Is there an Optimal Capital Structure for your Firm?

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Credit Ratings, Capital Management and Corporate Treasury Conference
Auckland, 30 August 2010

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Background

- CFO's choice of the firm's financial structure matters
- Task is complicated, with limited helpful advice offered by academia
- A theory of optimal capital structure remains one of the great unsolved problems of modern corporate finance

Background ctd.

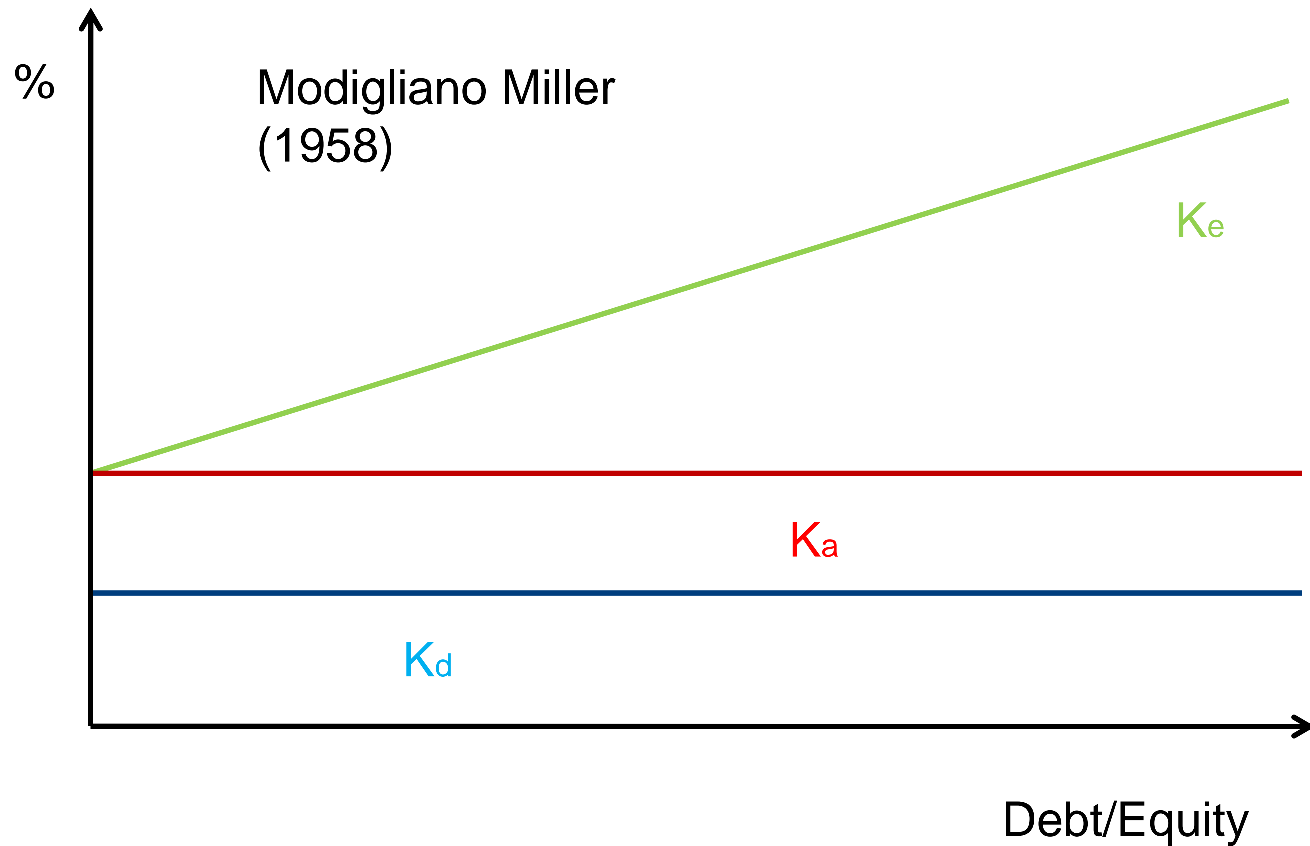
- Capital structure is a subset of financial strategy
- Financial strategy should support the execution of competitive strategy
- All about: the maximisation of firm value

Background ctd.

