Leverage is one of the major causes of a firm's distress. It is not just limited to patently reported statistics of financial ratios, but is rather a deep issue. Often (not always!) straightforward and disclosed leverage on the balance sheet will get adjusted in prices, embedded in risk premiums; however it is the hidden leverage which will be more ominous.

## Types of Hidden Leverage

1. Off-Balance Sheet Leverage – Operating Leases

Many a times a company will sport rapid growth and high return on capital or equity. However it may even be achieved through off-balance sheet leverage by simply taking material assets on an operating lease basis. So when retail stores, aircraft, equipment or any material asset is leased by a company, it basically involves a portion of the rental going to fund financial leverage costs.

This lowers the flexibility to survive through down turns. Plus it gives a false appearance of the company's rapid growth as being sustainable especially during environments with low and declining general interest rates. It also wrongly incentivizes growth and expansion during the highly competitive periods which may come back to bite later. It requires a trained eye and a forensic or critical accounting mindset (not just tools) to identify and adjust for such hidden leverage risk.

2. Off-balance Sheet Leverage- Securitization

If rapid growth along with maintaining superb liquidity and strong cash flow generation surprises you, make sure to check if there is leverage hidden from the balance sheet through selling of receivables or debtors or even sometimes with advances from vendors.

Such a debt generated by selling of receivables will not be apparent from traditional financial ratio analysis. The company will be more dependent on credit cycle than it appears to be while at the same time cash flows or liquidity will not be  as strong as they appear. Continued growth is required to keep motion in positive direction to avoid the unwind.

3. Derivatives

Derivatives will have embedded leverage and will require relatively less upfront capital depending on security type and regulations. However they have their own accounting nuances and often what appears on financial statements is the tip of the iceberg of underlying exposure assumed. It further brings collateral requirements and counterparty factors in to picture.

Non- financial corporations are subject to external influences, factors and often use derivatives to mainly hedge them out. However as is usual with many financial transactions, it is tough to foresee variables and much less the volumes required. This may lead to the hedge turning out to be risky as either the direction is wrong or volume is overly aggressive. Financial corporations will use derivatives as both market making/middlemen role as well as in proprietary capacity to either hedge or speculate. This makes analysis complex.

Whatever the technicalities, as an investor one needs to dig out and grasp the details to fully comprehend the leverage to underlying factors and its impact.

4. Pledged Shares:

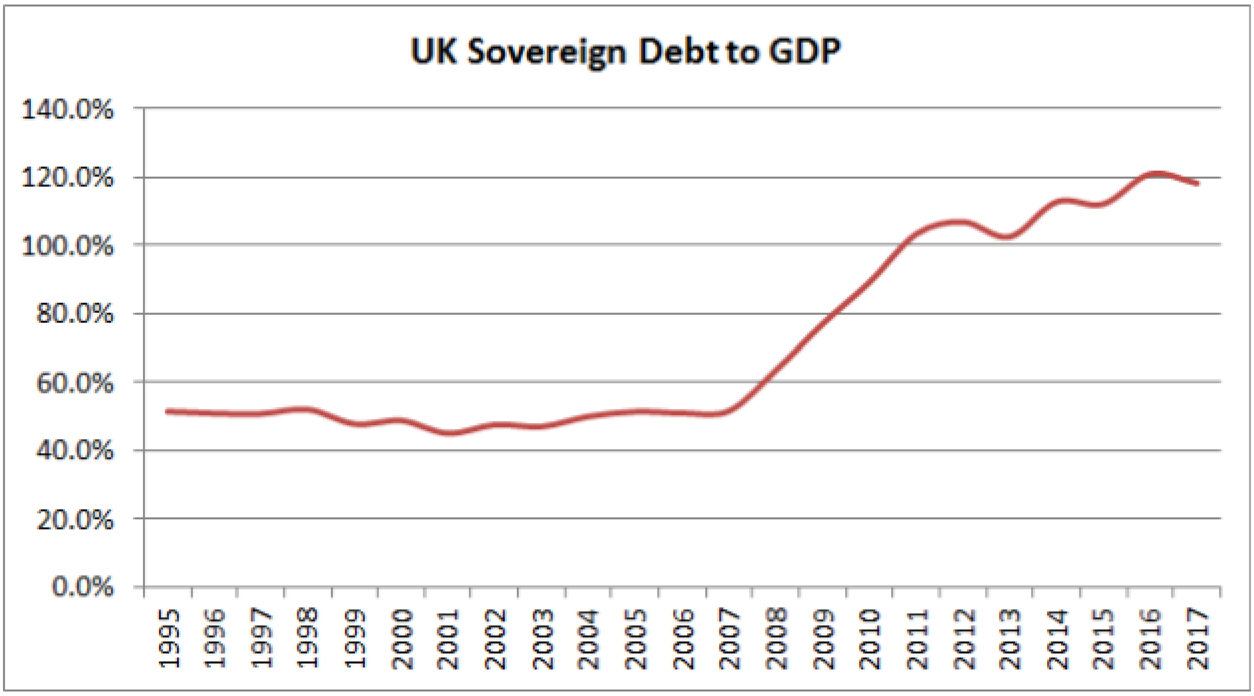
When there is a concentrated ownership profile of company shares, the owner may decide to pledge these assets for use to other purpose or to free up capital. So indirectly the other shareholders of the company also become subject to possible volatility in case those obligations are invoked and may interrupt the prolonged share price momentum party which they are counting on.

