Changing face

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REFLECTS ON THE CHANGING FACE OF UK CORPORATES.

Executive summary

- The last decade has seen UK corporates taking on a greater array of capital structures, shrinking the role of the head office, and burying the conglomerate structure.

As a corporate banker, I am struck by how little treasurers appreciate the rapidly evolving face of corporates in the UK. Any person returning from a five-year trip to Mars (or New York, for that matter) would be amazed at the changes that have taken place. Treasurers play a major role in helping corporates to develop strategy, so it is worth examining the changes that have taken place, recognise the forces that have influenced the change and be conscious of where we are heading.

THE CORPORATE TODAY In the last 10 years we have seen a significant evolution of the UK corporate including, for example, the demise of both the conglomerate and the corporate head office. What has happened to Hanson, Trafalgar House, Bass and the other giants of the UK corporate world of the 1990s? What has replaced this corporate model?

In the 1980s and 1990s Hanson grew by acquiring disparate mature industries and employing financial management efficiencies to reduce their cost base. Bricks, batteries, chemicals, fruit juice and tobacco companies were all added to the Hanson empire. Through its head office, the company was able to grow the business by attacking the cost base of each acquisition. Imitators sprang up and potential targets learned the lessons and soon Hanson ran out of opportunities for further expansion. Growth slowed and investors began to question the contribution of the head office within the group. The pressure built for it to break up.

Before Hanson, there were names such as Lonrho, which had built a disparate conglomerate including goldmines, hotels, freight-forwarding and vehicle distribution. Lonrho's head office was seeking to diversify earnings so that the company could provide consistent earnings throughout an economic cycle. The corporate head office was an intermediary between the shareholder and the operating unit, smoothing out the bumps in earnings. By the 1990s the corporate head office was looking to contribute more by means of synergy. Vickers, for example, manufactured Rolls-Royce cars, tanks and medical equipment. The Vickers head office saw itself as an engineering company and looked for synergy between its engineering businesses.

IN STARK CONTRAST Compare the 1990s picture to now, and the contrast could hardly be starker. Today, we see names such as GUS, which is in the process of separating its Experian credit-checking business away from its retailing businesses of Argos and Homebase, thereby cutting out the requirement for a corporate head office. The management has been under pressure to realise value for the shareholder. Up to now, analysts had been divided as to whether GUS should be viewed as a growth or yield stock. They had difficulty comparing GUS to its competitors and were marking its shares down accordingly. In separating the businesses, management believes that the constituent parts will have a higher value than the whole group.

In addition to changes to the corporate structure and the shrinking role of the head office, the modern corporate uses a greater array of capital structures – for example, pub chains and water companies within securitisation structures, and private equity taking ownership of retail chains and food processing businesses. A wide variety of infrastructure assets such as airports and gas pipelines are being taken over by the infrastructure funds, such as those managed by Macquarie or Challenger.

From the investors' point of view, the landscape has changed significantly as well. In the 1970s there were, relative to now, only a small number of investment instruments. At the same time corporates had to deal with exchange controls and high inflation. It was difficult to hold foreign shares. Today there is a proliferation of investing instruments including emerging market funds, hedge funds, index-linked funds and option-linked instruments. This applies not only to equities but also debt instruments.

In the 1960s banks were the main source of funds for most borrowers. Today, disintermediation has given lending banks a minority role. In the US, bank lending accounts for only 16%-18% of total corporate borrowing.

The pressures forcing these changes on corporates have changed as well. The external factors influencing corporates 10 to 20 years ago included capital controls, volatile exchange rates and high inflation. Today, a more sophisticated accounting profession exerts a greater influence and that has been a driver in allowing corporates to measure their weighted average cost of capital more accurately and explore the horizons of the optimal balance between debt and equity. Add this to the greater proliferation of debt and equity instruments that are available to the issuers and we have seen a number of corporates testing the boundaries of what is possible. Some of the leverage multiples undertaken by corporates today are many times what would be considered the norm 10 years ago.

WHAT NEXT? Having identified the recent changes that have taken place and some of the pressures at work we should try and extrapolate the major influences of the changes on the UK corporate.

REDUCING IMPORTANCE

Globalisation: It is difficult to see how globalisation and the associated breakdown of barriers to trade and the movement of capital, will continue to dominate the development of the corporate. It is true that some of the major markets, such as China and India, have yet to open up fully; nevertheless, as a concept, globalisation is likely to be of reducing importance.

Transparency in accounting: Likewise, with ever greater transparency in accounting, it is difficult to see how much more accounting sophistication can develop.

CONTINUING THEMES Shareholders and lenders are showing greater appetite in managing risk for themselves. Shareholders are increasingly insistent that corporates simplify their businesses so that there is more transparency to the investors who can then compare and contrast similar businesses. From this they can learn more about their investments and manage the risks themselves. Lenders too are showing greater ability in managing risk. There has been a significant increase in liquidity for non-investment-grade debt in the last 10-15 years. Lenders have the tools to measure portfolio diversity and balance their portfolios, thereby reducing risk. The development of debt trading, credit default swaps and collateralised debt instruments have helped lenders package debt and sell it on. This active management of portfolios enables lenders to take on more risk.

UNCERTAIN OUTCOMES

Pensions: It is still too early to conclude that the pension issue is not a major factor in influencing the changes to the face of corporates.

Hedge funds: The true impact of hedge funds has not yet been felt. Regulators have very little idea as to their impact on the economy.

NEEDS WORKING ON Study and research on the following topics would be welcome by treasurers and investors alike:

- Measuring the volatility of cashflow;
- Measuring the liquidity of debt markets; and
- Measuring the volatility of liquidity of debt markets.

Improvements in understanding any of these topics would enable companies to take on more leverage and increase confidence of refinance. Bankers would benefit too as there would be yet another derivative market to develop.

HISTORY, A SERIOUS TOOL Conservative MP Iain Macleod once said: “History is too serious to be left to the historians.” In the absence of a crystal ball, history is a serious enough tool for the treasurer to take to strategy meetings. It would be too presumptuous to think that even some of the views outlined here will come to pass, but this article will have served its purpose if it provokes thought and discussion so that treasurers can increase the value of their contribution to corporate planning sessions by having a sure foundation as to where they have come from.

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