- Financial strategy choices fall into three areas:
  - Capital structure – the mix of debt and equity
  - Distribution policies – the dividend policies that achieve and support the chosen capital structure in the short, medium and long-term
  - Financing arrangements – the nature of debt and equity securities issued (and alternative financing arrangements used)

- My focus: what mix of debt and equity maximises the value of the firm in the current environment?

The Theory



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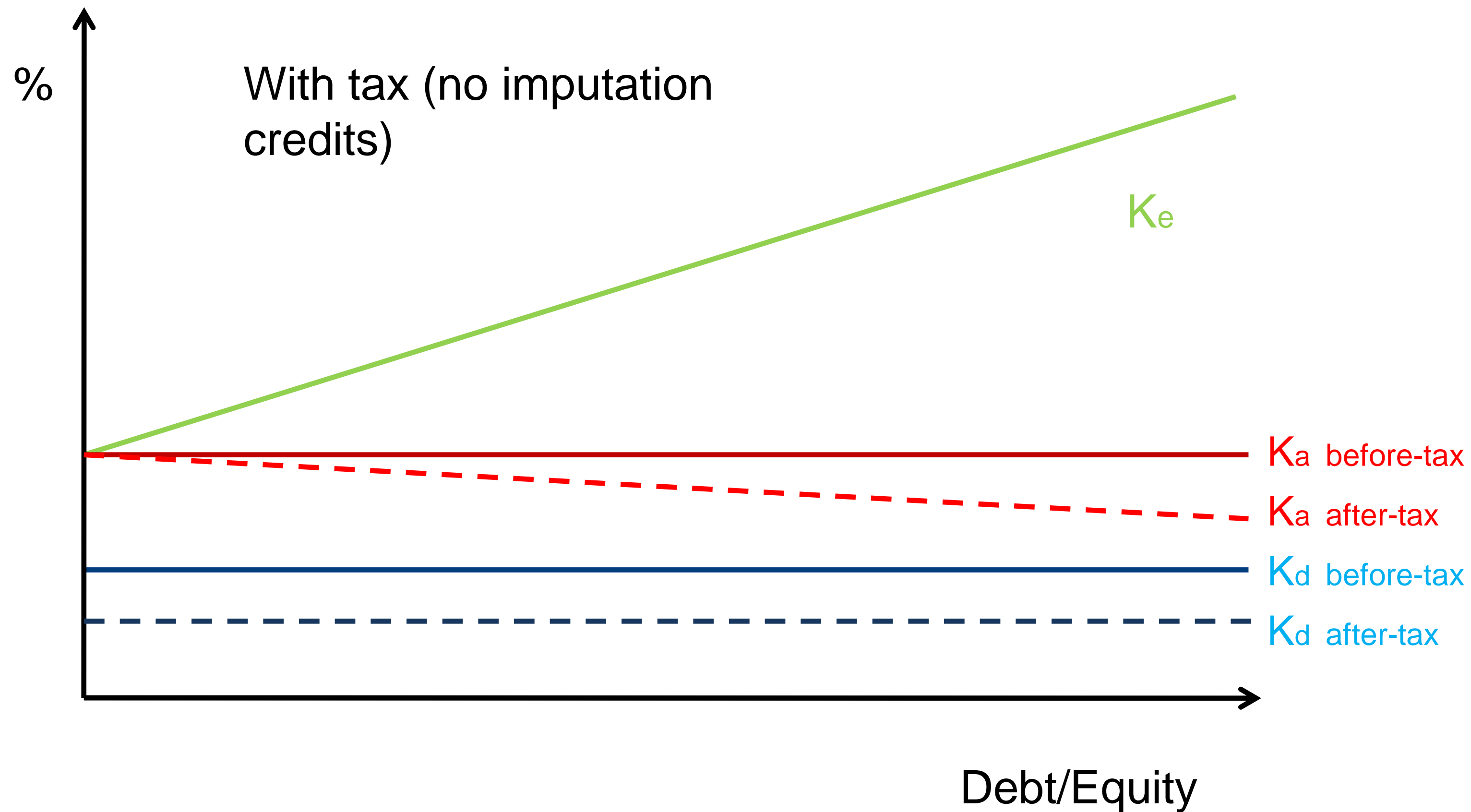
The Theory ctd.

