AFP® EXECUTIVE GUIDE
Capital Structure: Striking the Right Balance
Executive Summary

In today’s highly competitive and regulated business environment, one of the most important tasks for treasury and finance practitioners is to ensure that their companies are funded as effectively as possible. This means striking the right balance between the use of debt and equity to fund their organizations, to allow these companies to meet their long-term objectives. This guide has been designed to support practitioners in achieving this balance. It does not prescribe a set objective or target, rather it poses questions for the reader to consider in the context of their own organizations.

The guide has two main goals. First, it has been designed to support treasury professionals when developing their capital structure policy. Creating an effective capital structure is much more complex than simply targeting a particular leverage ratio over time. While it is possible to target a particular split between debt and equity to finance a company, there are many different dynamics that can affect how a decision to increase debt, for example, will affect the treasury and wider operations of that company.

Second, because the decision on capital structure is a fundamental one, it will be taken at board level. It is part of the finance team’s role to explain the implications of different decisions to board members before a final strategy is agreed. The guide will help CFOs, Finance Directors and Treasurers to develop presentations for the board. It should also help board members without financial experience to understand the complexities underpinning the decision, so they can help agree strategy from a better-informed position.
Why is Capital Structure Important?

The purpose of a company’s capital structure is to support the business’ growth given a highly competitive and regulated environment. Although there are a number of theories that seek to explain how companies should set their capital structures, there is no single structure that is appropriate for all corporations. Setting an appropriate capital structure is a balance between maintaining the financial strength of the company and providing sufficient opportunities to create growth. Get it wrong and a bad decision can result in a company losing control of strategy. But get it right and a company can grow with the confidence that it has sufficient financial flexibility to take advantage of opportunities as they arise and to provide protection in the event of a downturn in the economy.

What is capital structure?

A company’s capital structure describes how a company finances its long-term operations, via a balance between debt and equity. The challenge for any organization is to identify the best combination of financing to allow it to achieve its long-term strategic objectives. Corporate finance theory suggests that companies should seek a balance between debt and equity which maximizes their value. There are a number of different theories, each of which suggests an optimal capital structure can be calculated via one metric or another. However, it can be easy to get distracted by theories, especially those which provide an easily measurable solution, not least because no single theory is fully backed by evidence.

Although theory suggests the decision is primarily about achieving the lowest cost of capital, in reality it is much more nuanced than that. The decision has implications for the organization’s ability to respond to changes in the market environment and, critically, to take advantage of investment opportunities, which may occur from time to time. For this reason, determining an organization’s capital structure is a fundamental strategic decision that will need to be made at the board level.

When making this decision, it is critical to retain sight of the core feature of capital structure. This is simply that a board must set a structure capable of supporting the achievement of its strategic objectives. A good structure will allow the company to grow and meet business objectives in the prevailing market environment. Metrics and measurements are useful tools, but they should never be the sole determinant.

All businesses have to accept some risk. In the case of start-ups, for example, shareholders accept a major risk when making the initial decision to form a business. The initial risks change as the business starts to grow. Established corporations face similar challenges; as products mature and the business environment changes, management has to decide whether and when to take opportunities to invest in new projects. For each opportunity, an organization’s corporate leadership will need to evaluate its risks and its potential returns, both from a standalone basis and from a wider corporate strategy perspective. In other words, a prospective opportunity must be both attractive in its own right, but it must also support the organization’s achievement of its wider objectives.

For Stephane Bello, Executive Vice President (EVP) and CFO of Thomson Reuters, this is a critical task. “I always try to get the right balance between making the capital structure as efficient as possible without exposing the business to undue risk.”

What is the practitioner’s role?

The treasury practitioner’s role in this process is twofold. First, they must help board members to make an informed decision about the most appropriate capital structure for their organization. In most organizations, few board members have formal finance training or experience, so explaining the likely implications of different decisions will be helpful. The process for providing this information to the board will vary between organizations. In many cases, information will be routed through the CFO, although sometimes treasury practitioners may be required to brief board members directly.

How do you educate the board?

Ensuring the board is able to make an informed decision is one of the CFO’s primary responsibilities. Setting the capital structure is the core financial strategy from which every other treasury and finance policy will flow. Thomson Reuters holds five board meetings a year, one of which is on capital structure and capital strategy. At the meeting, EVP and CFO Stephane Bello reviews the key principles governing the company’s approach to capital strategy and discusses near-term recommendations. At this meeting, the board is asked to make a series of decisions: on the balance between debt and equity, how the company plans to use capital and on any share repurchase scheme. “The board has to sign off the capital strategy,” explains Bello, “as it is designed to support the overall business strategy.”
Second, practitioners must then implement the board's decision. Although achieving a balance between debt and equity might appear relatively straightforward, in reality the differing characteristics of the various types of debt and equity mean implementation is just as important as the board’s strategic decision. Within both categories of debt and equity, there is a wide range of different instruments, each of which have slightly different qualities. For example, debt includes publicly issued and privately placed securities, as well as loans sourced from banks and other lenders, while equity includes common stock and retained earnings. In addition, some companies also issue hybrid securities, such as convertible bonds and preference shares, which have characteristics of both debt and equity. Most organizations will use a combination of different funding mechanisms, not least to maximize the pool of potential investors. Each instrument will give each lender (or group of lenders) different claims on the borrower, both in normal business conditions and after a trigger event (and each instrument may have a different trigger event, from failure to make a payment to falling below a preset cash ratio).

Given these differences, the details of each individual debt and equity financing can have a clear and identifiable impact on the borrowing company. In the case of debt, details to manage will include an instrument’s maturity (when a refinancing may be necessary), any covenants or other terms (which the company is required to meet) and the currency and interest rate associated with the debt (both of which will need to be managed). These differences can result in treasury practitioners having to ensure their organizations continue to comply with potentially conflicting terms and conditions set at each round of financing. For that reason, it is just as critical to select appropriate, and complementary, financing instruments, as it is to achieve the set overall capital structure. Selecting inappropriate instruments may restrict the organization’s ability to retain its financial flexibility and, therefore, ultimately its ability to meet its core business objectives.

