

Customized corporate financing

Maintaining an optimized financing structure is an essential aspect of running a business. Both banks and the financial markets offer a full range of financing options that can be tailored to specific needs. With an ongoing, forward-looking analysis of a company's financial structure, a solution can be found for every situation.

Rudolf Pauli



Any corporate activity requires financing. From the moment it is set up, a company needs cash, resources and collateral before it can begin producing goods or services in the first place. An existing firm needs capital if a planned expansion of the business exceeds its own financing capabilities. Deciding on the amount and type of financing and identifying the optimum financial structure are central issues in a firm's development, however big or small the operation involved. The right ratio of debt to equity financing and the use of intermediate forms of financing depend on the risks of the business, capital intensity, fluctuations in cash flow and the size of the stake which those providing the capital take in the company. The type of financing used will vary according to the requirements of the market, as will the associated costs, such as dividends and interest payments. One goal of corporate financing is to maintain a healthy balance between costs and risks. In extreme cases, inadequate financial planning can lead to bankruptcy.

Prevention is better than cure

There are currently around 428,000 companies registered to do business

in Switzerland, the vast majority of which (99.7%) are small and medium-sized enterprises. Over the last five years, almost 50,000 new companies have been set up, while during the same period 20,000 filed for bankruptcy. The founding of new companies and the bankruptcy of existing ones are evidence of a dynamic economy, and in this sense a good sign. From a practical point of view, however, there is a very unpleasant side to a company shutting down, in terms of the heavy financial and social costs that can result.

A regular check-up can do a lot to preserve a company's assets. A recent analysis of bankruptcies showed that in 35% of cases the danger of failure had been recognized at least one year before bankruptcy proceedings were filed. In

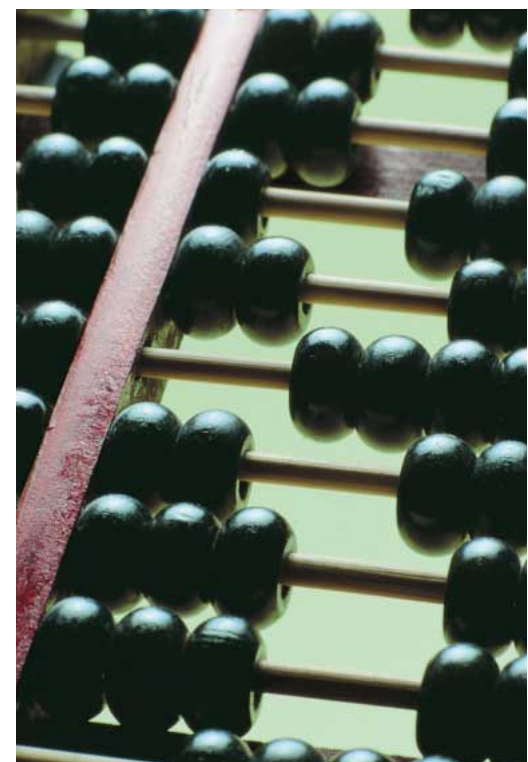
Financial check-ups on a regular basis

three quarters of the cases the risk was identified within the context of a financial analysis conducted by the company itself or initiated by a bank. The ability to maintain an appropriate relationship between the balance-sheet structure and the development of costs and earnings is an important litmus test of a company's health. A firm can protect itself from going under by regularly reviewing its

financial structure, recognizing financial problems at an early stage and taking appropriate action.

The goal is to optimize the debt-to-equity gearing

Small and medium-sized enterprises in Switzerland have a relatively low level of equity capital, which increases risk and with it the importance of financial management. When making international comparisons, however, one must remember that there are sometimes



major differences between countries with regard to accounting rules. Throughout all sectors of Swiss industry equity capital on average amounts to a little over 25% of companies' total assets. The most recent official data available, however, which date from 1998, show a wide variation in this figure. The instruments and watchmaking, and the chemical industries, for example, have an equity ratio of over 60% and 45% respectively, while in the construction and the hotel and restaurant sectors the level is only about 23%.

The leverage effect is the starting point for optimizing a company's debt ratio. Return on equity increases as a company's debt grows, provided that the return on all assets employed is greater than the interest payments on the debt. This point, however, is just one among many that need to be considered. There may be a number of factors that influence a company's debt financing policy. These criteria include financial flexibility, credit rating, the volatility of earnings and cash flows, the amount internal funds available, market interest rates as well as the possibility of deducting interest payments on debt from taxable earnings. In most cases, a combination of various forms of financing is the best solution.

Equity capital as the basis

The type of financing that is best suited for a company, and takes due account of the risks to which it is exposed, depends very much on the stage of development which the company has reached. Basically, the greater the risk which appears to

attach to the investment, the greater the need for equity capital. It is generally difficult to obtain debt financing during the development of new business ideas or during the start-up phase, as the financing risk is very high. New firms offer little or no

security; much is based simply on ideas, and there are no revenues yet. The founders of the company

often supplement their own capital with that of family or so-called business angels, who also provide their expertise.