The Theory ctd.



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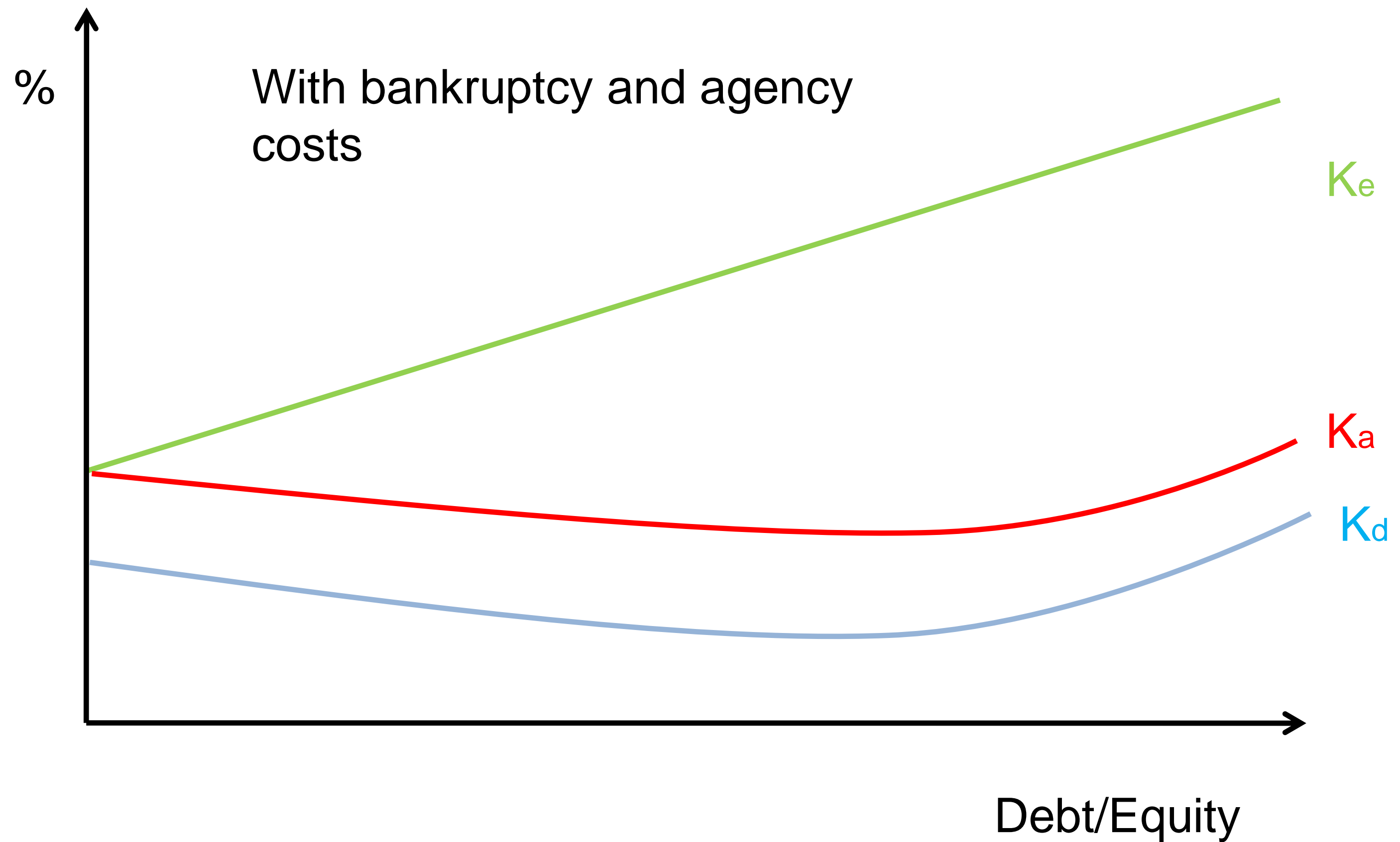