**Is There an Optimal Capital Structure?**

Because of its central importance to corporate strategy, there are a number of theories aimed at helping companies to develop the most efficient capital structure. This section outlines the core theoretical concepts and assesses whether it provides sufficient direction to treasury practitioners. It assesses ways in which practitioners can adapt the concepts behind an optimal structure to develop a target capital structure.

**What is the optimal capital structure theory?**

There are a number of theories that aim to define the optimal capital structure for any company. Of these, the most often used is trade-off theory, which suggests that organizations trade off debt and equity to reach an optimal position, which is where its weighted average cost of capital (WACC) is at its lowest point. Assuming a company is initially financed by equity, any new financing arranged by debt would be cheaper than issuing new equity, not least because organizations benefit from being able to deduct interest payments on debt for tax purposes. At each new round of financing, the organization chooses to issue additional debt because, as the level of debt increases, so too does the value of interest payments that can be deducted for tax purposes. At this point, the company’s WACC would also continue to fall because of the relative cost of issuing debt and equity. However, as companies increase their level of debt, the burden of meeting the repayment schedule increases, resulting in a higher risk of bankruptcy and its associated costs. Recognizing this, new potential investors would start to demand an increased return on their investment as the ratio of indebtedness increased, eventually resulting in an increase in WACC, as debt and equity costs start to increase. This point at the bottom of the curve represents the theoretical optimal capital structure, illustrated in the diagram below.

However, although the theory is straightforward, it is less useful as an explanation of how organizations approach their capital structure decisions. The fundamental problem is that few organizations even try to calculate the costs of bankruptcy and so cannot try to determine their lowest potential WACC. Internal factors also play an important role. For example, companies are more likely to accept a higher leverage ratio if they can be confident that, in bankruptcy, their assets will retain...
their value. Other companies may not be mature enough to be able to trade-off debt and equity; start-up companies may use other capital budgeting techniques to calculate the value of their assets, because future cash flows may not be generated for some time. These companies may also use simulations to try to determine whether to make any new investments.

Comparing the characteristics of debt and equity
Given the difficulty in identifying an optimal capital structure or, perhaps more realistically, a structure that works, trying to target an appropriate leverage ratio is not sufficient. Instead, it is critical that all parties to the board’s decision on capital structure understand the implications of accepting different forms of financing for their companies. This means having a clearer understanding of how the characteristics of debt and equity financing vary.

The characteristics of debt financing
When considering increasing debt, understanding how additional debt impacts an organization is key. Companies can increase debt in many different ways and from many different types of lenders. There will be different consequences in the event of a debt default, depending on whether that debt is secured against collateral or not. Finance can also be arranged privately from a variety of lenders not limited to banks, specialist asset and lease financiers, and via public markets, making the debt a matter of public record.

Advantages
Generally debt costs less than equity for two key reasons. First, debt has a lower risk because of the key commitment to pay under the terms of the agreement. Second, debt repayments are usually tax deductible – although there are some circumstances in which it is not.

There are other potential benefits from issuing debt, which may arise depending on the detail of the instruments used:
• **Imposes discipline on financial management**
  Debt imposes restrictions that can add discipline to the company.
• **Debt can be used a risk management tool**
  It is possible to structure the debt to help manage foreign currency and interest rate risk. Borrowing can be arranged in a particular currency to match particular cash flows so, for example, a company can use cash flows generated in one currency to meet repayment obligations in that currency. This can also be structured via the use of a foreign exchange swap, so that funds can be borrowed in a currency with a lower interest rate but repaid in a currency in which the borrower generates cash, although there are additional counterparty risks associated with such transactions.

  Practitioners can also structure the next financing round to retain a target balance of fixed to floating rate debt as part of a wider approach to managing exposure to interest rate risk.

• **Easy access to liquidity**
  Capital markets are generally well established and have, apart from some key moments, demonstrated to be relatively liquid and an efficient way of raising both short-term and long-term finance. This is easier for more strongly rated credits, especially as changes in bank regulations force investors to look elsewhere to place deposits. The availability of capital market funding does vary between countries both in terms of the depth of the market and in terms of the role of ratings. For example, the level of unrated bond issuance in France and Germany is much higher than in the more ratings-driven US market.

• **Positive impact on shareholders and shareholder value**
  From the shareholders’ perspective, debt is attractive because their shareholdings do not lose value as a direct result of the fundraising (although the increased leverage might have an impact). Similarly, holders of debt play no direct role in the management of the company (unless there is a default), although the need to maintain or achieve a particular credit rating to attract bond holders can have an impact.

Disadvantages
Just as debt finance offers some advantages to companies, so there are some disadvantages, some of which can escalate as the level of debt increases.

• **Discipline turns to restrictions**
  Depending on the terms and conditions imposed by the lender, assuming additional debt may restrict a company’s ability to manage its assets in a particular way. Most commonly, banks may place covenants in loan documentations that require the borrower to operate within certain constraints. This means as well as meeting particular loan repayments, the company must also commit to certain conditions (e.g. maintaining a certain debt to equity ratio). This will impose additional compliance and reporting requirements on the company and there may be significant consequences in the event of a breach of covenant. Note that, while covenants do represent a constraint on a company, they become a problem if they either prevent the company acting as planned or, more worryingly, if they contain conditions not fully understood by the borrowers. That said, in many organizations, the need to comply with covenants provides
a trigger to impose stricter financial discipline on the company itself.

