The case for gearing up

Bill Robinson of PwC examines what levels of gearing companies should be aiming to achieve and how to calculate the right level.

How much debt can we take on? This is a question most of us occasionally ask ourselves in a private capacity – how big a mortgage can we safely afford? The question becomes urgent when we move house, and we may consider it when interest rates rise or fall, or when the tax treatment of borrowing changes. But most of the time we just accept the debt we have without thinking too hard whether or not it is optimal.

The same is true of companies. Treasurers know that in theory they can save tax and create shareholder value by taking on more debt. They also know that more debt means more risk, which will push up the cost of capital and offset the tax savings. So there is an optimum level of debt which they should be actively seeking, in order to maximise shareholder value. But in practice, most companies only scrutinise their debt to value ratio when they are doing a deal.

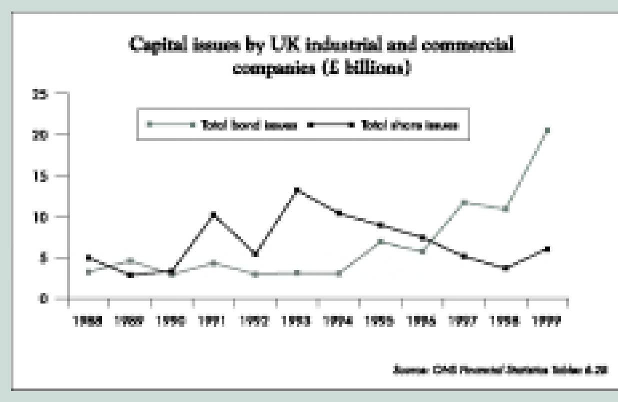
Active management

However, deals should not be the only trigger. Companies can make a lot of money by more active management of their balance sheet. In any market you need to reconsider your strategy when key parameters change. If the cost of debt falls, or if the tax treatment of equity worsens, then the optimum level of debt will change. Both have happened in the UK recently. As a result, many companies today have too little debt.

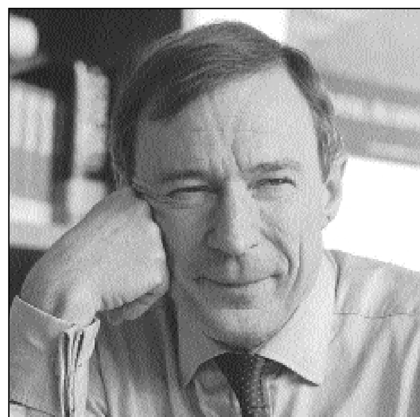
The cost of being under-geared should not be underestimated. Every pound of debt saves tax with a net present value of 30 pence. If the re-structuring is properly presented, that saving should be reflected on the share price. A company that increases its debt to value ratio by 10 percentage points (eg from 20 to 30 per cent) could increase its share price by three per cent. That represents a third of the growth that shareholders expect in a year, a free gift from the taxman.

If it's such a good idea, why haven't companies already done this? The answer is that the smarter companies are already acting. Since the mid-1990s there has been a major shift from equity to bond finance in the UK, as *Figure 1* shows. Two thirds of new capital issues used to be equities. Now it is more than two thirds bonds. Corporate bond issues in the UK more than doubled last year, from £10bn to £20bn.

FIGURE 1



What is driving this exponential growth? Obviously the take-over boom is part of the story. But there are other powerful drivers. When Gordon Brown abolished the 20 per cent refundable tax credit on dividends paid to pension funds, he massively increased the tax charge on distributions. They now bear the full brunt of corporation tax, which interest payments on bonds escape. Pension funds looking for income prefer to hold bonds.



Bill Robinson

Another key driver is the sharp fall in government borrowing around the world. Governments are issuing fewer bonds. Pension funds still need to buy them, to provide income for a growing retired population. So corporates are operating in a sellers' market. Long bonds can today be issued very cheaply by the standards of the past quarter century.

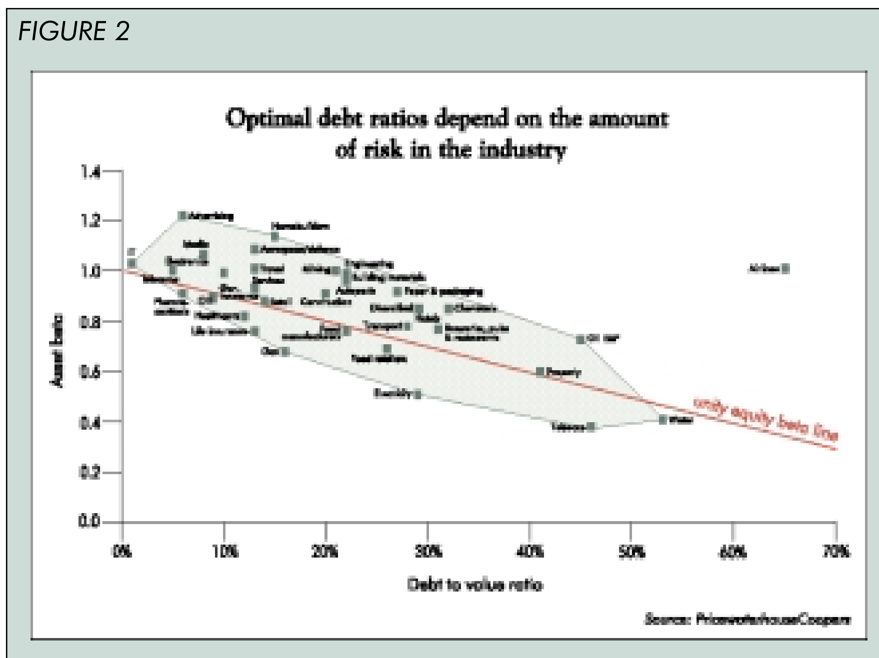
Of course gearing up is not right for every company. There are huge differences between sectors. In the so-called New Economy, where investors are still queuing up to buy stock, issuing equities is obviously a better bet than issuing bonds. But in the Old Economy, where share prices have slumped and dividend yields soared, the attractions of bond finance have never been so great.

