AMERICAN BANKER

What Is Operating Leverage, Exactly?

Davenport, Todd. **American Banker** [New York, N.Y] 06 Feb 2006: 9.

Abstract (summary)

Companies can use financial leverage to make sure their equity is achieving the best possible returns, and in good times can use credit leverage to boost results. But operating leverage is a measure of whether a company is getting good value for its costs. Positive operating leverage, in which revenue growth outstrips expense growth, is a virtual guarantee of earnings growth; negative operating leverage, if persistent, virtually guarantees the absence of profit.

"The efficiency ratio is a report card on where you are from a snapshot basis," said Anthony Davis, an analyst at Ryan, Beck & Co. Because it assesses growth differentials, "operating leverage is more dynamic. You are looking at the most recent quarter's rate of growth in revenues and expenses, and that's an indicator of the progress you're making in improving the efficiency ratio."

"If a company is efficient, it's harder and harder to use operating leverage to drive earnings growth," she said. "We've seen companies in the past doing this -- repeatedly. They push too hard on the leverage and not enough on reinvesting for revenue growth."

Full Text

Given the frequent reference to operating leverage during discussions of banks' financial performance, it's natural to assume that there is some common definition.

Only there isn't. With the confounding state of banks' financial reporting these days, just getting agreement on earnings per share is challenge enough. Common agreement on a term that attempts a broad interpretation of revenues and expenses doesn't stand a chance.

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negative operating leverage, if persistent, virtually guarantees the absence of profit.

It's a popular topic, said Gerard Cassidy, an analyst at RBC Capital Markets. "It seems that every year there's a new focus in banking, and right now that focus is operating leverage," he said.

Its currency is an indication of the middling prospects for bank earnings. When times are good, talking about controlling expenses is shouting into the wind. And when times are bad, the earnings killer is always credit, not expense.

For now, banks are in between. The industry has enjoyed a strong run over the past couple of years, but earnings prospects are dimming in the face of compressed margins from a flat yield curve and tough competition. As concerns about top-line growth mount, operating leverage has become a popular indicator of a bank's ability to deliver good results in difficult conditions.

"When revenue is growing strongly you don't have to focus on it," said Terry McEvoy, an analyst at Oppenheimer & Co. "But when revenue isn't easy to come by, it's the expense side you control where you highlight the flexibility and wherewithal to keep growing earnings."

Operating leverage has long been a standard metric for fee-based banks specializing in trust and custodial services, where economies of scale are far more evident and easier to model than in traditional banking.

But its use is spreading. Of the nation's 10 largest banks, only JPMorgan Chase and BB&T did not discuss operating leverage during recent conference calls and investor presentations.

Operating leverage "is something that is a clear focus for the executive management team and driven all way through the organization," Mark Chancy, SunTrust Banks ' chief financial officer, told investors during a Jan. 31 presentation. He proved the point by using the term nine times, and discussed at length the Atlanta company's targets for it.

Few conversations about operating leverage are short. Measuring it is conceptually simple, but practically maddening.

The figure is meaningful only if it accounts for items that form a reasonable basis for estimating a company's future performance. That presents a dilemma very similar to determining operating earnings -- analysts frequently can't agree which income and expense items are properly considered operating.

Revenue determinations are messy enough. Most analysts add taxable-equivalent net interest income (before credit provisions) and fee income. They generally agree that one-time gains from asset sales -- business units and branches, for instance -- should be subtracted.

Some analysts -- but not all -- also adjust for gains and losses from the securities portfolio. Others adjust for gains or losses on loan sales. The question of how to handle venture-capital and private-equity gains is equally vexing, and again, not answered the same way consistently. Given its volatility, there are analysts who net out trading income, and even mortgage banking results.

In short, any revenue item that can't be reasonably predicted or modeled is liable to be removed from the calculation.

The expense side of the equation is also troubling. Analysts generally subtract amortization of deposit intangibles and merger costs from expenses. What about amortization of mortgage servicing rights? Debt prepayment penalties? Charges from balance-sheet restructurings, or other items described as "special" in nature by the banks that take them, but suspiciously like operating costs to disinterested observers?