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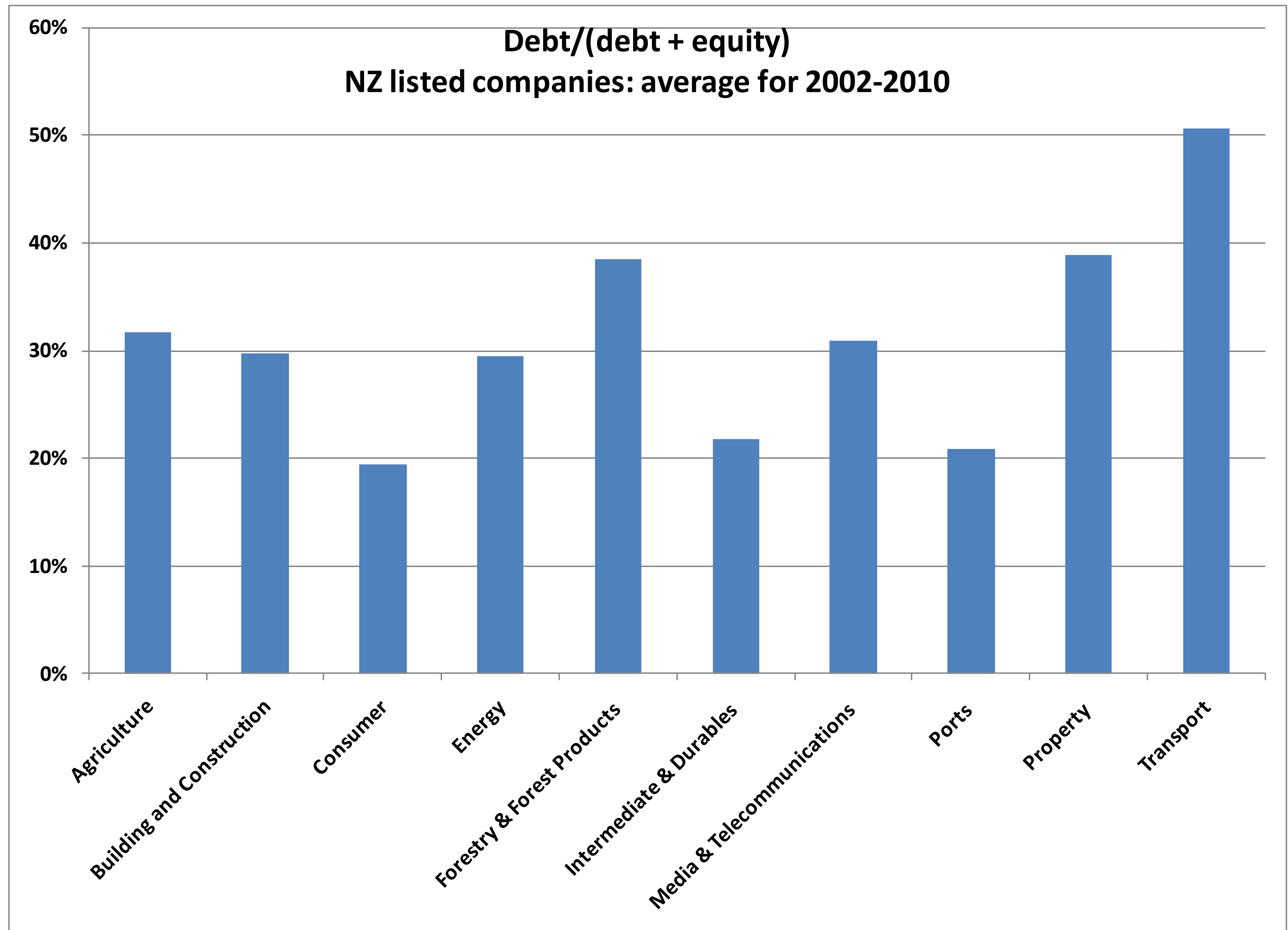
The Evidence



