In this edition of coming to class with one page on our company (United Technologies) we will be discussing leverage, and its role in our company as well as its role in other companies in industry. To begin, a table is included (Table 1) to show the leverage ratio of some of the major competitors in the aerospace industry:

|  |  |
| --- | --- |
| **Company:** | **Leverage Ratio (debt/equity)** |
| United Technologies | 3.2 |
| Rolls Royce | 4.45 |
| Boeing | 14.9 |
| GE | 5.01 |
| Lockheed Martin | 15.86 |

Table 1

Following initial surprise of a leverage ratio for United Technologies of 3.2 (meaning that the company is more than 75% debt), more research was done to see what other companies in industry were doing with their capital structure. Rolls Royce was also analyzed, and were seen to have an even higher leverage ratio, with more than 80% of their company being composed of debt.

Considering the similar market share of United Technologies and Rolls Royce, it would be interesting to see the leverage ratios for the “giants” of the aerospace industry (Boeing, GE and Lockheed). These companies were even worse with their leverage ratios, with Lockheed being the highlight; almost 95% of Lockheed Martin is financed by debt. This leverage ratio serves two purposes though. While it acts as a multiplier for return on equity, it also allows the competing companies to take advantage of economies of scale, which are crucial in the aerospace industry to get the most competitive contracts.

Is this leverage a good thing? Well, as long as the companies are making money, this leverage ratio will multiply their return on equity. For example, United Technologies has a strong return on equity of 25.98%, which is largely in part to their high leverage ratio. Because of Lockheed’s aggressive capital structure and strong financial position, they enjoy a return on equity of 110.54%. But this is a dangerous game to play. If any of these companies wind up in the red even for a year, their losses will be magnified by their leverage ratio, and even a giant like Boeing could go under very quickly. Rolls Royce is in a tricky position right now, as their profit margin and total asset turnover have been decreasing recently, reducing their return on equity to a mere 1.46%. If they keep up this trend, they could easily get themselves into trouble.

For United Technologies specifically however, their stance on leverage has served them well over the years, and has kept their return on equity between 20 and 25 percent over the last 10 years. I would be wary of abruptly increasing leverage to model Boeing or Lockheed Martin, as they already have a strong hold in the market share, and may have a tough time scraping market share away from other companies in the industry.

The cash conversion cycle for United Technologies is 80 days. This was very boring, as all of the companies listed had very similar cash conversion cycles, meaning that it is unlikely that companies in the aerospace industry can do much better than this. Analysis between companies also was very boring, and this can just be considered to be “industry standard”.