Financial Leverage & Trading On Equity

- The proportion of debt in the overall capital is also called financial leverage. As the financial leverage increases, the cost of funds declines because of increased use of cheaper debt but the financial risk increases.
- The impact of financial leverage on the profitability of a business can be seen through EBIT-EPS (earnings before interest and taxes-earning per share) analysis as in the following example.
- Three situations are considered :-
  1. There is no debt in situation
  2. Debt of Rs. 10 lakh. All debt is at 10% p.a.
  3. Debt of Rs. 20 lakh. All debt is at 10% p.a.

	Situation i	Situation ii	Situation iii
Debt	Nil	Rs. 10 lakh	Rs. 20 lakh
E bit	4,00,000	4,00,000	4,00,000
Interest	Nil	1,00,000	2,00,000
E-bit (earnings before taxes)	4,00,000	3,00,000	2,00,000
Tax	1,20,000	90,000	60,000
Eat (earnings after taxes	2,80,000	2,10,000	1,40,000
No. Of shares of rs.10	3,00,000	2,00,000	1,00,000
Eps	0.93	1.05	1.40

Total funds used = 30 lakh
Interest rate 10% p.a.
Tax rate = 30%
e-bit = 4 lakh

- The company earns Rs. 0.93 per share if it is unlevered.
- With debt of Rs. 10 lakh its eps is Rs. 1.05.
- With a still higher debt of Rs. 20 lakh, its, eps rises to Rs. 1.40.
- Why is the EPS rising with higher debt? It is because the cost of debt is lower than the return that company is earning on funds employed.
- The company is earning a return on investment (ROI) of 13.33% e-bit this is higher than the 10% interest it is paying on debt funds.
- With higher use of debt, this difference between ROI and cost of debt increases the eps. This is a situation of favorable financial leverage.

- In cases, companies often employ more of cheaper debt to enhance the EPS. Such practice is called **Trading on Equity.**
- Trading on Equity refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.
- An increase in debt may enhance the EPS but as pointed out earlier, it also raises the financial risk.
- Ideally, a company must choose that risk-return combination which maximizes shareholders' wealth. The debt-equity mix that achieves it, is the optimum capital structure.