Choosing the right mixture

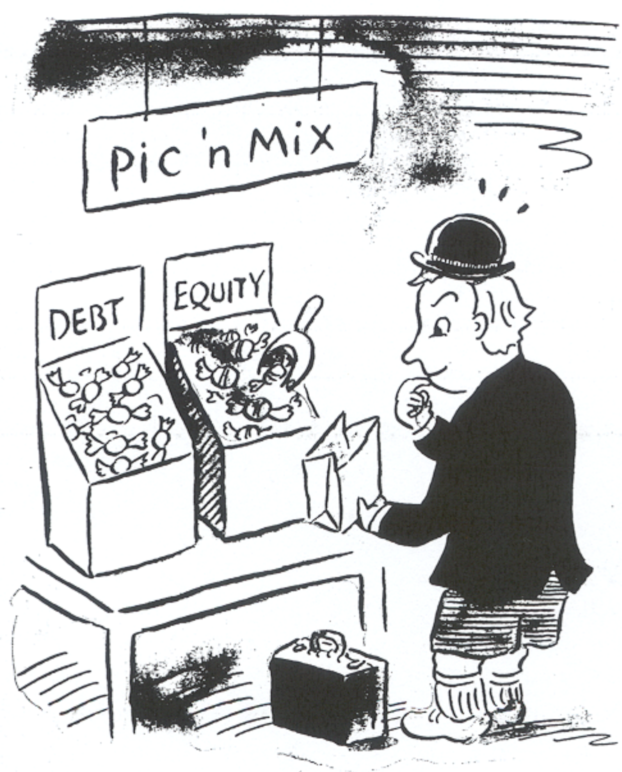
The threat of deflation is making company treasurers rethink their financing strategies

REGRETS? He has a few. In the past few years, as group treasurer, he led his company, an international energy giant, through several big share buy-backs. Now, he is preparing for retirement, and his successor is moving in at headquarters. Pacing round the kitchen of the company flat that doubles as his temporary office, he is plagued by doubts: "We ought to be issuing equities like mad and retiring our debts, not the other way around."

He is not alone. For decades, conventional wisdom has told finance directors that they can lower their companies' cost of capital by borrowing more, because debt is cheaper than equity. But that was during the long inflation. These days, prices in many countries and industries are falling, or at least threatening to do so. Treasurers fear that debt, instead of providing leverage and producing higher returns on equity, could just become a burden. "In a deflationary environment, you want to have less debt and more equity," declares Anthony Stern, treasurer of Bass, a British brewer.

This was exactly the conclusion American firms drew in the 1930s, during the most recent big deflation. From very high levels, debt was cut to about 27% of total company capital in the 1940s. Recently, firms have been piling debt back on—it now accounts for 58% of capital. In Europe, the story is similar.

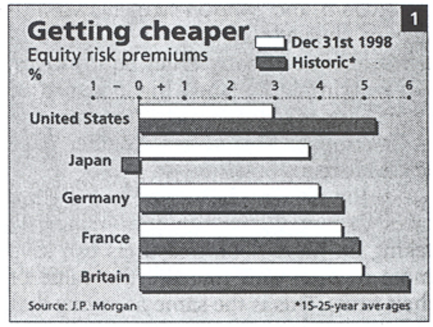
Today, companies in industries that have been hit hardest by deflationary pressures, such as manufacturing, chemicals, or oil and gas, are thinking once again about restructuring their balance sheets. The only reason he has not, says one treasurer, is that a share issue could be seen as defensive and would embarrass his board of directors. Nevertheless, "the tide is turning" in favour of a higher proportion of equity, says Reg Hinkley of BP Amoco, an oil multinational.



Gerry Salkin, a finance professor at Imperial College in London, even talks about "a new balance-sheet paradigm".

This has an appealing logic. Debt is the promise to pay money back in the future. While inflation erodes that sum's real value, deflation increases it. Moreover, as prices fall, so do returns on assets financed with borrowed money. Companies are stuck with repaying the same amounts out of declining profits. So just as leverage helps profits to grow in good times, it makes them fall further in bad times. Over time, the company will find it harder to refinance its borrowing; bankruptcy might even threaten. Similarly, no individual would be advised to take out a big mortgage if he expected his income to drop.

