Test 3, Lecture 8 Review

Financial Risk and Financial Leverage

Financial Risk

* Financial Risk: the additional risk placed on the common stockholders as a result of the decision to finance with debt

Financial Leverage

* WACC: the weighted average of the costs of the various components of the firms capital structure
  + So far, we’ve taken the firms capital structure as a given but now we want to look at how adjusting the components of debt and equity can maximize firm value
    - This is called the optimal capital structure for a firm
* Financial Leverage: the extent to which a firm relies on debt
  + If the firm uses more debt in its financing, the firm has increased leverage

What Impact Does Leverage Have on the Firm?

* Look at earnings per share (EPS) to determine what impact leverage has on the firm

EBIT

- Interest ( = Debt x Interest Rate on Debt)

= Taxable Income

- Taxes

= Net Income

EPS = (Net Income)/(shares outstanding)

* Overall, leverage…
  + Increases expected shareholder return
  + Increases volatility (shareholder risk)
* If we increase leverage, we are increasing leverage for the firm