1.1.5 LEVERAGING

Leveraging increases or decreases the yield on equity of a financed investment project. When a project's yield is higher than the financing cost[1], the borrower makes money with the lender's money, whereas when a project's yield is lower than the financing cost, the borrower has to disburse additional money to reimburse the loan since the project does not generate enough cash flow. Very often, for maximum leverage, investors tend to want to borrow as much as possible. However, we must remember that when we rely on financing, we increase the risk of the project since the monthly payments represent financial obligations that reduce the owner's margin should there be a decrease in revenues. Here are two examples:

Example 3: Positive Leveraging Impact

Example of Positive Leveraging

	Investment without leverage		Investment with leverage
Value of the Property	$ 100,000		$ 100,000
Net Income Before Financing	$ 12,000		$ 12,000
Total Yield on the Investment	**12%**		**12%**
Equity Invested	$ 100,000		$ 25,000
Mortgage	$ 0		$ 75,000
Financing Cost at 10% for 25 years (interest only)	$ 0	Annual Cost	$ 7,316
Net Income after Financing	$ 12,000		$ 4,684
Equity Invested	$ 100,000		$ 25,000
Yield on the Equity Portion *	**12.00%**		**18.74%**

(* Net Income after Financing / Equity Invested). Excludes the Capital Portion of the Loan.

Example 4: Negative Leveraging Impact

Example of Negative Leveraging

	Investment without leverage		Investment with leverage
Value of the Property	$ 100,000		$ 100,000
Net Income Before Financing	$ 8,000		$ 8,000
Total Yield on the Investment	**8%**		**8%**
Equity Invested	$ 100,000		$ 25,000
Mortgage	$ 0		$ 75,000
Financing Cost at 10% for 25 years (interest only)	$ 0	Annual Cost	$ 7,316
Net Income after Financing	$ 8,000		$ 684
Equity Invested	$ 100,000		$ 25,000
Yield on the Equity Portion *	**8.00%**		**2.74%**

(* Net Income after Financing / Equity Invested). Excludes the Capital Portion of the Loan.

[1] Interest rate applicable on a loan that would finance the project.