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Leverage & Its Types

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Abstract

Leverage, as a business term, refers to debt or to the borrowing of funds to finance the purchase of a company's assets. Business owners can use either debt or equity to finance or buy the company's assets. Using debt, or leverage, increases the company's risk of bankruptcy. It also increases the company's returns; specifically its return on equity. This is true because, if debt financing is used rather than equity financing, then the owner's equity is not diluted by issuing more shares of stock.

Investors in a business like for the business to use debt financing but only up to a point. Beyond a certain point, investors get nervous about too much debt financing as it drives up the company's default risk.

Keywords: Financial Leverage, Firms' Value, Financing, Profitability.

Introduction

Every firm whether small scale firms or large scale firms need funds to operate; especially large scale firms, they need funds to expand their operations and activities. The motive of every firm is to make profit, maximise owner's wealth, and to achieve this motive they need to source for fund in order to finance their operations and activities. Firms have multiple financing sources to finance their investment. Basically, financing sources can be categorised into two; the internal financing sources which include reserves and retained earnings; external financing which includes long-term loans, bond issuance, ordinary and preferred stock issuance. (These sources are long-term sources of finance). Firms must choose the best financing sources to reach the optimal capital structure so that they can make suitable financing decision that would enable them achieve positive returns.

Types of leverages:-

A) Financial Leverage

Financing the firm's assets is a very crucial problem in very business and as a general rule there should be proper mix of debt and equity capital. The use of long-term fixed interest bearing debt and preference share capital along with equity share capital is called financial leverage or trading on equity.

The fixed cost funds are employed in such a way that the earnings available for common stockholders (equity shareholders) are increased. A fixed rate of interest is paid on such long-term debts (debentures, etc.). The interest is a liability and must be paid irrespective of revenue earnings. The preference share capital also bears a fixed rate of dividend.

But, the dividend is paid only when the company has surplus profits. The equity shareholders are entitled to residual income after paying interest and preference dividend. The aim of financial leverage is

to increase the revenue available for equity shareholders using the fixed cost funds. If the revenue earned by employing fixed cost funds is more than their cost (interest and/or preference dividend) then it will be to the benefit of equity shareholder to use such a capital structure. A firm is known to have a favourable leverage if its earnings are more than what debt would cost. On the contrary, if it does not earn as much as the debt costs then it will be known as an unfavourable leverage.

Every firm has to make its own decision regarding the quantum of funds to be borrowed. When the amount of debt is relatively large in relation to capital stock, a company is said to be trading on their equity. On the other hand if the amount of debt is comparatively low in relation to capital stock, the company is said to be trading on thick equity.

Financial leverage= % change in earning per share/ % change in earning before interest and tax

Financial leverage assumes that the firm is capable of earning more on assets than that acquired by use of funds, on which fixed rate of dividend is paid.

Importance of Financial Leverage:

The financial leverage shows the effect of changes in EBIT on the earnings per share. So it plays a vital role in financing decision of a firm with the objective of maximising the owner's wealth.

1. It gives an idea about the impact of changes in sales on the operating income of the firm.

2. High degree of operating leverage magnifies the effect on EBIT for a small change in the sales volume.

3. High degree of operating leverage indicates increase in operating profit or EBIT.

4. High operating leverage results from the existence of a higher amount of fixed costs in the total cost structure of a firm which makes the margin of safety low.

5. High operating leverage indicates higher amount of sales required to reach break-even point.

6. Higher fixed operating cost in the total cost structure of a firm promotes higher operating leverage and its operating risk.

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7. A lower operating leverage gives enough cushion to the firm by providing a high margin of safety against variation in sales.

8. Proper analysis of operating leverage of a firm is useful to the finance manager.

B) Operating Leverage

Operating leverage results from the presence of fixed costs that help in magnifying net operating income fluctuations flowing from small variations in revenue. The fixed cost is treated as fulcrum of leverage. The changes in sales are related to changes in revenue. The fixed costs do not change with the change in sales. Any increase in sales, fixed costs remaining the same, will magnify the operating revenue. The operating leverage occurs when a firm has fixed costs which must be recovered irrespective of sales volume. The fixed costs remaining same, the percentage change in operating revenue will be more than the percentage change is sales.

The occurrence is known as operating leverage. The degree of operating leverage depends upon the amount of fixed elements in the cost structure. Operating leverage can be determined by means of a break even or cost volume profit analysis.

The degree of leverage will be calculated as:

Operating Leverage = Contribution/Operating Profit

Contribution = Sales-Variable cost

Operating Profit = Sales – Variable Cost – Fixed cost

or O.P. = Contribution-Fixed Cost

The break-even point can be calculated by dividing the fixed cost by percentage of contribution to sales or P/V Ratio.

Break Even Point = Fixed Cost/P/V Ratio

P/V Ratio = Contribution/Sales

Thus, degree of operating leverage can be computed as below:

Degree of Operating leverage= % change in operating profit/ % change in sales

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C) Combined Leverage

It measures the total leverage due to the both operating and financial leverage.

Combined leverage= % change in earning per share/ % change in sales

Thus, to conclude we can say that in operating leverage change in sale have effect on EBIT; in financial leverage change in EBIT have effect on EPS. So the firm uses proper amount of both operating leverage and financial leverage as even a small change in sale changes EPS.

EPS increase if sale increases and EPS decreases if sale decreases; there is a positive reBoth financial and operating leverage magnify the revenue of the firm. Operating leverage affects the income which is the result of production. On the other hand, the financial leverage is the result of financial decisions.

The composite leverage focuses attention on the entire income of the concern. The risk factor should be properly assessed by the management before using the composite leverage. The high financial leverage may be offset against low operating leverage or vice-versa.

The degree of combined leverage can be calculated as follows:
Degree of Combined Leverage (DCL) = Percentage Change in EPS/percentage Change in Sales

Or, Combined Leverage = Operating Leverage *Financial Leverage

Importance of Combined Leverage:

1. It indicates the effect that changes in sales will have on EPS.

2. It shows the combined effect of operating leverage and financial leverage.

3. A combination of high operating leverage and a high financial leverage is

very risky situation because the combined effect of the two leverages is a multiple of these two leverages.

4. A combination of high operating leverage and a low financial leverage indicates that the management should be careful as the high risk involved in the former is balanced by the later.

5. A combination of low operating leverage and a high financial leverage gives a better situation for maximising return and minimising risk factor, because keeping the operating leverage at low rate full advantage of debt financing can be taken to maximise return. In this situation the firm reaches its BEP at a low level of sales with minimum business risk.

6. A combination of low operating leverage and low financial leverage indicates that the firm losses profitable opportunities.

Conclusion

In short, the term 'leverage' is used to describe the ability of a firm to use fixed cost assets or funds to increase the return to its equity shareholders. In other words, leverage is the employment of fixed assets or funds for which a firm has to meet fixed costs or fixed rate of interest obligation—irrespective of the level of activities attained, or the level of operating profit earned. Leverage occurs in varying degrees. The higher the degree of leverage, the higher is the risk involved in meeting fixed payment obligations i.e., operating fixed costs and cost of debt capital. But, at the same time, higher risk profile increases the possibility of higher rate of return to the shareholders.

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