6.1.1 Forms of Ownership and the Financing of Operations

Unit: Unit 2 – Treasury Applications

Module: Module 6 – Managing corporate structure

Date: 1 September 2016

Summary: A look at the implications of different levels of ownership of group operations and alternatives for their financing, as well as a brief look at life as a treasurer under different ownership structures.

Keywords: parent, subsidiary, group, ownership, joint venture, associate, central services, risk, reward, ownership, financing, corporation tax, thin capitalisation, dividend, deductibility, trapped cash, guarantee, recourse, equity, loan, royalties, fees and charges, shareholder agreement, ring fence, minority, joint venture, deadlock, project finance, private equity

Contents

1 Introduction 1
2 The toolkit and the dimensions 4
2.1 Extent of ownership 4
2.2 Leverage 4
2.3 Source of debt funding 6
2.4 Cash management systems 6
2.5 Central services 6
2.5 Remittances to and from the parent / group companies 7
2.6 Shareholder agreements 7
3 Non-recourse financing of subsidiaries 8
4 Ownership of operating units, the view from above 9
4.1 100% owned operating units 9
4.2 Issues where ownership is 100% 10
4.3 50.1% to 99.9 % owned subsidiaries 11
4.3.1 Ways that 50.1% to 99.9 % owned subsidiaries might occur 11
4.3.2 Ways that problems might occur in 50.1% to 99.9 % owned subsidiaries 12
4.4 50% owned operating units, joint ventures 13
4.5 Less than 50% owned operating units, joint ventures 14
5 The parental influence, the view from below 15

Learning outcomes:

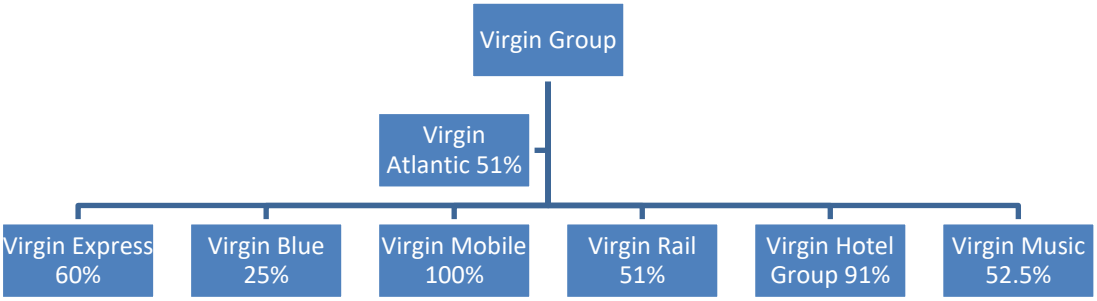
1. 100% ownership of subsidiaries is probably the norm.
2. Minority ownership and joint venture investments are increasingly common.
3. Some groups specialise in non 100% owned operations.
4. Some sectors are full of minority and joint venture investments.
5. Investments can be viewed from different directions: legal, loan definition, accountancy.
6. The treasurer faces questions around operations financing, day to day funding and cash management as well as the provision of central services such as derivatives, netting plus credit support products such as letters of credit and guarantees.
7. The broad dimensions of decision making centre around: risk, reward, ownership, financing.
8. The choice of leverage of an investment is a key decision
9. The choice of source of debt funding is also a key decision as is the recourse under that debt.
10. The movement of funds into or out of operations must be one of: equity, loan, dividend, royalties, fees and charges.
11. Shareholder agreements are useful tools to confirm arrangements between shareholders for financing and other matters.
12. Non-recourse financing of subsidiaries is a very useful tool and can limit risk while increasing reward.
13. Non-recourse financing is broadly the private equity approach, which contrasts with the full recourse method often used by conglomerates.
14. When using non-recourse financing, it is important that lenders understand the model in use.
15. 100% ownership allows maximum freedom to the treasurer.
16. The existence of a minority can be difficult, especially where the subsidiary carries the company name or the parties do not have the same resources. It is easy to shift the risk / reward balance by using group resources to subsidise the minority. Equally the minority can complain about pricing of intercompany transactions.
17. Subsidiaries with minorities are often included in loan agreements and may have to comply with covenants and can cause cross default.
18. Joint ventures are relatively easier for the treasurer to manage but can carry high profile risks. Issues are more managerial than treasury related.
19. While many treasurers work in quoted companies, where there is high autonomy to decide strategy, many treasurers work in structured vehicles, such as private equity or project finance, where there is much less autonomy.

