# Investors: Ignore This Number at Your Peril

## Description

This year is set to be a year of change. As such, being able to adapt is likely to be a crucial attribute for investors. The EU in its current form is at the beginning of the end, with negotiations between the UK and EU forecast to commence. China's growth rate is continuing to slow, while in the US a new President is set to put in place radically different policies compared to those of his predecessor.

Global economic growth could come under pressure if confidence among consumers, businesses and investors declines. Given the uncertainty present right now, this would not be a major surprise. At the same time, higher inflation could become a reality if Donald Trump lowers taxes and raises spending as expected. Therefore, focusing on one number in particular could prove crucial in a high-inflation, low-growth environment this year.

## Sustainable business



The number in question is the interest coverage ratio. It is calculated by dividing a company's operating profit by its interest payments. This tells an investor how many times the business was able to pay the interest on its debt using its most recent profit figure.

A company which has an interest coverage ratio that demonstrates it was able to service its debt many times over is more likely to be a sustainable business than one which is already struggling to afford debt servicing costs. At the present time, interest rates are at or close to historic lows. Therefore, debt interest payments are unlikely to move lower, unless a company chooses to reduce its total debt. As such, it seems prudent for investors to hold stocks which have a margin of safety when making interest payments. If not, their viability as a going concern could be called into question and a fundraising may be required.

## A difficult outlook

As mentioned, the global economy faces an uncertain future. A slowdown in world GDP growth could lie ahead and this may cause the profitability of businesses to decline somewhat. This would reduce the ability of a company with debt to make interest payments. This makes a margin of safety even more important at the present time than it otherwise would be.

Similarly, if inflation rises due to Trump's planned higher spending and lower taxation policies, interest rates may follow. Policymakers in the US and abroad may wish to cool higher inflation, which is normally done through a higher interest rate. While some company debt will be fixed rate, many businesses will have floating-rate debt which will fluctuate in line with interest rate changes. When combined with a fall in profitability, this could lead to difficulties in not only repaying debt, but in servicing it, too.

## Takeaway

Although the affordability of debt has not been a popular topic in recent years, it is likely to become one over the medium term. The combination of an uncertain outlook for the global economy and the prospect of higher inflation could reduce the ability of many companies to service their debt. In such a situation, shareholders may be called upon to boost balance sheets across a wide range of sectors. In order to avoid this and the potential for losses, holding stocks which enjoy a wide margin of safety when it comes to their interest coverage ratios could be a prudent move.

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