**Chapter 5: Bonds**

**Understanding Leverage**

**Quick Recap:**

Why is it better for your business to issue bonds rather than equity?

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**Bonds & Leverage**

A company has 2 main choices when looking to raise finance. What are they?

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**What is meant by leverage?**

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**Scenario 1: Increase in Value of Business**

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| **The value of a company is £100mn at the start of the year and this goes up to £120mn by the end of the year.**  **The outcomes would depend on how the business is financed.**  **If the company is financed PURELY by equity, then this means ALL of the 20% gain will be for the shareholders.**  **The share value will increase by 20% as shown in the diagram.** |

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| **If the company is financed by $50mn debt and $50mn equity then:**  **The value of the equity would go up from $50mn to $70mn.**  **The debt amount would stay the same at $50mn.**  **Overall there is a 40% increase in equity.**  **(20/50 \*100 = 40%)**  **The GAIN has been MAGNIFIED** |

**What if the borrowing had been even bigger?**

Assume that the **Starting Value is still $100m** and the **Ending Value is $120mn**.

Assess the impact on the shareholders but this time with:

1. 60% debt
2. 90% debt

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**Scenario 2: Decrease in Value of Business**

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| **The value of a company is $100mn at the start of the year and this goes down to $90mn by the end of the year.**  **The company was financed through $50mn Equity and $50 Debt.**  **The outcomes could be:**  **If the company is financed PURELY by equity, then this means ALL of the 10% loss will be felt by the shareholders.**  **The share value will decrease by 10%** |

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| **If the company is financed by £50mn debt and £50mn equity then:**  **The value of the equity would go down from £50mn to £40mn.**  **The debt amount would stay the same at £50mn.**  **Overall there is a 20% decrease in equity.**  **(10/50 \*100 = 20%)**  **The LOSS has been MAGNIFIED** |

**What if the borrowing had been even bigger?**

Assume that the **Starting Value is still $100m** and the **Ending Value is $90mn**.

Assess the impact on the shareholders but this time with:

1. 60% debt
2. 90% debt

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