A sustainable concept of corporate funding

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bei

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EXECUTIVE SUMMARY

I PROBLEM DESCRIPTION

The economic downturn and, accordingly, the changing conditions in the money, capital and credit markets, moved the refinancing of corporations into focus. During this crisis, many companies experienced a very expensive and limited, or even impossible, availability of external funds, since credit spreads spiked as investors required higher risk premiums. The financial crisis turned the booming economy into a global recession, where companies suffered strong liquidity shortages. Many firms experienced negative operating cash flows and operating losses, while they had to repay outstanding credits and bonds, guarantee their refinancing and undertake required investments in operating assets. Given the recent importance of liquidity, the subject of this thesis is the development of a sustainable funding concept for non-financial companies in Switzerland. This concept not only covers the liquidity requirements and optimal funding sources, but also incorporates periods of economic downturns when refinancing becomes difficult.

II METHODOLOGY

The first part of the thesis describes the main theoretical concepts of capital structure policies such as the trade-off and pecking order theory, as well as the debt capacity. In addition, previous studies and empirical findings are discussed. Data covering 142 listed Swiss non-financial companies are used to test the trade-off theory. For this purpose, the cost of capital for each firm is derived as of the end of December 2009 and minimised afterwards in order to reach an optimal leverage, which in turn maximises the firm value. Calculation of each firm's debt capacity then shows the feasibility of the implementation of the optimal capital structure. In order to learn more about funding decisions, the liquidity holdings of each company is assessed by calculating their current, quick and cash ratio.

Using the results of the analysis and previous empirical findings from the literature, a framework for a sustainable funding and liquidity concept is derived in the second part of this thesis.

The third and main part turns its focus toward funding markets and instruments. The key external funding instruments with the corresponding money, credit, capital and equity markets, as well as Swiss Banks' credit policies, are briefly described and empirically analysed. The analysis of the credit market is based on the corporate credit volume statistics from the Swiss National Bank (SNB), whereas the Swiss money market for funding is assessed by consulting an expert because of a lack of data. The capital market is analysed in both the U.S. as well as in Switzerland. This is because the U.S. capital market is highly developed and data on credit volumes and conditions date back as far as 1984. Furthermore, the funding conditions are defined by the credit spreads and funding volumes are measured by the bond issuance volume. The Swiss equity market for funding is investigated by the quarterly volume of share capital increases at the Swiss Stock Exchange SIX. In addition, the ways that economic and political events influence these markets is examined. In order to derive recommendations for a sustainable funding concept, the current diversification in funding instruments and sources, as well as the maturity schedule of financial liabilities of Swiss companies, are analysed. An assumption is made that the companies included in the Swiss Market Index (SMI), on average, provide the best basis to derive predictions for an optimal diversification in funding instruments, sources and maturities. Combining these results with the general framework derived in part two leads to a general and sustainable funding and liquidity concept for Swiss companies.

Through evaluation of interviews from personnel of selected companies, the fourth and last part of the thesis investigates whether firms' funding behaviour is in accordance with the sustainable funding concept. Deviations from the optimal funding are identified and potential needs for action are formulated individually for each company.

III RESULTS

The optimal capital structure that minimises the cost of capital and thus maximises the firm value, is far above the current leverage in all sectors. On the one hand, this can be explained by the observation that most companies are constrained by the debt capacity in order to implement the optimal leverage. On the other hand, more than half of all companies do not fully use their debt capacity and consequently do not try to reach an optimal leverage. Consequently, the trade-off theory fails to explain the capital structure decision of Swiss non-financial companies. Observation of the liquidity holdings of Swiss companies shows that cash and liquid assets are excessive and, as a result, inefficient. Three fundamental reasons might explain why the leverage is low, debt capacities remain unused and liquidity holdings are excessive: First is the company's desire to preserve its flexibility by self-financing, second is the refinancing risk and third is the current conditions in the credit, money and capital market.