There's also little agreement as to the appropriate periods of comparison. Some analysts compare sequential quarters, arguing that banking isn't seasonal like other industries. Others say a particular quarter should only be compared against the year-earlier quarter, noting that some banks record specific gains or expenses in the same quarter every year, and that the longer intervening period is a better baseline.

Still others maintain that quarter-to-quarter comparisons aren't valid, and that annual assessments -- or even comparisons over several years -- are the only way to come to appropriate conclusions.

Analysts acknowledge these are subjective decisions; calculations of operating leverage are rarely the same.

By rough estimates, only two of the nation's 13 largest retail banks -- Wells Fargo and PNC -- achieved positive operating leverage in the fourth quarter compared with the third quarter. (JPMorgan Chase & Co. could argue it did as well; the company's revenues declined, but expenses dropped more.)

A quarter in which a company claims a series of unusual items presents a particular challenge for calculating operating leverage. Citi's fourth quarter is by some estimations the zenith of inscrutability.

Three analysts asked about operating leverage during Citigroup's Jan. 20 conference call. One of them, Diane Merdian of Keefe, Bruyette & Woods, wondered whether it was a "hopeless exercise" to attempt to strip away the "umpteen" special items in Citi's results.

Sallie Krawcheck, Citi's chief financial officer, acknowledged that any attempt to normalize the company's results "would make your head hurt."

Industry analysts have traditionally used the efficiency ratio, or operating costs divided by operating revenues, to measure cost discipline, but operating leverage offers some nuances that the efficiency ratio cannot capture.

"The efficiency ratio is a report card on where you are from a snapshot basis," said Anthony Davis, an analyst at Ryan, Beck & Co. Because it assesses growth differentials, "operating leverage is more dynamic. You are looking at the most recent quarter's rate of growth in revenues and expenses, and that's an indicator of the progress you're making in improving the efficiency ratio."

Charles Peabody of Portales Partners LLC makes a second distinction. Operating leverage is a worthwhile indicator for all banks, while the efficiency ratio isn't a particularly helpful point of comparison for banks with different business models.

"If you have a strictly commercial-oriented bank, you should be able to produce an efficiency ratio in the 40%-plus level, but if you have a heavy retail, branch-banking franchise, it is going to be tough to get into the low 50s," Mr. Peabody said. There are "trust banks, retail banks, corporate banks, investment banks. Organizations have developed niche expertise, and that's why people are now looking at operating leverage rather than efficiency ratios."

Bankers and analysts alike said the current fascination with operating leverage does have its shortcomings.

Jeff Davis of FTN Midwest Research said interest rates can distort the measure. Because it incorporates net interest income, wide spreads produced solely by the right yield curve can push revenue higher and overstate operating leverage; by the same token, he said, a flat yield curve can understate it.

Ms. Merdian appreciates the value of operating leverage, but said relying too heavily on it can dissuade companies from making necessary investments.

"If a company is efficient, it's harder and harder to use operating leverage to drive earnings growth," she said. "We've seen companies in the past doing this -- repeatedly. They push too hard on the leverage and not enough on reinvesting for revenue growth."

Indexing (details)

Subject	Operating leverage
Title	What Is Operating Leverage, Exactly?
Author	Davenport, Todd
Publication title	American Banker
Volume	171
Issue	24

Pages	9
Number of pages	0
Publication year	2006
Publication date	Feb 6, 2006
Year	2006
Section	Market Monitor
Publisher	SourceMedia
Place of publication	New York, N.Y.
Country of publication	United States
Journal subject	Business And Economics--Banking And Finance
ISSN	00027561
Source type	Newspapers
Language of publication	English
Document type	News
ProQuest document ID	249890591
Document URL	http://search.proquest.com.ezproxy.saintleo.edu/docview/249890591?accountid=4870
Copyright	(Copyright c 2006 Thomson Media. All Rights Reserved.)
Last updated	2012-01-18
Database	2 databases View list