Financial Gearing: Some practical considerations from a managerial finance perspective

By Joe Molumby B Comm. C Dip AF, M Sc. (ITA), MIAFA, Examiner for Professional Level Managerial Finance.

Introduction

Glen Arnold has indicated that within a given industry, wide variations in the degree of financial gearing of companies can be observed. There are several factors influencing these variations.

Financial gearing relates to the proportion of debt in the capital structure of an organisation. The more debt that a company has in their financial structure, the higher the level of its financial gearing. This leads to increased risk and earnings volatility. For instance, net income in firms with high financial gearing is more sensitive to changes in interest rates and other variables. Several factors can influence the level of financial gearing in a company. In this article we will examine the primary factors from a practical perspective that influence these variations in the degree of financial gearing.

1. Characteristics of the business

The primary consideration here is the cash generation capability of the business.

Some companies generate consistently large amounts of cash inflows and are therefore seen as being capable of taking on high levels of debt. In contrast, other companies with irregular cash flows that may be received at the end of projects instead of an ongoing basis are not capable of meeting obligations to repay debt on a regular basis. Consider, for example, industries that are based on speculative long-term projects (mining, oil extraction etc.) and have consequent higher financial risk with greater uncertainty of cash flows. Firms in these industries will have most of their cash flows occurring as balloon payments at the later stages of the long-term projects with greater risk of delayed or negative cash flows and hence higher risk premiums will be charged by those institutions that are willing to provide debt capital. We can see the contrast here with companies in the food retail sector where regular cash flows are evident, albeit on low profit margins. It is interesting to note that in the current Covid 19 recessionary climate, firms in this sector are considered as 'essential businesses' and can stay open attracting regular trade thus generating steady amounts of cash inflows.

From the perspective of suppliers of debt, there is a primary focus on the cash generation ability of client firms. This has a direct impact on the levels of financial gearing because these institutions will look favourably upon regular cash producing companies when providing debt due to their capability to repay both loan interest and capital.

Further considerations relating to the underlying characteristics of the business include:

(a) liquidity of assets and the presence of a second hand market for these assets;
(b) the sensitivity of the business to economic conditions.

Regarding the liquidity of assets, it can be noted that there is a more readily available market for retail shops in the food sector when compared to the difficulties that will be encountered in trying to realize an investment in mining or oil extraction equipment that has few alternative uses. This situation is exacerbated when the assets under consideration are of interest to specific sectors only and can be affected by technological obsolescence for the trade in value.

The sensitivity to economic conditions can be assessed in many ways by measuring the behaviour of a company's fundamentals (revenues, expenses, net income, cash flows etc.) in relation to changes in the macro economy. For instance, one of the most significant expenses for the airline industry is fuel and therefore its profits and cash flows are highly sensitive to changes in oil prices. However, other factors may have an impact as evidenced by the dramatic decrease in demand for air travel over this past year because of the Covid 19 pandemic. Apart from such extraordinary events, the revenues of the airline industry have always been sensitive to political and other unexpected events (such 9-11 or natural disasters). Such uncertainty can lead to lenders perceiving higher risk and a reluctance to provide debt capital for such industries.

2. Degree of operating gearing

Operating gearing refers to the extent to which the firm's costs are fixed. The profits of firms with high operating gearing, such as car or steel manufacturers, are very sensitive to changes in demand. They have high break-even points (the turnover level at which profits are achieved) but when this level is exceeded a large proportion of any additional sales revenue directly results in higher profits because of the relatively low variable costs. In the case of a food retailer, most of the costs are variable (mainly its purchase of goods for resale), whereas for a steel manufacturer, most of the costs are fixed. Food retailers consequently generally have high debt levels as they have lower breakeven points than steel producers and hence lower margins of safety as a cushion in the event of poor trading performance. Steel producers, by comparison have higher fixed costs and are very sensitive to changes in demand. For instance, in the current economic climate, steel is one of the main components for new car production and since this market is in a severe downturn, suppliers of steel and other materials are struggling to generate revenues but are committed to paying large amounts of fixed costs. Because of these commitments, manufacturers with high degrees of operating gearing tend to have low levels of financial gearing.

