Financial leverage part 1+2

1- Definition of Financial Leverage

Financial leverage is the concept of using borrowed capital as a funding source. Leverage is often used when businesses invest in themselves for expansions, acquisitions, or other growth methods. It's also an investment strategy that uses various financial instruments or borrowed capital to increase the potential return on an investment.

Key Takeaways

- Leverage refers to using debt or borrowed funds to amplify returns from an investment or project.
- Companies can use leverage to invest in growth strategies.
- Some investors use leverage to multiply their buying power in the market.
- A range of financial leverage ratios gauge a company's financial strength with the most common being debt-to-assets and debt-to-equity.

Leverage involves using debt or borrowed capital to undertake an investment or project. It's commonly used to boost an entity's equity base. The concept of leverage is used by both investors and companies:

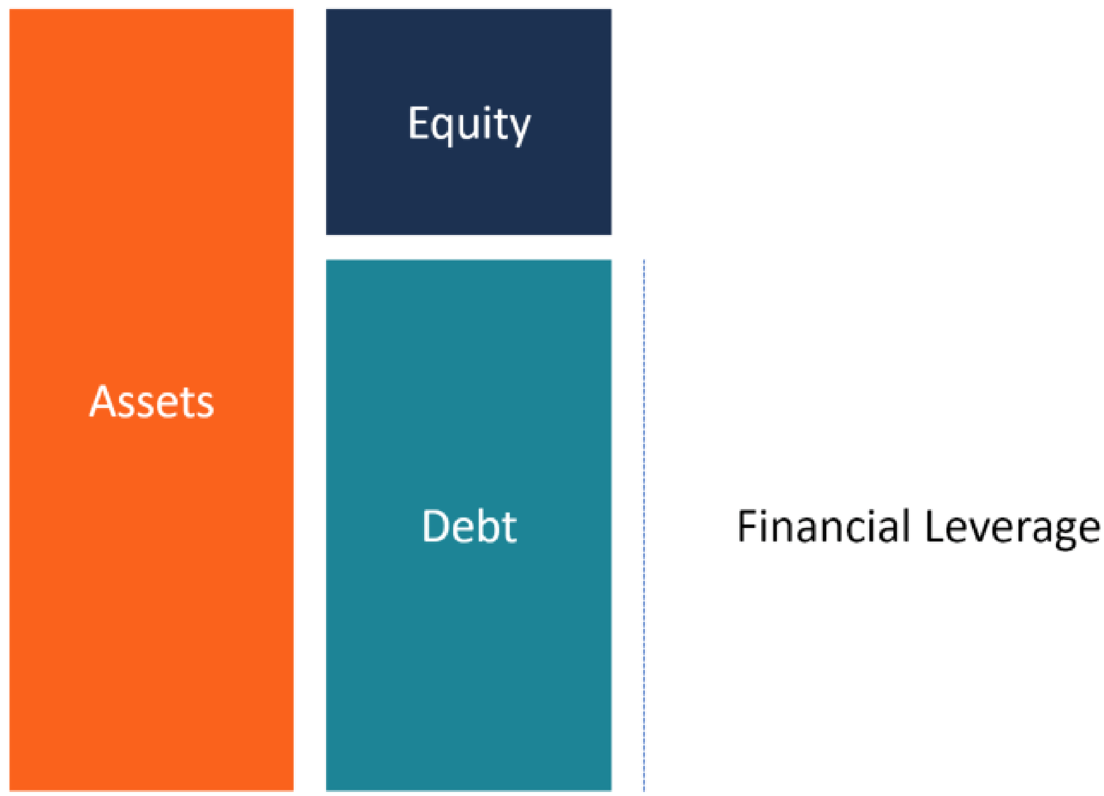
- Investors use leverage to significantly increase the returns that can be provided on an investment. They leverage their investments using various instruments including options, futures, and margin accounts.

- Companies can use leverage to finance their assets. They can use debt financing to invest in business operations to influence growth instead of issuing stock to raise capital.

