Operating leverage vs financial leverage pdf

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Operating leverage and financial leverage are two different metrics used to determine the financial health of a company. Operating leverage is an indication of how a company's costs are structured. The metric is used to determine a company's breakeven point, 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. 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 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: salariesrentutilitiesinterest expensedepreciation 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 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. May 01, 2022 May 01, 2022/ Steven Bragg Operating leverage measures a company's fixed costs as a percentage of its total costs. It is used to evaluate the breakeven point of a business, as well as the likely profit levels on individual sales. The following two scenarios describe an organization having high operating leverage and low operating leverage.High Operating LeverageIn a high operating leverage situation, a large proportion of the company's costs are fixed costs. In this case, the firm earns a large profit on each incremental sale, but must attain sufficient sales volume to cover its substantial fixed costs. If it can do so, then the entity will earn a major profit on all sales after it has paid for its fixed costs. However, earnings will be more sensitive to changes in sales volume.Low Operating LeverageIn a low operating leverage situation, a large proportion of the company's sales are variable costs, so it only incurs these costs when there is a sale. In this case, the firm earns a smaller profit on each incremental sale, but does not have to generate much sales volume in order to cover its lower fixed costs. It is easier for this type of company to earn a profit at low sales levels, but it does not earn outsized profits if it can generate additional sales. A software company has substantial fixed costs in the form of developer salaries, but has almost no variable costs associated with each incremental software sale; this firm has high operating leverage. Conversely, a consulting firm bills its clients by the hour, and incurs variable costs in the form of consultant wages. This firm has low operating leverage.To calculate operating leverage, divide an entity's contribution margin by its net operating income. The contribution margin is sales minus variable expenses.For example, the Alaskan Barrel Company (ABC) has the following financial results: Revenues $100,000 Variable expenses 30,000 Fixed expenses 60,000 Net operating income $10,000 ABC has a contribution margin of 70% and net operating income of $10,000, which gives it a degree of operating leverage of 7. ABC's sales then increase by 20%, resulting in the following financial results: Revenues $120,000 Variable expenses 36,000 Fixed expenses 60,000 Net operating income $24,000 The contribution margin of 70% has stayed the same, and fixed costs have not changed. Because of ABC's high degree of operating leverage, the 20% increase in sales translates into a greater than doubling of its net operating income.How to Use Operating LeverageWhen using the operating leverage measurement, constant monitoring of operating leverage is more important for a firm having high operating leverage, since a small percentage change in sales can result in a dramatic increase (or decrease) in profits. A firm must be especially careful to forecast its sales in these situations, since a small forecasting error translates into much larger errors in both net income and cash flows.Knowledge of the level of operating leverage can have a profound impact on pricing policy, since a company with a large amount of operating leverage must be careful not to set its prices so low that it can never generate enough contribution margin to fully offset its fixed costs. 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Likewise in business, leverage refers to the use of a relatively small investment or a small amount of debt to achieve greater profits. That is, leverage is the use of assets and liabilities to boost profits while balancing the risks involved. There are two types of leverage, operating and financial. Operating leverage refers to the use of fixed costs in a company's earnings stream to magnify operating profits. Financial leverage, on the other hand, results from the use of debt and preferred stock to increase stockholder earnings. Although both types of leverage involve a certain amount of risk, they can bring about significant benefits with little investment when successfully implemented. OPERATING LEVERAGE Operating leverage is the extent to which a firm uses fixed costs in producing its goods or offering its services. Fixed costs include advertising expenses, administrative costs, equipment and technology, depreciation, and taxes, but not interest on debt, which is part of financial leverage. By using fixed production costs, a company can increase its profits. If a company has a large percentage of fixed costs, it has a high degree of operating leverage. Automated and high-tech companies, utility companies, and airlines generally have high degrees of operating leverage. As an illustration of operating leverage, assume two firms, A and B, produce and sell widgets. Firm A uses a highly automated production process with robotic machines, whereas firm B assembles the widgets using primarily semiskilled labor. Table 1 shows both firm's operating cost structures. Highly automated firm A has fixed costs of $35,000 per year and variable costs of only $1.00 per unit, whereas labor-intensive firm B has fixed costs of only $15,000 per year, but its variable cost per unit is much higher at $3.00 per unit. Both firms produce and sell 10,000 widgets per year at a price of $5.00 per widget. Firm A has a higher amount of operating leverage because of its higher fixed costs, but firm A also has a higher breakeven point—the point at which total costs equal total sales. Nevertheless, a change of I percent in sales causes more than a I percent change in operating profits for firm A, but not for firm B. The "degree of operating leverage" measures this effect. The following simplified equation demonstrates the type of equation used to compute the degree of operating leverage, although to calculate this figure the equation would require several additional factors such as the quantity produced, variable cost per unit, and the price per unit, which are used to determine changes in profits and sales: Operating leverage is a double-edged sword, however. If firm A's sales decrease by I percent, its profits will decrease by more than I percent, too. Hence, the degree of operating leverage shows the responsiveness of profits to a given change in sales. FINANCIAL LEVERAGE Financial leverage involves changes in shareholders' income in response to changes in operating profits, resulting from financing a company's assets with debt or preferred stock. Similar to operating leverage, financial leverage also can boost a company's returns, but it increases risk as well. Financial