Equity based on market values

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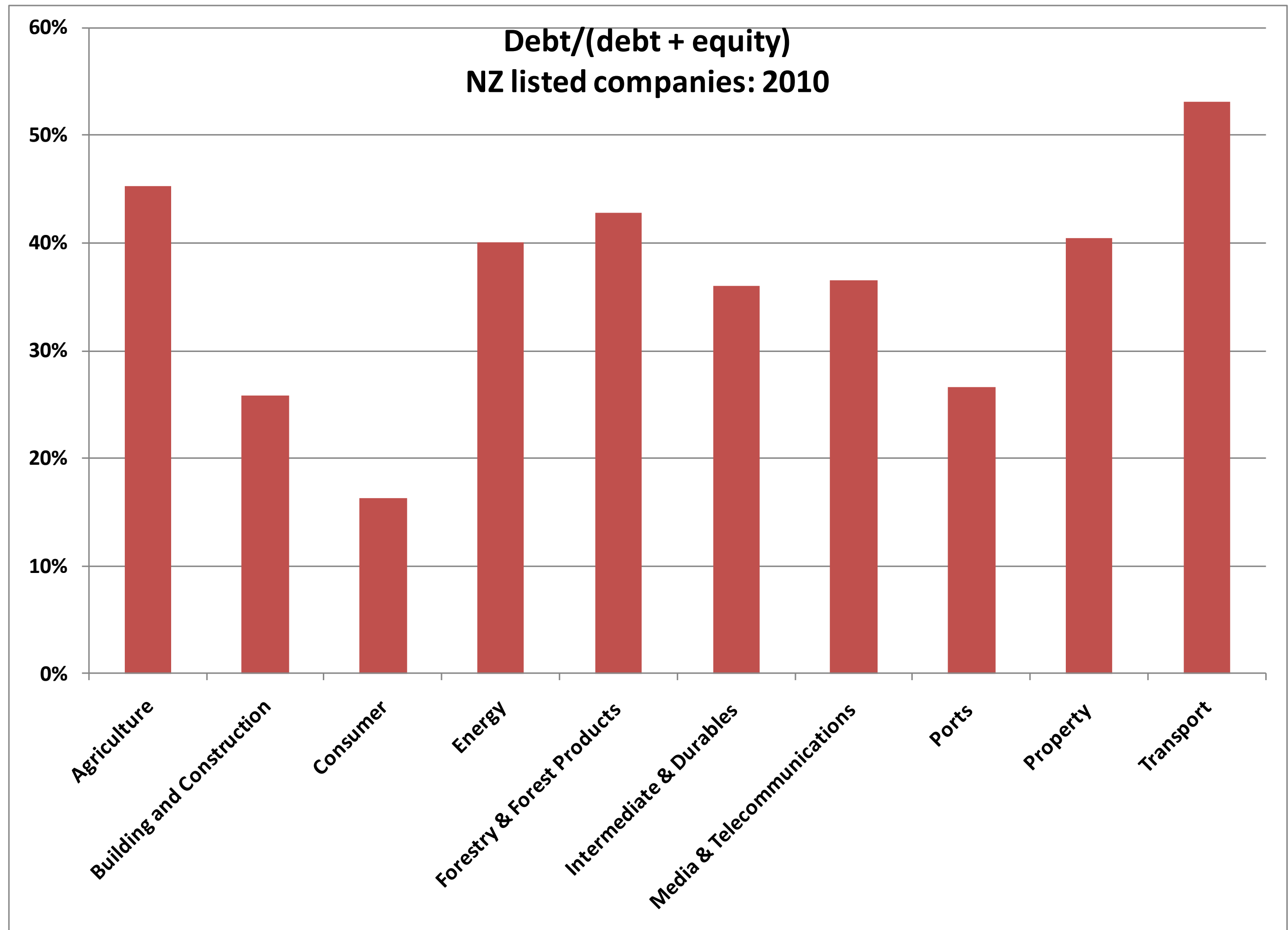
The Evidence ctd.