1 Introduction

Probably the majority of businesses (at least where there is a distinct treasury function) are formed of groups of companies, comprising a parent and its wholly owned subsidiaries (i.e. 100% owned). Much of treasury management is about financing the overall group or the parent and many treasurers will join mature groups where the channelling of funds up and down the group has been more or less automated. However, beneath the glamour of group funding of bond issuance and syndicated facilities is the issue of how its subsidiaries are financed. 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 the parent.

100% ownership, while probably the norm, is by no means the only way of investing in an operating unit. Any level from nil upwards is possible and arguably a lower percentage ownership is a key risk limitation tool. With reduced M & A activity in the 2010s following the general economic uncertainty following the financial crisis, such investments are more common. Many groups make non 100% ownership a key plank of policy:

Example 1: Virgin Group (simplified diagram and not necessarily up to date)



Virgin rarely invests in 100% ownership but does attach its brand name to its operations, which may give rise to reputational risk if one business fails, especially as the businesses have broadly retail customers.

Example 2: The oil and gas industry

	Downstream	Upstream	Train 1	Train 2	Train 3	Train 4	Refinery
State investment	65%	65%	70%	65%	68.5%	70%	51%
ExxonMobil	10%	10%	30%	18.3%			10%
Total	10%	20%		16.7%			10%
Mitsui	7.5%	2.5%			1.5%		4.5%
Marubeni	7.5%						4.5%
MQL International		2.5%					
ConocoPhilips					30%		
Royal Dutch Shell						30%	
Idemitsu							10%
Cosmo							10%

The ownership chart shown here, of investment in oil and gas operations in a Middle East country, shows how a mixture of ownership types is commonly included in one entity.

The language involved, which is importantly reflected in loan and other agreements, includes:

- Parent - the holding company for the group
- Subsidiary - any group company where ownership is greater than 50%[1]
- Group - the parent and all subsidiaries
- Associate - an investment where ownership is 50% or less[2]

There are four different approaches to this set of types of investment:

- Firstly, is the legal approach to control, broadly following the shareholding but often controlled by shareholder agreements and limited by rights of minorities enshrined in culture and law.
- Secondly, is the loan definition approach where anything can be written down, although some standard documentation (such as in high grade and high yield bonds) is difficult to change.
- Thirdly, is the economic approach, where control, risk and reward might fall.
- Finally, is the accounting approach where the rules are set down in accounting standards. Accountancy includes the concept of associate, i.e. a company where the parent has a less than controlling interest.

A Joint Venture is a special case of a subsidiary or associate, where the mutual rights and obligations of the shareholders are set out in a formal Joint Venture agreement. A Joint Venture may be set up by two or more shareholders in order to meet a particular mutual need, and the structure is common in project finance.

[1] Or where the parent has control over the company – perhaps by Board membership and voting rights.
[2] Or where the 'parent' does not have control.

Given a particular level of ownership, the questions facing the treasurer in each of these cases broadly centre on:

- overall financing
- funding of day to day operations
- cash management
- central services such as
    - intercompany multi-lateral netting
    - FX deals and other derivatives
    - bank provided letters of credit and guarantees
    - intercompany support for local debt
    - intercompany or bank support for other liabilities such as regulatory, pension schemes, customers, suppliers etc
    - shared service centre support
    - insurance
- intercompany trading
- royalties and management charges
- dividends and capitalisations

The dimensions under which to consider choices in this area are broadly around:

- risk
- reward
- ownership
- financing

These can become a little confused unless clear decisions are made. Frequently the treasurer is in the firing line for these sorts of decisions:

Example 3: Non 100% ownership
Gullible plc owns a business in the Middle East which sells and installs engineering solutions in the dairy industry. The ownership of this business is 75%. Operating management in the UK is familiar only with 100% ownership, permitting unquestioned intercompany financing for all investment, for both expansion and covering any working capital or losses.