- **Increased financial risk**
  Increasing debt does represent an increase in financial risk assumed by the company and will, at some point, increase the company's WACC. At this point, they may lose the flexibility to be able to increase borrowing further, at least on existing terms. They may have to accept more constraints and/or pay higher interest costs to raise additional debt. This adds to financial risk, both in terms of meeting higher debt repayment costs and also, on maturity, of achieving refinancing on acceptable terms.

- **Debt markets may dry up**
  Although weaker credits may have more difficulty, even the strongest credits need to have contingency plans to finance maturing debt. Even though it is rare for markets to completely dry up, practitioners are wise to manage their capital structure so that they are not fully reliant on immediate liquidity in the debt markets to finance or refinance. Practitioners will do this by holding more cash on the balance sheet than might be suggested in theory and by tapping debt markets when there is no immediate funding requirement.

- **Overleveraging could lead to a negative impact on shareholders**
  Shareholders are aware that bondholders have priority in the event of any bankruptcy or similar event, and may exercise their voting rights collectively should they feel the organization is becoming overleveraged.

### The characteristics of equity financing

Note that for the purposes of capital structure, equity financing includes both the issuance of new shares or stock and the use of retained earnings to finance a new project.

#### Advantages

- **No external constraints**
  There is no obligation under equity financing to make fixed payments or, necessarily, to meet particular targets or comply with covenants.

- **No refinancing risk**
  Equity investors redeem their investment via secondary market stock sales. Equity financing does not mature and so there is no need to repay investors and therefore no refinancing risk.

- **Preserves access to liquidity**
  Because it is subordinate to debt finance, any equity financing protects against bankruptcy as it can mitigate against any losses for other creditors.

#### Disadvantages

- **Lack of discipline**
  With equity finance, especially retained earnings, it can be easy to be less rigorous when calculating the cost of capital, than would be the case when arranging bank finance with associated covenants.

- **Issuance costs**
  Equity sales usually need to be underwritten and the cost of doing so can be high. Compared with debt, equity finance cannot be written off for tax purposes.

- **Impact on shareholders**
  Any sale of equity will extend voting rights to new shareholders. This might dilute control of existing shareholders, except where managed via a rights issue, and as the number of shares increase, by definition the earnings per share decreases. The board will need to communicate their intentions to shareholders clearly.

### Target capital structure

The concept of the optimum capital structure is helpful as a theoretical concept, but in practical terms it is of limited value to financial professionals seeking to implement a capital structure strategy on behalf of their organizations. At the very least, the optimum capital structure concept only focuses on the relative cost of debt and equity. It does not reflect the wider environment in which corporations operate. For example, the cost of financing can be affected by the nature of the company’s activities, its cash flows and its asset base; the business life cycle of a mining company is vastly different to that of a retailer. Cash flows and asset bases both have an impact; the asset base can provide collateral against longer-term loans and steady cash flows allow a borrower to service loan repayments. Service industries are different again. In summary, the asset base and pattern of cash flows enable companies to carry different levels of debt and so each company will want a capital structure that reflects these differences.

Given this information, many companies choose to set a target capital structure. Instead of being a theoretical point on a curve on a diagram, a target capital structure is likely to be a ratio of debt to equity within a target range. The finance team will seek to arrange any new borrowings such that the company remains within this target range over time. If the level of debt starts to fall towards the lower end of the range, the company will seek to raise new finance via debt issuance. If the level of debt starts to rise towards the higher range, the company will look to raise finance via equity. The range is set by the company’s board and management in a way that reflects their understanding of the relative debt capacity of the com-
pany. If the management's understanding of the company's debt capacity is correct, as long as the company's financing is within the target range, the company's cost of capital will remain relatively constant. Only by financing outside this range (either by taking on more debt or issuing more equity) will the cost of capital increase significantly, and the company will experience a fall in value.

From a theoretical perspective, using the concept of a target capital structure, rather than an optimal capital structure, is helpful as it reflects the dynamic nature of the environment in which companies operate. Very few finance practitioners have the ability to calculate WACC accurately on a daily basis; even fewer try. Given volatile exchange rates, constantly moving interest rates and the complexity of tracking all relevant data, a target capital structure makes much more sense.

This target also recognizes the way in which this situation can change over time. For instance, as companies generate cash, the debt to equity ratio naturally falls. Opportunities to invest for the longer term vary over time too, especially as management and the board alter their approach to risk as the wider economy strengthens or weakens. For example, management may prefer to rely more on equity finance (notably in the form of retained earnings) as the economy weakens.

Reflecting Reality in the Capital Structure

Assuming each organization should identify a target capital structure, this target should reflect all the various factors that will impact its cost of capital and its debt capacity. These factors will be both external, such as the business and regulatory environment, and internal, such as the group's corporate culture and, especially, its overall appetite for risk. Without a clear understanding of these factors, companies will not be able set a target capital structure that reflects the interests of potential investors and that permits the company to achieve its corporate objectives.

External factors

There are a number of key external factors that affect the decision on capital structure. These are:

Perception of business risk

In general terms, the higher the perception of business risk, the lower a company's debt capacity is likely to be. Put simply, an investor's perception of a company's inherent business risk is critical to being able to raise finance. All investors have different target risk and returns, driven primarily by the nature of the

Changes to Capital Structure over the Years

In a paper, “A Century of Capital Structure: The Leveraging of Corporate America,” John Graham, Mark Leary and Michael Roberts analyzed the approach of US non-financial publicly traded firms toward their capital structure. The analysis found that there has been a significant increase in leverage from the initial period (1920 to 1945), when, in aggregate, companies maintained a leverage ratio of between 10% and 15%. The aggregate leverage ratio tripled between 1945 and 1970, and has remained above 35% since 1970. At the same time, companies have been reducing their cash (and other short-term instrument holdings): these stood at close to 25% of assets in 1945, falling to 6% in 1970, before climbing back to about 10% in 2010.

