Seeking a perfect structure

INTER-COMPANY FUNDING AND ALTERNATIVE FUNDING SOLUTIONS.

Executive summary

This article looks at the key decisions in managing inter-company funding and its importance for shareholder value.

Most businesses are formed of groups of companies which comprise a parent and its subsidiaries, and much of treasury management is about financing the overall group or the parent. But beneath the glamour of group funding lies the issue of funding its subsidiaries. Many of the same issues, such as the split between debt and equity and the length and terms of borrowing, arise for subsidiaries as they do for the group or parent. In this article we will refer to:

- parent (the holding company for the group);
- subsidiary (any group company, whatever the level of ownership); and
- group (the parent and all subsidiaries, as defined above).

Inter-company funding is important to shareholder value. The overriding aim of any business is to increase value for shareholders – that is, the parent's shareholders. Individual subsidiaries have to add value, not only for themselves but also for the parent, and efficient funding of subsidiaries is important to maximise the value of the parent's stake in them. Efficient funding of subsidiaries also enables the group to deploy cash efficiently, wherever needed in the group. This might be to pay dividends to shareholders, to pay interest on central borrowings, or to invest in new businesses.

Because shareholder value is measured through cashflows, the treasurer's first concern will be for the management of cash. The trend towards centralisation of management and control means that a treasurer who can control the cash in any country is 90% of the way to an ideal structure.

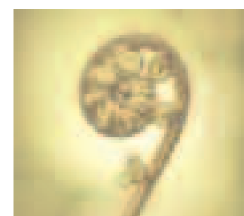
In groups with many overseas subsidiaries or joint ventures, the management of their funding takes up large amounts of time and the department forms very strong bonds with the tax department.

KEY ISSUES A number of key considerations play a major part in any inter-company funding decision. These are important for all subsidiaries, but particularly for any subsidiaries located overseas where many of the issues are encountered all the time.

- **Ownership** Deciding on whether a subsidiary should be wholly or partly owned is a critical decision. Equity ownership of 100% gives the parent total control, but also leaves it with 100% of the equity risk in the subsidiary. Ownership of 100% also implies moral and legal obligations by the parent to manage the subsidiary properly. If the parent holds less than 100% (and in some circumstances this need only be a few per cent less), the parent will generally have to negotiate with the other shareholders each time it wants to take action. Two sets of investors may have very different objectives, and minority shareholders may be unwilling to bear their fair share of their obligations to the subsidiary. In many countries, either a local shareholder is required by law or is a political necessity.

- **Equity versus debt** The next key decision is the amount of equity and debt. In an ideal world shareholders will wish to minimise their stake, and hence their risk, leaving the subsidiary with little equity and substantial local borrowings. Other reasons for minimising the level of equity include:

- minimising the level of equity and maximising the debt



generates the maximum return on equity;
- interest is tax-deductible whereas dividends are not, so maximising interest expense gains the maximum tax deduction for the interest so long as there are taxable profits; and
- minimising the level of equity minimises the chance of trapped funds (funds that cannot be remitted as dividends due to a lack of distributable profits) in the group company.

One real-world factor that increases the amount of equity in group companies is gearing. Lenders will only be willing to lend up to a certain point. The balance of funding has then to be sourced from equity and the subsidiary may not be able to afford the interest.

Another factor is tax. Tax authorities commonly have thin capitalisation rules that impose a minimum proportion of equity and maximum debt level for companies. Any interest paid on borrowings in excess of the limit is treated as dividends, and so is not tax-deductible.

PARENTAL SUPPORT So long as the parent has a legal or moral obligation to prevent the subsidiary from defaulting, the group actually has no *independent* capital structure. Although the proportion of debt and equity still matters for tax purposes, for risk purposes the credit strength of the subsidiary is that of the overall group. When parent company guarantees are given to subsidiaries' creditors, the benefits gained by using high local debt levels tend to evaporate.

Many companies have a policy of never giving parent company guarantees, although on occasion it is impossible to avoid doing so. However, it can be argued that the parent that walks away from its insolvent subsidiary is likely to have problems with all lenders thereafter.

Parent companies may prefer to issue letters of comfort, which evidence the moral obligation to support the subsidiary, without accepting a legal obligation to do so.

If a creditor is able to seek support from the parent, this is known as recourse to the parent.

SOURCE OF DEBT FUNDING Debt funding for the group will always ultimately be sourced externally. However, a group structure allows for a subsidiary's borrowings to be either locally or centrally from the parent (and channelled to the subsidiary by inter-company loan).

Local external borrowing may be useful to underpin local banking services such as cash management, trade finance or foreign exchange facilities. However, it can be more expensive than inter-company lending. Interest on cross-border borrowing (for example, an inter-company loan) may attract withholding tax (levied by the remitting country's tax authorities on the income to the recipient).