Investors who aren't comfortable using leverage directly can access leverage indirectly in a variety of ways. They can invest in companies that use leverage in the ordinary course of their business to finance or expand operations without increasing their outlay.

In most cases, the provider of the debt will put a limit on how much risk it is ready to take and indicate a limit on the extent of the leverage it will allow. In the case of asset-backed lending, the financial provider uses the assets as collateral until the borrower repays the loan. In the case of a cash flow loan, the general creditworthiness of the company is used to back the loan.

This guide will outline how financial leverage works, how it's measured, and the risks associated with using it.



When purchasing assets, three options are available to the company for financing: using equity, debt, and leases. Apart from equity, the rest of the options incur fixed costs that are lower than the income that the company expects to earn from the asset. In this case, we assume that the company uses debt to finance asset acquisition.

2- Calculate of Financial Leverage

An entire suite of leverage financial ratios is used to calculate how much debt a company is leveraging in an attempt to maximize profits.

Debt Ratio

You can analyze a company's leverage by calculating its ratio of debt to assets. This ratio indicates how much debt it uses to generate its assets. A company has relied on leverage to finance its assets if the debt ratio is high. A ratio of 1.0 means that the company has $1 of debt for every $1 of assets. It has more assets than debt if it's lower than 1.0 and it has more debt than assets if it's higher than 1.0.1

Debt Ratio = Total Debt ÷ Total Assets**Debt Ratio** = **Total Debt** ÷ **Total Assets**

You're using all debt, including short- and long-term debt vehicles when you calculate this ratio.

Debt-to-equity (D/E) Ratio

You can measure leverage by looking strictly at how assets have been financed instead of looking at what the company owns. The debt-to-equity (D/E) ratio is used to compare what the company has borrowed to what it has raised from private investors or shareholders.

Debt-to-Equity (D/E) Ratio = Total Debt ÷ Total Equity**Debt-to-Equity (D/E) Ratio** = **Total Debt** ÷ **Total Equity**

A D/E ratio greater than 1.0 means that a company has more debt than equity, but this doesn't necessarily mean that a company is highly leveraged. Each company and industry typically operates in a specific way that may warrant a higher or lower ratio.2

Startup technology companies might struggle to secure financing, and they must often turn to private investors. A debt-to-equity ratio of .5 or $1 of debt for every $2 of equity may therefore still be considered high for this industry.

3- Advantages and Disadvantages of Financial Leverage

Advantages

- ✓ Some investors and traders use leverage to amplify profits. Trades can become exponentially more rewarding when your initial investment is multiplied by additional upfront capital. Using leverage also allows you to access more expensive investment options that you wouldn't otherwise have access to with a small amount of upfront capital.
- ✓ Leverage is best used in short-term, low-risk situations where high degrees of capital are needed. A growth company may have a short-term need for capital resulting in a strong mid-to-long-term growth opportunity during acquisitions or buyouts.
- ✓ Leverage enables smart companies to execute opportunities at ideal moments to exit their leveraged position quickly rather than using additional capital to gamble on risky endeavors.

Disadvantages

- ✓ If investment returns can be amplified using leverage, so too can losses. Using leverage can result in much higher downside risk, sometimes resulting in losses greater than your initial capital investment.
- ✓ Brokers and contract traders also often charge fees, premiums, and margin rates. They require you to maintain a margin account with a specific balance. You'll still be on the hook for extra charges if you lose on your trade.

- ✓ Leverage also has the potential downside of being complex. Investors must be aware of their financial positions and the risks they inherit when they enter into a leveraged position. This may require additional attention to one's portfolio and contribution of additional capital should their trading account not have a sufficient amount of funding per their broker's requirement.

4- Risks of Financial Leverage

Although financial leverage may result in enhanced earnings for a company, it may also result in disproportionate losses. Losses may occur when the interest expense payments for the asset overwhelm the borrower because the returns from the asset are not sufficient. This may occur when the asset declines in value or interest rates rise to unmanageable levels.

- **Volatility of Stock Price**

Increased amounts of financial leverage may result in large swings in company profits. As a result, the company's stock price will rise and fall more frequently, and it will hinder the proper accounting of stock options owned by the company employees. Increased stock prices will mean that the company will pay higher interest to the shareholders.

