
AS 9091


AS 9091

Hypocrisy on Leverage

Financial Leverage is the level of debt a company has. As in a family, if I take too much debt, I run very high risks: in an investment with debt I increase my return on the Invested Capital (in fact Invested Capital is lower, since I am putting in less personal money), but, in case of a crisis, with lower cash flows, I can have difficulty paying back that debt. If I can't make it, I go bust.

After the last few years, the danger of leverage is, obviously, very clear to all.

However, on the leverage following an acquisition, a lot of hypocrisy is evident. An entrepreneur sells his company to a financial investor (for example, a Private Equity Fund). The fund invests partially with their own money, partially taking debt (as stated, to have a higher return, otherwise there is no advantage to making the acquisition, and their investors buy Treasury Bonds). The money goes to the entrepreneur who, typically, remains with a minority stake, and maybe with some operative responsibilities in the company.

If everything goes fine, fine. But, if hard times come, then hypocrisy arises, placing the good (the entrepreneur) on one side, and the bad (investors) on the other.

The largest majority of entrepreneurs who have sold stakes of their companies, decided to do so not only "to reinforce them managerially", "to open the governance to external management", "because my children are not interested", etc., etc., but also to make money.

Rightly, maybe after thirty years of work. And the more money, the better. The fact that the money necessary to pay their stake came from leverage (i.e., putting debt on their company, their "baby"), was pretty clear to them.

Then, when remaining in the company in some managerial role, they start seeing difficulties in repaying the debt, and they start saying, "the company is healthy, it still has a positive EBITDA even in such a crisis…the problem is that THEY have put too much debt on it…", they are absolutely right. Unfortunately, it would be much more honest and elegant to also say to themselves and to their supporters that the debt was mostly taken to pay them. When offers from potential buyers from the industry were not so attractive, who was telling financial advisers to solicit (possibly with a competitive bid) that weird (but more generous) world of financial investors?

P.S. If the company has difficulty paying its debt, the real owners become the lending banks. In your opinion, whom could a bank, seeing difficulties, call to "rescue" the company? Just by chance, the former entrepreneur who is still there, has always been saying that things were going bad, and for small change gets back the company….Bingo!

Giovanni Carlino
(2012)

CARLINO & ASSOCIATI