When seeking an explanation, the analysis did not find sufficient evidence to suggest the pattern was a result of changes to companies' characteristics or variation in industry composition over this time. Instead, the writers found a much stronger negative correlation between U.S. government fiscal policy and corporate capital structure activity, such that they found that “when the government reduces debt issuance, corporations increase their use of debt relative to equity, resulting in an increase in corporate leverage.” On the other hand, while the writers found a positive correlation between tax rates and the use of debt relative to equity in the first period of the study, this relationship has not held in more recent years.

The paper’s core conclusion is that the changes documented in the paper cannot be fully explained by traditional capital structure theory and it recognizes that wider economic factors are important when seeking to explain corporate capital structure decisions. The full paper can be read here.

funds they are investing. There is a form of risk-reward spectrum with investments in start-up technology companies toward one end and investments in long-established utility companies near the other. Finance managers have to understand where their organizations are on that spectrum so that they can appreciate a realistic sense of their target capital structure. Without this understanding, they may find it more difficult (and more expensive) to identify investors to support them.

Understanding the degree of relative business risk requires an analysis on the stability of cash flows and overall profitability. The more stable the cash flows, the more confidence a manager will have in committing to a debt repayment schedule. The more stable overall profitability, the less likely bankruptcy is, so the better able the company is to manage its borrowings. There will likely be fewer constraints on borrowings as the company can demonstrate good cash flow. Any covenants should be drawn such that they have no foreseeable adverse impact on the company as a whole.

**Market conditions**

Any target capital structure decision needs to be capable of being implemented. Just because a company wants to issue debt to remain within the target range, it does not mean that the market conditions will enable the company to meet those objectives.

First, market conditions can vary significantly such that the availability of a particular type of financing is either expensive or, in some cases, temporarily unavailable. This may be a global situation or specific to a particular market. These will play a role as they affect both borrowers’ appetite for funding (especially where the funding requirement comes from the appetite to invest, rather than to cover working capital requirements) and the potential investors’ appetite for risk. Since 2008 we have seen different countries grow at different rates, with market confidence varying accordingly.

Second, companies looking to finance internationally will experience different conditions in each market in which they operate, making it easier to raise finance in some markets than others. The overall size of the markets vary considerably from country to country, so it may not necessarily be possible to raise the desired volumes in smaller markets. (It may also not be prudent to try to raise large volumes in a smaller market to avoid becoming over-reliant on a small number of investors, especially on maturity.) It is also important to consider specific market practices in each country, especially on the debt side; in some countries, bank finance is more widely used than the local bond market. For example, for US-based organizations, the domestic US money and capital markets are generally deep and liquid, especially for the stronger credits. Weaker credits may need to approach alternative lenders, but even then there are a range of providers prepared to support them, albeit at a price. In other markets, the money markets or capital markets may not offer the level of financing needed by particular companies. This applies in many of the key markets in Europe and Asia. Here, the range of financing opportunities outside the global finance centers will not match that available in locations such as New York, London, Singapore and Hong Kong.

Also, note there may be different expectations of potential borrowers between different markets. One example comes from the use of credit ratings. The US is highly ratings driven, whereas other markets, especially smaller ones, rely more on name recognition.

Understanding the scope of different markets is an important element of achieving fundraising in those locations. Effectively, when setting the target capital structure, finance managers also have to understand where they expect to be able to issue debt or arrange bank loans. Note too that there may be foreign exchange risk management implications when seeking to tap liquidity in some foreign markets.

**Regulatory environment**

Practitioners have to work within the prevailing regulatory environment in which their businesses operate. This applies just as much to capital structure management as to other treasury activity. There are a number of factors that can affect the company’s capital structure. The most common factor is the group’s exposure to tax, as interest payments on debt are tax deductible. This means that the higher the rate of tax paid by the company, the more the company can use the tax deductibility of interest payments to reduce the level of income liable to company tax. For US-headquartered companies, the relatively high US corporate tax rate has also influenced many organizations to retain cash balances outside the US to avoid having to pay high levels of tax on repatriation. This inevitably has an impact on capital structure with greater amounts of cash being held on balance sheets than would normally be suggested by theory.

Practitioners in multinational organizations will also need to ensure all intercompany financing arrangements, including the capitalization of all group entities, are compliant with Base Erosion and Profit Shifting (BEPS) rules and that they have the ability to capture all the necessary data on a country-by-country basis.

Regulation plays an important role in other ways too. Exchange controls can make it more practical for group entities in certain jurisdictions to raise funds locally, because of
How Important are Credit Ratings?

First, understand what they are and how they are used. For many market participants, credit ratings are a key piece of information that reflects the underlying creditworthiness of the business. Fundamentally, a credit rating is a view by the agency of an issuer’s ability to meet any relevant financial obligations in full and on time. It is not a guaranteed view and it is not a prediction of likely future outcomes. Credit ratings are a useful tool because they shortcut the process of providing information about a particular issuer (or set of issuers) and help investors by categorizing issuers into levels of creditworthiness.

From an issuer’s perspective, credit ratings are important because of the role they play in many investors’ investment policies, whether the investment instrument is debt or equity. Few investors will rely completely on ratings when selecting a potential investment in either stock, bonds, commercial paper or any other instrument. However, they are much more likely to rely on ratings when deciding not to invest or when to sell any existing investment. Most investment policies contain restrictions that limit the proportion of any invested cash to be placed in instruments with ratings below a certain threshold. Any change in credit rating might represent a trigger to reduce or completely withdraw holdings instruments issued with that rating. These triggers are important for investors as they help investors to manage counterparty credit risk.

The key issue for any treasury practitioner is to understand the implications of any change in rating, which will be more acute in ratings-driven markets. There may be a sell-off of some paper, resulting in a change in bondholders or stockholders, depending on the precise change in rating; a shift from investment grade to “junk” will have the greatest implications. In the short term, this may not matter too much as the borrower will continue to have to meet its obligations. It may cause more difficulties when any existing debt needs to be refinanced for three reasons. First, the price will increase to reflect the reduced demand for the paper among the current investor pool. Second, any roadshows and other marketing events will be more complex as it may be necessary to widen the pool potential investors, all of whom may require additional information. Finally, there may be an impact on stockholders too. For example, dividends may need to be cut to continue to afford current spending.

