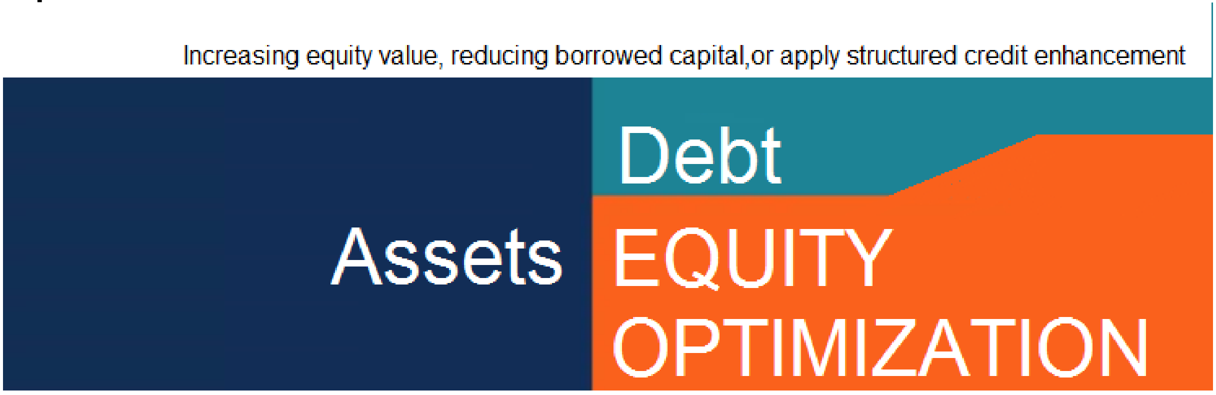
Another item to improve the equity ratio can be found in current liabilities.

Debt capital is subdivided
into current liabilities and
long-term liabilities

If fewer short-term liabilities appear on the balance (because invoices are paid more quickly) then the equity ratio is increased accordingly because the debt capital is reduced, which is made up of long-term and short-term liabilities.

Repaying long-term loans and reducing short-term liabilities are also ways to increase the equity ratio.

But what can you do if you cannot optimize your equity, or your equity ratio as explained here?



If your options are limited to increase equity or the equity ratio to trigger funding or even Government Grants, a structured product may offer a solution. A good example is the power project seeking access a PPA from a Government as stated in the intro to this report.

If you seek such a solution right now feel free to schedule a call with me.

Email JW@morrisireland.com
Phone | Whatsapp | Signal +353.86.0325153 | ZOOM PMI 831 001 0621
Skype live:.cid.6cd26c65b963314a
Visit my Website http://morrisireland.com