- **Bankruptcy**

In a business where there are low barriers to entry, revenues and profits are more likely to fluctuate than in a business with high barriers to entry. The fluctuations in revenues may easily push a company into bankruptcy since it will be unable to meet its rising debt obligations and pay its operating expenses. With looming unpaid debts, creditors may file a case at the bankruptcy court to have the business assets auctioned in order to retrieve their owed debts.

- **Reduced Access to More Debts**

When lending out money to companies, financial providers assess the firm’s level of financial leverage. For companies with a high debt-to-equity ratio, lenders are less likely to advance additional funds since there is a higher risk of default. However, if the lenders agree to advance funds to a highly-leveraged firm, it will lend out at a higher interest rate that is sufficient to compensate for the higher risk of default.

- **Operating Leverage**

Operating leverage is defined as the ratio of fixed costs to variable costs incurred by a company in a specific period. If the fixed costs exceed the amount of variable costs, a company is considered to have high operating leverage. Such a firm is sensitive to changes in sales volume and the volatility may affect the firm’s EBIT and returns on invested capital.

High operating leverage is common in capital-intensive firms such as manufacturing firms since they require a huge number of machines to manufacture their products. Regardless of whether the company makes sales or not, the company needs to pay fixed costs such as depreciation on equipment, overhead on manufacturing plants, and maintenance costs.

5- Difference between operating leverage and financial leverage

Operating leverage is an indication of how a company's costs are structured. The metric is used to determine a company's , which is when revenue from sales covers both the fixed and variable costs of production. Financial leverage refers to the amount of debt used to finance the operations of a company.

Key Takeaways

- Operating leverage and financial leverage both tell you different things about a company's financial health.

- Operating leverage is an indication of how a company's costs are structured and also is used to determine its breakeven point.
- Financial leverage refers to the amount of debt used to finance the operations of a company.

Operating Leverage and Fixed Costs

Operating leverage measures the extent to which a company or specific project requires some aggregate of both fixed and variable costs. Fixed costs are those costs or expenses that do not fluctuate regardless of the number of sales generated by a company. Some examples of fixed costs include:

- salaries
- rent
- utilities
- interest expense
- depreciation

Operating Leverage and Variable Costs

Variable costs are expenses that vary in direct relationship to a company's production. Variable costs rise when production increases and fall when production decreases. For example, inventory and raw materials are variable costs while salaries for the corporate office would be a fixed cost.

Operating leverage can help companies determine what their breakeven point is for profitability. In other words, the point where the profit generated from sales covers both the fixed costs as well as the variable costs.

A manufacturing company might have high operating leverage because it must maintain the plant and equipment needed for operations. On the other hand, a consulting company has fewer fixed assets such as equipment and would, therefore, have low operating leverage.

Using a higher degree of operating leverage can increase the risk of cash flow problems resulting from errors in forecasts of future sales.

Financial Leverage Explained

Financial leverage is a metric that shows how much a company uses debt to finance its operations. A company with a high level of leverage needs profits and revenue that are high enough to compensate for the additional debt it shows on its balance sheet.

Investors look at a company's leverage because it is an indicator of the solvency of the company. Also, debt can help magnify earnings and earnings per share. However, there is a cost associated with leverage in the form of interest expense.

When a company's revenues and profits are on the rise, leverage works well for a company and investors. However, when revenues or profits are pressured or falling, the debt and interest expense must still be paid and can become problematic if there is not enough revenue to meet debt and operational obligations.

Difference between operating leverage and financial leverage

Category	Financial leverage	Operating leverage
Meaning	Utilising borrowed capital to boost returns and reduce taxes.	Leveraging fixed costs to enhance returns.
Measurement	Assesses financial risk within the company.	Evaluates operational risks of the organisation.
Impact	Greater leverage implies higher financial risk.	Higher operating leverage indicates greater operational risk.
Preference	Widely preferred for growth opportunities.	Less commonly prioritised.