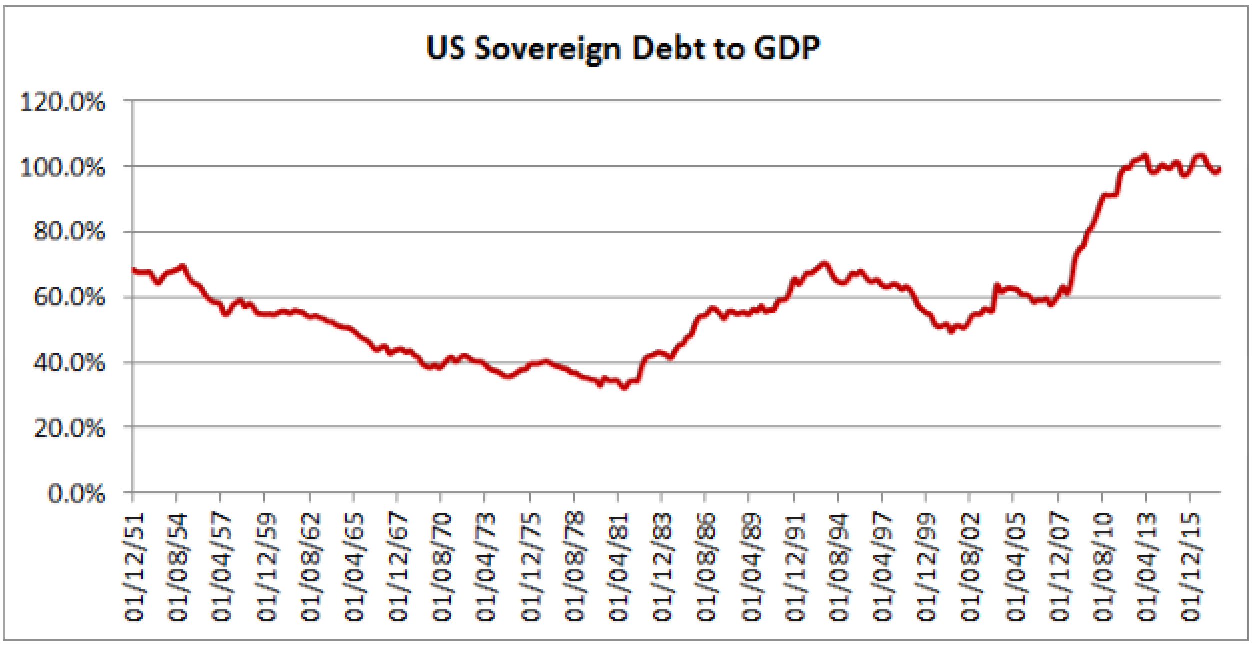
5. System Level Leverage: (a) Margin Debt (b) National Level Debt

