LEVERAGE

Meaning, Importance of Capital Gearing / Leverage,
Types of Leverage (Theory & Examples) – Operating Leverage,
Financial Leverage, Composite / Total Leverage
(Examples Based on Preparation of Income Statement be taught)
Effects / Implications of Leverages, Trading on Equity – Merits and Limitations

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INTRODUCTION

Financial decision is one of the integral and important parts of financial management in any kind of business concern. A sound financial decision must consider the board coverage of the financial mix (Capital Structure), total amount of capital (capitalization) and cost of capital (Ko). Capital structure is one of the significant things for the management, since it influences the debt equity mix of the business concern, which affects the shareholder's return and risk. Hence, deciding the debt-equity mix plays a major role in the part of the value of the company and market value of the shares. The debt equity mix of the company can be examined with the help of leverage.

MEANING

The term leverage refers to an increased means of accomplishing some purpose. Leverage is used to lifting heavy objects, which may not be otherwise possible. In the financial point of view, leverage refers to furnish the ability to use fixed cost assets or funds to increase the return to its shareholders.

James Horne has defined leverage as, "the employment of an asset or fund for which the firm pays a fixed cost or fixed return.

IMPORTANCE OF CAPITAL GEARING / LEVERAGE

What is Capital Gearing?

The term capital gearing refers to the ratio of debt a company has relative to equities. Capital gearing represents the financial risk of a company. It is also referred to as financial gearing or financial leverage. A company is said to have a high capital gearing if the company has a large debt as compared to its equity.

For example, if a company is said to have a capital gearing of 3.0, it means that the company has debt thrice as much as its equity.

The term 'capital gearing' refers to the relationship between equity capital (equity shares plus reserves) and long-term debt. It may be planned or historical, the latter describing a state of affairs where the capital structure has evolved over a period of time, but not necessarily in the most advantageous way.

In simple words, capital gearing means the ratio between the various types of securities in the capital structure of the company.

A company is said to be in high-gear, when it has a proportionately higher/large issue of debentures and preference shares for raising the long-term resources, whereas low-gear stands for a proportionately large issue of equity shares.

The problem of capital gearing is very important in a company. It has a direct bearing on the divisible profits of a company and hence a proper capital gearing is very important for the smooth running of an enterprise.

In case of low geared company, the fixed cost of capital by way of fixed dividend on preference shares and interest on debentures is low and the equity shareholders may get a higher rate of dividend. Whereas, in a high geared company the fixed cost of capital is higher leaving lesser divisible profits for the equity shareholders.

The capital gearing in the financial structure of a business has been rightly compared with the gears of an automobile. The gears are used to maintain the desired speed and control. Initially, an automobile starts with a low gear, but as soon as it gets momentum, the low gear is changed to high gear to get better speed.

Similarly, a company may be started with high equity state, i.e. low gear but after momentum, it may be changed to high gear by mixing more of fixed interest bearing securities such as preference shares and debentures.

It may also be noted that capital gearing affects not only the shareholders but the debenture holders, creditors, financial institutions, the financial managers and others are also concerned with the capital gearing.

TYPES OF LEVERAGE

Leverage can be classified into three major headings according to the nature of the finance mix of the company. The company may use finance or leverage or operating leverage, to increase the EBIT and EPS.

OPERATING LEVERAGE

The leverage associated with investment activities is called as operating leverage. It is caused due to fixed operating expenses in the company. Operating leverage may be defined as the company's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes. Operating leverage consists of two important costs viz., fixed cost and variable cost. When the company is said to have a high degree of operating leverage if it employs a great amount of fixed cost and smaller amount of variable cost. Thus, the degree of operating leverage depends upon the amount of various cost structure. Operating leverage can be determined with the help of a break even analysis.

Operating leverage can be calculated with the help of the following formula:

OL = Contribution / EBIT

Where,
OL = Operating Leverage
C = Contribution
EBIT = Earnings Before Interest & Tax

Degree of Operating Leverage

The degree of operating leverage may be defined as percentage change in the profits resulting from a percentage change in the sales. It can be calculated with the help of the following formula:

DOL =Percentage change in profits / Percentage change in sales

Uses of Operating Leverage

Operating leverage is one of the techniques to measure the impact of changes in sales which lead for change in the profits of the company. If any change in the sales, it will lead to corresponding changes in profit. Operating leverage helps to identify the position of fixed cost and variable cost.

