

### **Debt Calculation**

One thing I want to address is the value of debt. The value of debt, from your writing is correct, from a technical aspect. If I was to give my 2 cents, the technical value of debt is only substantiated if there is: 1) enough value in the assets to cover the debt, 2) cashflow can cover the interest payments of the debt.

The technical calculation assumes 1) the company can make the interest payments, 2) the company can refinance the debt, or repay the debt. If the company chooses to repay the debt, it is important to see if the Co. has enough assets, or cash to do so. If not, then that debt will not trade anywhere near par, and act like equity.

**Imagine you have 2 glass cups and a pitcher. The pitcher represents Enterprise value.**

**If you pour the water from the pitcher into the 1<sup>st</sup> glass cup, which represents debt, and there is still residual left in the pitcher, then the debt can sell at/above par. That residual represents the equity, which will be poured into the 2<sup>nd</sup> glass cup.**

**If you pour the water from the pitcher into the 1<sup>st</sup> glass cup, which represents debt, there is not enough to fill the 1<sup>st</sup> glass cup, your debt will sell at a discount to par. You will have no residual value for the equity, which means equity is worthless. Your 2<sup>nd</sup> glass cup will be empty.**

Distressed debt investors calculate the EV, and back into the debt value and equity value.

When we value stocks, we assume there is residual Enterprise value, after accounting for debt. However, this may not be the case. This is why it is important to look at the balance sheet, to see if our asset is composed of worthless goodwill, or uncollectable accounts receivables, or worthless factories (i.e. publishing companies). If these are worthless, then in the event of a bankruptcy, there will not be enough assets to cover the debt, which means as an equity investor, we will be holding worthless paper.

This is why I always calculate tangible book value, for downside protection.