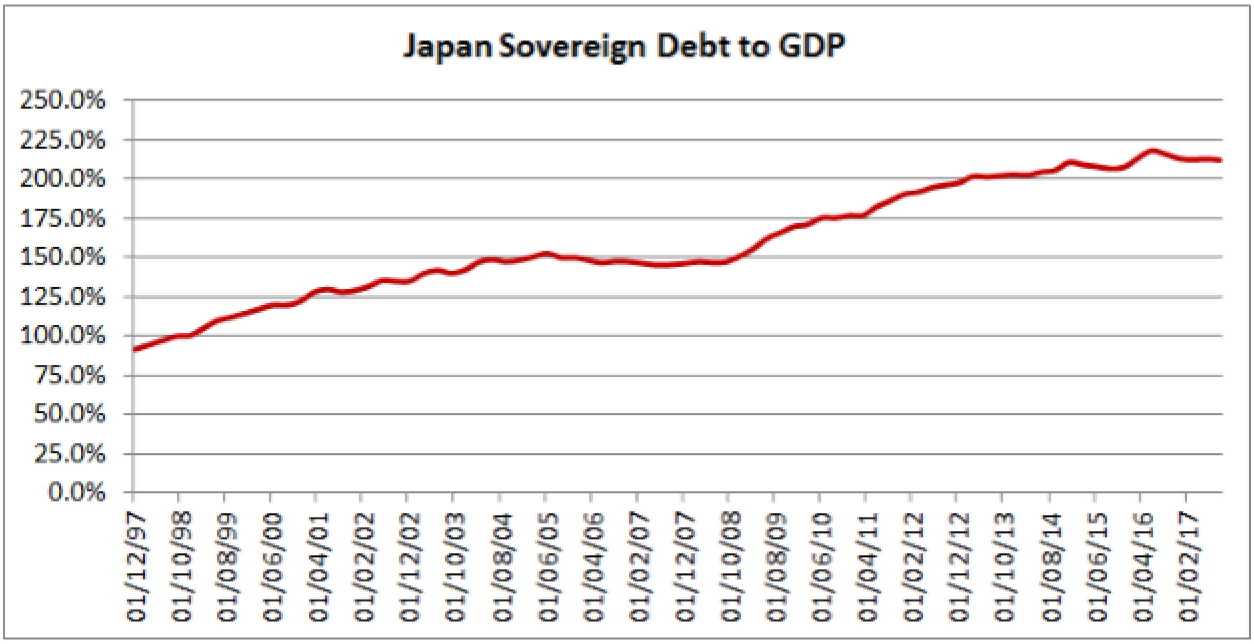
It is naïve to think that just because a particular company has a conservative financial leverage profile; it will be spared the ills of leverage. This is because, no company can operate in a vacuum and is part of complex social system (any cursory observer of history and currencies will know it well). So when the debt levels rise at system level, beyond a certain level all social subjects will be in the same boat and experience pain in one form or the other. Be it the linkage of company with overleveraged customers in the value chain at micro level, or households, corporate, sovereign sector at macro level. Asset price growth and debt growth are different sides of the same coin. Hence when you are enjoying rapidly rising asset prices and high valuations in various forms of assets – remember that it is just one side of the balance sheet.

There is inherent circularity in debt cycles and reversals happen at lightning speed.

They say time takes its own revenge. We will see.