Taking these aspects into consideration and in relation with previous empirical findings, basic principles for a sustainable funding and liquidity concept are formulated. The concept is based on four building blocks; i.e., the liquidity and capital structure, the liquidity requirements, internal sources of funding and external sources of funding. These four elements are closely interconnected and constitute a general and optimal funding concept for all companies. The liquidity requirements are mainly driven by a company's investment strategy regarding future expansions and acquisitions, which cause cash outflows, as well as by the company's operating activities, which generate cash inflows. High volatilities in cash flows increase liquidity requirements since optimal liquidity holdings are difficult to predict and require incorporation of more buffers, such as higher debt capacities.

Liquidity requirements can be financed with internal or external sources. Internal funding sources comprise retained earnings, depreciation, disposal of assets and provisions. They are company-specific and need to be determined individually by each company. Regarding external funding sources, debt and equity can be distinguished, where debt can be further subdivided into the money, capital or credit market. Increases in liquidity requirements induce a rise in cash from internal or external sources and inevitably cause a change in the liquidity and capital structure.

The current external funding of Swiss corporations is striking. By the end of June 2010, the funding through equity was 892 billion Swiss francs, measured by the market capitalisation of the Swiss All Share Index, followed by bank credits outstanding to companies of 398 billion Swiss francs and only 61 billion corporate bonds outstanding. Equity is by far the most common funding source in Switzerland, which is not surprising considering the debt-to-enterprise ratios of the companies within the sample. The credit market is dominated by the two biggest banks, UBS and Credit Suisse, with 43% of the total market volume, followed by the canton banks with 27%. The credit assessment process is similar among Swiss banks and the rating systems are analogous to the leading credit rating agencies, Standard & Poor’s and Moody’s. Comparing the historical patterns of credit limits granted and credit limits used implies that credit limits are raised if demand for credit increases.

After the beginning of the financial crisis in mid-2007, credit limits grew and reached their peak in June 2009, whereas the utilisation of these limits stayed constant or declined. Therefore, the conclusion can be drawn that the credit market for funding is always available, independent of the size of the company, the sector within which the company operates and the general economic conditions. The Swiss money market is dominated primarily by banks and companies from abroad and is not suitable as a funding source for Swiss non-financial companies. Emission costs for commercial papers are high and access to the money market is restricted to internationally known and first-grade companies with a certain issuance volume. The observation of the U.S. capital market shows that the market is highly developed, since demand has overtaken supply and the market is transparent at any time. This contrasts with the Swiss capital market, which is highly concentrated and limited to a few big issuers. Therefore, the U.S. capital market provides an excellent indicator for the current conditions of the Swiss bond market. Credit spread patterns are strongly driven by political and economic trends. The credit spreads are always higher for lower rated bonds and the funding conditions remain poor for longer, but less frequent, periods of time than for higher rated companies. Overall, the conclusion can be made that the credit market is accessible to Swiss companies with a credit rating of BBB and superior, independent of the sector in which the company operates. However, the observation can be made that the Swiss capital market is insufficiently used and has high potential for Swiss industrial corporate funding in the future.

Companies should be aware that the conditions for funding in different markets might become unfavourable in future periods, which will make refinancing expensive or impossible. Therefore, diversification of the instruments, the source and the maturities of funds is important. The companies listed within the SMI, on average, build a good indication for this diversification. Considering the optimal diversification, the indications of the different markets, the individual investment strategy and cash flow volatilities from operating activities, the sustainable and optimal funding concept is well-founded.

IV ASSESSMENT

The derived concept for sustainable corporate funding might help companies to disclose which aspects belong to a solid financing base, how these different aspects interact with each other and how they can be improved. The goal for each company should be an optimal reconciliation of liquidity holdings, the capital structure and sources of external and internal funding, as well as the diversification in the instruments, sources and maturity structure. The concept provides general recommendations and indications for an optimal funding in Swiss companies, which can be adjusted to be firm specific.

The application of the concept to selected Swiss companies showed that a large potential still remains for improvements leading toward optimal funding. However, since the financial crisis, the companies have apparently learned that diversified funding instruments and sources are absolute necessities, as well as a good apportioning of debt maturities. All companies are now optimising these fundamental aspects in order to guarantee sustainable funding over years that will secure refinancing and allow for financial flexibility during times of economic downturn.