Dividends and intercompany financing are centrally controlled in Gullible plc.

When the treasurer questions the wisdom of advancing sums in this case, operating management do not understand the issue and simply state that the business is majority owned and controlled. When pushed for help with financing, the minority shareholder simply claims poverty and of course seeks a consistent and increasing dividend stream.

It is easy to see how risk and ownership can diverge in these situations.

So far we have taken the view of the treasurer of a parent company. Equally, of course, the businesses of which we are talking have a management structure and have to take treasury

type decisions, often employing a dedicated treasurer or at least assigning treasury roles to individuals. The view from this treasurer also merits attention.

This reading gives a brief introduction to these issues. 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. Where there are exchange controls in the countries of investment, an added layer of complication is added.

2 The toolkit and the dimensions

The treasurer has several tools in the toolbox which can be applied to these situations:

2.1 Extent of ownership

This is a key starting point and generally not within the control of treasury. That is not to say that the treasurer cannot point out the implications of different ownership structures.

2.2 Leverage

The leverage decision is as important for subsidiaries and other investments as it is for the group as a whole, but possibly more crucial where an investment is not 100%.

Where ownership is 100%, the parent usually juggles debt and equity to minimise tax but other factors are also important. Typically, high debt is chosen where levels of corporation tax are high because this maximises the interest deduction[3].

Let's look at an example to see how this works:

Example 4: Switching debt between jurisdictions

Partly revisiting Playwell and Playhard from Unit 1, but this time looking at tax and ignoring currency effects, Playwell finances a German subsidiary purely with equity:

		Playwell UK		Playwell Germany	Consolidated	
		£m		£m equiv	£m equiv	
External debt	7%	(100.00)	7%		(100.00)	
Intercompany debt	7%	0.00	7%	0.00	0.00	
Taxable earnings		20.00		12.00	32.00	
Interest		(7.00)		0.00	(7.00)	
Pre tax earnings		13.00		12.00	25.00	Tax rate
Tax	15%	(1.95)	30%	(3.60)	(5.55)	22%
Post tax earnings		11.05		8.40	19.45	

[3] The principle of deduction of interest from taxable profits is under broad threat. One proposal in the US (in discussion in early 2017) would remove such deduction.

If the external debt is retained but 'pushed down' into the German subsidiary, so that there is a mix of equity and debt in the German subsidiary, we now have the following:

		Playwell UK		Playwell Germany	Consolidated	
		£m		£m equiv	£m equiv	
External debt	7%	(100.00)	7%		(100.00)	
Intercompany debt	7%	100.00	7%	(100.00)	0.00	
Taxable earnings		20.00		12.00	32.00	
Interest		0.00		(7.00)	(7.00)	
Pre tax earnings		20.00		5.00	25.00	Tax rate
Tax	15%	(3.00)	30%	(1.50)	(4.50)	18%
Post tax earnings		17.00		3.50	20.50	

The tax rate has dropped because the interest on debt has been shielded at a higher tax rate. Note that this works even though there is an interest receipt on the intercompany debt. To get from the first situation to the second would need some engineering, such as large dividends or a recapitalisation.

We have kept things simple with a standard interest rate. Note that the benefit reduces as interest rates fall. What would be the benefit if rates were zero?

The benefit is unchanged if the debt in Germany is external.

Note, however, that tax authorities commonly have rules (thin capitalisation rules, or rules which have a similar effect) which 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 is therefore not deductible for tax (deemed dividends) although some jurisdictions may be more punitive.

