TALK TO EXPERTS -18

Author

OVERLEVERAGED BALANCESHEET

Next important reason we shall look into, briefly at that since the subject is too vast and complicated to be put in simple language, is what they call overleveraged balance sheet of the developers. Let us try to understand the two important words: balance sheet and leveraged balance sheet. Again, we are not using specific terminologies used in those fields but only trying to explain in a simple way so that the matter will reach an uninformed common man who, in fact, forms the majority and whose contribution by way of tax to the country is significant. A nation owes not only to the billionaires but also to the ordinary breadwinner.

When you use the word 'balance' it naturally suggests more than one element; minimum there must be two to balance. Here the two sides are we can say, the money you have and the money you use for business.

Sometimes, in fact, many more times. the business you want to engage yourself in needs so much money that what you possess as your own money is not enough and so you go in for a loan and you borrow the money you need apart from your own money. The next thing is, the business you do must bring you some more money, returns or profit, than what you have put in; if the business does not bring you such more money, then, it is said the business is running in loss. Normally, there must be a good balance between the money you put in the business and the money you get out of the business. A balance sheet of your company must have these two sides showing your investment, the money you are putting in and the returns, the money you are getting out of the business.

A good balance sheet means that the business is paying much more than you put in , always; and, the excess money you get out of it is increasing, generally speaking, year by year. If you want to raise loan from some financing institutions, say a bank , the loan you get is dependent on the balance sheet. If there is profit in the balance sheet, your company becomes eligible for loan because your profit shows you can pay back your loan. Profit indicates the definite possibility of repayment.

Now, let us move on to the word 'leveraged'. Let us see what is leverage and how it works. First of all, leverage is used in investment. You can use a lever with force for greater advantage. What you normally cannot move with all you strength, you do it with a lever. In other words, it means, ultimately, to use something to gain maximum advantage. In our context, you borrow money and invest in business so that your profit will be more. This is leveraged investment. When you borrow money, you have to pay interest for the loan; and, the profit you get out of that portion of the leveraged investment must be more than the interest you pay for the loan. In such cases, the leverage investment is proper and productive. On the other hand, you put in the business more of leveraged investment and less of your own money, then, the profit becomes less because you have to pay more interest for the loan. If the business is run in favourable circumstances and you get profit means, you will have some money for you even after paying off the interest for the leveraged investment. But, if the business is not in favourable situation any more and your business ends up in loss means you will have no money left for you after paying off the interest; simply, you will be losing your own money. In this context, your leveraged investment becomes over-leveraged.

We have seen the significance of the two words and in our next session, we shall consider how this overleveraged balance sheet affects project.