In addition to the conventional form of equity financing involving issuing stock, the main growth area in the last few years has been in venture capital for new firms, private equity for restructuring or

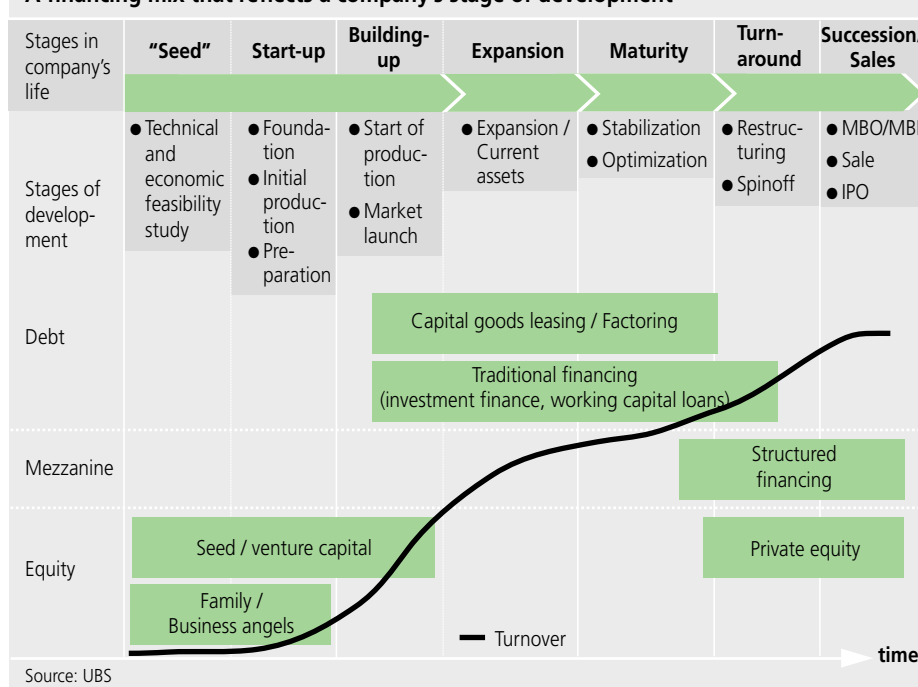
management buy-outs or buy-ins. These alternative forms of equity financing offer the advantage of being linked to management support and coaching. They boost a company's credit rating and form a good basis for a potential exit strategy (IPO, trade sale, buy-back). In addition, the capital is invested in a long-term and flexible fashion. However, potential drawbacks include the fact that the investors will have a say in how the company operates. Moreover, there are long-term obligations and the problem of dilution, in other words, a reduction in the value of the securities that are already in circulation.

Attractive hybrids

The term Mezzanine financing derives from the Italian word *mezzanino*, or intermediate floor of a building. It includes a series of

A combination of financing is the recommended solution

A financing mix that reflects a company's stage of development



The type of financing available will depend largely on the stage of development the company is in. The structural mix needs to be monitored on an ongoing basis and adjusted to specific needs within the framework of an overall financing concept.

hybrid financing instruments that link equity-based and debt-based financing characteristics. These types of financing contracts typically involve the subordinated ranking of the capital made available (reflecting the nature of equity capital). They are also characterized by a fixed term to maturity and by tax advantages. For this quasi-equity, the investor receives a higher rate of interest than would be the case for debt financing, reflecting the risk involved. Mezzanine models offer a variety of attractive possibilities, such as options to increase the equity stake or earnings-related interest-payment components and exit clauses. Companies and investors can tailor the form of the financing to their specific needs in terms of both return and risk.

- *Participation certificates* are equity paper with dividend rights and a share in any proceeds from liquidation, but without voting rights.

- *Convertible and warrant bonds* give the right to convert the debt contract wholly or partially into an equity contract. The conversion right can be defined for the borrower and/or the lender. The exercise of the right can be specified for a certain point in time or within a certain period of time. In the case of warrant bonds, the conversion right or the right to acquire additional equity can be separated from the original financing instrument and be valued or traded separately.

- *Dividend-right certificates* are securities similar to bonds; they ensure the right to a share of profits and in any liquidation proceeds. They can be set up with or without a redemption clause.

- *Subordinated loans* are usually handled like a traditional loan. If the debtor becomes insolvent, however, the investor's claim is satisfied only after other claims have been settled (in order of rank). The loan can be subordinated to the claims of either individual higher-ranking creditors or all of them. In the latter case, the loan should be regarded as closer to equity than to debt.

