Building the perfect balance sheet

Academics worry about the optimal balance street structure and a company's weighted average cost of capital (WACC). Whether such worries extend beyond the campus to the treasurer's office it is hard to ascertain.

The theory is simple enough: if an organisation can find its optimal balance sheet structure then it can maximise its returns to shareholders, (see *Box 1*). In the long term for shareholders, finding the optimal balance between debt and equity will far outweigh the benefits of chasing an extra five basis points (bp) on the interest rates. Low interest rates – in nominal if not necessarily real (inflation adjusted) terms – mean that borrowing seems to be cheap if measured in cash outflows. With interest rates at a 40–50-year low and historically low credit spreads in relation to government bonds, structuring the balance sheet has become a key concern.

For treasurers the answer to the question 'what is the optimal balance sheet structure?' is 'it depends'. It depends on the industry sector – capital intensive industries have markedly different balance sheet management issues to the service sector – and the company's individual situation. If a company is in an acquisition phase, it will require more financial headroom than if it is growing organically. Combine this with the retirement and refinancing of debt, plus the emergence of corporate cash piles and managing the balance sheet to optimise returns for shareholders becomes a real challenge.

The balance sheet is a snapshot of how the business is growing and developing, reflecting market and business conditions. The balance sheet needs to have flexibility in order for the business to fulfil its strategic objectives. Treasurers are increasingly looking at the risk management of the balance sheets in a holistic fashion. This attempt at joined-up thinking is reflected in the ways that financial institutions present their products to corporates in offering to manage those risks. Organisations need to consider whether their approach to balance sheet management is both flexible and innovative. For instance, with the current weakness of the dollar some non-US-based treasurers are contemplating entering the US in order to create dollar denominated liabilities, which would reduce materially in terms of their home currency if (or is that when?) the dollar strengthens. A practice that other treasurers would view as extremely risky. The treasurer will often work with a small group of advisers to fine-tune any deals. Talk to financial institutions and they say that treasurers are becoming much more sophisticated and wise in their use of a handful of advisers in terms of discussing strategy before firm action is taken.

Having decided on the amount of debt that the company can stomach, the treasurer and the finance director in conjunction with their advisers have to decide whether to borrow short or long, whether to fix or float. A company that achieves lower cost of debt today must realise that the trade-off could be more volatility in the long term. With the current levels of liquidity the need for securing finance over the long term seems faintly absurd. It is tempting to think that in a global market lenders and finance are like buses – there will always be one around the corner in 10 minutes. But a treasurer that bets the house on continually finding good short-term lending may live to regret the call.

The Treasurer's Challenge: managing value in today's rate environment. This series of articles is supported by The Royal Bank of Scotland. Other articles to be printed in *The Treasurer* during the autumn will include case studies on investment and funding options, and a round table where leading market figures will discuss the issues raised by the series. See www.treasurers.org/thetreasurer/rateseries.cfm for more details.

The only way to construct the optimal balance sheet is to build the model, test the different scenarios and what-ifs and come to a conclusion by a process of trial and error. The priorities remain consistent, but often unspoken: there is a need to protect the shareholders and keep volatility to a minimum, while attempting to maximise earnings and achieve other key performance targets. Few can doubt that this is tricky but the aims should be clearly set out and the board will be looking to the treasurer to deliver.

TODAY'S BALANCE SHEET ISSUES

Pension liability The debate over pensions seems endless. Tempting though it may be, sponsoring companies cannot just ignore the profile of the pension fund tucked away menacingly in the corner of the balance sheet. If corporates are to raise their rate of return then those with pension liabilities need to put their pension house in order as one way of lowering the overall cost of capital.

Surprisingly, despite the publicity surrounding pensions, some large corporates are still unaware of the financial risk that sponsoring

Executive summary

- If an organisation can find its optimal balance sheet structure then it can maximise its returns to shareholders.
- The ideal balance sheet structure will typically depend on whether a company is growing organically or in an acquisition phase.
- Having decided on the amount of debt a company can manage, the treasurer has to decide whether to borrow short or long, whether to fix or float.
- A company that achieves lower cost of debt today must realise that the trade-off could be more volatility in the long term.
- Issuing hybrid capital could suggest the corporate is weak in the same way that the City has traditionally viewed rights issues as a shoring up of the balance sheet.

companies are facing with their pension funds. The big question for balance sheet management is how to de-risk the pension fund. If a sponsoring company is making a substantial payment to the pension fund, that may be the best time – within of course the regulatory constraints – to see if it is possible to look at defining and then funding the pension deficits over an acceptable period.

Cash piles One of the under-explored balance sheet issues of recent years is the global savings glut driven by corporates. Between 2000 and 2004, the switch from corporate net borrowing to net savings across the G6 economies amounted to over $1 trillion. The rise in corporate saving has been across North America, Europe and Japan and has occurred in both financial and non-financial corporates. Whether and when this desire for corporates to save will unwind is hard to judge. But it does mean many treasurers in corporates are faced with challenges rarely experienced. The share buy-back phenomenon is a result of this savings glut as treasurers struggle to maximise returns.

Financial reporting It would be odd if the management of the balance sheet didn't include a key overlay of accounting and financial reporting. The continuing refinement of accounting under IAS 39 *Financial Instruments: Recognition and Measurement* is taxing treasurers. They are increasingly being asked to decide how they wish to use the increasing range of hedge tools available. Some are choosing to hedge where there is a high correlation in the movement or value of the asset or liability that is being hedged, and hence qualify for hedge accounting. Alternatively, organisations can elect to economically hedge knowing that they are happy to accept – and explain to investors – the resulting volatility and impact that goes through the P&L.

Box 1. Optimal capital structure – the basics

- The cost of equity is not explicitly stated in the profit and loss (P&L) account: by contrast the cost of debt – interest charges – is itemised. Perhaps that is why it is tempting to forget that debt is a cheaper source of funding than equity. Debt is safer than equity, so warranting a lower return, and the interest paid is tax deductible.
- Some debt is better than no debt as it lowers the weighted average cost of capital (WACC). But at some point additional debt becomes too risky. Being under-geared is inefficient and will cause a steady leakage of shareholder value. Being over-geared can be disastrous and may lead to considerable destruction of shareholder value. This cliff-edge profile argues for a degree of conservatism.
- The optimal capital structure (OCS) – the ideal ratio of debt to total capital structure is dependent on the risk profile of the business. A firm's beta is a measure of this systematic risk. A stable reliable cashflow will support a very high level of gearing as in a utility. Cyclical or volatile predicted cashflow will require higher equity. Capital structure follows a company's growth cycle. In a business start, forgiving shareholders are willing to give up cash today for growth tomorrow. Such companies haven't got the stomach or the cashflow to meet the regular interest payments. Once established, the debt providers become more willing to lend to the firm.

POSSIBLE WAYS AHEAD – HYBRID CAPITAL Hybrid capital is one possible method that corporates could use. In terms of balance sheet management it does send conflicting signals, however. Issuing hybrid capital could suggest the corporate is weak in the same way that the City has traditionally viewed rights issues as a shoring up of the balance sheet.

The high profile given to hybrid debt, at least by the investment bank salesmen, is a good reminder that the capital side of the balance sheet needs managing just as much as the debt side does. Indeed the new reporting standard for the Operating and Financial Review (OFR) requires comment on why an entity has adopted its particular capital structure. A more positive spin is that with interest rates low, rates on hybrid capital are low. The other advantages are that it is not as expensive as issuing new equity and it does not significantly dilute equity holders. Whether treasurers will be convinced by those who favour hybrid capital remains to be seen.

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