Capital Structure Optimization – The Basics

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As a consultant specializing in all things related to the capital structure of Latin American companies, I am often asked about how to determine the optimal mix between debt and equity. The answer of course varies according to industry, company size, ownership structure, among many other factors. But in general terms, it boils down to two fundamental variables: the cost of capital and the risks associated with too much leverage.

When a company periodically defines its capital structure preferences, it should always look ahead. Management needs to be realistic about its current situation and future ambitions, and today's capital structure should reflect the company's strategic and tactical objectives, considering the short, medium and long terms.

The cost of capital derives from the different sources of capital that finance the company's assets and operations, and is calculated by averaging the weighted cost of each. For the most part, the less risk taken by the investor implies a lower cost of capital for the company. On the other hand, the shareholders assume the most risk and therefore pure equity carries the highest cost. Additionally, there are tax advantages to debt over equity as interest payments can be tax-deductible while dividends are calculated on after-tax income.

So, the temptation is to finance operations and investment with as much debt as possible given the lower cost, especially with today's interest rate levels, but management must avoid creating a dangerously over-leveraged balance sheet, which can leave the company and its shareholders at risk. It is always best to leave room for the unexpected. Companies that leverage their balance sheets to the maximum may find themselves in trouble if cash flows change suddenly, which can happen with exchange rate volatility, interest rate movements, changes in the competitive environment, M&A activity, among other events.

Management teams tend to be aggressive with their strategic planning and growth strategies, but they must be conservative and cautious with capital structure issues. This is because things never go exactly as planned – NEVER. An adequate capital structure will allow a company time to adjust its course when it observes changes in its ability to perform as expected.

There are other advantages to finding the right balance between an efficient cost of capital and manageable debt levels. For example, companies looking to grow inorganically have greater negotiating power when they are less leveraged, due to easier access to new funding as well as potential efficiencies from restructuring the debt of the acquired entity.

Some companies are subject to criticism by shareholders for their extremely low leverage, especially when holding high levels of cash. A clear example is the ongoing dialogue between Apple Inc.'s management and activist investor Carl Icahn, which has prompted bond issuances and a share buyback program. However, it is much more common for us to see companies that have gotten into trouble for high debt levels that became unmanageable when something unexpectedly changed in their environments.

It is important to mention that modifying the capital structure takes time and may require changes to the company's organization and culture, depending on the nature of the investors and/or lenders. For instance, the company may need to adopt additional corporate governance practices or permit independent review by research analysts and rating agencies or implement new internal oversight mechanisms.

Finding the balance between debt and equity is a delicate endeavor, and definitely more of an art than a science. It is not easy to get it right, which is why it is so important for management to proactively invest considerable time and effort into preparing its capital structure for its business plan while taking into account the uncontrollable elements that could affect its performance.

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