

## Degree of financial leverage Interview prep questions

### A. Conceptual Interview Questions

1. **What is the degree of financial leverage?**  
Degree of Financial Leverage (DFL) measures how sensitive **EPS** is to changes in **EBIT** due to fixed interest costs.
2. **Why does financial leverage increase EPS volatility?**  
Because interest is a fixed cost, any change in EBIT disproportionately affects earnings available to shareholders.
3. **How is financial leverage different from operating leverage?**  
Operating leverage arises from fixed operating costs, while financial leverage arises from fixed financial costs (interest).
4. **What does a DFL greater than 1 indicate?**  
The company is using debt, and EPS will change more than proportionately to EBIT.
5. **Can a company have zero financial leverage?**  
Yes, if it has no debt and no interest expense. In that case,  $DFL = 1$ .
6. **Why is interest considered a fixed financial cost?**  
Interest must be paid regardless of the company's profitability.
7. **How does financial leverage affect shareholder risk?**  
Higher leverage increases both potential returns and downside risk for shareholders.
8. **Why does DFL increase when EBIT is low?**  
Because  $EBIT - \text{Interest}$  becomes small, making DFL mathematically larger.
9. **Is high financial leverage always bad?**  
No. It can enhance returns in stable environments but becomes risky during downturns.
10. **How does financial leverage impact a recession?**  
High leverage magnifies losses when EBIT falls, increasing default risk.
11. **Why is DFL important in capital structure decisions?**  
It helps management balance return maximization with financial risk.
12. **How does tax affect financial leverage?**  
Interest provides a tax shield, lowering effective cost of debt.
13. **What happens to DFL when debt is repaid?**  
Interest decreases, reducing DFL and financial risk.

**14. Why do startups usually have low financial leverage?**

Due to unstable cash flows and limited debt capacity.

**15. How do investors use DFL?**

To assess earnings volatility and risk before investing.

**B. Numerical / Direct Calculation Questions**

**Formula used:**

$$\text{DFL} = \text{EBIT} \div (\text{EBIT} - \text{Interest})$$

1. EBIT = 1,000; Interest = 200  
 $\text{DFL} = 1,000 / 800 = \mathbf{1.25}$
2. EBIT = 5,00,000; Interest = 1,00,000  
 $\text{DFL} = 5,00,000 / 4,00,000 = \mathbf{1.25}$
3. EBIT ↑ 10%, DFL = 2  
 $\text{EPS} \uparrow = 10\% \times 2 = \mathbf{20\%}$
4. EBIT = 2,00,000; Interest = 50,000  
 $\text{DFL} = 2,00,000 / 1,50,000 = \mathbf{1.33}$
5. EBIT = 8,00,000; Interest = 6,00,000  
 $\text{DFL} = 8,00,000 / 2,00,000 = \mathbf{4 \text{ (Very high risk)}}$
6. No debt  
 $\text{DFL} = \mathbf{1}$
7. EBIT ↑ from 10,00,000 to 12,00,000 (20%); EPS ↑ 30%  
 $\text{DFL} = 30\% / 20\% = \mathbf{1.5}$
8. EBIT = 4,00,000; Interest = 1,00,000  
 $\text{DFL} = 4,00,000 / 3,00,000 = \mathbf{1.33}$
9. EBIT = 1,20,000; Interest = 40,000  
 $\text{DFL} = 1,20,000 / 80,000 = \mathbf{1.5}$
10. EBIT ↓ 10%, DFL = 3  
 $\text{EPS} \downarrow = \mathbf{30\%}$
11. EBIT = 9,00,000; Interest = 3,00,000  
 $\text{DFL} = 9,00,000 / 6,00,000 = \mathbf{1.5}$
12. EBIT = 6,00,000; Interest = 5,00,000  
 $\text{DFL} = 6,00,000 / 1,00,000 = \mathbf{6 \text{ (Extremely risky)}}$
13. EBIT ↑ 15%, EPS ↑ 45%  
 $\text{DFL} = 45\% / 15\% = \mathbf{3}$
14. EBIT = 2,50,000; Interest = 50,000  
 $\text{DFL} = 2,50,000 / 2,00,000 = \mathbf{1.25}$

15.  $EBIT = 10,00,000$ ; Interest = 0  
 $DFL = 1$

### C. Scenario-Based / Practical Questions

1. **Impact of high DFL in recession?**  
EPS falls sharply, increasing default risk.
2. **Same EBIT, different debt levels, who is riskier?**  
The firm with higher debt (higher interest  $\rightarrow$  higher DFL).
3. **Why would management increase leverage?**  
To boost EPS and ROE when cash flows are stable.
4. **How does DFL help equity research?**  
It helps forecast EPS sensitivity under different EBIT scenarios.
5. **Utilities: high or low DFL?**  
Moderate to high, due to stable cash flows.
6. **Effect of DFL on DCF valuation?**  
Higher leverage increases equity risk and discount rate.
7. **Effect of rising interest rates?**  
Interest expense rises, increasing DFL and risk.
8. **Why do lenders monitor DFL?**  
To assess repayment capacity and solvency risk.
9. **After issuing bonds, what happens to DFL?**  
Interest increases  $\rightarrow$  DFL increases.
10. **EBIT approaches interest, what happens?**  
DFL becomes extremely high, signalling danger.
11. **Why avoid firms with extreme DFL?**  
Small EBIT shocks can wipe out EPS.
12. **Impact on dividends?**  
High leverage reduces dividend-paying flexibility.
13. **Explain DFL to non-finance people.**  
“Debt makes profits grow faster but losses too.”
14. **Role in stress testing?**  
Helps simulate EPS impact under EBIT shocks.
15. **Why is DFL critical in M&A?**  
Post-merger debt can dramatically change earnings risk.

## D. Interview Tips to Increase Hiring Chances (Very Important)

### 1. Always Explain Before Calculating

Interviewers prefer **logic + clarity** over speed.  
First explain **what DFL measures**, then calculate.

### 2. State Assumptions Clearly

Mention assumptions like:

- No preference dividends
- Interest is fixed
- Tax ignored for simplicity

This shows **professional maturity**.

### 3. Link DFL to Risk and Decision-Making

Never stop at the number. Always add:

“This indicates higher financial risk due to fixed interest obligations.”

### 4. Use Real-World Context

Relate DFL to:

- Debt-heavy companies
- Cyclical industries
- Recession scenarios

### 5. Avoid Common Mistakes

Confusing DFL with DOL  
Forgetting interest in denominator  
Not interpreting the result

### 6. Be Ready for Follow-Up Questions

After DFL, interviewers often ask:

- DOL vs DFL
- Combined leverage
- Risk mitigation strategies

### 7. Practice Calm, Structured Answers

Use this structure:

1. Definition

2. Formula
3. Calculation
4. Interpretation

This **dramatically improves** interview scores.

**All the best! Hope this helps!**