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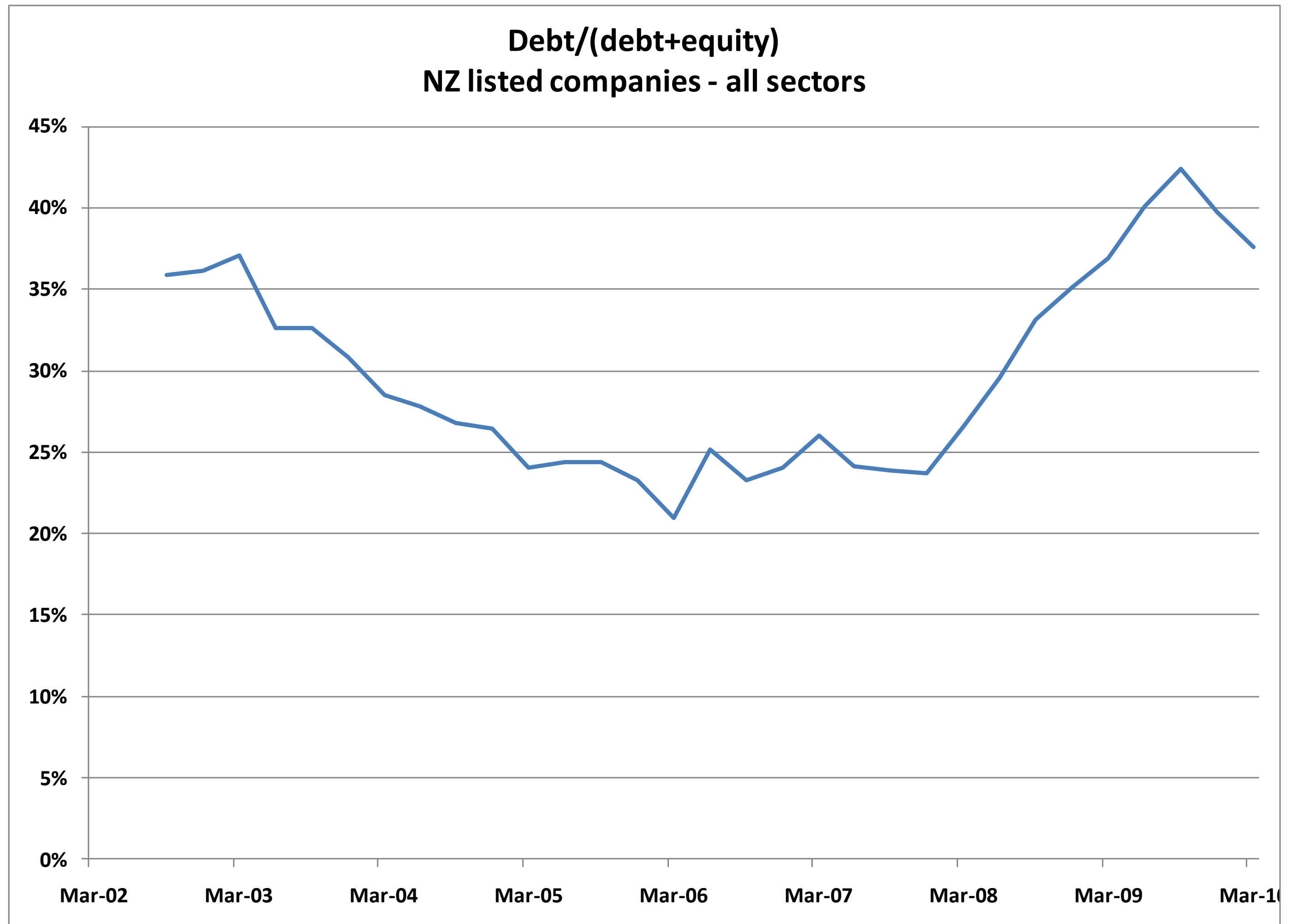

