Module 2

The Language and Tools of Financial Analysis

Leverage Measures (Creating value with other people's money)

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Leverage (gearing)

The profitability measures focus on the return to the investors – the owners/ shareholders – but many firms also rely on debt financing.

- Debt owners do not participate in profit sharing, but…
- Unlike equity, debt needs to be repaid regardless of the firm's financial circumstances

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Leverage (gearing)

Debt financing provides a significant tax advantage (interest is tax deductible) but…exposes the owners to financial distress risk,

- where the firm's operating cash flows are insufficient to meet current obligations

More debt means higher distress risk and may cause a conflict of interest between the firm's investors.

- Equity investors want the firm to invest in risky projects
- Debt investors want the firm to avoid risky projects

Debt-Equity Ratio

The proportional use of financing the firm's operations is expressed in the Debt-Equity ratio:

$$\text{Debt-Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

Debt-Equity Ratio

DE ratio can be computed using either book value or market value of equity:

$$\text{Debt-Equity Ratio}\left(\text{Kellogg's,2014, BV}\right) = \frac{12{,}302}{2{,}851} = 4.31$$

$$\text{Debt-Equity Ratio}\left(\text{Kellogg's,2014, MV}\right) = \frac{12{,}302}{23{,}478} = 0.52$$

What does the difference tell you?

Debt Ratio

As a proportion of total assets :

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

$$\text{Debt Ratio}\left(\text{Kellogg's,2013}\right) = \frac{11{,}867}{15{,}474} = 0.77$$

$$\text{Debt Ratio}\left(\text{Kellogg's,2014}\right) = \frac{12{,}302}{15{,}153} = 0.81$$

Again, market value ratios may differ significantly from book value ratios

Interest Coverage Ratio

A measure that better expresses the likelihood of financial distress is interest coverage:

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expense}}$$

which captures the ability of the firm to generate sufficient income to cover interest expense

$$\text{Interest Coverage Ratio}\left(\text{Kellogg's,2014}\right) = \frac{1{,}034}{209} = 4.95$$

Comparison

	KELLOGG'S		KRAFT	
	2014	*2013*	*2014*	*2013*
D/E	4.31	3.29	4.26	3.46
D/A	0.81	0.77	0.81	0.78
ICR	4.95	12.09	3.90	9.16

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