Optimal capital structures

FOR ANY COMPANY, THE OPTIMAL CAPITAL STRUCTURE IS A MOVING TARGET, SO REGULAR REVIEWS OF THE CAPITAL STRUCTURE ARE VITAL TO ENSURE THAT BUSINESSES ARE ABLE TO EFFICIENTLY DEPLOY THEIR STRATEGY AND GROW SUSTAINABLY, AS CHRISTIAN LEIBL AND YURI POLYAKOV EXPLAIN

Much has been written about the abundance of cash sitting on corporate balance sheets in recent years. But as the global economy continues to recover, the pressure on corporates to maintain precautionary liquidity is decreasing. In fact, with activist shareholders demanding that accumulated cash be put to use, the new challenge for treasurers is to ensure that the company's capital structure ensures sufficient flexibility for current (and expected future) economic conditions – rather than focusing on those experienced during previous financial crises.

Against this backdrop, now is an opportune time to reconsider what the optimal capital structure should be. Finding the right balance between cash, debt and equity funding is both an art and a science, since an optimal capital structure is a dynamic concept that shifts as the economic environment changes. Moreover, it is unique to each company – optimal means different things to different issuers, varying in line with specific operational or strategic contexts, as well as industry sector characteristics and management objectives.

As such, while textbooks might, from the outset, suggest defining a company's optimal capital structure in terms of the lowest weighted average cost of capital, it is actually far more practical to start by asking a simple question around objectives: what is it that you want to solve? Being realistic and open in answering this question – regardless of whether the company is looking to reduce its cost of capital or simply to maintain a conservative financial profile – is the only way to achieve a capital structure that is fit for purpose at that time.

IMAGE SOURCE

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With the objectives identified, it is worth taking the time to carefully consider what needs to be optimised in the company's existing capital structure, and what is sustainable about it. During this process, it can be useful to keep in mind some guiding principles around what an optimal capital structure should deliver:

Optimal capital structure: guiding principles

1. **Efficiency.** Debt is always cheaper than equity and the capital structure should therefore include as much debt as the company is willing to afford, based on future cash flows. It is important to recognise here that affordability may be limited by industry sector. Companies in industries with stable cash flows, where the predictability of their cash generation is high, will inevitably be able to afford more than those in volatile industry sectors.
2. **Flexibility.** When thinking about the optimal

capital structure and affordability levels, it is vital to leave headroom to absorb the impact of any unwanted internal or external events – such as operational challenges or changes in interest rates – on cash flows and profit margins. This provides a safety barrier that is more efficient than holding a stockpile of cash.

3. **Liquidity.** Given the uncertain world in which treasurers operate, it is important to ensure that the company can tap different markets for liquidity as and when required. Having access to a broad funding toolkit will assist greatly in achieving the optimal capital structure and, indeed, for adjusting it over time. In addition, the broader the access to liquidity, the more routes that are available in the event a stress closes some routes to market.

Conducting a thorough review of the company's existing capital structure with a view to optimising it also means questioning the status quo. Is a large cash buffer really required any more? Is it in fact causing a drag on the efficiency of the capital structure?

Another area where corporates may want to do some soul-searching is credit ratings. For some companies, one of the main objectives of an optimal capital structure is to maintain a target credit rating, which grants them access to their optimal level of capital market liquidity. For other companies, though, the credit-rating target is more of a cultural or philosophical level that the company likes to maintain, rather than a funding strategy-driven necessity. While that is absolutely the company's prerogative, it is important to formally recognise this when setting the parameters of the optimal capital structure.

After all, credit ratings can open doors to investors' money. While investment-grade companies generally find good market access through the cycle, being sub-investment grade does not preclude an issuer from finding liquidity. The size of the debt financing that the company needs to raise and the market conditions at the time of issuance also play an important role. Over time, many companies have successfully tapped alternative funding sources, such as private placements, unrated bonds and loans, as well as hybrid instruments. Moreover, it is not only the financial profile or balance sheet structure of a particular company that determines the quality of its credit profile; it is the interplay between the industry dynamics, business model and balance sheet. So while credit ratings are important, they should not necessarily be perceived as the be-all and end-all.

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A forward-looking approach

With so many considerations to take into account, how then can a company put all of this into practice to implement an optimal capital structure?

The answer: by taking a forward-looking view. The first step here is to build a base case for affordability, which means determining the expected future cash flows of the company. This should reflect the operating environment and business risks (including industry-specific characteristics, for example, change in competitive dynamics), as well as the macroeconomic environment. The treasurer's strategic business partners, such as relationship banks, will be able to assist in building this out.

From those future cash flows, it is then possible to determine how much debt the company could, in theory, afford and, in turn, how much equity should be in place.

Once the base case is determined, it is advisable to test its resilience using scenario analyses. This means stress-testing key cash-flow drivers, such as operating profits, interest rates, FX rates, working capital, capital investments and other growth initiatives – which can be impacted by business or financial market conditions. The key is to stress-test for both in a way that is consistent with the specific challenges faced by the business. Take a Europe-based airline business as an example. If there is a significant move in the £/$ exchange rate, then not only will the jet fuel price change, since commodities are priced in dollars, but customer demand characteristics are likely to change accordingly. This means that a single event in the FX market could have a double impact on the business.

Taking into account all the different risk factors that could affect the company's profit margins and cash flows in this way helps determine whether the proposed capital structure (resulting from the 'affordability test') is still functional and affordable. In other words, does the debt/equity mix need to provide adequate headroom – or to maximise efficiency?

Stress-testing also provides an opportunity to consider how the optimal capital structure will tally with the company's risk management strategy, and vice versa. How can the treasurer better manage any of the scenario stresses in order to increase cash-flow visibility and reduce cash-flow volatility, for example? Treasurers should also take into account how risk management techniques may impact the optimal capital structure.

Time to review

Once all of these considerations have been factored in, the treasurer can set about implementing the capital structure that has been determined as optimal. But part of taking a forward-looking view also means recognising that this is a moving concept – and, as such, it needs to be monitored, reviewed and adjusted from time to time. A simple rule of thumb here is that if the company's cash flows change by more than 10% from one year to the next, then it is time to revisit your capital structure and risk management strategy.

And whenever you undertake this review, regardless of the company's credit rating or industry sector, the guiding principles should always be: efficiency, flexibility and liquidity.

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