Similarly, where taxes on dividends are high, and best avoided, cash generation can be applied to debt rather than to dividends. In countries where capital (and dividend) distributions are complicated by exchange controls, high debt levels also avoid the difficulty of "trapping" cash inside the country.

Debt can include intercompany debt as well as external debt guaranteed by the parent or another group company, or indeed by a third party such as a bank.

Beyond this leverage also increases equity returns (and risk) of course.

Under 100% or near 100% ownership, the parent may have a legal or moral obligation to prevent the subsidiary from defaulting, so the subsidiary actually has no independent capital structure. If the debt is intercompany debt, then it is really de facto equity.

© Association of Corporate Treasurers

Where the ownership is less than 100%, the leverage decision becomes based more on risk factors and the sharing of risk between shareholders than on pure tax or exchange control grounds.

2.3 Source of debt funding

Local borrowing is typically either:

- intercompany
- locally provided with shareholder guarantees (not necessarily in proportion and often joint and several)
- locally provided with bank or third party guarantees
- locally provided without recourse to any other party

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 intercompany lending. Interest on cross border borrowing (e.g. an intercompany loan) may attract withholding tax, which is a tax levied by the remitting country's tax authorities on the income to the recipient.

One effect of the global financial crisis has been to see bank relationships become retrenched into more domestic arrangements, as governments which support their own banks are reluctant for their taxpayers' money to subsidise jobs in foreign countries. Accordingly, the use of indigenous banks may always give some extra advantage when seeking local finance and facilities.

2.4 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 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. However, these systems also become conduits for financing. It is vital to ensure that this financing follows the risk / reward intention behind the ownership of the investment.

2.5 Central services

These include:

- multilateral netting
- shared service centres
- in house banks and central hedging
- insurance
- letters of comfort
- guarantees

These are generally charged for at an arm's length rate but some do carry credit risk (e.g. guarantees, forward FX, etc.) which may change the risk / reward profile embedded in ownership proportions.

2.5 Remittances to and from the parent / group companies

The parent may need to send cash to operations or to extract it from them. There are five core forms of remittance, and all non-trading flows (i.e. flows that are not settling intercompany trading transactions) must take one of these forms.

Equity injection: This is a permanent means of sending cash from the parent to the subsidiary by buying shares, although capital reductions are also possible.

Loan: This is a means for temporarily sending funds in either direction between the parent and the subsidiary. Loans must be documented and must be interest-bearing at market rates in order to comply with international transfer pricing rules. Some loans become broadly structural and permanent.

Dividends: This is a means of sending cash permanently from the subsidiary to the parent. Dividends can only be paid out of distributable profits.

Royalties: This is another means of sending cash permanently from the subsidiary to the parent. Royalties must be paid in accordance with a royalty agreement, and the rate of royalties must be at market rates. Royalties are paid from pre-tax profit and are generally deductible for tax purposes.

Fees and charges: This is another means of sending cash permanently from the subsidiary to the parent. Fees and charges must be paid in accordance with a management agreement, for services actually provided by the charging entity (e.g. central accounting or treasury services). Fees and charges are paid from pre-tax profit and are generally deductible for tax purposes.

Loans, royalties, fees and charges are mentioned here as going strictly up and down the ownership chain. However, this need not always be the case. The charging for use of intellectual property (royalties) and the provision of services can go in any direction and to any group company, 100% owned or less. The owner of the IP or provider of the services is the one that should be paid, but the arrangement can be routed in many directions. In addition, loans do not need to be made up or down the ownership structure and in fact many groups use financing companies or holding companies to do this particular task.

2.6 Shareholder agreements

Where there is a minority stake, it is usual to have a shareholders' agreement. This should cover issues such as:

- financing
- further investment
- dividends
- fees and charges
- royalties
- board membership
- exercise of voting rights

The construction of these is clearly important, although they may of course, not exist. If not negotiated at the outset, the mere suggestion of such an agreement can send the wrong signals to another shareholder.