Operating leverage measures the relationship between the sales and revenue of the company during a particular period. Operating leverage helps to understand the level of fixed cost which is invested in the operating expenses of business activities. Operating leverage describes the overall position of the fixed operating cost.

FINANCIAL LEVERAGE

Leverage with financing activities is called financial leverage. Financial leverage represents the relationship between the company's earnings before interest and taxes (EBIT)or operating profit and the earning available to equity shareholders.

Financial leverage is defined as "the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the earnings per share". It involves the use of funds obtained at a fixed cost in the hope of increasing the return to the shareholders."The use of long-term fixed interest bearing debt and preference share capital along with share capital is called financial leverage or trading on equity".

Financial leverage may be favourable or unfavourable depends upon the use of fixed cost funds.

Favourable financial leverage occurs when the company earns more on the assets purchased with the funds, then the fixed cost of their use. Hence, it is also called as positive financial leverage.

Unfavourable financial leverage occurs when the company does not earn as much as the funds cost. Hence, it is also called as negative financial leverage.

Financial leverage can be calculated with the help of the following formula:

FL = EBIT / PBT

Where,

FL = Financial leverage
EBIT = Earnings Before Interest & Tax
PBT = Profit before tax.

Degree of Financial Leverage

Degree of financial leverage may be defined as the percentage change in taxable profit as a result of percentage change in Earnings before interest and tax (EBIT). This can be calculated by the following formula:

DFL= Percentage change in EBIT / Percentage change in taxable Income

Uses of Financial Leverage
Financial leverage helps to examine the relationship between EBIT and EPS.

Financial leverage measures the percentage of change in taxable income to the percentage change in EBIT.

Financial leverage locates the correct profitable financial decision regarding capital structure of the company.

Financial leverage is one of the important devices which is used to measure the fixed cost proportion with the total capital of the company.

If the firm acquires fixed cost funds at a higher cost, then the earnings from those assets, the earning per share and return on equity capital will decrease.

COMPOSITE / TOTAL LEVERAGE

When the company uses both financial and operating leverage to magnification of any change in sales into a larger relative changes in earning per share. Combined leverage is also called as composite leverage or total leverage.

Combined leverage expresses the relationship between the revenue in the account of sales and the taxable income.

Combined leverage can be calculated with the help of the following formulas:

$$CL = OL \times FL$$

$$CL = C / EBIT \times EBIT / PBT = C / PBT$$

Degree of Combined Leverage

The percentage change in a firm's earning per share (EPS) results from one percent change in sales. This is also equal to the firm's degree of operating leverage (DOL) times its degree of financial leverage (DFL) at a particular level of sales.

Degree of combined leverage = Percentage change in EPS / Percentage change in sales

TRADING ON EQUITY

Trading on equity, which is also referred to as *financial leverage*, occurs when a corporation uses bonds, other debt, and preferred stock to increase its earnings on its common stock.

Trading on equity is a financial process in which debt produces gain for shareholders of a company. Trading on equity happens when a company incurs new debt using bonds, loans, bonds or preferred stock. The company then uses these funds to gain assets which will create returns which are larger than the interest of the new debt. Alternatively, trading on equity called financial leverage. If it helps the company to generate profit and results in a higher return for the shareholders on their investment, it is considered a success. Companies usually go this way to boost earnings per share.

'Trading on equity' is called so because the company gets its loan amount from the creditors based on its equity strength. Companies usually borrow funds at favourable terms by taking advantage of their equity. If the amount borrowed is large as compared to the company's equity, it is categorised as 'trading on thin equity.' When the borrowed amount is modest, the company is 'trading on thick equity.'

MERITS

- Enhanced earnings: By borrowing the funds necessary, the company creates for itself more avenues of earning revenue by obtaining new assets.
- Tax treatment is favourable: The borrowed funds have an interest expense that is tax deductible. So, the borrowing company has to pay lower tax. So, basically, the new debt results in a reduction of the total cost for the borrower.

LIMITATIONS

Trading on equity has its own set of risk factors. It may result in further losses if the interest expense cannot be paid off by the business. You should note that such borrowings can cause high-risk situations for a business, which is depending on the borrowed amount to finance its operations.

If there is an unexpected rise in the interest rates, it can cause losses because the financial burden of the interest would increase for the company. So, while trading on equity holds the promise of potential increased returns, there is also a real risk of bankruptcy you must take into account.