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