3 Non-recourse financing of subsidiaries

Multinational companies tend to juggle the proportion of debt and equity to meet tax and exchange control considerations. However, debt lent by the parent equates to equity because of the risk attached, as is any debt guaranteed by the parent or another group member or by a bank under a counter indemnity or guarantee from a group company. Arguably debt supported by a comfort letter is also really equity as failure to honour a comfort letter carries such a high reputational risk. This is the case even if the loan is charged at arm's length rates or a fee for loan support guarantees is charged. It is about risk sharing on default that is important here.

However, it is possible to make external debt non-recourse to the rest of the group, creating real leverage and increasing the expected return on equity. It allows a hands-off approach and extends the reach of group funds. It is particularly useful where there are exchange controls. It is likely, though, to be substantially more expensive than full recourse debt. Arguably the two approaches are economically identical because the upside is always owned by the company (and consolidated etc.), but in fact any loss is strictly limited. A group buys a real option to walk away when using non-recourse debt.

Example 5: Non-recourse financing of 100% owned subsidiaries
Tata Global Beverages, an Indian company, wished to expand in the UK by buying Tetley Tea. It had only £71 million to invest against a purchase price of £271 million. It raised the £200 million on a non-recourse basis. It enjoys the upside but its downside is strictly limited to the loss of £71 million. Financing is on a leveraged basis with different layers of debt.

Of course this model is essentially the Private Equity model, where highly geared investments are made on a completely non-recourse (to the PE investor) basis. It is fully accepted that some investments will fail. Contrast this to a conglomerate approach where the usual financing approach is full recourse throughout the group, in the hope of improving credit status and lowering the overall costs of debt.

It is vital to ensure that the lender is quite clear about the approach taken.

Example 6: Non-recourse financing of 100% owned subsidiaries
TeHe Inc is a very large engineering conglomerate based in the US. It adopts a transaction based approach to banking relationships. It is very acquisitive and its usual approach is to change the name of an acquired company to TeHe [XXXX]. Thus a company called 'Allcall SA' would be renamed 'TeHe Allcall SA'.

It also has a policy of not issuing guarantees to banks providing facilities to subsidiaries. Its approach is that if the bank wants to lend to one of its subsidiaries, it will not stand in the

way. However, the bank's approach may be slightly different, and it may assign TeHe risk to the exposure on the basis that TeHe is unlikely to allow any of its subsidiaries to default.

This allows considerable doubt as to whether TeHe will stand behind the subsidiary. The transactional nature of the banking relationship is unlikely to lead to a sensible conversation to resolve the issue.

Note that businesses financed on a non-recourse basis will broadly be ring fenced from the rest of the group so that dividends, intercompany loans up, royalties and fees etc. will be prohibited.

4 Ownership of operating units, the view from above

We now investigate the various options for ownership.

4.1 100% owned operating units

To a large extent this is the ideal structure because it allows the greatest possible freedom for the treasurer. It really is possible to say to operating management that treasury will look after the balance sheet and management can look after the profit and loss account. It is usually the chosen route unless impossible or specifically chosen for other reasons.