3. Borrowing capacity and financial gearing level.

This factor can be viewed from the perspective of suppliers of debt or from a company's viewpoint. Both parties have an interest in the age and type of assets that are being financed. Where the business has assets that do not tend to depreciate e.g., property or where there is an active second hand market these companies are more likely to have higher borrowing capacity than firms that have assets with limited use. However, there is a limit to the amount of suitable assets that a company will possess that it is willing to sell off so that loans can be repaid. From a bank's perspective, when considering the security required for extending a line of credit, the assets that are available as collateral will be examined. The nature, age and likely sale proceeds in the event of having to sell off the asset will have a direct impact on the amounts and terms of borrowing. These are important factors in determining the limits to total borrowing imposed by the lenders and the levels of financial gearing.

4. Agency costs

Agency costs is another factor to consider. These are the direct and indirect costs of attempting to ensure that agents act in the best interest of principals as well as the losses resulting from failure to ensure that they act this way. Lenders will require a premium on the debt interest to compensate for the additional cost of monitoring and restrictions in the form of covenants may be built into a lending agreement. Managers do not like restrictions placed on their freedom of action – hence they will be averse to incurring debt and high gearing levels.

5. Managerial preference for the proportion of debt or equity in the financing structure

For reasons outlined above, it might be expected that managers of companies will be cautious about entering into debt arrangements. However, this is not always the case. Possible motives for managers to increase gearing levels include:

(a) Bonuses based on reported earnings per share (EPS)
(b) Negotiations with employees.

Managers often receive bonuses based on EPS. Net income can be increased by taking on debt financed projects that are profitable in the short term but may not increase shareholder wealth in the long run. If these projects were financed by increased equity, the new shares issued would dilute the degree of control of existing shareholders and would also decrease the reported EPS.

Increased debt can improve the bargaining position of the firm when negotiating wage rates with employees. Low debt encourages employees, through the bargaining power of their Trade Unions or representative bodies to raise wage demands. A company with high cash outflows due to interest payments resulting from debt servicing can use this to point out that they cannot be generous to employee demands for increased wages.

6. Other Factors

There are numerous other factors that will influence the levels of financial gearing for a company. These include:

(a) Financial Slack – Having cash and/or spare debt capacity allows firms to avail of positive net present value projects and opportunities that arise.
(b) Tax Shield – For companies that have taxable profits, one significant advantage of debt finance is that the interest payments are tax deductible.
(c) Signalling Effect - The issue of loan capital can be interpreted as a sign that the directors (and the providers of debt) perceive the company to be in a strong financial position to meet future regular interest and capital repayment obligations.
(d) Control – In spite of the risks arising from increased levels of financial gearing, companies may prefer to finance new projects with debt capital because a fresh issue of equity will reduce the degree of control for existing shareholders.
(e) Interest Rates – The rates of interest attached to loan agreements may deter or encourage firms from taking on increased debt in their capital structure. Currently, interest rates are at historically low levels, but uncertainty regarding future trends in rates and in future economic prospects can have an impact of the financing decisions of companies.

Conclusions

Students need to be aware that there are a multiplicity of factors influencing the wide variations in the degree of financial gearing. The factors considered in this article are not comprehensive. We have briefly discussed some practical considerations relevant to financial gearing. Students should be aware that there are various theories and models that can also be considered, including the work of seminal writers such as Modigliani and Miller on the topic of capital structure.

In this article we viewed debt as one homogenous unit as opposed to being heterogeneous whereby different types of debt instruments may be more suitable for individual firms in different sectors. However, the factors outlined above can provide an insight into the key practical issues that must be considered by all companies when making the important financial gearing decision that will have a direct impact on the balance between risk and return and the ability to increase shareholder wealth.

References: Arnold, G. (2013) *Corporate Financial Management*, 5th Ed, Pearson.