Hang onto your cash

IN HIS ACT WINTER PAPER, PETER HICKSON (PICTURED) BROUGHT A FASCINATING SLANT TO THE QUESTION OF HOW TO FIND THE OPTIMUM CAPITAL STRUCTURE, AS **PETER WILLIAMS** EXPLAINS.

Executive summary

- For over 30 years, Peter Hickson has been a professional finance manager – or, as a headhunter once put it, an executive mercenary – dealing with a host of issues from the corporate coalface. In a highly entertaining, thought-provoking and provocative ACT Winter Paper, sponsored by Barclays Capital, Hickson shared his corporate experience to answer the question, optimum capital structure – fact or fiction?

In financing its balance sheet, the board of a public company has to deal with many parties – shareholders, lenders, management and customers – all of whom have their own objectives. Sometimes those needs are aligned. More often they are not.

Introducing his career at the ACT Winter Paper, Peter Hickson said: "Over the years I have worked as Finance Director of a number of companies, both private and public. I have been involved in many different industries ranging from construction to defence, from television to money-broking, taking a brief glance at a zoo and fine china on the way. I have experienced public and private companies, FTSE and AIM. Most of them were international, so I've been round the world a few times. I've been taken over three times and bought more than a hundred companies."

Towards the end of his career, Hickson claimed he "became respectable" when he unexpectedly became Finance Director of Powergen, which was at the time number 50 in the FTSE. He said: "Not until I left Powergen to become Non-Executive Chairman of AWG did I move away from finance. And that was not for long because, ironically, I was forced to become my own finance director within months."

Hickson took the audience back to 1970, the year he qualified as an accountant. "Things were different then. I had been a trainee accountant, known as an articled clerk at that time. Articles themselves were a mystery, the mystery being that as trainees we got no training! We didn't have calculators, let alone computers or email. You booked long-distance phone calls, and if you went overseas you depended on the telex machine clattering out your messages. When we wrote our budgets, they stopped at operating profit. Inflation and cashflow was ignored while the balance sheet was purely the way of summarising the result."

A NOVELTY – CASHFLOW STATEMENTS That was all to change in the 1970s, the time when Hickson left the profession to join Pearson as chief accountant of one of its growing manufacturing divisions. 1974 was when the crunch came. It was the year in which NatWest had to make a public statement that it was not bust; inflation was 20% and interest rates close to 15%. Pearsons recorded massive stock profits each quarter but at the same time, said Hickson, it was running out of cash.

"We had drawn up our budgets and submitted them to our parent company. For the first time they had insisted on cashflow statements, a novelty which of course we strongly resisted! To our surprise our budgets were rejected.

"We were even more surprised to receive a visit from Pearson's finance director, a very grand and noble gentleman. He came to tell us that our budgets were not acceptable, all capital expenditure had to be cancelled, we had to reduce our debt and pay our profits up as a dividend. 'Surely not all capital expenditure?' we said. 'Oh yes,' he said.

"All capital expenditure was cancelled until further notice. High inflation and high interest rates had created the problem; shaky bank

liquidity exacerbated it. For the first time, it was brought home to us all how important cashflow and balance sheet were to a company. We had seen the secondary bank crisis and the launch of the Bank of England lifeboat and now we were directly affected. It may seem obvious now in a benign period of low inflation and interest, but then was not a time to have too much debt."

After Pearson, Hickson had a spell in the construction industry. He moved to the defence sector where one task was to find some cash in double-quick time over Christmas for a US subsidiary whose bank went bust – but not before recalling all its loans. After tangling with the US banking industry he worked in media and moneybroking for a company which needed to merge to gain some balance sheet strength to compete. After that merger, Hickson joined Powergen.

THE QUEST FOR THE EFFICIENT BALANCE SHEET Hickson recalled: "Powergen was a great success story and had grown steadily since privatisation. When I joined Powergen, it enjoyed a balance sheet stacked full of assets and cash. Cashflow from electricity generation was predictable and we could finance our expansion whether it was overseas, in the North Sea or at home. It looked a pretty good balance sheet to me, so you can imagine my surprise to be asked at an analysts' meeting what I proposed to do to improve its efficiency! I was unaware that the balance sheet was inefficient, and, as a financial child of the 1970s, I was enjoying being in charge of substantial net worth generating lots of cashflow with very little debt. I thought we were pretty efficient. 'No,' the analysts said, 'you must increase your debt, hand large amounts of capital back to the shareholders and then you will be efficient.' Our brokers agreed. It would enhance our earnings – which it did a bit – and increase our share price – which it didn't."

The theory was that the shareholders would remember the cash given back to them and would therefore be willing to support future rights issues when more equity was required. And as Hickson wryly suggested it meant the company had an efficient balance sheet. So Powergen embarked on a £2bn buyback programme.

However the theory did not work out. Three years later when the company wanted to make a major US acquisition priced at $5bn it needed cash to complete the deal. Hickson said: "Because of my balance sheet efficiency, of course, I was short of cash as we had acquired East Midlands Electricity the year before. It was the height of the dotcom boom; our share price had dropped to half the buyback level, and we had tumbled out of the FTSE.

"None of our shareholders wanted to buy equity in an old industry, so we had to do it with debt. Our gearing rose towards 100% and, presumably, our balance sheet became efficient as a result. It didn't look that way to me. I found I no longer had financial capacity for further strategic moves, either here or in the US. Shareholder equity seemed now a thing of the past.

"If only I had kept my £2bn, I would have been so much more in control. We could have continued our growth in the US, we could have developed our international side and expanded in Europe. Instead, this weakening of the balance sheet probably led to the sale of Powergen to E.on, a company who could scoop us up for cash, presumably because of the inefficiency of its balance sheet!"