Exhibit 1: Features of 100% ownership of operating subsidiaries

Structure	Comment
Subsidiary is owned 100%.	Treasurer can dictate leverage, funding methods and policy, based on cost, tax and country issues.
The subsidiary has a very low equity base.	A low equity reduces the amount of capital at risk in the country and implies high debt.
The subsidiary has a high level of debt.	The interest charge on debt is tax deductible and decreases profits, thus reducing the tax charge. Mitigates issues of trapped cash (where exchange or regulatory controls prohibit movements of cash to parent).
Trade creditors rely on parental name for security. Guarantees could be added.	Parental support will usually be moral but could be made legally binding. No issues on lack of trade credit.
The company has low cost external debt which is non-recourse to the parent.	Local debt does not use up central facilities, is likely not to attract withholding tax on interest and further reduces capital at risk in the country because in extremis, the subsidiary can be abandoned in difficult times and 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 intra-group, this is added if it saves costs.	Parental loans are likely to be the cheapest form of debt, being sourced in the home country on a wholesale basis. If the subsidiary's country is secure from risk then intra-group funding is often the mechanism of choice.
Intra-group funding can be made and repaid at will as there are no exchange controls.	Minimum cash balances are held locally
Cash management can be automated	The business can be slotted into cash management arrangements allowing automated funding in liquidity concentration. Other services such as multilateral netting, insurance, in house banking can be offered.
Currency is convertible.	Cash remittances are easily converted to or from other currencies used by the group.
Dividends are freely remittable and suffer no withholding tax.	Timing of dividends can be made to suit tax planning in the parent.
Management charges and royalties are permitted and tax deductible.	Further flexibility with regard to tax planning. Further reduction in local taxable profit.

4.2 Issues where ownership is 100%

In the real world, there will be limitations on what can be achieved. It is now worth seeing the effect of having to cope with a less than ideal situation.

Exhibit 2: Potential issues under 100% ownership of operating subsidiaries

Issue	Effect
Local law imposes obligations on Directors	Directors are subject to local company law, (usually with personal liability) which will commonly insist that they exercise due care and attention in performing their duties, and which may require that Directors act in the interests of the company, not its shareholders (in order to protect the interests of creditors such as employees, suppliers and the tax man). Despite 100% ownership therefore, a plan may be impossible to implement unless subsidiary Directors are comfortable that they are acting within the law.
Parental name weak.	Local creditors seek reduction in credit limits, or insurance or guarantees.
Thin capitalisation rules and equivalents.	A country usually limits the amount of interest deduction for tax in some way. This affects equity / debt mix and intercompany loans may be treated more harshly than external debt.
No local finance is available.	Intercompany lending must be used if debt financing is sought. This may run into currency or convertibility or exchange control problems.
Intercompany funding cannot be made and repaid at will due to exchange controls.	Either local debt must be used or the company must be equity funded.

Issue	Effect
Currency is not convertible.	If local debt is not available this usually means that the company must be equity funded. Any cash generated by the subsidiary is effectively trapped due to the 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.
Regulation forbids non-residents accessing cash management system.	Need to rely on local staff who may be part time or have different loyalties.
Regulation or systems limitations do not allow cash pooling.	Each subsidiary must be independently managed. Cash utilisation very inefficient.
Dividends are not freely remittable or suffer withholding tax.	Large effort to obtain dividends, timing is not predictable and withholding tax then has to be reclaimed if possible.
Management charges and royalties are not permitted and tax deductible.	Less opportunity to manage profit and tax in country; less opportunity to recharge for services provided by the parent or group.

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 cash flows to the parent.

4.3 50.1% to 99.9 % owned subsidiaries

This structure is arguably one of the most difficult to manage. Because the operating unit is a subsidiary and consolidated, it is immediately less obvious to management that there is a minority. Generally, life continues as for any other operating unit, so that management accounts are received as normal, budgets made, management meetings held and so on. Minority shareholders may well be employees in exactly the same way as for 100% subsidiaries and so the 'respect' for management will be the same. It is very much up to the treasurer to grip the situation and ensure that risk, reward and financing follow the ownership structure.

4.3.1 Ways that 50.1% to 99.9 % owned subsidiaries might occur

The following are typical examples where this situation might occur:

- Strategic stake by industry participant.
- An acquisition may be made where management needs to be incentivised with an equity stake.
- Laws in a country prohibit 100% ownership with say 50% being owned by staff or local co-operative or local government.
- A distributor insists on owning an equity stake in a venture in a country.
- It might arise from a trade sale with management retaining a stake.
- It may be a way to motivate management.
- Historical reason lost in the mists of time.

