Capital Structure:
The Cash Conundrum

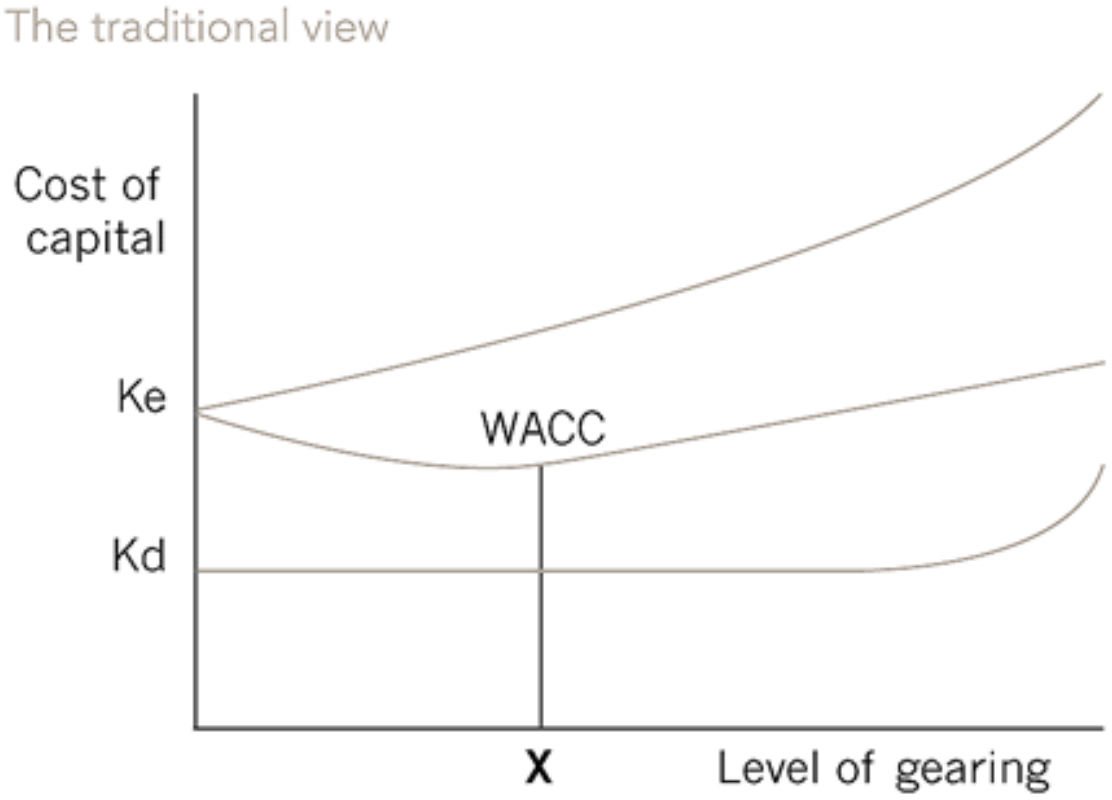
Summary

My previous article on efficient cash management leaves open the question of what treasurers should do with the cash concentrated through their balance management efforts. Recently there has been more press about whether corporates' excess cash means working capital and cash efficiency no longer matters. Efficiency emphatically still matters – here's why.

Capital structure in flux

Capital structure is one of the basic elements of any business set up because the capital structure determines the business' risk capacity. Other than rent seeking, risk is a prerequisite for reward (and even rent seeking carries political risks).

Traditionally capital structure is part of business resilience and sustainability. Businesses need a mix of equity, debt and cash to protect the business from adverse change – this is partly a board level management decision and partly a matter of market inputs since the WACC (weighted average cost of capital) curve gives the optimal leverage for the business.



Simply put, equity is risk free in the sense that it never has to be repaid but it is very expensive, and debt is riskier because it must be repaid and interest payments must be paid on time but it is cheaper and additionally interest is tax deductible (whereas dividends are not). However, as leverage increases debt becomes riskier to lenders and its cost rises for the borrower. (Longer term debt is less risky because there is more time to earn cash to repay it but it is more expensive.)

Cash is part of a business' financial flexibility – cash saves the business from having to raise external funding in times of difficulty. But cash is very expensive because yield on cash is very low and the cost of funding it is WACC (not the cost of borrowing alone). So investors value modest cash balances for sustainability, but the cost of high cash balances exceeds their benefit in terms of lower WACC.

The agency problem that is at the heart of businesses with shareholders is also addressed by appropriate capital structure –

shareholders and the board (who are supposed to represent them) can "keep management honest" by requiring high leverage relative to the business risk and low cash.

The traditional view is nicely summarised by this nice article on Apple's cash:

> "Cash is a liability. If you come across a company that is cash rich and has nothing else, its enterprise value will be zero."

But things change …

Corporate cash exceeds USD 5 trillion globally

Given the traditional approach to capital structure, how can we explain the huge amounts of corporate cash that are so much reported in the news? And why are investors tolerating such seemingly inefficient levels of cash? Here are some factors:

- Fragmented market: corporate debt is also very high so looking at net cash may reduce the apparent anomaly; further it seems that the excess cash is very concentrated in tech and pharma, so it may be inappropriate to generalise.
- Subpart-F: US corporates leave cash abroad because it would be taxed 30% on repatriation; or they wait for tax holidays that come once a decade – hence the large tech companies having huge cash balances (abroad) and borrowing cheap debt (in USA) to fund share repurchases.
- GFC: the global financial crisis, which caused liquidity fears in many markets, may have scared corporates into holding more cash as (albeit expensive) self-insurance.
- Rise of knowledge businesses: there is evidence that high R&D businesses need and keep more cash that traditional asset heavy businesses; an interesting NBER paper suggests that tech start-ups use more cash initially and may return it when they turn cash positive.