Falling prices also undermine a big argument in favour of borrowing: that it provides a shield against tax (because, in most



countries, interest payments, unlike dividends, are tax-deductible). Deflation tends to reduce taxable profits, and thus the value of that tax shelter. It also gives companies other tax breaks: depreciation, for instance, is a tax-deductible non-cash expense calculated on the historic cost of assets, not their replacement cost, which may soon be lower.

In this new paradigm, it is no solution merely to switch from fixed to floating-rate debt. Interest rates may go down, but they rarely become negative, so the real cost of borrowing can easily rise in deflationary times.

The only good answer to the dilemma, therefore, seems to be to raise equity capital. Companies are not compelled to pay it back and, if profits and cashflow really do head south, they can stop paying dividends. Certainly, one would not expect investors to pay high prices for new issues of shares, as they discount this risk. But in practice, after last year's wobbles, stockmarkets are once again close to record highs. As long as markets are so generous, what better time for companies to replenish their equity reserves and get creditors off their backs?

Treasurer island

Unfortunately, says Paul Gibbs, an analyst at J.P. Morgan, an American bank, "treasurers don't understand this stuff at all." As day-to-day managers of cash and debt, they tend to mistake the hard numbers of interest and dividend payments for the actual cost of capital. Properly defined, that cost includes all future returns (income and capital gains) that investors expect when they accept a company's risk. This cost—rather than merely the size of current dividend payments—determines the value of a firm and its share price (and so, complicating the manager's decision, the value of his share options). The trouble is, this "true" cost of capital works in mysterious ways.

For one thing, in a perfect world (ie, one without taxes) it is not affected by the mix of debt and equity at all. Decades ago, Franco Modigliani and Merton Miller, two academics, showed that for every bit of additional debt a company issues, equity investors will simply demand a higher return on their shares to compensate for the extra risk of bankruptcy. This is true whether price levels are rising or falling.

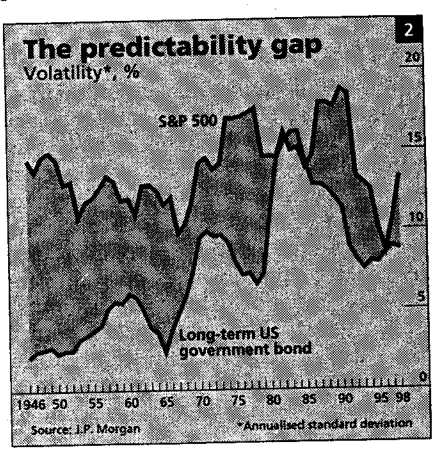
In the real world, however, there are taxes, so capital structure does matter. By taking on more debt, treasurers can save more in taxes and increase the value of their firms. This is the same as saying that by borrowing they can lower their after-tax cost of capital. It is one of the justifications for share buy-backs—and may remain so, even if deflation takes hold.

It is true that, by leading to both lower profits and lower interest rates, deflation may reduce some of these tax savings—although not by much, because if interest rates fall, so will the rate at which the value of future tax savings is discounted. It is also true that, during deflation, indebtedness increases the risk of bankruptcy. But this does not mean that all borrowing is bad—just that some companies should reduce the ratio of their debt to their equity.

Certainly, equities look much more attractive for companies than do bonds. Equity currently seems to cost firms barely more than debt (ie, the return investors expect from shares is not much higher than the return from bonds). Historically, according to J.P. Morgan, American investors demanded a risk premium of about 5% for shares compared with bonds. These days, that equity risk premium hovers nearer 3%. The gap has also narrowed in most European countries, but widened in deflationary Japan (see chart 1 on previous page).

Nobody knows why the premium has narrowed. Yet one big reason is probably inflation, and the big fluctuations it produces in interest rates, and hence in bond prices. Investors expect a higher return from shares than bonds because shares have tended to be more volatile. But in the past few decades that volatility gap has narrowed: at times bonds have even become as volatile as shares (see chart 2).

