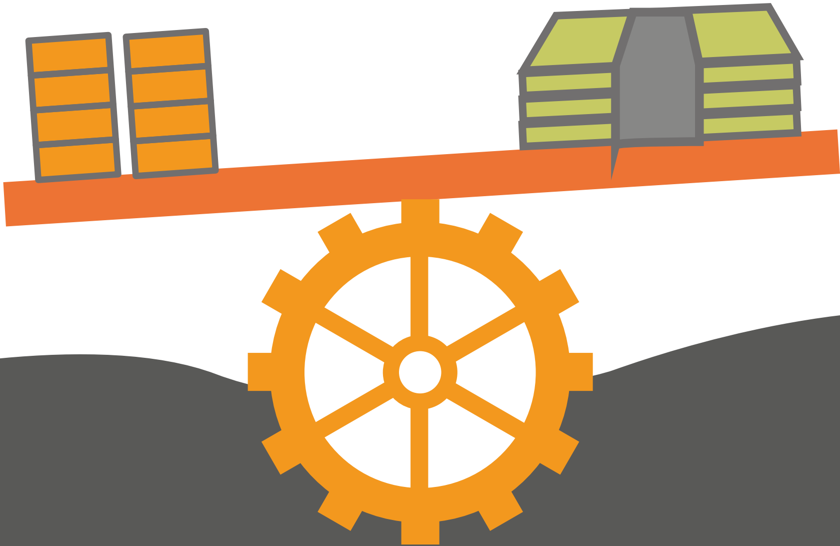


Chapter 7

Gearing or Leverage Ratios

How can I analyse the indebtedness of my organisation?

Gearing or leverage ratios measure the overall burden of debt an organisation bears, in comparison with its assets or the equity that shareholders have in the business.

Gearing or leverage measures indebtedness.

A highly-leveraged business, or one with high gearing, means that creditors have committed more funds to the business than shareholders.

On the face of it, the firm may appear to be in a tricky situation, but debt-finance may be a cheaper option - allowing equity investors to make greater returns.

Gearing or Leverage Ratios measure how many pounds creditors have committed to the business, for every pound shareholders have committed.

Debt-Equity Ratio

The debt-to-equity ratio equals a business' total liabilities, divided by shareholders' funds.

Debt Equity Ratio = Total Liabilities / Shareholders' Funds

To find total liabilities, we simply add long-term liabilities and current liabilities.

Using X-AMPLE's balance sheet, this is £1m plus £5m, which gives us £6m.

		£
Current liabilities		
Creditors: amounts falling due within a year		(5 000 000)
Long-term liabilities		
Creditors: amounts falling due after more than one year		(1 000 000)
Total liabilities		(6 000 000)

Total Liabilities = Long-term Liabilities + Current Liabilities

1m + 5m = £6m

We can now calculate X-AMPLE's debt-to-equity ratio.

Debt-equity ratio = total liabilities / shareholders' funds

6m / 4m = 1.5

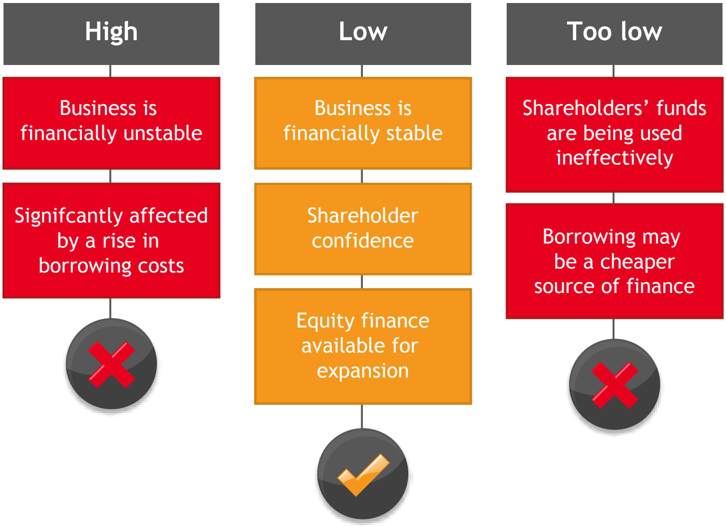
£6m divided by £4m, gives a debt-to-equity ratio of 1.5.

This means that for every £1 shareholders have committed to the business, creditors have committed £1.50.

A high debt-to-equity ratio may indicate that the business is financially unstable, and could be significantly affected by any rise in borrowing costs.

A low debt-equity ratio generally indicates that the business is more financially stable. Shareholders have the confidence to invest in the company and fund its expansion.

However, if the debt-equity ratio is too low, it may mean that shareholders' funds are being used inefficiently. It may be cheaper to fund the business by borrowing more.



Debt-Service Coverage Ratio

Debt-service coverage ratio measures how many times over a business could afford to pay the interest it owes on its debt.

The debt-service coverage ratio (or interest coverage ratio) is calculated from a business' operating profit or earnings before interest and tax, divided by its interest payments or debt service.

Using X-AMPLE's profit and loss account, this is £6.5m divided by £0.5m, giving a debt-service coverage ratio of 13.

Debt-service Coverage Ratio = **Operating Profit** / **Interest Payments**

Profit and Loss Account for X-AMPLE Ltd for the Year Ended 30th September 2016		
	£	£
Sales		20 000 000
Cost of sales		(8 000 000)
Gross profit		12 000 000
Less expenses		
Marketing costs	(3 000 000)	
Administration	(2 000 000)	
Depreciation	(500 000)	
		(5 500 000)
Operating profit		6 500 000
Interest		(500 000)

6.5m / 0.5m = 13

This means that X-AMPLE could afford to pay the interest it owes on its debt 13 times over.

If the debt-service coverage ratio is too low, it indicates that a slight rise in borrowing costs could leave the business struggling to service its debt, because it cannot pay the interest.

A low debt-service coverage ratio – the business may struggle to make its interest payments if borrowing costs rise.