- Competitive advantage: some researchers find that high cash buffers confer a competitive advantage to businesses and further discourage competitors with less cash.
- Governance: investors may be tolerating high cash levels – at least in developed countries (and here) – because they trust management (relatively) more than alternatives; a related view is that since managers have better information than investors they may be able to generate higher returns for the cash.

It may also be possible that the trend is reversing or at least stabilising. News reports indicate that other businesses with large cash reserves may follow Apple's lead in returning excess cash to shareholders – this is in the context of Apple repatriating $252B to take advantage of the current US tax amnesty. In this period of exceptional profitability and cash flow, businesses may be feeling less need to hold large cash buffers.

In summary, we can observe that at least some businesses are holding historically unusual cash balances that we cannot explain with traditional economic and corporate theory.

Finding the right capital structure

Treasurers are now faced with a conundrum – the traditional tools for determining an appropriate capital structure may no longer be working and new generally accepted practice has not resolved to replace them.

In principal – at least for public companies – letting the market provide answers would seem the logical choice. However, treasurers will be rightly reluctant to run experiments in the markets with their capital structure.

Fortunately, simulations can stand in for market experiments. One common solution is to using rating agency methodologies to find an effective capital structure, based on the not unreasonable notion that rating agencies reflect market norms. (In fact, enlightened

boards often specify a target rating to their treasurers rather than specific quantative limits.) Another alternative is to ask investors what they expect from the business in terms of capital structure. And of course, there is always the old standby which is following peers.

Whatever cash level or range is decided by the board should be followed by treasury. In good years or quarters, cash in excess of the decided range (or implied by the target rating) should be returned to shareholders.

Working capital and cash management

Large cash holdings come in part from tight working capital and cash management. They are not a reason to loosen capital efficiency. As quoted above, cash is from an investor perspective a liability. Investors know that profits are illusory and that value for them is generated from cash flow – so they will continue to focus on cash efficiency regardless of cash balances.

Investors value capital efficient businesses higher than inefficient ones, so the focus on capital efficiency remains critical. There are many suitable metrics available (ROIC, RONA, EVA, NWCR, etc) – it matters less which one is used than that one of them is used to keep the focus on capital efficiency throughout the business.

Likewise, it is incumbent on treasury to ensure that cash is handled effectively and safely with good cash management practices (and here).

Investing cash

Once the board has determined either directly or by specifying a target rating the target cash range, treasury needs to invest the cash appropriately. Invariably treasury's investment objectives are

1. Safety (preservation of capital),

2. Liquidity (availability of funds), and
3. Yield (interest income)

in that order. In fact, several surveys show that treasurers put 60% of their effort into safety, 30% into liquidity, and only 10% into yield. The emphasis is firmly on maintaining access to the cash rather than profiting from it (because cash is a huge cost in any case when counted against WACC).

Treasurers have a range of investment products that can be used to safely store cash, including:

- Bank deposits
- Money market funds
- Supply chain financing
- Segregated accounts
- Self investing

Bank deposits

Bank deposits are becoming less easy with the advent of Basel III and especially NSFR and LCR which mean that banks are reluctant to take short term deposits. When a bank deposit has to be committed for 60 or more days, treasurers are not meeting the liquidity objective stated above.

One interesting development from these regulations is that banks are remunerating current account balances that qualify as operating cash with deposit like rates, so that doing nothing with your cash becomes an attractive option.

Of course, leaving cash with banks (whether in deposit or current accounts) represents a risk concentration that may compromise the safety objective stated above.

Money Market Funds (MMF)

MMFs have become increasingly popular with treasurers because they offer good risk diversification and high liquidity (often same day availability and routinely next day availability). This popularity is enhanced with the regulatory challenges of bank deposits above.

Regulations are also affecting MMFs. Treasurers prefer CNAV funds but regulatory and accounting pressures are pushing the industry towards VNAV funds which create more accounting complexity and can generate accounting classification issues.

Supply Chain Financing (SCF)

Cash rich businesses are increasingly deploying their cash to support their supply chains with techniques like dynamic discounting. The effective yield and relatively low risk are attractive but there may be difficulties with the liquidity target (cash tied up in shorter accounts payables cannot easily be liberated, and disrupting suppliers may be disruptive to the underlying business) and the impact on working capital metrics (shorter accounts payables) may not be flattering unless well communicated.

Segregated accounts

Segregated accounts often seem like an attractive and tailor made solution, but they are only viable for very large cash balances for example over USD 100 million.

Self investing

Only the largest treasuries can justify the expense and managerial overhead of running investment operations in house. Further, it is difficult to get risk diversification with any but the largest balances – and this problem is resolved with MMFs which can be thought of as a way to outsource investment to more professional larger scale institutions.

Conclusion

Capital structure and the consequent cash level decisions have become more complicated in the current low interest rate environment. This may prove to be the new normal but for now treasurers do not yet have established models and maths to guide them. None the less, tight working capital and cash management remain critical for firms because investors need to be paid from cash flow. Determining the appropriate cash levels and communicating them to investors is a key foundational element of treasury and indeed business effectiveness. Cash investment remains a non-core activity focussed on damage limitation rather than yield.

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