One part of capital structure management is, therefore, to understand the importance of any credit ratings to the investor community on both the debt and equity sides and then establish how important it is to achieve (or retain) a particular credit rating. A stable rating may help to provide stability in financing, in the investor pool and in debt pricing. Note that it may not be necessary to target a specific rating (e.g. BBB) to achieve that stability, as a general investment grade rating may be sufficient. Moreover, the agencies do change their methodology periodically, so the maintenance of a specific rating may require companies to alter their approach to reflect any changes, without any appreciable gain.

Understanding how the agency develops its rating will help to manage capital structure too. This will help practitioners understand how each agency will respond to particular capital strategy decisions, such as a new debt issuance program. This knowledge will help the treasurer determine the most efficient use of existing liquidity and whether it is appropriate to issue new debt. With a qualitative assessment, the analyst will consider how the funds raised by the debt issue will support the business and impact future cash flows in a way that a quantitative assessment cannot. Keep in mind that a rating agency’s view of a particular company or issuer will be framed by its wider view of both the industry in which the company operates and the country in which it is based.

Practitioners will also need to determine how best to interact with ratings agency. It is good market practice to maintain good relationships with ratings analysts. There are plenty of ways to do this, but it should involve a sharing of information at least once a year and about important interim corporate actions. Analysts can be given access to confidential information which is not shared with other parties, such as banks and other investors. Managing a relationship in this way means that analysts are more receptive to information when things don’t turn out as well as expected.
the difficulties in repatriating cash to the home office. Where
funds are raised centrally and then disbursed via intercompany
loans, companies need to ensure they comply with tax and
other regulations, such as transfer pricing rules.

**Internal factors**

Similarly, there are a number of internal factors that also
impact on capital structure decisions.

**Corporate structure**

For multinational organizations, for example, managing
capital structure has become much more complex. They need
to decide where to raise funds. In other words, companies can
choose between a centralized funding model, where funds are
raised centrally and then disbursed throughout the group (this
often has the benefit of being more cost-effective as the central
group may enjoy a stronger credit rating) and a localized fund-
ing model, where funds are raised locally. This might be to tap
into different investor pools, to match the currency of debt
liabilities with locally generated revenue streams, or because
the corporate culture is one where these decisions are managed
at subsidiary level.

**Management style**

The group’s management style also plays an important role.
Companies, which aim to grow quickly, will generally seek to
finance this growth by debt. By definition, any growth in the
corporation has a greater impact on earnings per share than

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**Case Study: Managing Capital Structure in a Cash Generative Business**

For many companies, achieving an efficient capital structure means evaluating whether to fund
new projects via debt or equity issuance. However, for cash generative businesses, the calculation
can be different. These companies are often able to finance expansion or investment in R&D
from retained cash flow, so deciding how any retained cash is used becomes more important.

One example is a multinational retailer, which uses retained cash to finance the opening of
any new stores, both domestically and internationally, as long as the decision meets the
company’s internal return on investment conditions. When entering a new territory, it establishes
a local subsidiary, which is capitalized by the parent from its free cash flow. Additional new
in-country stores can then be opened, financed by cash flow generated from the first store,
which is, if necessary, additional cash from the parent.

Although the company has arranged some short duration debt to fund specific projects over
the years, the company has not come to the market for long-term funding in recent years. The
CFO and the treasurer recognize that it would be difficult to justify any debt issuance, given
the company’s strong cash flow and the current interest rate environment, as the primary
impact would simply be an increase in interest expense.

With much of the free cash flow reinvested back into the business, the company also has
to manage relationships with its shareholders. As well as seeking to achieve an appreciat-
ing share price, the company rewards shareholders via the payment of a regular, quarterly
dividend. It also has an established share buyback program which has been operating for a
number of years.

This company shows how its specific management style plays a key role in determining its
ideal capital structure. The decision to expand organically means the company has a low debt
to equity ratio and, without a change in strategy, this is unlikely to change. More importantly,
though, this decision has allowed the company to achieve its objectives: it has continued to
grow over recent years, its share price has appreciated and it has been able to make regular
returns of cash to shareholders.
growth financed by increased share issuance. However, the capital structure should also protect the company against very fast growth; too much growth can result in cash flow problems, which can result in management losing control of the capital structure.

**Corporate appetite for risk**

This general management style contributes to a wider corporate appetite for risk. This appetite will influence not only the company's overall approach to growth, but also its attitude to managing the full range of risks faced by the company. As with other factors, a company's approach to risk can change over time, as their businesses develop. This general appetite will also influence how the company assesses potential new investments; a mining company is necessarily more conservative than a retailer for example. It is important to reassess this appetite for risk periodically and, critically, confirm that the capital structure reflects this.

Market conditions will also affect an appetite for risk. For example, companies will tend to hold more cash in uncertain times, although this does give rise to other risks, such as how to manage this cash.

**Asset structure**

Each company's underlying asset structure will have a critical impact on the level of debt it can support. If assets are owned, then the company may be able to use them as collateral to secure other borrowings. Potential investors will also assess how any unsecured assets are (and can be) used to generate cash flows to repay any borrowings.

Managing the asset base effectively is a critical task in managing the wider capital structure. Although it may be efficient to use certain assets as security for a particular loan, bondholders might react negatively if this results in less free cash flow remaining available to meet obligations due to them. As with the wider issue of capital structure management, getting the balance right between using assets as effectively as possible while retaining sufficient free cash flow is crucial. It is very important to talk through any potential changes with both bondholders and rating analysts to understand their implications before making any decision on committing certain assets as collateral.