CASH MANAGEMENT SYSTEMS The importance of cash management systems relates to the importance of cash as a group resource. Not only do subsidiaries need to be funded, but as they generate cash the parent needs the ability to

Table 1: The ideal funding structure

Structure	Comment
Subsidiary is owned 100%	Treasurer can dictate funding methods and policy
Subsidiary has a very low equity base	Reduces the amount of capital at risk in the country and implies high debt
Subsidiary has a high level of debt	Interest on debt is tax-deductible and decreases profits, reducing the tax charge. Mitigates issues of trapped cash (where cash movements to parent are forbidden)
Trade creditors rely on parental name for security	Parental support is rarely legally binding. No issues on lack of trade credit
Company has low-cost external debt which is non-recourse to the parent	Local debt is likely not to attract withholding tax on interest and reduces capital at risk in the country because the subsidiary can be allowed to fail
If cheaper finance can be obtained by adding the parent's or group's support by way of guarantee or comfort letter, this is added if it saves costs	The benefit of lower cost debt is balanced against higher group capital at risk
If cheaper finance can be achieved by lending inter-company, this is added if it saves costs	Parental loans are likely to be the cheapest form of debt. If the subsidiary's country is secure from risk, inter-company funding is often best
Inter-company funding can be made and repaid at will	Minimum cash balances are held locally
Currency is convertible	Cash remittances easily converted to or from other currencies used by the group
Cash management system in country allows same-day cash movements, remote access by parent and pooling	No delay in funding cash needs or collecting surplus cash, no need to rely on local management, and efficient management of local cash and liquidity
Dividends freely remittable and suffer no withholding tax	Timing of dividends can be made to suit tax planning in the parent
Management charges/royalties permitted and tax-deductible	Further flexibility for tax planning, and further reduction in local taxable profit

defund them in order to safeguard the cash centrally and use it elsewhere as needed. Cash management systems are important to ensure that cash can be moved efficiently and quickly around the group.

REMITTANCE TO AND FROM THE PARENT The parent may need to send cash to subsidiaries or extract it from them. There are five core forms of remittance, and all non-trading flows (flows that are not settling inter-company trading transactions) must take one of these forms.

- **Equity injection** A permanent means of sending cash from the parent to the subsidiary by buying shares.
- **Loan** A means of temporarily sending funds in either direction between parent and subsidiary. Loans must be documented and interest-bearing at market rates in order to comply with international transfer pricing rules.
- **Dividends** A means of sending cash permanently from subsidiary to parent. Dividends can only be paid out of distributable profits.
- **Royalties** Another means of sending cash permanently from subsidiary to parent. Royalties must be paid in accordance with a royalty agreement and at market rates. Royalties are paid from pre-tax profit and are generally deductible for tax purposes.
- **Fees and charges** Another means of sending cash permanently from subsidiary to parent. Fees and charges must be paid in accordance with a management agreement for services actually provided by the charging entity (such as central accounting or treasury services). Fees and charges are paid from pre-tax profits and are generally deductible for tax purposes.

THE IDEAL FUNDING STRUCTURE The ideal overseas subsidiary would have the features outlined in Table 1.

LIMITATIONS TO FUNDING STRUCTURES In the real world there are limitations on what can be achieved. Table 2 shows the effect of having to cope with a less than ideal situation.

There is no single ultimate answer to the perfect subsidiary funding structure. It can be seen that each country and subsidiary has to be managed on an individual basis. Real-world decisions on this topic require careful analysis and commercial judgement. What must be remembered is that an investment by a parent company in a subsidiary must stand up in terms of cashflows to the parent.

This article is based on Study Unit 2, Capital Markets and Funding, Section 4: Inter-company Funding and Alternative Funding Solutions for the Certificate in International Cash Management (CertICM) from the ACT.

Table 2: Limitations to funding structures

Issue	Effect
Less than 100% ownership but still in control	Minority owner must not feel they are disadvantaged by the pricing of inter-company loans, for example, or paying for financial support
Less than 100% ownership but still in control	Parent may not want to fund 100% of debt capital if it does not enjoy 100% of profits
Less than 50% ownership – ie, a joint venture (JV)	JV partners only contribute group capital to the JV under the terms of the JV deal
Parental name weak	Local creditors seek reduction in credit limits, or insurance or guarantees
Thin capitalisation rules	A country usually limits the amount of interest deduction for tax. This affects equity/debt mix and inter-company loans may be treated more harshly than external debt
No local finance available	Inter-company lending must be used if debt financing is sought. This may run into currency or convertibility or exchange control problems
Exchange controls limit inter-company funding	Local debt must be used or the company must be equity-funded
Currency not convertible	If local debt is not available, the company must probably be equity-funded. Any cash generated by the subsidiary is effectively trapped due to lack of convertibility
Cash management system in country works on next day or later basis	Cash may accumulate and funding must be done earlier than is ideal
No non-resident access to cash management system	Need to rely on local staff who may be part-time or have different loyalties
Cash pooling prevented by regulation or not supported	Each subsidiary must be independently managed. Cash utilisation very inefficient
Dividends pay withholding tax or are not freely remittable	Large effort to obtain dividends, timing is not predictable, and withholding tax then has to be reclaimed if possible
Management charges and royalties not permitted or tax-deductible	Less opportunity to manage profit and tax in country. Less opportunity to recharge for services provided by the parent or group