In the end, said Hickson, it all worked out OK in the sense that the Powergen shareholders received a good price and E.on acquired a good company. However lingering doubts remain.

"What was lost, and this may not matter, was the ability for the Powergen board to control its own destiny and deliver better long-term value to our shareholders. Our balance sheet was simply no longer strong enough to compete with our large European rivals. We ran out of strategic options and, as our chairman used to say, we became a part of someone else's strategy."

The takeover worked out for Hickson as well. He left finance to take on a part-time retirement job as non-executive chairman of AWG, one of the five big privatised water companies. The idea was the job would take 1½ days a week. As a traditional water company, AWG was UK-focused, had four million captive customers, no competition and a predictable cashflow.

But in the second half of the 1990s – prior to Hickson's arrival – AWG changed its strategy and began to invest across the globe in New Zealand, Chile, Thailand, Australia, Norway, Vietnam, the Philippines and Czechoslovakia and China where the company was building a water treatment plant in time for the Beijing Olympics, four times the size of anything AWG had built before. Hickson said: "Unfortunately, it was not easy and AWG rarely made any money from these ventures."

The company had also purchased construction company Morrison, and various development businesses for £250m although it eventually wrote off £100m. According to Hickson, the focus on acquisition and the non-regulated aspect of the business meant that the importance of Anglian Water to the group was downgraded, although in 2002 the division provided 120% (sic) of the group's operating profit.

“NOBODY FORESAW THE DOTCOM BOOM. SO WE WERE BACK-TO-FRONT WHEN WE NEEDED FINANCE – TOO MUCH DEBT AND TOO LOW A SHARE PRICE.”

By the time of Hickson’s arrival, the share price was falling. “The board tried to split the businesses but that was impossible. So they decided to refinance the water company, ringfence it and leave it to operate on its own independent of the AWG board.

“This meant a £3.5bn refinancing of the water company which was completed in the middle of 2002. The company was ringfenced from the parent, a whole range of new governance and restrictions were introduced, and the whole event was announced to the shareholders with a £50m return of capital. The shareholders liked the cash – but not that AWG had spent £140m in bank fees. The share price went into freefall.”

It was at that stage that Hickson became chairman. Speaking to the shareholders it was clear to him that they had lost confidence in the company, its diversification strategy and were worried by the losses and the debt. But the company was still generating cash through “the good old water company”.

Hickson’s arrival coincided with interest from private equity raiders. German firm WestLB offered £5.20 a share. Hickson was convinced the offer was too low. In a shake-up of the company and management, Hickson became acting chief executive officer and persuaded the shareholders to stay with them, partly through a payment to shareholders of £200m.

By the end of 2003 the company had a new management team – a new CEO arrived early in 2004, rapidly followed by a new finance director – and the company had disposed of most of its overseas interests. The question for Hickson now was how to persuade the shareholders that this was a good business to invest in?

“The answer, of course, was in the water company. We were a utility; we had a cashflow; we were an income business. Our yield was then over 10% and that was the attraction. There was no danger that we were going to cut the dividend; in fact, we knew we could grow it in line with inflation. So that’s what we said. We publicly promised to deliver inflation-proofed dividends and our growth investors turned into income investors. With a committed yield, the share price at last began to move beyond the private equity ranges. We promised we would return more capital from further disposals. With low interest rates and falling bond yields, we became an attraction for the income investor. It reflected what the new management team were doing – eliminating loss-makers, improving core profitability, removing exceptional costs, and derisking the business. We were reducing the gearing and focusing on cash extraction. The share price continued up and beyond the private equity guys.”

But as the private equity disappeared, so the infrastructure funds arrived. “We had seen off four private equity bids in the first year, partly because they had failed to bid the right amount, but mainly because we persuaded the shareholders to stay. However, we knew that large infrastructure funds, mainly from overseas, were becoming interested in companies like ours. They wanted more than our dividend yield, they wanted the whole cashflow. And with long-term liabilities – pensions – they wanted long-term assets. Their return requirements were lower, so they could pay a high price. We had seen them pursuing other infrastructure assets such as BAA, ABP and lining up to bid for Thames Water. So it was only a matter of time. And sure enough in September last year they arrived and offered to buy AWG for just under £16 a share. We no longer had anything left for our shareholders except the price – over three times the WestLB offer. Nobody else could compete and the deal closed just before Christmas. It was the end of AWG as a public company but we had used our cashflow to get the best price we could.”

OPTIMUM CAPITAL STRUCTURE – FACT OR FICTION? Hickson’s stories tell a number of things. First, different issues determine the structure. Shareholders, lenders, management and the board should all be aligned, but that does not always happen. But underneath it all, it’s the cash you need – that’s what matters.

At Pearson it was a question of reducing the debt and surviving. Many didn’t. In the US defence company it was a question of finding some cash and another bank.

Hickson said: “Powergen was more complicated. We had a politically correct structure which satisfied shareholder greed. But nobody foresaw the dotcom boom. So we were back-to-front when we needed finance – too much debt and too low a share price.

“And then AWG – in some ways the perfect structure, a subsidiary which couldn’t stop generating cash. It kept us alive when we were nearly under. And it drove the share price. It worked for us.

“And now the infrastructure guys have arrived. AWG is now 85%-geared and the equity has been financed 80% by debt. Is it optimum? Well, it will depend on the cashflow – and events. Because in the end, it is events, not plans, which shape crises and disaster. In the 1970s it was high inflation and interest rates. The late 1980s brought us recession. The 1990s ended with the dotcom boom. What will this decade bring? Whatever it is, my message is keep control of your cash. That’s the only sure-fire structure which keeps you going. It has lots of uses, but without it events will control you, not the other way around.”

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