Ratio Analysis—The Gearing Ratio

Specification requirement—Gearing ratio – calculation, interpretation and importance.

When we look at a firms capital employed, that is a company's sources of long term capital, there are up to 3 categories of finance available. The first is Share Capital, the second Reserves, and the third Loan Capital ie. long term liabilities or long term borrowing.

A company's gearing is the percentage of capital employed by the business that is financed by loan capital, in relation to that part of capital funded by equity (shares) and reserves and loan capital.

Note. Because accounts are not always in exactly the same format you may see the loan capital titled in slightly different ways, e.g. Long Term Liabilities, or Loans due for repayment in more than 1 year. Whichever format the title it should be clear that it is borrowed money. Reserves can also be called by different names , the most common is Retained Profit.

Describing Gearing

A business with low gearing is one that is funded (financed) in the main by share capital (equity) and reserves, whilst one with high gearing is funded in the main by loan capital.Gearing is expressed as a %. As a guide, a gearing ratio of above 80 is very high, 60—80% is high, and below 40% is low. But we must not be too prescriptive. Before we take a view on the level of gearing, we must take into consideration all the information about the company that is available.

A highly geared business is one where the largest proportion of the funding of the business has come from borrowing. When high gearing exists, interest paid on debts reduces profits available to shareholders, and if interest rates increase the costs of the business can rapidly increase. But high gearing is not necessarily a bad thing. It may indicate that a company is adventurous in is expansion plans, and may have taken the opportunity to invest by borrowing at low rates. A company with low gearing is one where the largest proportion of the funding of the business has come from investment by shareholders.

As low gearing will be a result of a low level of borrowings, this can indicate that the firm is growing through reinvestment of profits, minimising risk. But low gearing may indicate that a firm is not aggressive enough to survive, and may not be seeking opportunities for growth. ,

Calculating Gearing.

The formula for calculating gearing is:

Gearing =

$$\frac{\textbf{Long Term Liabilities} \text{ (LTL)}}{\textbf{Share Capital and Reserves and LTL}} \text{ times } \frac{\mathbf{100}}{\mathbf{1}}$$

We see from the formula, that we use LTL twice, once above the line, once below the line. By doing this we can never have gearing of more than 100%.

Example Calculations

.	£M
Long Term Liabilities	
Mortgage	**386.8**
Bank Loan	**71.0**
Share Capital (Ordinary)	**575.0**
Reserves	**196.3**
Total	**1229.1**

$$\frac{386.8 + 71.0}{386.8 + 71.0 + 575.0 + 196.3} \text{ times } \frac{100}{1}$$

$$= 37.2\%$$

Gearing is a calculation that must be practiced. All past BS3 papers have accounts questions, and by looking at the Balance Sheets given, you will learn how to identify the figures needed for a gearing calculation, and where the figures are placed on a balance sheet.

Commenting on Gearing

If we find a highly geared company, we must look at the type of business involved. Are it's profits or sales growing fast? Is the level of gearing falling? If both these factors are found then we may be able to comment favourably on the gearing ratio. But on the other hand high gearing will mean that a larger proportion of profits are used to pay interest on loans, instead of being reinvested or paid to shareholders. We must ensure that we balance these arguments. A highly geared company can suffer from a loss of control, the lenders to the company will want a say in how the business is run. And remember bankers do not necessarily make the best businessmen!

Even with if we take a positive view of high gearing, it is worth noting that many company failures over recent years have been accompanied by spectacularly high gearing ratios. High gearing leads to high interest repayments, and as soon as profits start to fall, the banks get nervous, and can withdraw their support!

The reverse arguments apply to companies with low gearing. Low interest bills mean more profits to distribute as dividends. The business could be concentrating on investing from cash flow and not overextending itself. But on the other hand the business could be too conservative in it's outlook, missing out on investment opportunities and new markets. The management of the business might realise too late, that in the long run, borrowing to invest and grow should have been the option chosen.

Notes