While price levels stayed comparatively stable for most of modern history, they have become harder to predict since the inflationary 1970s. A modest deflation, on this basis, would simply reflect a return to the former predictability for bonds. In which case the equity risk premium might also be expected to return to its historic levels. That would be bad news for the stockmarket, for it implies a fall in share prices. But it need not be disastrous for treasurers who have prepared themselves.



Parallel imports

Hardly the full Monti

LEVI STRAUSS likes to assure its customers that its 501 jeans in Paris, France are the same as in Paris, Texas. Well, not exactly the same: French 501s cost more than twice as much as American ones. An ideal opportunity for trade? Not if Levi, these days a troubled firm that has just announced the closure of half its American factories, has its way. It is suing 24 European retailers, including Tesco, a British supermarket chain, for selling cheap Levi jeans imported from unofficial sources outside the European Union. Support for long-suffering French jean-wearers may come from the European Commission. But not enough.

Companies such as Levi are finding it increasingly hard to charge different prices in different markets. Sharp traders can easily buy products where they are cheap and resell them where they are dear. Between countries within the EU's single market, such "parallel" trading is legal. But EU legislation outlaws parallel imports of cheap branded goods, such as jeans or CDs, from outside the EU.

Consumer groups, parallel importers, and many retailers are up in arms over this. They say the law helps brand-owners to restrict competition and fleece European consumers. Mario Monti, the EU's single-market commissioner, is sympathetic. He wants governments to consider changing the law. On February 25th he set the ball rolling when he presented to EU ministers a new report on the consequences of reform by NERA, an economic consultancy.

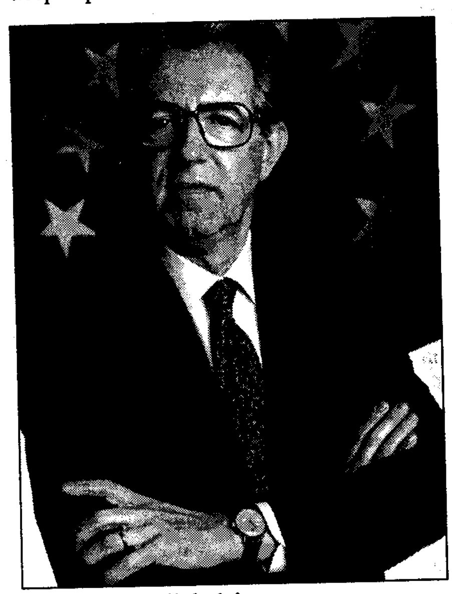
Brand-owners argue that parallel imports damage their brands and expose consumers to piracy and fraud. They argue that cheap parallel imports are ultimately harmful because they reduce firms' incentive to invest in their brands or in after-sales service. And they claim that parallel imports are often not the genuine article: they may have different specifications, be old or damaged stock, or even be fakes.

These arguments are self-serving. Parallel imports are legal in America and within the EU, yet consumers do not visibly suffer. On the contrary. Parallel imports increase competition for brand-owners and retailers, which leads to lower prices. Consumers also get more choice. They may prefer to do without after-sales service on their Walkman (or, indeed, jeans) if it means paying less. When they genuinely value such a service, unofficial retailers such as Tesco have as much incentive to provide it as official distributors. The risk of counterfeits is also a red herring. Legalising parallel imports of genuine Nike shoes does not mean allowing in fake ones as well.

Keener competition would, however, dent the profits that brand-owners make in the EU market—by as much as 35% in the consumer-electronics sector, according to NERA. But firms would still have an incentive to invest—the fear of losing market-share. Fiercely competitive markets such as America's are associated with more spending on brands, not less. Indeed, according to NERA's survey, brand-owners have no intention of cutting back on such spending if parallel imports are allowed in.

The real worry about legalising parallel imports is that it may do too little to boost competition, not too much. According to NERA, the prices of consumer-electronic goods and domestic appliances would at first fall by no more than 2%, while the prices of cars and CDs would decline by less than 1%. The price falls would be small because supplies of parallel imports are tiny compared with the overall EU market.

The threat of huge volumes of parallel imports from America may eventually spur deeper price cuts. But not necessarily. Al-



Mario's parallel vision