GAMES PEOPLE PLAY

THERE WAS A TIME WHEN WE WERE ALL A LOT CLEARER ABOUT WHAT WE WERE GETTING INTO BUT TODAY MARKETS, THERE ARE VERY FEW ABSOLUTES, SAYS ARTHUR BURGESS.

It lies very deeply within the human consciousness to categorise things in a binomial fashion. Most of us realise it to be too facile, but we persist in the division of the world into the 'one of us' and the 'not one of us' camps.

It is therefore natural to classify finance into the 'equity account' and the 'debt account'. In the case of a sole trader or even a small company it is probable that these will completely cover the population of finance sources encountered over the course of a business life. Yet, even in such elementary environments, it is possible to identify differences in the nature of components of each group of entries.

It is therefore worth considering in a broader context the nature of the subject we are trying to tackle. Maybe we should regard it as being the side of the balance sheet nearer the window. That seems too broad, so we will concentrate on the primary sources of capital funding for companies from the plain vanilla ordinary share, through the spectrum of equity hybrids and structured debt, to the plain vanilla medium-term bank loan. Even that may be too ambitious. The exam question 'Discuss World War Two, its causes and consequences – use both sides of the page if necessary' springs unbidden to mind.

Nevertheless, even if the topics can be touched on only in a superficial manner, it would seem to be a useful exercise to review the properties and behaviour of the various forms of funding, and to realise that in today's market there are very few absolutes. Many of the funding opportunities have both debt and equity properties, and most instruments can be disaggregated into basic building blocks by using derivatives – many of which can then be priced independently. By performing this exercise carefully you become aware of the possible pitfalls and can assess the key elements of added value.

As a treasurer, it is always right to ask how the latest bijou gewgaw offered by your friendly banker adds value. That added value can only come from existing stakeholders, or from the new stakeholders you hope to bring in. Are they being treated in a manner which you will be able to defend comfortably in future meetings with debt or equity holders? Intuitively, you know where a slug of the value will go – into the banker's fees – so when all the evaluation is done, you must also ask yourself if that is a fair remuneration for the inventiveness or industry contributed by your financial adviser.

EQUITY: PURE AND SIMPLE. In theory (well, in origin at any rate) equity is the money put into the company at the outset by the owners. Equity is what gives the proprietors the right to decide what should be the nature of the business – is it going to be a shop or a trader or a manufacturer, or what? Small businesses dominated by a family, or another small cohesive group, work just like that. But a company with a widespread group of small shareholders who have not organised themselves into a clique does not works in a very different way – direction is set by management, who may or may not themselves be shareholders.

But, in the modern world of finance, shareholders, especially

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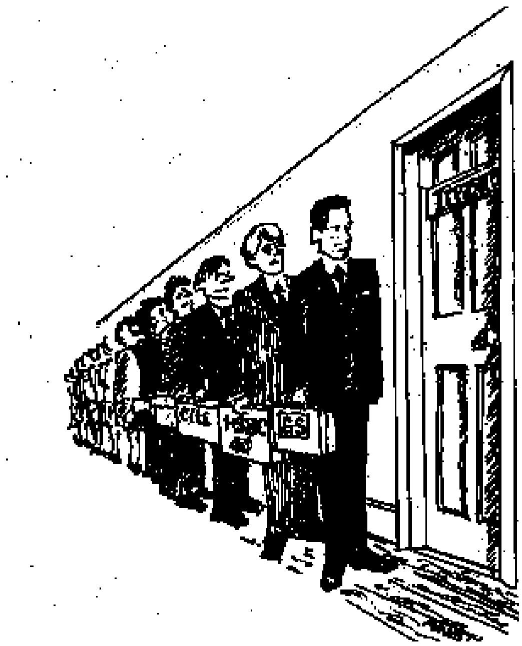

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shareholders of big companies, are not disparate – the pension funds and the insurance companies – a clique with about as much independence as a flock of sheep or a herd of lemmings (is it a herd?). Very large sheep, huge lemmings. Creatures capable of moving funds the size of a medium-sized modern state, managing portfolios representing a substantial percentage of the total value of the stock market. Driven by the twin sheepdogs of the equity analyst and the media pundit (neither of which has ever managed a whelk stall) big shareholders move as a group to lionise or to despise management teams of a particular company or sector. Managers of industrial companies consequently attempting to be loved by essentially faithless shareholders fruitlessly chase objectives quite inimical to the long-term wellbeing of their businesses.