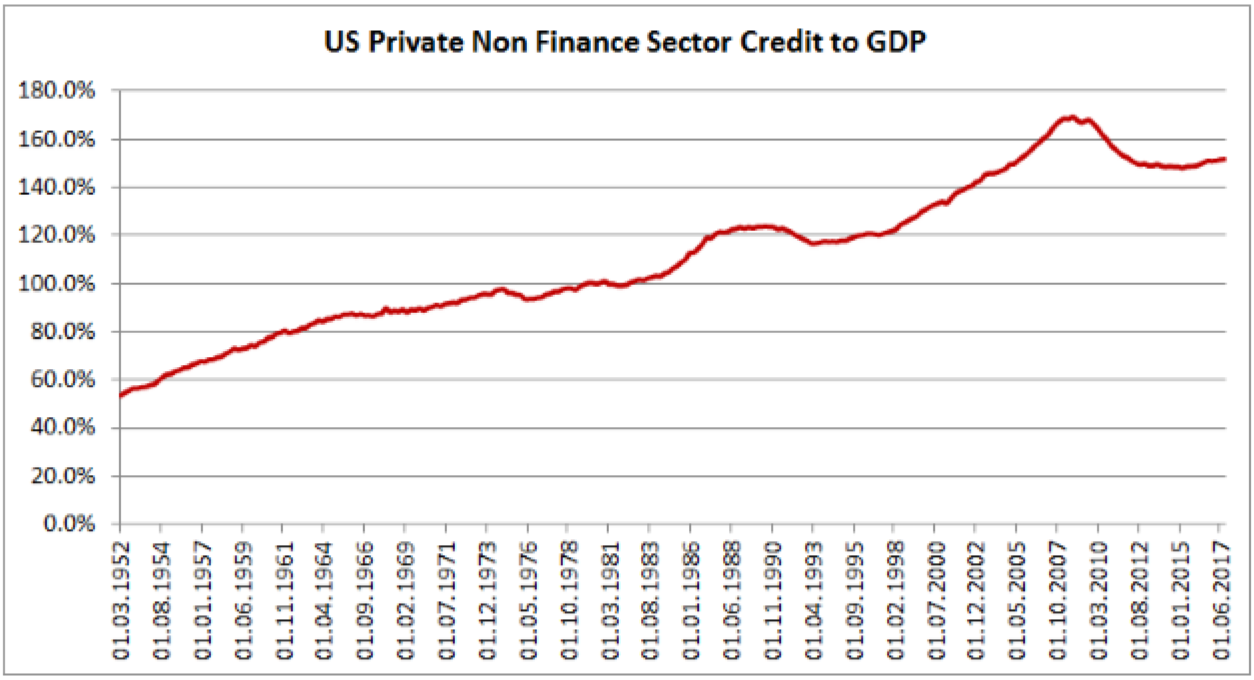


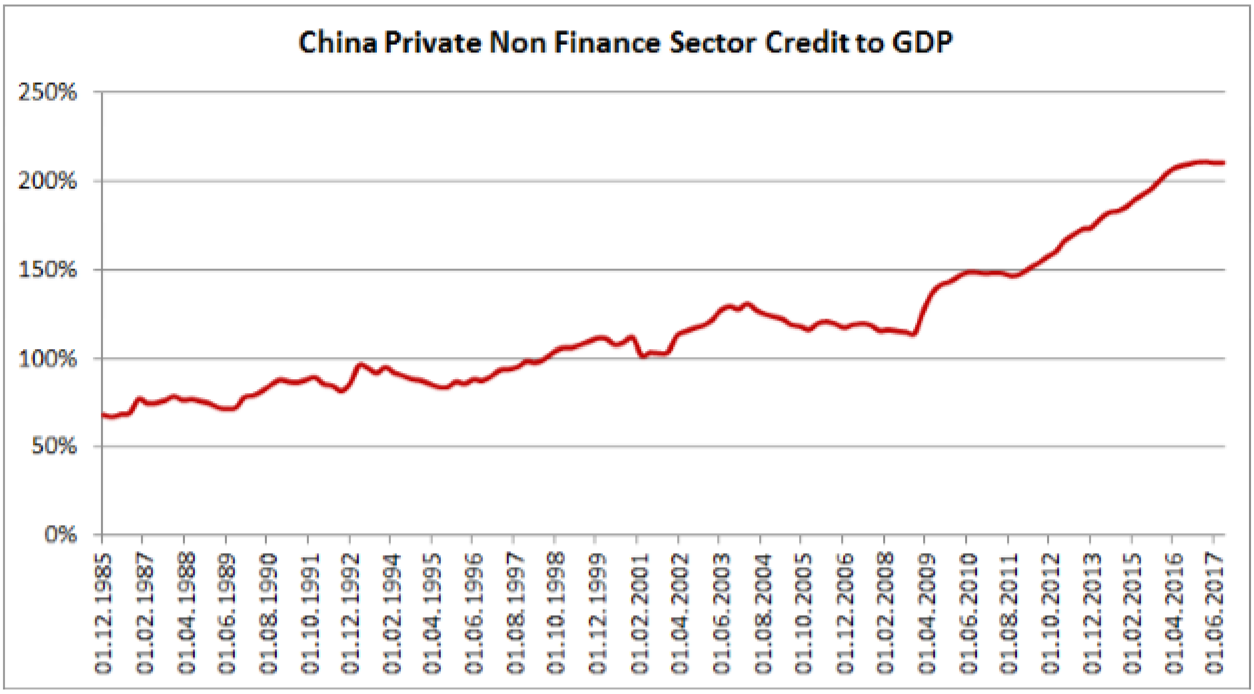


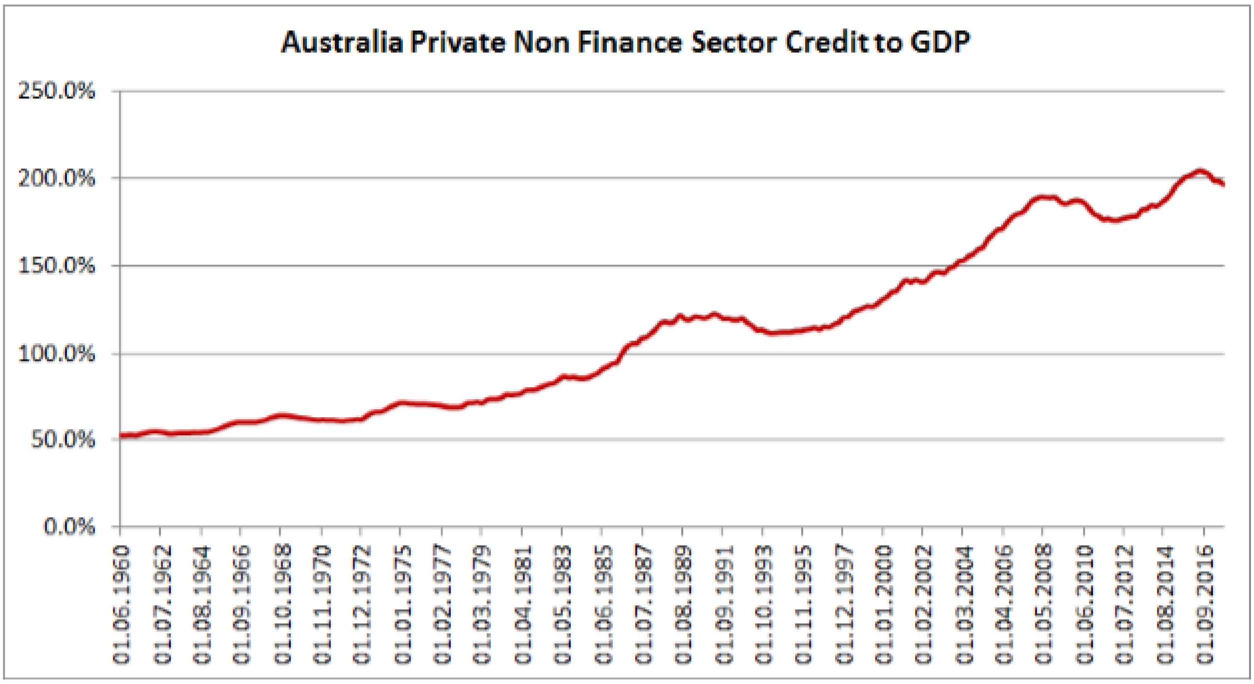