Once the case is made

Suppose then you are persuaded that there is a case for increasing your company's gearing. There are two immediate questions: how much do you borrow? And, what do you do with the money?

The answer to the second question clearly depends on your business strategy. If you face plenty of growth opportunities, then the Board can simply lower the hurdle rate for new projects, so

FIGURE 2



more go ahead. You tell the market that you are gearing up to expand the business, and your higher gearing will itself be a signal of confidence. Young companies tend to be largely equity financed (especially internet start-ups). But in the more mature companies, debt is definitely a sign of dynamism.

What if your business is profitable but not growing? A share buy-back is the obvious option. It sends a signal that you value your equity more highly than the market does. If you play your hand well you can end up with an increase in the share price that is greater than the tax savings.

Borrowing levels

So how much should you borrow? The average debt to value ratio in the UK is well under 30 per cent – for more than half of the FTSE 350 it is under 20 per cent. But some major industries – water, property, tobacco, oil, airlines – have much higher debt ratios. What drives these differences?

The main driver is the volatility of future earnings, and the extent to which they depend on the economic cycle. Debt payments are fixed, and no company likes to run the risk that a cyclical dip in earnings will leave interest cover dangerously low. So an industry with a safe earnings stream can afford higher gearing. The amount of water, or tobacco, that people consume hardly varies across the economic cycle, which is why these industries are relatively highly geared.

This basic truth can be used to construct a risk map of British industry. If we plot gearing against a measure of macro-economic risk, we find that industries cluster broadly round a downward sloping line as shown in *Figure 2*. This tells us that firms in industries which are inherently non-risky tend to gear themselves up to the point where they are as risky as the average for UK industry as a whole. A firm or industry which is exactly on the downward-sloping line has the gearing level which would give the firm an equity beta of unity, equivalent to the market average. Any company which is below and to the left of the line can probably afford to gear up – especially if it is below and to the left of the average for its industry.

Placing a company on this risk map is the first step in establishing the feasibility of higher gearing. The second step is to look at the likely effect on the cost of borrowing of taking on more debt. This is an issue which tends to be shrouded in mystery, but there is a great deal of data in the market which can shed light on the mystery. By looking at the borrowing costs and gearing levels of similar companies we can make reasonable inferences about the likely effect of a higher debt burden on the creditworthiness of the company in question.

Once we have a plausible estimate of the effect of higher gearing on borrowing costs, we have a quantifiable trade off. As the company gears up, the tax savings increase steadily, whereas the borrowing costs increase slowly at first and then more rapidly. There are standard models which, given these parameters, will calculate the optimum level of borrowing.

The end of the beginning

But this isn't the end of the story, only the end of the beginning. No company would choose a level of gearing on the basis of a half-understood calculation that drops out of a model. In the real world the company has to be robust, at the chosen level of gearing, in a range of business scenarios. Will the company survive to enjoy its tax gains at the higher level of gearing if consumer spending turns down, or inflation takes off, or interest rates are raised, or a new low-cost competitor starts eating into market share? These are the sort of questions that any Board will ask. They can only be answered by doing some intelligent modelling of company earnings over a number of years and a range of alternative scenarios.

And, if you think about it, those are also the sorts of question that each of us might ask ourselves when we contemplate gearing up to buy a bigger house. By and large, the younger we are, the more we are disposed to tolerate a large debt-to-income ratio. This is partly because we assume that our income will grow, and partly because we are prepared to tighten our belts if things go wrong. Companies that take on additional borrowing send out similar signals of youthful dynamism.

The difference between companies and individuals is that owner-occupiers no longer get a tax break on their interest charges. By contrast the corporate tax system today offers a greater tax break for debt that is greater, relative to equity, than it has been for many years. This is a good time to gear up for growth. ■

Bill Robinson is head UK Business Economist at PricewaterhouseCoopers and a former Special Adviser to the Chancellor of the Exchequer.

This article is drawn from the recent PwC Bulletin and Report 'A good moment to re-structure the balance sheet?' Copies available from dr.bill.robinson@uk.pwcglobal.com, or ring 0207 213 5437.