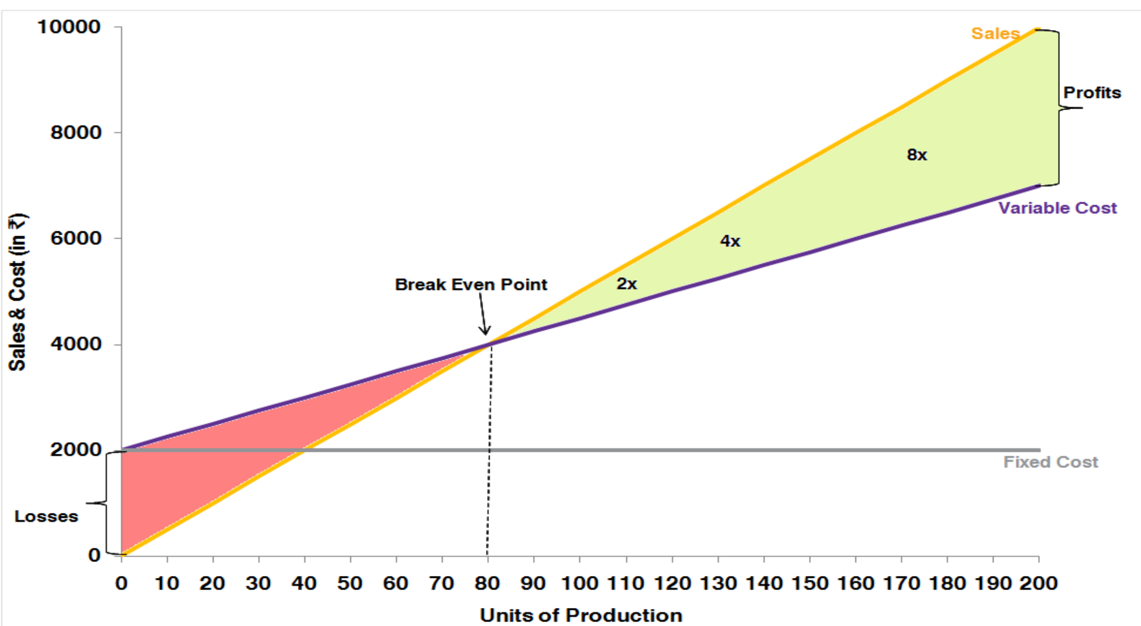
Types of Leverage

- A company is said to be leveraged[1] if it has fixed cost (operating leverage) or debt (financial leverage).

Operating Leverage

- A company which has fixed costs in its operations is said to have operating leverage.
- Operating leverage reflects effect of fixed cost on a company's operating profits.
- Higher the ratio of fixed cost to variable cost, higher is the operating leverage.
- For operating leverage companies, a small change in sales will result in large change in its operating profit.
- These companies tend to make higher profits when sales are increasing and more losses when sales are decreasing.
- Companies with operating leverage benefit with increase in their sales which can be because of better capacity utilization, product mix, price increase.
- Chart below graphically shows an example of how a company with better capacity utilization, generates higher profits.



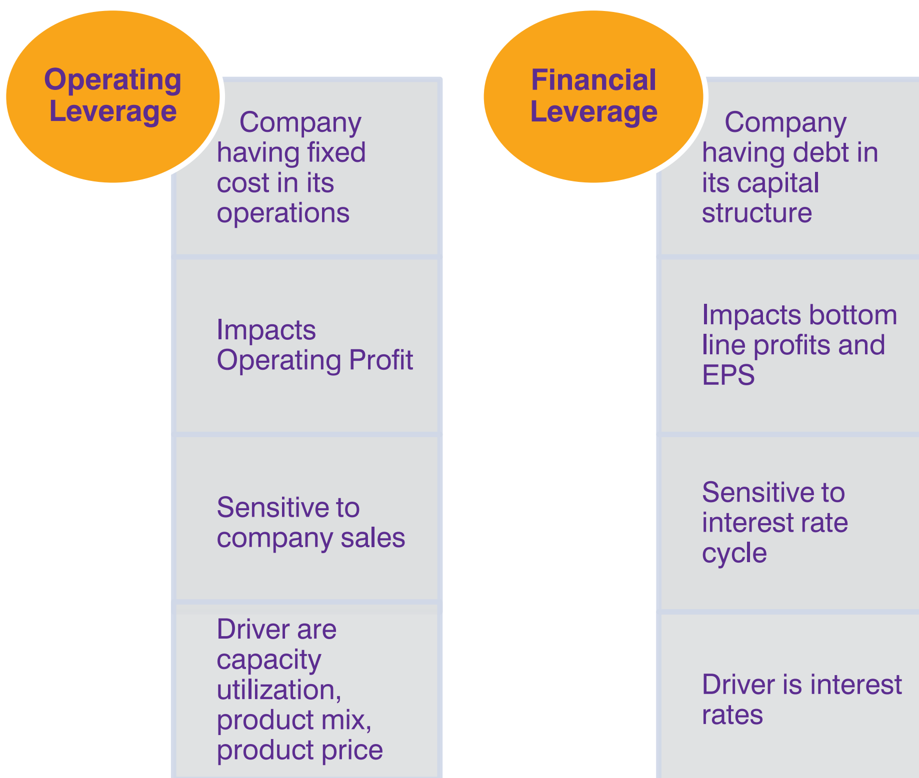
[1] Refer to ReWISE on Leverage

- From above chart, we can see that a company starts making profits after it reaches it breakeven point i.e. when sales = costs.
- Increase in capacity utilization (above 80 units) magnifies profit. With increase in units produced, fixed cost per unit remains same and only variable cost per unit increases thereby generating huge gains.
- Small incremental change in sale units, from 80 units to producing 110 units multiplies the profit by 2 times and producing 170 units multiply company profit by 8 times.
- We can see how a company with operating leverage benefits with better capacity utilization as incremental sales tends to absorb fixed costs resulting in higher profits.
- Similarly, a company can benefit from operating leverage by increasing selling price or adding product mix as with same amount of cost per unit, profits can multiply.

Financial Leverage

- Company which has debt in its capital structure is said to have financial leverage.
- Higher the debt in the capital structure, higher is the financial leverage.
- Debt does not impact company sales or operating profit but impacts bottom line profits and EPS[2] as company has to pay interest.
- Companies with financial leverage benefit when interest rates fall as with lower interest out go, profits multiply increasing EPS.

Operating and Financial Leverage snap shot



[2] Refer ReWISE on Sensex EPS