Operating Leverage

Operating leverage is a concept that relates to the relationship between fixed and variable costs. Fixed costs are fixed expenses such as rent, loan payments, memberships, etc. Variable costs are non-consistent expenses such as gas prices, equipment repairs, etc. Another good way to think about it is that fixed costs remain the same regardless of sales and variable costs change based on sales volume. Operating leverage shows the effect on operating income as sales grow.

Let's take a theoretical company called ABC Software Inc., a software company. ABC Software Inc. has high fixed costs such as rent and salary expenses, but it does not cost them much to sell additional software. They would have high operating leverage because they have expensive fixed costs upfront. Let's look at another theoretical company, XYZ Software Consulting. We know that XYZ Software Consulting has low operating leverage because its expenses range in terms of the number of hours and employees it takes to complete a project. Note that it is essential to compare the operating leverage between companies in the same industry. For example, software companies will tend to have higher operating leverage than companies in the consulting industry based on different needs.

There are a few ways to calculate operating leverage. For simplicity's sake, we will use the formula fixed costs divided by fixed costs plus variable cost. Let's take ABC Software Inc., for example. ABC has $1 million fixed costs and $20,000 in variable expenses. Their operating leverage is .98. If we look at XYZ, it also has $1 million in fixed costs but $80,000 in variable expenses because of the additional fees it has to pay its onboarding process. The operating leverage of XYZ is .93.

We know that with ABC's higher operating leverage, they will be able to set fair prices for their consumers and generate a profit. It shows that ABC is better at using its fixed expenses to generate profits, which will help attract shareholders.

It's important to understand operating leverage because it goes a long way in determining how much of sales growth, or sales declines, fall to the bottom line of net profit. For companies with extremely high operating leverage, for example, a 10% growth in sales may lead to 20% or more growth in profits. Likewise, a 10% drop in sales could lead to 20% or more drop in profits. In this way, operating leverage is an important factor in both understanding earnings potential and risk.

For more, please see a paper written by Michael Mauboussin, et al. titled "Operating Leverage: A Framework for Anticipating Changes in Earnings."

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