“INTRODUCTION TO FINANCIAL LEVERAGE AND FINANCIAL PERFORMANCE ”

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Meaning

- The dictionary meaning of the word leverage is **'the power to control'** or **'augmentation'** or **'acceleration'**. In terms of business finance, the **leverage** is employment of **debt fund or borrowed capital** to accelerate earnings. Financial leverage is purely a **financial tool** used immensely by managers involved in the decision-making processes related to capital structuring decisions, mergers and acquisitions, ascertainment of cost of capital etc.

FINANCIAL LEVERAGE

The employment of debt in the capital structure has a deep impact on the **profitability** of the company as the judicious use of funds is a pertinent requirement. The **liquidity** of a company is also impacted by leverage. The greater the degree of debt funds employed, the greater will be outflow of cash in terms of cost of servicing the debt. That does affect the cash profit earned by a company. Moreover, debt funds also have to be redeemed after certain duration of time. It also affects the **solvency** factor. The **efficiency** of the borrower decides as to how leverage affects various aspects of financial health of the company.

RATIONALE

Further, if a company's capital structure is dominated by equity alone, the **advantage of tax shield** that **leverage offers** will not be available. In order to fulfil expectations of high number of equity shareholders, the company has to **distribute a certain proportion of profit** as dividend to **placate or appease equity shareholders**. This tightrope walking is made easy by the judicious use of leverage. Leverage can not guarantee acceleration of earnings as it depends on **cost of borrowing** and the ability and foresightedness of the financial managers to use the leverage to **magnify earnings**.

EFFECTS OF FINANCIAL LEVERAGE

- ROI is greater than the interest rate: in this situation, it is advisable to borrow because the firm is generating revenue at a rate greater than the rate of borrowing. If the firm is borrowing at a rate of 10 % p.a. and if it's ROI is 18 % p.a. This is a case of **highly favourable leverage.** This is called trading on equity.
- ROI equals the interest rate: In this scenario, leverage is **neither favourable nor unfavourable.** But if other factors at play are tilting the balance in favour of borrowing, then by all means the manager should employ leverage.
- ROI is lower than the interest rate: Now this is a precarious situation because the rate of earning is not able to keep up with the rate being paid on borrowed funds. It doesn't make sense to borrow in such a situation. This is called **unfavourable leverage.**

- As long as the rate of earning is higher than the cost of borrowing, leverage is beneficial. However, if there is a **possibility of a decline in the rate of earnings, the company should try to dispose** of debt fund to the extent permitted by availability of sufficient funds or earnings generation or disposable short-term investments. **Thus, the impact of financial leverage on the profitability, liquidity, solvency and efficiency that a company enjoys, presents a wide and comprehensive scope for research and analysis.**

Growth Of Stock Exchange

Sr.	On 31st Dec	1946	61	71	80	91	95
1	No. Of St. Exchanges	7	7	8	9	20	22
2	No. Of Listed Companies	1125	1203	1599	2265	6229	8593
3	No. Of Securities issued by listed companies	1506	2111	2838	3697	8947	11784
4	Capital of listed companies CIRI (Crore Rs.)	270	753	1812	3973	32041	59583
5	Market value of capital of listed companies (Crore Rs.)	971	1292	2675	6750	110279	478121

Source: RBI Handbook Page No. 339-342

Debt Funds TO Total Funds Raised

Sr.	Year	Percentage
1	1995-96	56.60
2	1996-97	73.10
3	1997-98	94.50
4	1998-99	98.20
5	1999-2000	93.40
6	2000-01	95.40
7	2001-02	98.20
8	2002-03	97.90
9	2003-04	78.30
10	2004-05	78.20
11	2005-06	77.90
12	2006-07	81.70
13	2007-08	73.40
14	2008-09	93.50

Source: RBI Annual Statistics

Financial Performance Defined

The **FOUR PILLARS OF FINANCIAL PERFORMANCE** are delineated as under :

1. PROFITABILITY
2. LIQUIDITY
3. SOLVENCY
4. EFFICIENCY

PROFITABILITY

- Profitability can be defined as a barometer that measures the capacity of business unit to utilise various resources at its disposal including Fixed Assets to generate profits so as to ensure and dole out returns to its investors and repay debt along with interest.

LIQUIDITY

- Liquidity can be defined as the measure that conveys the financial adequacy and strength of a firm to be able to meets its immediate (short-term) obligations.

SOLVENCY

- Solvency as a measure of financial performance reflects the ability of a firm to meet all its obligations including long-term obligations. It is also an indicator of long-term financial stability of a firm.

EFFICIENCY

- Efficiency is a measure that shows how **effectively a company has employed its resources to magnify its earnings** resulting from operating efficiency. In other words, how **efficient the company is in converting its inputs into targeted outputs within the constraints of time limit, availability of raw materials, labour, finance etc.** It is also a measure of level of efficiency achieved by a company in asset management, receivables management etc.