Equity based on market values

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The Evidence ctd.

- Caveats:
  - ratios can vary significantly within a sector
  - ratios can vary significantly for a single company over time
  - data covers listed companies only

What really matters?

- Maximising value requires striking the right balance between too much and too little financial flexibility:
  - too little financial flexibility means that the business:
    - may forego profitable investment opportunities through the inability to access funds when needed
    - faces an unacceptable risk of the costs of financial distress
  - too much financial flexibility:
    - raises the probability of agency costs, e.g. pursuit of unprofitable/unnecessary projects

What really matters? ctd.

- In practical terms, finding the right balance between debt and equity effectively involves determining:
  - the maximum level of debt that the business can sustain under normal operating conditions
  - without having an unacceptable risk of financial constraints reducing value by impacting on investment opportunities or causing financial distress
  - the ability to access equity markets is also key

What really matters? ctd.

- Assessing this debt level requires an assessment of a number of factors including:
  - expected operating conditions and earnings
  - factors that can cause “abnormal” operating conditions and how they impact to reduce earnings
  - the probability of these abnormal events and outcomes occurring
  - the probability of unexpected acquisition opportunities
  - what constitutes acceptable and unacceptable risk

What really matters? ctd.

- Factors that impact on financial flexibility:

  1. Source and uses of financial flexibility
  2. Debt covenants
  3. Credit rating criteria

What really matters? ctd.

1. Source and uses of financial flexibility

- Draw-down of existing debt facilities
- Defer/suspend dividends
- New equity
- Asset sales
- Defer investment projects
- Non-senior debt (eg hybrids/project finance/cross-border leases)

What really matters? ctd.

2. Debt covenants:

- set parameters on key financial ratios. Breach may invoke a review or give rise to default
- the primary financial strategy benchmark is to maintain a target credit rating.
- an investment grade rating ensures access to a broad range of debt providers/investors.
- the potential effects of dropping below an investment grade rating include:
  - Higher debt funding costs.
  - Funding constraints (lower appetite from capital markets and banks), more reliance on favourable borrowing “windows”.

What really matters? ctd.

3. Credit rating criteria:

- provide a useful external reference point for the expected cost of borrowing in various scenarios and also the expected access to debt markets
- to ensure that a BBB+ credit rating is maintained Meridian's financial policies have targeted:
  - A gearing policy Debt / (Debt +Equity) <35%;
  - Interest cover EBITDA/Interest > 2.75X;
- S&P provides some high-level guidance on the bands for key ratios for energy utilities likely to be associated with specific ratings:

What really matters? ctd.

3. Credit rating criteria ctd:

	Funds from operations interest coverage (x)		Funds from operations to total debt (%)		Total debt to total capital (%)	
	A	BBB	A	BBB	A	BBB
Transmission and distribution	3.25	2.0	15	10	55	65
Generators	6.75	4.25	42	27	35	45
Vertically integrated cos	4.25	2.75	27	18	45	56

Source: Standard and Poors: Ratings Methodology For Global Power Companies

Lessons from the GFC

- How has the GFC altered views on optimal capital structure?
  - more conservative levels of debt
  - wider range of assumptions for stress testing
  - more conservative financing structures
  - staggered durations
  - banks are more friendly again now
  - banks in good times tell you bonds are expensive
  - but CFO needs options in back-pocket

Lessons from the GFC ctd.