**Profitability**

Retained earnings are often an important source of funding for the company, particularly because they do not have the costs associated with either debt finance or equity raising. The challenge is to use retained earnings effectively. Because they are an internal source of funding, a company is not reliant on investor appetite (and their terms and conditions) to finance the next project. However, this lack of external scrutiny may mean any cost-benefit or similar analysis of an internally resourced project is less robust.

The availability of retained earnings will change over time. Initially, during a growth phase, companies are more likely to borrow to fund expansion. Over time, as the business developments (e.g. new products come to market), they will tend to de-lever as funds are generated to repay the debt. The problem is that companies which need the funds are typically charged more for them as they don’t have the free cash flow or retained earnings available to reduce investor’s risk.

**Stakeholder interests**

As far as possible, it is very important to align capital structure to all stakeholder interests. At first sight, it might be difficult to reconcile the demands of shareholders, who want growth, and those of bondholders, who are more concerned with risk management. However, if the capital structure is clear and is consistent with the broader business strategy, all stakeholders should retain confidence, even their priorities will continue to vary.

**Customer and supplier base**

For some organizations, maintaining a strong capital structure is critical to building the customer or supplier base. This applies when the customers or suppliers place creditworthiness high on their criteria when purchasing new products or services. This is important for banks, for example, as no customer will want to bank with an institution which might fail. It also applies when an organization puts a project out to tender. In the case of a manufacturer wanting to build a new production facility, potential contractors will only apply if they think the manufacturer is financially robust enough to meet its obligations.

“Our management team needs to balance the investment time horizons for all our stakeholders. Ninety-eight percent of our stores are franchised. Our franchisees typically sign 20 year agreements with us, so we have to align our management decisions, including capital structure considerations, to them and their interests. If we don’t, it could be to the detriment of the company as a whole.”

Grady Walker, Treasurer, Popeyes Louisiana Kitchen.
Desire to retain financial flexibility

Ultimately, most finance managers want to be in a position where they have access to sufficient funds when they need them. More generally, this retaining some spare debt capacity, in case more funds are needed. At the same time, companies may also decide to fund opportunistically, by taking advantage of cheaper funding as and when it becomes available. When arranging debt financing, practitioners should also try to ladder the maturity schedule across all borrowing, so that the company is not faced with a significant refinancing problem when a large proportion of its borrowings all mature at the same time.

“Debt usage today has to be restrained to maintain financial flexibility, that is the ability to fund future profitable investment opportunities.”

Michael Roberts, William H. Lawrence Professor of Finance, the Wharton School, the University of Pennsylvania.

Determine an appropriate target capital structure

All these variables can be combined with the concept of a trade-off between debt and equity to develop a target capital structure for any company. While the relative importance of each factor will vary between companies, the process of considering each one will help practitioners and the board identify the most appropriate target capital structure for their respective organizations.

Selecting a target rate

When moving into new markets or making a new investment, any capital budgeting decision will require a hurdle rate of return. As long as the expected return is higher than this hurdle rate, the company should decide to invest.

However, it can be difficult to select this hurdle rate and, in particular, whether this should be an actual rate based upon the individual project or a longer term target rate. “At Thomson Reuters, we always use a target rate, which is higher than our current cost of capital”, explains Tim Collier, CFO Financial and Risk. “We use a target rate to continue to drive growth and improvement and to reflect the riskier nature of new investments.”

Achieving the Desired Capital Structure

The previous sections have helped readers identify the factors to consider when determining what might constitute the most appropriate structure for their organizations. As with the implementation of any policy, it will only be successfully achieved if the practitioner can manage the, sometimes complex, details.

Consider the details

It is all very well looking at the concept of debt or equity, but in reality this distinction masks a whole host of characteristics which can have a major impact on companies. In particular, practitioners should examine the detail of any potential debt and equity financing very carefully.

Debt

Ensuring the organization is able to honor all its various obligations is central to the treasury department’s role. For organizations reliant on different sources of debt finance, in addition to making any interest payments, managing these obligations can require compliance with a number of different conditions imposed by the lenders. In an ideal scenario, these conditions are the same or very similar. However, this is only likely if practitioners take care when negotiating the detail of any new financing agreement.

At the same time, raising new finance will alter the organization’s exposure to risk, notably interest rate and refinancing risk. Any new financing must be viewed in the context of the organization’s other lending, as well as any commitment, or expectation, to reward shareholders.

This section highlights the key issues for practitioners when negotiating the detail of any new debt financing.

Structure

When arranging new debt, consider the following:

- **Purpose**
  Understanding the purpose of any new financing is critical. There are many different reasons for arranging new financing, ranging from the need to refinance existing debt to take advantage of low interest rates, to raising finance for a specific new project. Each of these will imply slightly different requirements from the financing which need to be considered individually and as part of the wider capital structure.

- **Debt term**
  Consider the impact of any debt’s term on the overall debt profile, especially on the maturity date. Organizations will also need to consider the balance between short- and long-
Case Study: Managing Capital Structure at Thomson Reuters

Thomson Reuters has a framework of key principles which guides the management of its capital structure: maintain a strong and stable capital structure with ample liquidity and financial flexibility, target a solid investment grade credit rating, balance between reinvesting in the business and returning capital to shareholders, and focus on driving free cash flow growth. In addition, the company targets a leverage ratio of 2.5x net debt to EBITDA and a dividend payout rate of 40% to 50% of free cash flow over the long term. The company aims to achieve a balance between a strong capital structure and financial flexibility, which offers the returns that their shareholders expect.

“We discuss this framework regularly with the board and externally. Participants are familiar with our strategy and appreciate the clarity of our approach”, explains Treasurer, Michelle Scheer.