Traditional loans in modern form

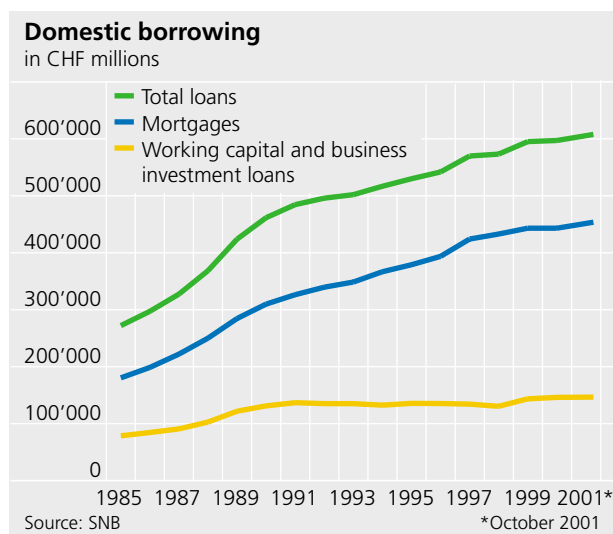
Nowadays, if a company needs debt capital, it can choose from a broad range of possibilities tailored to specific needs and combine them with each other. Traditional bank loans continue to be the main financing instrument for small and medium-sized Swiss firms. Of the total loan volume in 1998, estimates are that about CHF 178 billion – rather more than 30% – went to small and medium-sized companies.

- *Working capital financing* helps to finance inventories, work in progress or accounts receivable. It therefore offers extra flexibility in terms of

planning and liquidity, and helps to smooth out seasonal fluctuations in business activities. These types of financing are short term in nature in that they can be terminated at any time by either party. The credit facility is granted after examining the balance sheet, income statement, budget, liquidity plan, etc; it is reviewed by the creditor once a year and adjusted if necessary. The terms and repayments for investment financing are usually based on the life and depreciation period for the investment goods and can be structured flexibly.

- *Leasing* allows a company to use the machines and objects needed for business without having to own them. Capital goods leasing is flexible and minimizes the impact on liquidity. However, the length of the life cycle of the leasing object is limited. Capital goods leasing involving small loan amounts is chiefly an alternative to credit lines and loans. For large amounts, in contrast, leasing of this type is often an alternative to fixed advances or fixed loans.

About four-fifths of banks' outstanding credit volume is secured by mortgages and thus booked as mortgage loans. Many types of loans that cater to borrowers' specific needs are booked as working capital and business investment loans.



● *Factoring* offers the possibility of having the company's accounts receivable collected by a third party (called a factor) and thus transferring the risk of receivables to the factor. This process can contribute to improving the management of liquidity. Factoring is a dynamic form of financing that does not have an upper limit. The technical prerequisites and the involvement of a third party have little adverse effect on the attractiveness of this form of financing.

● *Bonds* offer additional possibilities for raising capital on a fixed long-term basis for companies large enough to tap the capital markets.

How much debt capacity does a firm have?

The proper range for a firm's net debt burden over the medium term can be established by examining its debt capacity, which is determined using the operating free cash flow. Free cash flow (FCF) is calculated from operating profits (EBIT, earnings before interest and taxes) minus imputed taxes, replacement investments and any dividends plus operating depreciation. Because FCF can fluctuate, a stable value for assessing debt capacity is established, using past numbers and expectations for development going forward. In addition, this figure is adjusted to take account of fluctuations in the economic cycle. Business risks from operations play a crucial role in determining financial risk capacity.

If a company's net indebtedness (interest payments on debt minus liquidity excess to business require-

ments) over a longer period is significantly greater than its debt capacity, this means that a part of the debts carries with it entrepreneurial risks. As a result, the lender will expect a certain level of return to compensate for this risk. Conversely, debt capacity that has not yet been used up offers additional debt financing possibilities for expansion and acquisitions.

Investigating your own company using ratings

A rating serves to record and categorize risk, and forms the basis for the risk-adjusted pricing of loans.

The rating is the product of various factors which, taken together, give a detailed picture of the company, its operating environment and its risk profile. Included in all this is an analysis of financial factors (debt capacity, productivity, profitability, liquidity, debt-to-equity ratio), non-financial variables (company management, capital spending, budget planning, external factors,

transparency) as well as sector-specific and individual characteristics. Based on this type of overall assessment,

Rating process not only useful for big companies

every company can, working on its own or together with its bank, evaluate its financial structure as it is now and how it will be going forward. In this way, the company can actively use the potential it has to shape its progress. The rating process also acts as a component of an early-warning system. It forms the basis for securitization of loans, which will be used increasingly in future due to stricter capital adequacy rules for banks. The pooling of such receivables, units of which can then be traded on a stock

exchange, is simply not feasible without a standardized system of ratings.

The right finance at the right time

Planning and optimizing financing has long been part and parcel of management at large corporations. Yet small and medium-sized companies should also keep financial planning on their agendas. Sustained corporate success requires the right financing for every venture a company undertakes and every phase in its development.

Increasing numbers of banks see themselves as financiers in a broader sense, operating as an advisor and intermediary, instead of concentrating primarily on "selling" loans. Rather, banks are thinking in terms of solutions and tailor-made service packages created by working together with the client. If the client has problems, the problems are solved in the context of a long-term financial strategy. A risk-conscious financial culture creates advantages for all parties involved. It's always a good move for a company to take out the old abacus and ponder its financial state. ■

rudolf.pauli@ubs.com
☎ 01 234 25 56