Example 7: Acquisition leading to a minority stake
Outrepreneur Inc operates in the technology sector where ideas and intellectual property rights are very important. Creativity in one area is heavily focused on individuals. At the same time the ideas are important to be included in new products which only larger companies, such as Outrepreneur can introduce. At the same time entrepreneurs seek larger companies to buy out their ideas but also look for upside if the idea really takes off.

A standard model is therefore that private acquisitions are made of 95% of a target's share capital.

Example 8: Quoted minority
Ideas For Systems plc owns a subsidiary in Japan where its ownership is 58%. The balance is quoted on the Nikkei.

No one can recall why the minority exists.

4.3.2 Ways that problems might occur in 50.1% to 99.9 % owned subsidiaries

The broad main issue is that the parent should not fund 100% of the debt if it does not enjoy 100% of the profits. Clearly if the business fails, the lender has the equity stake and the loan at risk, compared to just the equity stake for the minority partner.

Example 9: Financing distorts risk
Gullible plc owns 75% of Gullible Middle East Ltd. It has the following capital structure and profit and loss account.

Assets	200	
Financed by	75	Gullible plc
	25	Minority shareholder
	100	Intercompany loan from Gullible plc Charged at 5%
Distributable earnings are	20	

Return on equity is as follows:

Gullible plc	20 / 175 comprising 15 from distributable plus 5 interest **= 11.4%**
Minority	5 / 25 **= 20%**

If Gullible Middle East fails, the 100 debt will have priority for repayment but all 175 is at risk. Clearly this financing distorts risk and reward.

A second issue is that the minority owner must not be made to feel that they are being disadvantaged, by pricing of intercompany loans or derivatives, for example, or paying for financial support.

These subsidiaries are likely to carry the parental name or have an association with them. Therefore, the risk from failure is much greater because of the infection risk to the reputation of the parent. Thus risk is not totally aligned with reward because the parent will have a proportionally higher propensity to support it under all circumstances. This is a similar issue to how governments bailed out banks in the financial crisis. This created moral hazard whereby the managers of banks were able to take high risks without any consequences of the failure of those risks.

It is usually easy for a powerful parent to finance all the requirements, not only in terms of access to finance but also for an easy life, but this distorts the risk / ownership balance as seen in example 8 above.

50.1% - 99.9% subsidiaries are subsidiaries for the purpose of loan agreements and might therefore:

- have to comply with the covenants contained in them, unless specifically carved out
- be required to give security, although this would disadvantage the minority
- be required to give guarantees in support of the group debt
- cause a cross default if local non-recourse debt goes into default

It might be difficult for the parent to offer guarantees to creditors of these subsidiaries as this again upsets the ownership risk / reward balance.

4.4 50% owned operating units, joint ventures

This situation is almost always a joint venture.

A 50% company is often called a ‘deadlock’ company for fairly obvious reasons. If there are two shareholders (or the other 50% group together) with an equal say, then a disagreement over strategy or indeed over any subject has no easy avenue for solution. Although this is a problem which is probably beyond the bounds of treasury, treasury may well have to negotiate a solution, given the problem.

Example 10: TNK-BP

BP owned 50% of the oil and gas venture in Russia, called TNK-BP. The other 50% was held by a group of oligarchs who banded together. Issues over strategy caused huge problems, including reputational problems for BP, essentially because of the deadlock.

Solutions were managerial and, to some extent, political, well beyond the limits of treasury.

It is interesting to consider what might happen in such a situation where ownership was 51%. While this gives voting control and likely the ability to appoint the board, it might not actually make things easier because the minority shareholders are likely to use political and legal influence to claim that their rights as a minority shareholder had been infringed.

A second scenario is where the 50% is owned by more than one shareholder, so that there are more than two possible views at the table. Then the 50% owner is the largest shareholder. Again, this is not really a treasury issue.

However, the broad thrust here is clear. Any provision of services, especially involving credit, should be made only on a basis where the other shareholders also participate equally. Thus loans to the venture should be made only if other shareholders make similar loans. Other products such as derivatives can perhaps safely be made but the treasurer must be sure to limit group exposure in these situations.