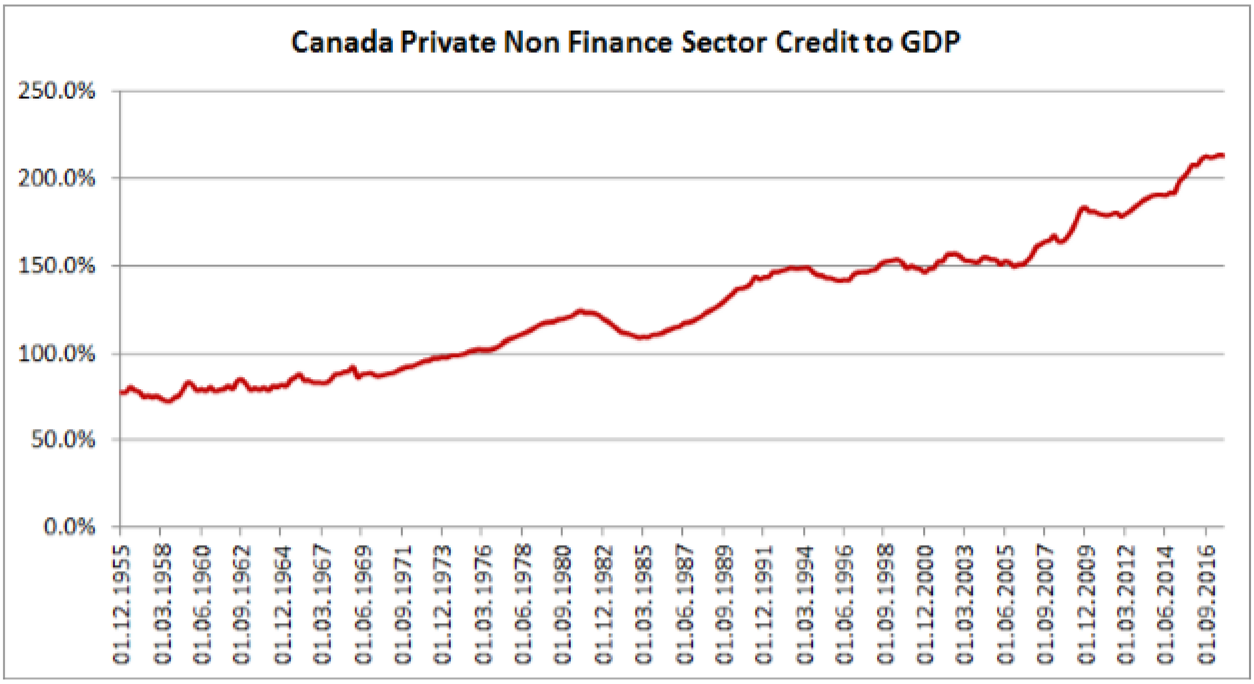

Sources: BIS, OECD.Data through Sep 2017

The charts above portray developments in the government sector level; in the following charts depict non- financial private sectors.

