PARENTAL RESPONSIBILITY

Financing subsidiaries can be a complicated business. Will Spinney explains

Most 'corporates' are made up of a myriad of limited companies. There is usually a 'top' holding company and then many subsidiaries. This applies whatever the ownership structure, so that quoted companies have a 'plc' at the top (or international equivalent) and private companies will have a parent. Some US companies do trade in the name of the quoted parent, but when it comes to overseas investments there is almost always a web of limited companies incorporated overseas, often with country-specific holding companies. The structure chart of some groups built up by acquisition can be bewildering.

In the same way that the overall group will have a debt/equity mix, so each subsidiary will also have a mix, and as the subsidiary makes investment and trades, it will have a cash flow that must be either funded or, at some stage, extracted. So for each subsidiary there is an initial financing decision and then a method must be found to manage day-to-day funding.

Figure 1 (below) shows some of the alternatives available. The parent (from the sources of external equity, retained profits and bank or other debt) can subscribe both equity and/or debt to finance the subsidiary. It could also persuade a bank (or other lender) to lend directly to the subsidiary.

Perhaps an ideal structure from the treasurer's point of view would be to have a very small equity base for the subsidiary and then lend the rest of the funds needed. Any cash generation could then be sent back to the parent as a repayment of this. Had the investment been all equity, then an upstream loan or dividend would be needed, which tend to be more difficult.

This is where the complications arise. The first is tax. A loan to the subsidiary will get a deduction of the interest for tax, but many countries limit this (through thin capitalisation rules). Equally, dividends might not fare well for tax (because of withholding tax, for example). The second complication is around exchange controls. Many countries exercise controls over capital and might be happy to see money coming into the country, but less than happy to see it leave, as repayment of either equity and debt or dividends and interest. All these factors need to be borne in mind and a balanced view taken as to the best approach. This is why treasury and tax are so very close in many companies. There is often a constant juggling of internal capital and dividends and loans.

Local bank debt seems ideal here as part of the solution, since there is usually no problem repaying that as a use of the cash flow. The bank may be less than happy with the credit of the subsidiary, however, and so it either charges a very high interest rate or asks for parental support, which may negate some of the benefits.

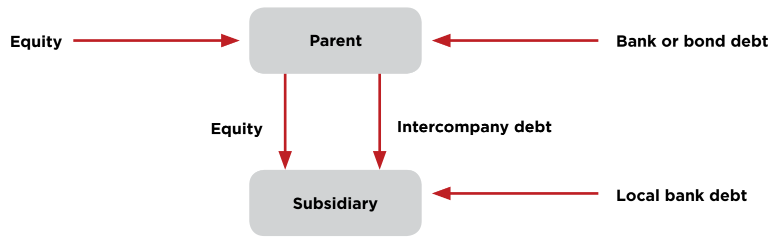
It is quite possible to replicate the leverage techniques used at group level to improve return on equity, but at a subsidiary level. In that case, the local bank debt would be 'without recourse' to the parent and a high leverage approach could be adopted. Tata Group is a classic example of this in practice, with its UK investments in Jaguar Land Rover and Tetley. It uses local finance to gear up the risk and improve equity returns to the parent. This isn't suitable for all businesses and all regions, however.

The next challenge for a treasurer is to fund the business on a day-to-day basis. This is where the cash management techniques of pooling or cash concentration come into their own. The cash is moved in the right direction either physically (concentration) or notionally (notional pooling), but economically there are intercompany loans happening to support this. So the conditions must be right and this usually means that these arrangements work best in westernised countries, where loans between parent and subsidiary are easy to make and repay.

Where regulations make such intercompany funding less easy, there is a tendency for there to be more local debt finance and a higher proportion of equity funding. A different approach may exist for each region or country and this makes for a busy life for the treasurer of a multinational.

We have generally been discussing a situation where the subsidiary is owned 100%. In all other cases, the situation is more complicated still.

Figure 1
Financing a subsidiary



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