The result is wild fluctuations in share prices often bearing little relationship to their underlying true worth. Indeed, it would be little exaggeration to liken share valuation to the decisions by the clothing industry as to which fashions are 'in' and which are 'out': should skirts be long or short, should men's jackets have three or four buttons. Thus the nature of equity, perceived by accounting and finance textbooks to be the stable long-term funding base of a company's balance sheet, has, for our largest firms, changed. It is no longer pure – it has become the sexy end of the finance spectrum – no longer simple – rather it is a complicated branch of psychology.

DEBT: THE BANKS' SUPPORT FOR BUSINESS. When the world was young, debt fell essentially into two general groups, categorised by maturity. Long-term debt in the form of debentures or mortgages were often secured on particular assets – a building or a machine – and had many of the same characteristics as equity. In particular, lenders were committed to the company and were likely to share in the pain of withdrawing their support. Holders of debentures tended to be holders for life, putting them in the safe until near maturity.

Short-term debt came from the company's friendly bank, and local bank managers knew, and held to account, the managers of the company. In their turn, bank managers were required by their area or headquarters to explain their lending – especially if it appeared to be going wrong.

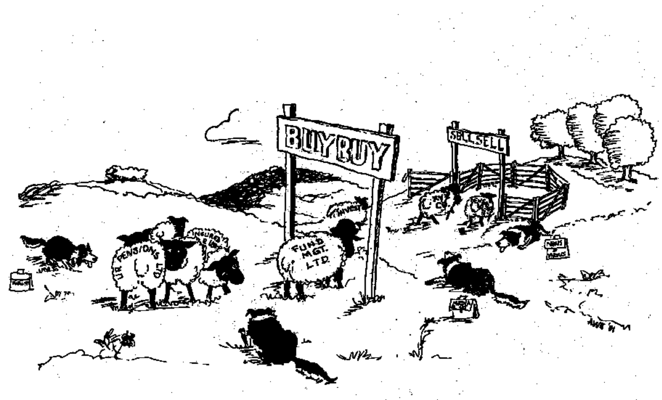
However, the development of secondary markets for debt, together with the removal of the intimate relationship between a company and its bank, especially the removal to quite a significant extent of a local banker's discretion, has resulted in a breakdown of this cosy arrangement.

THE BOND AND COMMERCIAL PAPER MARKETS. The development of the eurobond and commercial paper (CP) markets over the past few decades made the old-fashioned debenture and the bank loan less common. For most larger companies the old style of bank funding had become unattractive for the company and the bank. CP gave greater flexibility and massive size. The bond markets provided flexibility in terms of price, maturity and structure that the debenture market, dominated by a small group of insurance funds, would not match.

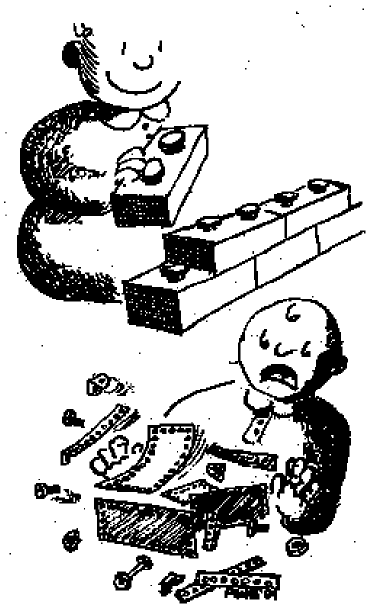
The possibilities of the new sources are endless, and the ability to divorce currency, maturity and coupon decisions from the issuance decision by subsequent management in the swaps market means that opportunities can be taken when available and tailored afterwards.

THE DREADED D-WORD. As if the disappearance of the loyal shareholder and the faithful banker were not enough, across the horizon came a new financial animal. Indeed, it turned out to be not just one type of beast but a whole herd which gradually infected and altered the behaviour of all previously known types of finance. The derivative came to stay.

