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Capital Structure And Capital Management: A Strategic Approach In Challenging Times

Background

As economic conditions have endured an elongated slowdown and interest rates have remained high for a lengthy period, a number of organisations have reconsidered their capital structure.

Considered application of capital structure discipline can minimise the probability of temporary relaxation of covenants or redefinition of measures (ratios and thresholds) being required.

This article looks at what we mean by capital structure, and the closely related area of capital management, and provides a framework for how we think about and act on these aspects to assist the sustainable operations of the organisation.

Introduction

Primarily and intuitively, capital structure refers to an organisation's appropriate mix of debt and equity, while capital management relates to the guardrails (or policy) and behaviours in place to support that capital. The capital structure setting and the capital management policy are specific to an organisation and incorporate a balance between shareholder and company objectives.

A framework for diagnosis of capital structure and management.

At the core of capital management is an assessment of the desired credit standing (actual or 'shadow' credit rating) of the organisation; for the financial and business profile of the organisation, what are the financial metrics required to support this targeted credit standing? One can then work backwards how to achieve and maintain this standing.

In order to select a target credit rating (i.e. what it should be and why) the following are typically influencing factors:

- Whether there are regulatory requirements the organisation must achieve (dependent on specific industry)
- Investor / shareholder expectations
- Market access (debt capital) – a certain minimum standing may be required to access some markets
- Pricing impacts – weaker credit standing seeing higher market pricing and potentially more rigid conditions placed on the organisation

Key Points

- *Assess a target credit standing (rating) that balances the growth and financial risk profile of the organisation*
- *Assign two core financial metrics (ratios) consistent with the achievement of this credit standing*
- *Monitor and report the current and future outlook financial situation of the organisation against these metrics*
- *If not being achieved within a timely manner, devise and implement internal and external solutions.*

- Current rating (not being unrealistically aspirational relative to this – i.e. 'desired state' should not be out of reach).

Thorough consideration of the above (including a potential survey of individual Board Members / Senior Executives) may help determine what credit rating and capital structure setting should be targeted as well as the likely implication of these settings.

Trade-offs that often need to be considered include:-

- The extent of borrowings required by the organisation (including the inflexibility that a certain level of debt may place on the business)
- The financial cost of servicing that debt and related reduction in free cashflow available for other purposes
- The capacity to absorb shocks (i.e. financial/liquidity headroom) with this constrained if debt levels are already elevated
- Conversely, the potential opportunity cost / slower growth implications if 'overly' prudent.

Agreement of a capital management policy can balance business growth and expansion with an acceptable financial risk profile, while recognising this optimal setting may be a matter of judgement.

Benefits of a specific credit rating being achieved may include the following:

- Encourage and provide greater certainty and self-imposed discipline around the business
- Continued adherence to a 'comfortable' capital position allows management to focus on the day-to-day running of

the business, and not being disproportionately focused on covenant compliance and negotiations - or market disclosures

- Furthermore, attainment and maintenance of the appropriate, required capital setting should assist the business not being forced into sub-optimal outcomes; for example, needing to raise equity (potentially diluting existing investors) when the share price is already at a lower level.

Capital management practice and strategy; supporting the organisation's 'glide-path'

The outcome of a target credit rating approach to capital management is to find and set two key financial ratios, being achieved over a medium-term horizon (12-24 months); for example, a cashflow measure and a leverage measure selected and monitored.

The capital management policy may apply these ratios to bands and time frames for compliance to be achieved. Regular check-ins are required and monitored ahead of potential restorative measures being implemented, such that compliance with the agreed ratios will be achieved in a sufficiently timely manner.

- Include a 'traffic light' system for desired state of 'green' compliance band with core ratios within desired ranges.
- A wider 'amber' zone outside of this preferred zone may allow temporary, limited divergence from the desired state (e.g. up to 12 months, but where management has a 'plan' developed if required to restore the stable financial position).
- A further movement outside of this 'amber' band and where compliance is not otherwise expected over a 24-month period is deemed a 'red' zone and an immediate action plan must be implemented.

Restorative action (if required)

In event of the capital management policy guardrails / zones being 'pushed up against', alternative courses of action are required.

At one level there are various internal, operational measures that might be leaned on in a reasonably timely manner such as:

- Reducing/delaying capital expenditures
- Restricting working capital commitments (e.g. destocking)
- Tighter control of operating costs

Other more structured avenues to restore the debt / equity mix over a slightly longer period may include:

- Business restructures
- Divestment of non-core assets or business units
- Adjustment (reductions) to dividend policy
- Slowdown in acquisitive behaviour
- Equity raise / paydown of debt
- Equally, a business may have a too-high credit standing at the expense of growth opportunities, in which case the opposite of the above may apply.

Finally

Successful capital management can be simply measured by it not constraining nor distracting management and the Board from efficiently and effectively running the company in implementation of agreed business plans.

Should the above considerations be relevant for your business, Bancorp/Barrington's multi-disciplinary team of experienced, innovative and easy to work with professionals are uniquely positioned to have a conversation around your circumstances.

Potential guardrail (net leverage to EBITDA)

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