3.2.4 Earnings and Sectoral Influence

Self-Test Questions

Unit:	Unit 1 – Treasury Strategy
Module:	Module 3 – Financial strategy
Date:	1 September 2016
Summary:	Questions exploring the issues around sector on financing decisions.
Keywords:	repayment profile, debt capacity, capital intensity, core debt, stability of revenues and earnings, flexibility, risk averse company, asset finance, leverage

Question 1
What are the differences which you might expect to see in the debt characteristics of the following companies, in terms of repayment profile and 'core' debt capacity?

a) Medium-sized civil engineering company
b) A utility such as a water company, with acquisitive ambitions
c) An acquiring company which is growing rapidly. Recent acquisitions have been rationalised with up to 50% of purchase price being reclaimed through divestments.

Question 2
Which sectors might be expected to use asset finance routinely in their financing? To what extent does this imply high leverage?

Question 3
Why are technology companies rarely financed by debt? Might there be exceptions to this?

Question 4
Despite the logic of leverage and low interest rates, many companies have more cash than ever. Does this nullify the science of corporate finance?

Answers

Answer 1

a) Medium-sized civil engineering company

This is likely to be managed on a project-by-project basis. Each project is likely to be large, with high levels of work-in-progress. Payment terms are likely to be based on interim payments for certified work done. Capital intensity is likely to be low. From this, the repayment profile of any debt is likely to be based on the timing of receipts for work done; the main requirement for debt is the investment in work-in-progress rather than any capital equipment. In this case, because of the 'project' nature of the business, working capital would be better funded by short-term debt repaid from revenue. The business is unlikely to generate a smooth, stable cash flow to support a high level of 'core' debt; because capital intensity is likely to be low the requirement for a 'core' debt is also likely to be low. The volatility of earnings implied by the 'project' nature of the business may also imply that a capital structure with relatively low debt would be appropriate to give the lowest WACC.

b) A utility such as a water company

This is likely to be a very stable company with smooth predictable revenues. Capital intensity is likely to be high with very high levels of capital expenditure for long periods. Some uncertainty is introduced by a possible acquisition programme to generate growth of earnings.

The repayment profile for debt in the core business is likely to be spread evenly over many years because the source of repayment is equally spread over many years. High capital expenditure is likely to be funded by debt which maintains that repayment profile, i.e. long term. Given the capital intensity and the stability of revenues and earnings, the use of 'core' debt is likely to be high. The stability itself implies that the lowest WACC is produced with a relatively high level of debt; but there is a risk that over-gearing initially, leads to a loss of flexibility to make acquisitions in due course.

c) An acquiring company

The demand for funding is generated by acquisitions, therefore the requirement is unlikely to be regular or forecastable. The sums involved may also be very large, although there may be many small acquisitions.

The repayment profile will reflect any expected divestments as well as anticipated equity issues. But it will need flexibility in case the company falls out of favour with equity investors, either because of a change in general market sentiment, or because investors criticise the results of the acquisition programme. The company's optimal capital structure may well change as the equity market's perception of risk changes, reflecting success as an acquirer as well as the risk inherent in the businesses owned. It would therefore be reasonable to expect a high proportion of debt due for repayment within one or two years to be repaid from divestment receipts or share issues. Both of these are uncertain; the timing of divestments may be difficult to predict as well as the cash to be received. Similarly, access to the equity market is difficult to be sure of - the market may change or the attitude to this particular company may change.

Due to this uncertainty, a risk averse company may arrange the repayment profile to be longer term (while reserving the ability to prepay debt) to give more flexibility over timing, or may raise debt convertible into equity. This would remove some of the risk associated with future access to equity funds.

The level of core debt will depend on the nature of the businesses acquired.

Answer 2

Sectors where asset finance is routinely used include those where assets are high in value but also have a good market in the relevant asset where price transparency and liquidity are both strong. Examples include:

Property companies. Property, especially in areas of strong economic activity are often high value, thus encouraging asset finance, and there is usually a good market, encouraging lending on a gone concern basis. Property returns are rarely at equity type levels, so leverage raises this to the required level.

