Leverage Ratio

June 19, 2020

- A leverage ratio is meant to evaluate a company’s debt levels. The most common leverage ratios are the debt ratio and the debt-to-equity ratio.

- A debt ratio is simply a company’s total debt divided by its total assets. The formula is: Debt Ratio = Total Debt / Total Assets
- The debt-to-equity ratio is a measure of the relationship between the capital contributed by creditors and the capital contributed by owners. It also shows the extent to which shareholders’ equity can fulfill a company’s obligations to creditors in the event of
- Debt-to-Equity Ratio = Total Debt/Total Equity

Why does leverage ratio matter?

- It indicates **financial health/credit risk** of a company
- If the ratio is higher, the ***lenders will have interference*** in the management as they have a higher stake in the business.
- The owner will have very ***fewer chances of borrowing further*** in the case of urgent requirements if the ratio is on a higher side but urgency can be managed well if the ratio is on the lower side.
- The Higher burden of interest will keep the **profits under pressure.**
- But, If the ratio is higher ***owners can retain control over their business*** with limited capital by preferring debts over the equity.

The ***owner can enjoy higher returns*** on equity because the total returns are

- divided into very few hands but it is only possible when the rate of return from the business is higher than the rate of interest charged by the debts. This is called “Leverage” or “Trading on Equity”.