A key protection here is the terms of the shareholder agreement.

4.5 Less than 50% owned operating units, joint ventures

Where the ownership of a venture is less than 50%, similar approaches are required as seen for 50% companies. Broadly, often very little engagement is made with these joint ventures. Typical examples include:

- Project finance where a stake is made to secure a contract for the underlying group business.
- Maintaining a stake in a business disposed of (to meet a price or retain an interest)
- De-risking a speculative venture
- Investment in the supply chain

Less than 50% joint ventures are relatively easy to manage treasury wise (although a minority shareholder then has to go along with a majority decision). Without control then using the capital of the group to support the JV is usually never done unless all JV partners contribute funds under the terms of the shareholder agreement between them, as in project finance for example when shareholder loans are a common tool. And a voting majority is usually clear, although a 25/25/25/25% JV could still be deadlocked.

The ventures do not often carry the group name, thus limiting reputational risk and there is no moral obligation to fund expansion or losses.

The ventures are also unlikely to participate in the usual group activities such as cash management, netting, insurance etc.

Example 11: Less than 50% Joint Venture

Uriah Ltd is in partnership with Kaylon GmbH to run U-Kay Ltd, a manufacturing company. Kaylon GmbH is in turn owned 100% by Teepee Inc, a US-based conglomerate. Teepee has a policy of not entering into finance leases and expects all members of its group to follow this policy.

U-Kay's ownership structure is:
47.5% Uriah
47.5% Kaylon
5% U-Kay Employee Share Trust

Effectively the JV is deadlocked, as the Share Trust would only intervene on matters crucial to the wellbeing of the employees.

U-Kay's bank financing is up for renewal, and it is apparent that the cheapest refinancing solution is to sell and lease back U-Kay's plant and equipment. Uriah's treasurer ends up negotiating with her opposite number in Teepee to quantify the benefits of a lease solution, and to get Teepee to relax its no-lease policy.

5 The parental influence, the view from below

The history of the ACT is broadly the history of the quoted company and the skills of the profession have grown to complement today's governance situation where the shareholders are relatively remote and the board of directors are broadly in control of the strategy of the group. While there is shareholder influence, it is generally up to management to come up with ideas and if they need shareholder approval, there is a push to investor relations. Shareholders are many and predominantly from institutions. The treasurer in this situation can probably be considered to have considerable autonomy and should generate the financing strategy (naturally meeting the demands of the business).

Increasingly, however, treasurers are found in private equity owned companies, joint venture arrangements and so on. While many aspects of treasury management do have the same autonomous feel in areas such as cash management, risk management and treasury operations, there are many other aspects where the strategy is a given and decided very much at the formation of the venture. This is mostly the case in financing.

Example 12: Project finance treasury
Daunting Dams DBH is a venture in the Republic of Benivakia. It has classic project finance borrowing facilities and shareholder loans. It appoints a treasurer to manage all aspects of treasury. The treasurer cannot influence financial strategy, which is already decided, with loans in place for up to 15 years. Any changes must broadly be agreed with the shareholders, who are relatively few, as well of course with lending banks.

Example 13: Private equity treasury
Risky Returns Inc is a private equity owned supplier of financial systems. There are three shareholders each with 33.33% of the shares and it has extensive loans. The treasurer has no influence on financial strategy and indeed at one stage is told to refinance to allow the payment of a large dividend.

Some relief comes when flotation appears on the agenda and the treasurer will be able to propose a financing structure suitable for its new ownership and achieve relate autonomy.

Example 14: Minority quotations
Hardacme plc is a London quoted natural resources company. 20% of the capital is floated on the London exchange while 80% is owned by a combination of oligarchs and the state of Hardistan. While this is essentially an agency and governance issue, the implications spill over into treasury with the major shareholders constantly seeking an audience with the treasurer and introducing local banks for bits of business.

Behind all this, of course, is that the treasurer will report to management, rather than shareholders, although at times this can sometimes be seen not to be the case.