leverage is concerned with the relationship between operating profits and earnings per share. If a company is financed exclusively with common stock, a specific percentage change in operating profit will cause the Table 1 Illustration Of Operating Leverage Firm A (High Automation) Firm B (Low Automation) Units Produced 10,000 10,000 Sales price per unit (P) S5.00 $5.00 Variable cost per unit (V) $1.00 $3.00 Fixed costs (F) $35,000 $15,000 Table 2 Asset Financing Firm A Firm B Long-term debt (8%) $10,000 $ 0 Stockholders equity 30,000 40,000 Total liabilities & equity 40,000 40,000 same percentage change in shareholder earnings. For example, a 5 percent increase in operating profit will result in a 5 percent increase in shareholder earnings. If a company is financed with debt or is "leveraged," however, its shareholder earnings will become more sensitive to changes in operating profit. Hence, a 5 percent increase in operating profits will result in a much higher increase in stockholder earnings. Nevertheless, financial leveraging makes companies equally susceptible to greater decreases in stockholder earnings if operating profits drop. For example, recall the two firms, A and B. At production levels of 10,000 widgets, they both had operating earnings (profits) of $5,000. In addition, assume that both firms have total assets of $40,000. Table 2 shows how the $40,000 of assets are financed for both firms. Firm A is financed with $10,000 of debt which carries an annual interest cost of 8 percent, and $30,000 of stockholders' equity (3,000 shares), firm B is financed entirely with $40,000 of stockholders' equity (4,000 shares). Firm A is leveraged and uses some debt to finance its assets, which can increase earnings per share but also risk. Table 3 shows the results of financial leverage on the firm's earnings. Panel A shows that as a result of the $800 interest expense from the debt ($10,000 X. 08 = $800), firm A's earnings per share are lower than firm B's. Because firm A is financially leveraged, however, an increase in profits will result in a greater increase in stock earnings. Panel B shows the results of a 10 percent increase in profits for both firms. Firm A's stockholder earnings increased from $0.84 to $0.94, an 11.9 percent increase, while firm B's stockholder earnings increased from $0.75 to $0.825, or 10 percent, the same as the increase in profits. Table 3 Illustration of Financial Leverage Panel A Operating Income = $5,000 Firm A Firm B Operating income (EBIT) $5,000 $5,000 Less: interest expense (800) (0) Earnings before taxes (EBT) 4,200 5,000 Less: taxes (40%) (1,680) (2,000) Net profits after taxes (NPAT) 2,520 3,000 Divided by number of shares 3000 4000 Earnings per share (EPS) $0.84 $0.75 Panel B Operating Income = $5,500 Firm A Firm B Operating income (EBIT) $5,500 $5,500 Less: interest expense (800) (0) Earnings before taxes (EBT) 4,700 5,500 Less: taxes (40%) (1,880) (2,200) Net profits after taxes (NPAT) 2,820 3,300 Divided by number of shares 3000 4000 Earnings per share (EPS) $0.94 $0,825 Increase in EPS $0.10 $0.94 Percentage increase in EPS 11.90% 10.0% Companies with significant amounts of debt in contrast with their assets are referred to as being highly leveraged and their shareholder earnings are more unpredictable than those for companies with less debt. Lenders and financial analysts often measure a company's degree of financial leverage using the ratio of interest payments to operating profit. From the perspective of shareholders, financing using debt is the riskiest, because companies must make interest and principal payments on debt as part of their contract with their lenders, but they need not pay preferred stock dividends if their earnings are low. Nevertheless, financing with preferred stock will have the same kind of leveraging effect as debt financing as illustrated above. Firms that use financial leverage run the risk that their operating income will be insufficient to cover the fixed charges on debt and/or preferred stock financing. Financial leverage can become especially burdensome during an economic downturn. Even if a company has sufficient earnings to cover its fixed financial costs, its returns could be decreased during economically difficult times due to shareholders' residual claims to dividends. Generally, if a company's return on assets (profits. total assets) is greater than the pretax cost of debt (interest percentage), the financial leverage effect will be favorable. The opposite, of course, is also true: if a company's return on assets is less than its interest cost of debt, the financial leverage effect will decrease the returns to the common shareholders. TOTAL LEVERAGE The two types of leverage explored so far can be combined into an overall measure of leverage called total leverage. Recall that operating leverage is concerned with the relationship between sales and operating profits, and financial leverage is concerned with the relationship between profits and earnings per share. Total leverage is therefore concerned with the relationship between sales and earnings per share. Specifically, it is concerned with the sensitivity of earnings to a given change in sales. The degree of total leverage is defined as the percentage change in stockholder earnings for a given change in sales, and it can be calculated by multiplying a company's degree of operating leverage by its degree of financial leverage. Consequently, a company with little operating leverage can attain a high degree of total leverage by using a relatively high amount of debt. IMPLICATIONS Total risk can be divided into two parts: business risk and financial risk. Business risk refers to the stability of a company's assets if it uses no debt or preferred stock financing. Business risk stems from the unpredictable nature of doing business, i.e., the unpredictability of consumer demand for products and services. As a result, it also involves the uncertainty of long-term profitability. When a company uses debt or preferred stock financing, additional risk—financial risk—is placed on the company's common shareholders. They demand a higher expected return for assuming this additional risk, which in turn, raises a company's costs. Consequently, companies with high degrees of business risk tend to be financed with relatively low amounts of debt. The opposite also holds: companies with low amounts of business risk can afford to use more debt financing while keeping total risk at tolerable levels. Moreover, using debt as leverage is a successful tool during periods of inflation. Debt fails, however, to provide leverage during periods of deflation, such as the period during the late 1990s brought on by the Asian financial crisis. [James A. Gerhardinger , updated by Karl Heil] Brigham, Eugene F. Fundamentals of Financial Management. Fort Worth, TX: Dryden Press, 1995. "Choosing the Right Mixture." Economist, 27 February 1999, 71. Dugan, Michael T., and Keith A. Shriver. "An Empirical Comparison of Alternative Methods for Estimating the Degree of Operating Leverage." Financial Review, May 1992, 309-21. 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