- Not everyone can access debt
- Key is what investors want
- Post-GFC there were a number of distressed recapitalisations

Lessons from the GFC ctd.

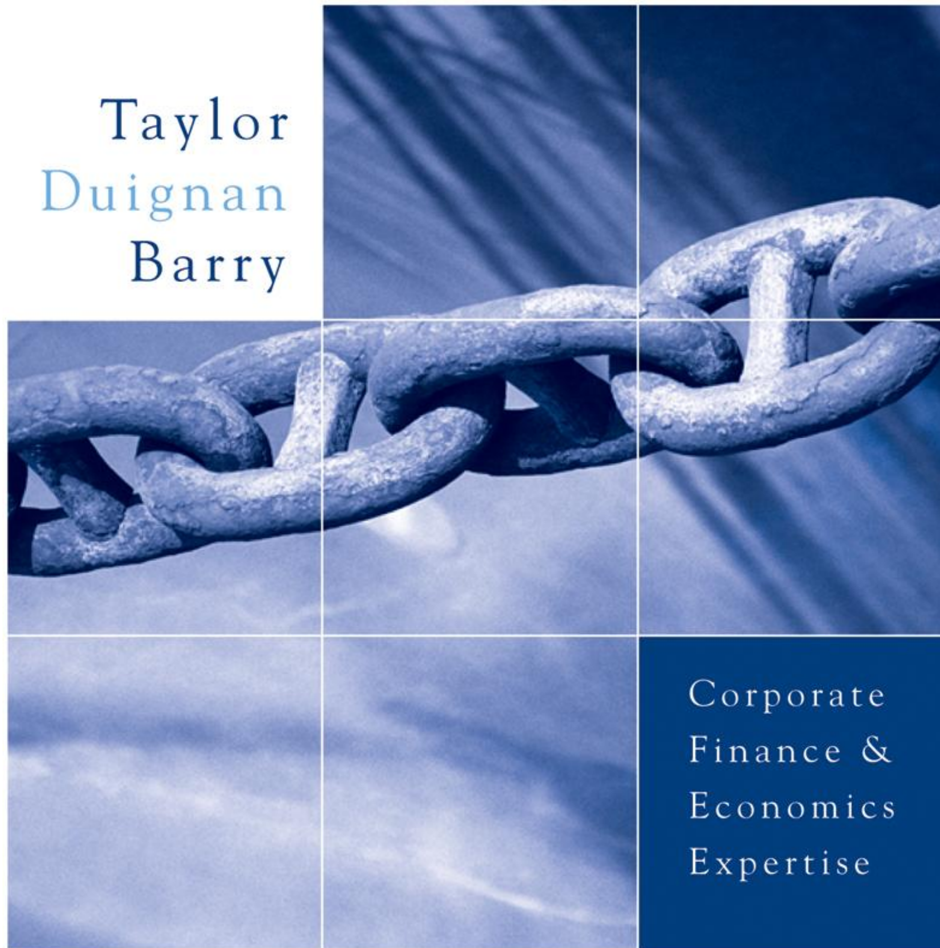
- Case 1. PGG Wrightson:
  - pre-GFC debt:EBITDA of 5- 6 was ok
  - Post GFC investors demand debt:EBITDA of 2
  - Investors wouldn't participate in the recapitalisation without reduced leverage
- Case 2. Fisher Paykel Appliances where debt blew out due to FX decline -P&L, not balance sheet, hedged?

Lessons from the GFC ctd.

- How able are you to access debt markets?
- Can you rely on banks to provide funds?
- What alternatives do you have to bank debt:
  - Bonds?
  - International debt markets?
  - Private placements?
- Will depend on your size and credit rating

Conclusions

- Capital structure matters
- Key is getting the balance right
- Don’t put all your financing eggs in one basket
- Keep your options open
- You as CFO/Treasurer have power (of information: don’t let others wield that power over you)



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