Transport companies. Transport assets, such as aircraft and trains are very expensive, encouraging asset finance and in the case of many, such as aircraft and cars, there is a good second hand market. Trains are perhaps not so liquid, but in an insolvency it is likely that a new operator would need to acquire the rolling stock vacated by the previous owner.

Asset finance often implies high leverage. If for example an aircraft is acquired on a lease, it is usually the whole aircraft that is acquired, so the asset itself is levered. In the case of property a mortgage can be taken for say 80% or 50% of property value as the parties choose. However the property business model usually required leverage.

For transport assets, an airline often finances some aircraft with outright purchase and other with asset finance, to achieve the desired balance.

Retail companies. Retailers now almost never own the properties from which they operate. Modern shopping centres don't really accommodate the concept and many retailers want to be able to open and close stores easily as business waxes and wanes. There was a fashion from the 1980s onwards for retailers to sell and leaseback their owned stores to fit this model. Note, however, that there are some signs of a reversal in this trend. Tesco has recently re-acquired many properties it had previously sold and leased back. However, Tesco has discrete plots of land on which only it operates, making this easier to undertake.

Answer 3

Technology is inherently risky, new ideas which need cash investment have a low proportion of projects which actually become products and generate cash. Financing those sort of projects is speculative and more suited to equity. In addition, even successful products often have a short life, even if profitable, thus making them unsuitable for any kind of term finance.

Here we see gearing work in the opposite direction to normal. So if a technology company has risky but rewarding projects with say, a 30% expected return, that on its own is just too risky for most equity investors, or at least on any large scale. So a large amount of cash would bring that overall equity return down to a level acceptable to fund managers and retail investors.

A company with a very strong underlying brand name or with long term cash generative products or a very good track record at converting ideas to product might be suitable as a borrower. Microsoft (one of a very few AAA corporates) immediately springs to mind here, although it could be argued to have utility like characteristics as well. Companies with a portfolio of other businesses which can carry debt might be an exception as well.

Answer 4

Many companies have amassed very large cash holdings.

Company	Cash and Investments	Total Debt	Rating as of June 4, 2015
Apple Inc.	178	36	AA+
Microsoft Corp.	101	28	AAA
Google Inc.	64	5	AA
Pfizer Inc.	54	37	AA
Cisco Systems Inc.	53	21	AA-
Oracle Corp.	45	32	AA-
Johnson & Johnson	33	19	AAA
Qualcomm Inc.	32	-	A+
Medtronic PLC	31	29	A
Merck & Co. Inc.	29	21	AA
Amgen Inc.	27	31	A
General Motors Co.	25	9	BBB-
Ford Motor Co.	22	14	BBB-
The Coca-Cola Co.	22	42	AA
Intel Corp.	21	13	A+
Amazon.com Inc.	17	16	AA-
General Electric Co.	16	16	AA+
EMC Corp.	15	5	A
eBay Inc.	15	8	A
FCA US LLC	15	13	BB-
Chevron Corp.	13	28	AA
Boeing Co.	13	9	A
Hewlett-Packard Co.	13	19	BBB+
Walgreens Boots Alliance Inc.	13	15	BBB
Procter & Gamble Co.	12	34	AA-

This picture shows the highest 25 cash holdings in the US at end 2014. The cash will no doubt be higher now. The cash is high because these companies have not spent money on capex or buy backs. There seem to be many reasons for this behavior, including:

Fear of capital market illiquidity
Fear of bank illiquidity
Copying everyone else

Inability to decide what to do with the cash
Wanting an easy life
Expecting to spend it very soon
Gaining real options
Investors don't want the cash

However, while it may be fashionable to hold cash, the science of corporate finance still holds and these companies are probably not acting as efficiently as they could be.