Scheer regularly discusses the capital structure with the CFO, which may lead to proposals to the board when necessary and there is also an annual meeting when the board discusses capital strategy in depth. To support board decision-making, Scheer will use scenario analysis to project how a particular decision might result over time, highlighting, for example, how the company’s debt profile might evolve over several years. At the same time, she will benchmark a number of balance sheet items and other metrics against the company’s peers.

The company has a number of long-term policies that require approval. Once a decision has been made, it is Scheer’s responsibility to implement it. “Using dividend policy as an example, we make a specific recommendation for that year. When making the recommendation [to the board], we try to put it into context by comparing it to cash flow and the current dividend rate, as well as considering historical practice and overall return of capital to shareholders. We have a public long-term target range for our dividend payout of between 40 and 50% of free cash flow. This year’s dividend is the 23rd annual increase in a row.”

For many activities, the timing of execution of the policy is a matter for the CFO and treasury. “For example, if we need to issue new term debt, we have flexibility on timing and on which market to go to (generally the US or Canadian markets). We will also ask our banks for their opinions on market conditions. A new debt issue may be planned for several months but then executed very quickly,” explains Scheer.

Scheer and her colleagues track a number of metrics to check on progress. “We have a series of balance sheet and other financial metrics which we track in a monthly treasury report. We watch our liquidity and debt profiles to monitor our refinancing risk: we aim for a smooth profile of maturing debt to avoid significant refinancing risk in any one year. We also track a number of working capital metrics and then look at our capital structure comparatively over time.”

The success of this approach can be seen by the fact that the company has not felt a need to change its approach since the financial crisis. “We haven’t held more cash since the crisis,” says Scheer, “but we do appreciate our strong committed credit facility and access to commercial paper. We have flexibility. It has also been helpful to validate the resilience of our free cash flow generation, which has been stable through the crisis and into future periods.”
term debt. The primary objective is to avoid having too much debt maturing at any one time. However, where debt is being raised to finance a particular project, practitioners will want to align the repayment schedule with anticipated future cash flows as much as possible.

• **Interest rate risk**
Before committing to any new financing, practitioners will want to understand how its conditions will affect their organizations' exposure to changes in interest rates. Organizations typically have a target ratio of fixed to floating interest rates to help manage that risk, so any new financing will need to reflect that, via the use of derivatives if necessary.

• **Foreign exchange risk**
It can often be possible to achieve a lower cost of funding by raising funds in a foreign currency and then swapping obligations back into the required currency. It can also be possible to manage foreign exchange risk more efficiently by arranging funding in certain currencies. In both situations, practitioners need to manage any exposure to foreign currency risk.

• **Tax**
Debt financing is attractive because organizations can offset their interest payments against their tax liabilities. However, practitioners will want to take care that any tax-efficient financing strategy does not expose their organizations to additional risks. In particular, tax authorities are working together to ensure organizations remit appropriate tax in each jurisdiction, for example by challenging base erosion and profit shifting (BEPS). This means practitioners need to work with their tax colleagues and with their advisors to ensure they are compliant with transfer pricing and thin capitalization rules (especially when they are raising debt centrally and then funding subsidiaries via intercompany loans). More particularly, organizations will want to avoid unnecessary scrutiny from the tax authorities (these will be time-consuming and costly and may negate any initial benefits, especially if any expected tax benefits do not materialize or if the organization suffers penalties). In addition, companies will want to avoid any associated reputation risk arising from any tax investigations (whether by the authorities or by activists or the media).

• **Terms and conditions, including covenants**
All debt finance carries some terms and conditions imposing restrictions on the borrower, even if it is little more than a repayment schedule. Practitioners must take care to understand these conditions and to ensure they do not conflict with either the objectives of the business or with any pre-existing terms. Managing these terms are crucial from the perspective of maintaining the organization's financial flexibility.

A failure to fully understand the implications of any covenant could be a career-limiting decision for the treasurer or CFO who agreed to the terms.

• **Other regulatory requirements**
Depending on the instrument used, there may be additional regulatory requirements. Issuing publicly listed securities will usually impose company filing and regulatory reporting requirements which will add cost to the process.

• **Cost**
Finally, consider the full cost of the new financing. This will include the interest rate on the new financing, with any associated hedging, as well as any arrangement costs, including legal fees. It should also include any associated costs, which might include the cost of committed facilities to support a commercial paper program or the opportunity cost associated with using a particular set of assets or cash flows as security for that finance.

**Stakeholder management**
Whenever making any change to capital structure, it is important to incorporate the interests of all stakeholders, both internal and external. Investors in different instruments issued by the company will have different interests depending on the terms of each instrument and its priority. This applies to secured and non-secured debt holders in particular, but there can also be differences between holders of different types of debt.

It is important to understand how current and potential investors will react to changes in the company’s capital structure, or even the detail within the capital structure. For example, replacing a bank loan with a new commercial paper program for working capital funding may result in the terms of the bank’s covenant being replaced by expectations made by credit analysts in rating agencies.

Consider the impact of different entities within a group raising debt. Holders of bonds issued by the parent company may not appreciate one of the major subsidiaries launching a major commercial paper program.

**Equity**
Equity finance can be raised in a number of ways. Companies that are already publicly listed can issue new shares via a rights issue, for example. Private companies can list their stock via an initial public offering (IPO). Public companies can be taken back into private ownership in a number of different ways. However, in every case, managing equity financing is
primarily about managing shareholder interests, whether the shares are privately or publicly held.

As with the other elements of capital structure, this is often a balance between ensuring sufficient funds are available for investment in the business and providing sufficient rewards to shareholders. This balance will vary significantly between companies. Importantly, it can change quickly too, especially if activist investors identify an opportunity to increase shareholder value.