In this new world, we encountered the financial engineer who could break down any one type of instrument into a few basic building blocks and reassemble them into what appeared to be new instruments. It was as though the world used to be made of Lego



'IN THE MODERN WORLD OF FINANCE, SHAREHOLDERS ARE A CLIQUE WITH ABOUT AS MUCH INDEPENDENCE AS A FLOCK OF SHEEP OR A HERD OF LEMMINGS'



'IN THIS NEW WORLD, THE FINANCIAL ENGINEER BREAKS DOWN ANY ONE TYPE OF INSTRUMENT INTO A FEW BASIC BUILDING BLOCKS'

blocks – solid and reassuring, clipping together into recognisable houses and kits – and suddenly each Lego block became, on closer inspection, a tiny Meccano set which could be unscrewed into sub-elements – plates, bars, screws and nuts. These sub-elements could then be rebuilt into something quite different. Worse was to come – markets developed in each sub-element.

Thus, in today's environment, a company could think it has a loan from ABC bank, but that loan could be sold in the secondary market to DEF bank. DEF could separate the credit element from the underlying loan and sell your credit derivative to GHI bank, while passing the financing element to JKL bank.

Who knows where it could all end? You borrow in Japanese yen to meet a need for Australian dollars. You borrow for 10 years to finance a project needing 20-year money, you use a zero coupon to take advantage of investor demand and on it goes. A company may have shares which form the underlying asset in a covered option play by a bank which has little to do with the company's financing. Convertible shares may be disaggregated into their elements and the new securities traded separately.

The result of all these shenanigans is that the behaviour of your securities is determined by the activities of traders who are not direct stakeholders in the manner of simpler times. Pundits pronounce on the outlook for your market sector, or on the general economy, and your share price, debt rating or acceptability to the market may yo-yo beyond your control. New categories of financial risk arise because every company is pressed to be super-efficient, to eliminate slack and so on. To help in meeting these pressures, better financing methods are offered.

The flexibility described above has also enhanced the ability of banks to design 'new products' to give companies the capacity of exploiting market anomalies and to benefit from better pricing, while the banker also enhanced his returns by charging (quite legitimately) for his inventiveness. Of course, on occasion it was not unknown for the bank to retain the lion's share of the financing gain – but if a treasurer is that gullible...

Unfortunately, the opinion formers in the financial world have also locked onto the question of returns. Management teams are pressed to reinvent their companies – to have higher or lower gearing, to have fewer or more product lines, to acquire or to dispose and to become 'leaner and meaner'.

The result is that financial activity exchanging debt for equity, or more commonly the reverse, has become a pass-time for people who, in earlier times, would have known better. Managers who knew their businesses rather than financial smoke and mirrors would have said "We make widgets – the money comes later". Maybe they were also wrong, but their view of the bigger picture of the objectives was less confused. As a result investors in their securities tended to know what they were buying. Now, who knows?

DEBT OR EQUITY OR DETY OR EQUIBT? No longer is it sensible to think in the old terminology. When additional finance is required, the treasurer with his key investment banking advisers must consider a whole spectrum from pure new equity to a pure loan. How does the balance sheet best respond to any particular combination? Would a loan with a right to convert into equity at some future date be better? Would it be better to have an option to buy out this right? What maturity is desirable? Should this too be flexible? What about currency? What about coupon?

And it doesn't stop there – remember that just as nature abhors a vacuum, so financial institutions abhor stability. Earnings for banks and dealers derive from activity, so if the company is sitting complacently thinking that its balance sheet is about right, it is the duty of the City to throw doubt into the collective consciousness. "If it ain't broke, don't mend it!" has become "If it ain't broke, break it!" (*Sotto voce* "And then we can help you mend it!"). So roll on the morality play:

Bank:	Your gearing is too low – you haven't enough debt.
Company:	But we don't need any more finance.
Bank:	You must have too much equity – buy some back. We can help you with that.
Company:	But we don't have enough liquid funds.
Bank:	You have lots of borrowing capacity. We can help you with that.
Company:	Who gains?
Bank:	The shareholders – debt is cheaper.
Company:	OK then.

Later

Bank:	Your company is too complicated – shareholders don't like it.
Company:	Perhaps we should demerge part of the business.
Bank:	We can help you with that.
Company:	Now we're vulnerable to the business cycle.
Bank:	You need a complementary business stream.
Company:	Maybe we could acquire another business.
Bank:	We can help you with that.

Later still

Bank:	Now you have too much debt, your gearing is too high.
Company:	But, but, but...

Exeunt omnes with echoes of "There's a hole in my bucket, dear Liza, dear Liza..." ringing in their ears.

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