Course: BBA Part II

Paper: X

Topic: Types of Leverage

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Leverage: Meaning and Its Types

The word 'leverage', borrowed from physics, is frequently used in financial management.

The object of application of which is made to gain higher financial benefits compared to the fixed charges payable, as it happens in physics i.e., gaining larger benefits by using lesser amount of force.

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.

Types of Leverage:

Leverage are the three types:

(i) Operating leverage

(ii) Financial leverage and

(iii) Combined leverage

1. Operating Leverage:

Operating leverage refers to the use of fixed operating costs such as depreciation, insurance of assets, repairs and maintenance, property taxes etc. in the operations of a firm. But it does not include interest on debt capital. Higher the proportion of fixed operating cost as compared to variable cost, higher is the operating leverage, and vice versa.

Operating leverage may be defined as the "firm's ability to use fixed operating cost to magnify effects of changes in sales on its earnings before interest and taxes."

In practice, a firm will have three types of cost viz:

(i) Variable cost that tends to vary in direct proportion to the change in the volume of activity,

(ii) Fixed costs which tend to remain fixed irrespective of variations in the volume of activity within a relevant range and during a defined period of time,

(iii) Semi-variable or Semi-fixed costs which are partly fixed and partly variable. They can be segregated into variable and fixed elements and included in the respective group of costs.

Operating leverage occurs when a firm incurs fixed costs which are to be recovered out of sales revenue irrespective of the volume of business in a period. In a firm having fixed costs in the total cost structure, a given change in sales will result in a disproportionate change in the operating profit or EBIT of the firm.

If there is no fixed cost in the total cost structure, then the firm will not have an operating leverage. In that case, the operating profit or EBIT varies in direct proportion to the changes in sales volume.

Operating leverage is associated with operating risk or business risk. The higher the fixed operating costs, the higher the firm's operating leverage and its operating risk. Operating risk is the degree of uncertainty that the firm has faced in meeting its fixed operating cost where there is variability of EBIT.

It arises when there is volatility in earnings of a firm due to changes in demand, supply, economic environment, business conditions etc. The larger the magnitude of operating leverage, the larger is the volume of sales required to cover all fixed costs.

2. Financial Leverage:

Financial leverage is primarily concerned with the financial activities which involve raising of funds from the sources for which a firm has to bear fixed charges such as interest expenses, loan fees etc. These sources include long-term debt (i.e., debentures, bonds etc.) and preference share capital.

Long term debt capital carries a contractual fixed rate of interest and its payment is obligatory irrespective of the fact whether the firm earns a profit or not.

As debt providers have prior claim on income and assets of a firm over equity shareholders, their rate of interest is generally lower than the expected return in equity shareholders. Further, interest on debt capital is a tax deductible expense.

These two facts lead to the magnification of the rate of return on equity share capital and hence earnings per share. Thus, the effect of changes in operating profits or EBIT on the earnings per share is shown by the financial leverage.

According to Gitman financial leverage is “the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on firm’s earnings per share”. In other words, financial leverage involves the use of funds obtained at a fixed cost in the hope of increasing the return to the equity shareholders.

Favourable or positive financial leverage occurs when a firm earns more on the assets/ investment purchased with the funds, than the fixed cost of their use. Unfavorable or negative leverage occurs when the firm does not earn as much as the funds cost.

Thus shareholders gain where the firm earns a higher rate of return and pays a lower rate of return to the supplier of long-term funds. The difference between the earnings from the assets

and the fixed cost on the use of funds goes to the equity shareholders. Financial leverage is also, therefore, called as 'trading on equity'.

Financial leverage is associated with financial risk. Financial risk refers to risk of the firm not being able to cover its fixed financial costs due to variation in EBIT. With the increase in financial charges, the firm is also required to raise the level of EBIT necessary to meet financial charges. If the firm cannot cover these financial payments it can be technically forced into liquidation.

3. Combined Leverage:

Operating leverage shows the operating risk and is measured by the percentage change in EBIT due to percentage change in sales. The financial leverage shows the financial risk and is measured by the percentage change in EPS due to percentage change in EBIT.

Both operating and financial leverages are closely concerned with ascertaining the firm's ability to cover fixed costs or fixed rate of interest obligation, if we combine them, the result is total leverage and the risk associated with combined leverage is known as total risk. It measures the effect of a percentage change in sales on percentage change in EPS.

The combined leverage may be favourable or unfavorable. It will be favourable if sales increase and unfavorable when sales decrease. This is because changes in sales will result in more than proportional returns in the form of EPS. As a general rule, a firm having a high degree of operating leverage should have low financial leverage by preferring equity financing, and vice versa by preferring debt financing.

If a firm has both the leverages at a high level, it will be very risky proposition. Therefore, if a firm has a high degree of operating leverage the financial leverage should be kept low as proper balancing between the two leverages is essential in order to keep the risk profile within a reasonable limit and maximum return to shareholders.