There are a number of key elements to consider when managing equity finance. These include:

- **Returning cash to shareholders**
  
  Some companies operate a total return policy combining both dividends and share repurchase programs, although earnings have to be relatively stable for this to be realistic. Others simply choose to return excess cash to shareholders, rather than have the additional responsibility of investing that cash. The mechanism for returning that cash may also have an impact on capital structure. Apple is an example of a US-based corporation holding significant cash balances outside the US: it has chosen to pay dividends by raising US debt, rather than repatriating non-US earnings.

- **Dividend policy**
  
  Communicating a clear dividend policy is important for two reasons. First, unlike movement in the stock price, the dividend payment represents an internal, board-level decision on the company’s current position and prospects and ambition for the coming year. For organizations accustomed to paying an annual dividend, any decision to reduce or stop a dividend payment provides a clear market signal, as does a decision to increase a dividend payment. Second, paying a dividend is one way to reward to shareholders for holding the company’s stock. For those companies who choose to reward shareholders in this way, paying a regular dividend is an important part of managing shareholder interests.

- **Share repurchase programs**
  
  As an alternative to issuing regular dividends, some companies choose to return cash to shareholders via a share repurchase program. As with the approach to dividends, investors will expect a share repurchase program to continue, if a company has implemented one for a number of years. Compared with a dividend payment, a share repurchase program is more flexible as, once a dividend payment has been made, it cannot be reversed.

“Markets react strongly negatively to dividend cuts, in contrast to the termination of a share repurchase program. Share repurchases offer firms more flexibility to distribute funds to shareholders but at the cost of being a weaker market signal of firms’ long-term profitability.”

Michael Roberts, William H. Lawrence Professor of Finance, the Wharton School, the University of Pennsylvania.

- **Reinvesting in the business**

  Some companies do not offer any form of dividend or share repurchase program, deciding instead to reinvest any earnings back into the business. Investors will expect this practice to continue and may question any decision to return cash in the form of a dividend.

- **Shareholder management**

  These differences in approach to rewarding shareholders highlight how important it is to maintain good relationships with them to understand their objectives and concerns.

  From time to time, companies may have to engage with activist investors. Activist investors typically try to change the strategic direction of the company as, for example, they can perceive an alternative strategy which they expect would deliver faster growth. It is critical that the board and finance professionals has a clear approach to managing all investor relationships and that it is capable of responding to, and engaging with, any activist investors.

“When thinking about capital structure, practitioners need to factor in dividend payments. They are considered more flexible than debt repayments but, in reality, it is difficult to make a decision to stop making a dividend payment.”

Tim Collier, CFO Financial and Risk, Thomson Reuters.
“Activists want to increase shareholder value. It is always good to listen to them carefully and perform a financial analysis of their ideas. For us, it was an enlightening process: it was a good opportunity for us to step back and evaluate what we do.”

Grady Walker, Treasurer, Popeyes Louisiana Kitchen.

Whenever making a decision on capital structure, whether to borrow or issue more equity, it is important to take shareholder interests into account.

Monitor performance

Finally, practitioners need to monitor performance. At the very least, companies should be able to track performance against all conditions listed in all bank covenants. The consequences for breach can be serious so any changes required to achieve this, such as an improvement to the cash forecasting system, should be given high priority.

More generally, practitioners need to be able to report on performance to the board, shareholders, bondholders, and other stakeholders. This can be via a combination of internal metrics and by benchmarking against relevant peers.

Remember your objectives

As with any activity, it pays to review the designed capital structure against the fundamental objectives.

• Does the structure support the achievement of the organization’s business objectives?
• Does the structure protect against risk? How exposed is the organization to market risk, such as interest rate or foreign exchange volatility?
• Does the structure provide financial flexibility? Is there sufficient debt capacity if necessary? What scope is there to respond to unforeseen events, whether opportunities to invest or a liquidity buffer against a downturn in the economy?
• Is the structure clear to manage? Are all lenders’ terms, conditions and covenants as consistent as possible and are they fully understood by practitioners? Does the company have processes in place to track compliance?

To conclude, in the words of one of Grady Walker’s colleagues at Popeyes, “Don’t make your capital structure more complex than your business.”

Checklist: Factors that Influence Target Capital Structure

When setting the target capital structure, practitioners need to consider both the environment within which their organizations operate and characteristics specific to their own firms. The following elements should be considered:

• Business risk
  How do investors perceive the company’s business risk?
  How stable are cash flows and profitability?

• Market conditions
  How are market conditions generally? Are there any special conditions that apply in the market identified as the source of any new funding? (For example, the maturity of domestic commercial paper varies. In the US, it has a maximum maturity of 270 days, but in the UK the maximum maturity is 364 days.)

• Regulatory environment
  What tax rules apply? Are there any other relevant regulations, e.g. FX rules?

• Corporate structure
  How are group entities capitalized? Are any entities permitted to raise external funds?

• Management style and appetite for risk
  How aggressive is the organization? What is the company’s appetite for risk?

• Asset structure
  How does the company’s asset base affect its capacity or debt?

• Profitability
  Does the company have sufficient retained earnings to act as a cushion in the event of an economic or business downturn and/or to fund new investments which may arise?

• Stakeholders
  What do existing and potential stakeholders (both bondholders and stockholders) expect?

• Customer and supplier base
  How important is the strength of a company’s capital structure to current and potential customers and suppliers?

• Financial flexibility
  How does the company define having sufficient financial flexibility? Does the current capital structure provide that?
Checklist: The Details of any New Financing

Before embarking on any new financing, practitioners should consider the following details:

• Why does the company need additional financing?
• If new debt, what is the term of the new finance?
• How will the new finance affect the company’s exposure to risk? Consider interest rate risk, foreign exchange risk, liquidity risk, refinancing risk and counterparty risk.
• What are the tax implications of the new finance?
• What terms, conditions or covenants apply if the new finance is arranged?
• Are there any other regulations that might affect the company?
• What is the total cost of the new financing? Consider opportunity costs too: will accepting any new financing prevent other actions?
• What do stakeholders think?
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