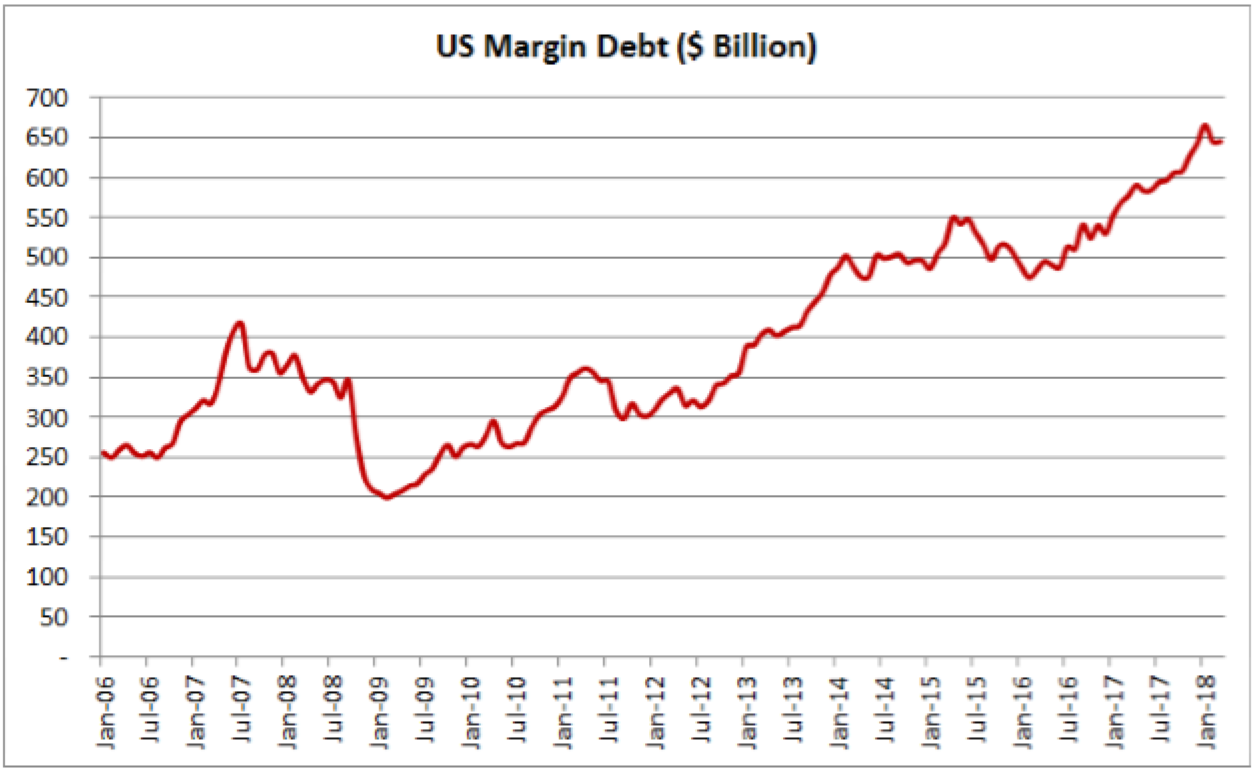

US Private Non Finance Sector Credit to GDP
180.0%
160.0%
140.0%
120.0%
100.0%
80.0%
60.0%
40.0%
20.0%
0.0%
01.03.1952
01.08.1954
01.01.1957
01.06.1959
01.11.1961
01.04.1964
01.09.1966
01.02.1969
01.07.1971
01.12.1973
01.05.1976
01.10.1978
01.03.1981
01.08.1983
01.01.1986
01.06.1988
01.11.1990
01.04.1993
01.09.1995
01.02.1998
01.07.2000
01.12.2002
01.05.2005
01.10.2007
01.03.2010
01.08.2012
01.01.2015
01.06.2017


China Private Non Finance Sector Credit to GDP
250%
200%
150%
100%
50%
0%
01.12.1985
01.02.1987
01.04.1988
01.06.1989
01.08.1990
01.10.1991
01.12.1992
01.02.1994
01.04.1995
01.06.1996
01.08.1997
01.10.1998
01.12.1999
01.02.2001
01.04.2002
01.06.2003
01.08.2004
01.10.2005
01.12.2006
01.02.2008
01.04.2009
01.06.2010
01.08.2011
01.10.2012
01.12.2013
01.02.2015
01.04.2016
01.06.2017




Sources: BIS, OECD.Data through Sep 2017




Sources: FINRA. Data through Mar 2018.

Finally I would like to cite a succinct observation by a well-known investor.

> *"Money is closely connected with credit but the role of credit is less well understood than the role of money. This is not surprising because credit is a reflexive phenomenon. Credit is extended against collateral or some other evidence of credit worthiness and the value of the collateral as well as the measurements of creditworthiness are reflexive in character because credit worthiness is in the eye of the creditor. The value of collateral is influenced by the availability of credit."*
>
> \- George Soros.

You may also like:

Distress & Deep Value Investing: Introduction