FINANCIAL LEVERAGE

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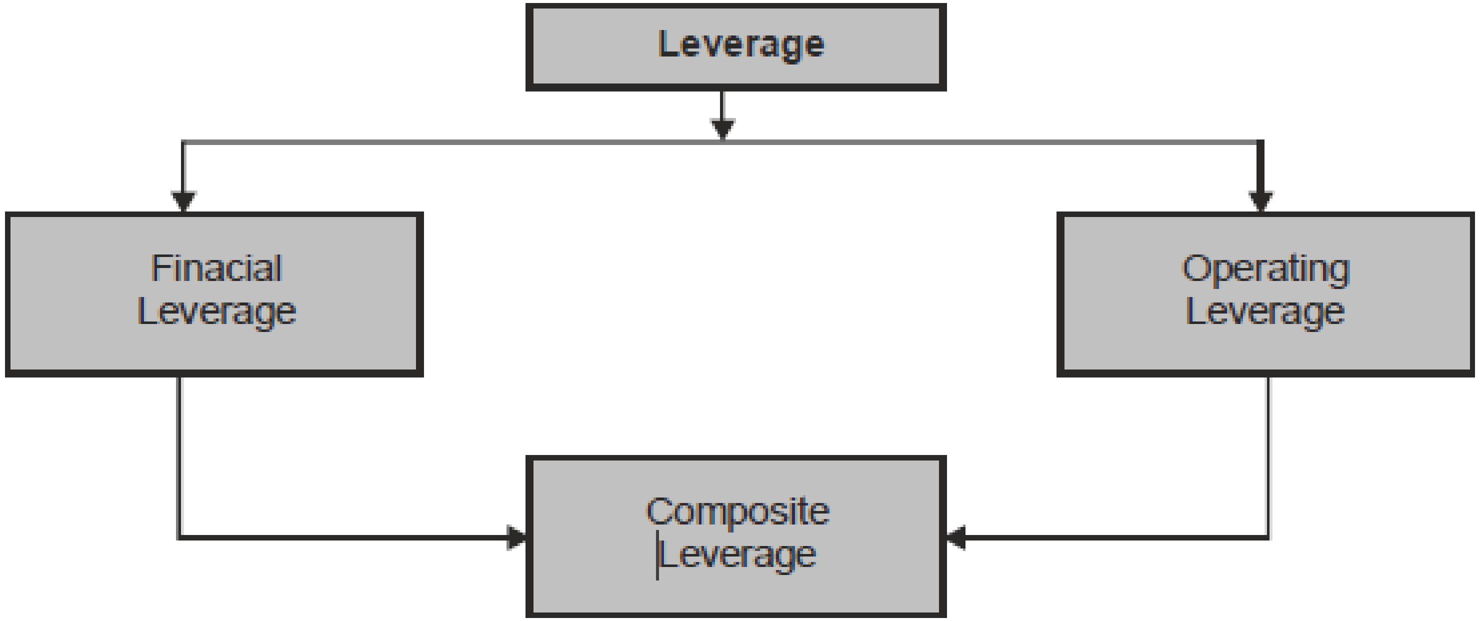
LEVERAGE

- leverage refers to furnish the ability to use fixed cost assets or funds to increase the return to its shareholders.



Financial Leverage

- Leverage activities with financing activities is called financial leverage.
- “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”.
- The term “trading on equity” is derived from the fact that it is owners equity that is used as a basis to raise debt i.e. traded upon equity.
- the financial leverage employed by a company is intended to earn more return on the fixed charged fund than their cost.
- The surplus or deficit will increase /decrease the returns on the owners equity.

Financial leverage example

- If a company borrows Rs 100 at 8% interest p.a. & invest it to earn 12% return p.a, now the balance of 4% p.a. after payment of interest will belong to the shareholder.....as it constitute from financial leverage.
- On the other hand, if the firm could earn only 6% p.a. return on Rs 100 the loss to shareholder would be 2% p.a.
- Thus, financial leverage provides the potentials of increasing the shareholders earning as well as creating the risk of loss to them.
- It is a double edged sword

Measures of Financial leverage

- Debt ratio: the ratio of debt to total capital i.e.
- *F.L. = D/D+E (V)*
- Where, D is the value of debt, E is the value of shareholders equity & V is the total capital (D+E).
- D & E is measured in terms of book value. The book value is called net worth. Shareholders equity may be measured in terms of market value.
- Debt-equity ratio: F.L = D/E
- The above two measure of F.L are also called capital gearing. They are static in nature & show borrowing position of the company at a point of time.
- Interest coverage : the ratio of net operating income (EBIT) to interest changes.
- F.L = EBIT/ Interest + (sinking fund/1- Tax rate)
- The above F.L is known as coverage ratio as it indicates the capacity of the company to meet fixed financial charges.

Financial leverage

- The primary motive of a company in using F.L. is to magnify the shareholders return under favorable economic condition.
- It is based on the assumption that fixed charges funds(such as loan from F.I, banks or debentures) can be obtain at a lower cost than the firm's rate of return on net assets(RONA or ROI).
- Thus when the diff. b/w earnings generated by asset financed by the fixed charges funds & cost of these funds is distributed to the shareholders, the EPS or return on equity increases.

EPS & ROE

- EPS = Profit after tax (PAT) / number of shares (N)
- EPS = (EBIT - INT) (1-T) / N
- Where, EBIT = Earnings before int. & tax, N is the number of shares outstanding, T is the corporate tax.
- ROE = Profit after tax (PAT) / value of equity

Financial leverage

- The Financial leverage (FL) measures the relationship between the EBIT and the Earning Per Share and it reflects the effects of change in EBIT on the level of EPS. Thus, It is concerned with the effect of changes in EBIT on the earnings available to equity share holders.
- DFL = % change in EPS / % change in EBIT
- OR
- FL = EBIT / PBT (EBIT-INT)