



Center for Cooperatives
UNIVERSITY OF WISCONSIN-MADISON

How a Banker Looks at Financial Leverage

by Lee Estenson, Vice President and Leading Team Manager, St. Paul Bank for Cooperatives

Published in *Year in Cooperation: A Cooperative Development Magazine*, Minnesota Association of Cooperatives, Spring 1996 -- Vol. 2 No. 2

Many of our discussions with customers are about financial leverage -- the mix and utilization of capital. Capital consists of debt and equity, so a discussion of financial leverage is really a discussion of "How much equity should we have versus how much debt?" The factors differ for each business and come together in a different way in each situation. Let's consider leverage from four perspectives:

1. Cost of capital, the textbook view of debt versus equity.
2. The business cycle influence, a much broader view.
3. Owner philosophy and commitment, a more inward look at the company and management.
4. Competitive advantage, comparing competition and the industry.

The Cost of Capital

All forms of capital have a cost. For debt, it is the interest paid. For too long many cooperatives assumed that equity had no cost because they were not required to pay dividends. Cooperative managers and directors now recognize that equity has a cost, in the form of an opportunity cost, sometimes called the hurdle rate.

Opportunity cost is the alternative use for the money -- investments, savings, land, machinery, or investment in another cooperative. You can never know exactly what the blended opportunity cost is for all of your members. Many argue that it is higher than the rate of interest paid on debt. The hurdle rate is self-imposed; it is what board and management determine to be the acceptable level of return on investment for risks undertaken. When a business evaluates financial leverage the overriding factor should be its ability to generate cash flow, both to service debt and to meet the necessary opportunity costs or hurdle rate.

Opportunity costs vary by situation. For example, opportunity costs may be lower in an arid climate where irrigation is unavailable. Irrigated areas with higher value alternatives may have higher opportunity costs.

It is not enough to measure cash flow against history and expected economic conditions. Sensitivity analysis of "What-if" questions to determine the impact of changing assumptions, especially those not in management's control, are very important. What if sales prices drop? What if input prices increase? What if interest rates rise? What if...? What-if questions help determine whether the opportunity cost or hurdle rate can be met under various economic conditions.

Another way of looking at cash flow is in terms of the projected revenues from the new assets being considered. Projected revenues give assets value and determine whether the return to capital is satisfactory. Assets are often approached from the vantage point of "What is their replacement value?" But replacement has no value if revenue and profits cannot be generated.

Generally, whenever the return on assets exceeds the cost of debt, leverage is favorable, and the higher the leverage factor (more debt and less equity) the higher the rate of return on equity. The rational thing to do then is to use more debt and less equity. But leverage is a two-edged sword. If the return on assets slips below the cost of debt the return to equity will quickly disappear. The business will go into a loss position more rapidly if leverage is high.

The Business Cycle Influence

Nearly every industry has a business cycle of good times, bad times, and times in between. You must survive the bad times to be around to enjoy the good times. The less debt you must service, the more likely you are to survive.

Some of the new-venture, value-added cooperatives provide good case studies of this point. Financial projections often indicate they can get by with relatively low equity, high-leverage beginning balance sheets. But those projections assume normal or even optimistic economic conditions. The financial projections don't hold when economic assumptions more appropriate for the more stressed portion of a business cycle are considered. Many successful new-venture cooperatives would not have survived their first business down cycle had they not had a solid financial leverage position (more equity and less debt) at start up.

In addition to surviving the low end of a business cycle, low leverage can mean opportunity to thrive during the bad times. The low end of the business cycle can provide very attractive purchase investment opportunities -- if you have the borrowing capacity to take advantage of them. But windows of opportunity often are relatively short and there may be little time for raising more equity capital, generating retained earnings or negotiating high-leverage loans with bankers. It is important to be strong enough to move quickly to get needed borrowing commitments in place.

Another important consideration is the business cycle's volatility. While stability may allow for high leverage, volatility dictates lower leverage. Historically, the regulated utility industry has been an example of a stable industry. It generally has enjoyed stable rates, stable earnings and stable growth. This stability has provided an environment for the utility industry to be more highly leveraged than other industries. At the other end of the scale might be the computer industry. It is fast moving; its products become obsolete within months. The result can be a very volatile business cycle with much less room for debt on the balance sheet.

Owner Philosophy and Commitment

Whoever controls the capital controls the business. Consequently, lenders are reluctant to provide more capital than the owners. Owners, as providers of equity capital, take the business risks and enjoy the profits of their success; they should be the major contributors of capital. The level of equity invested by the owners signals to the banker the commitment of the owners to both the concept and the company.

As capital shifts from equity toward debt (higher leverage), restrictions and conditions required by the lender increase. Generally, the higher the leverage on the balance sheet, the more restrictions the lender places on the borrower for such things as working capital uses, capital expenditures for fixed assets and equity revolvments.

On the other hand, the more equity on the balance sheet, the more freedom and flexibility are enjoyed by the owners of the business.

To some extent, owners can substitute "quasi equity" for "real equity." Quasi equity in certain marketing cooperatives includes pooling arrangements, grower agreements, delivery obligations and the like. True pooling essentially transfers some market risk to the growers, who are obligated to deliver their crop and who receive a partial payment advance at the time of delivery. The final price for the product is not determined until it has been processed or marketed and monies collected. The co-operative can then determine its needs for servicing debt and working capital and return the rest to the growers. Pooling can be a powerfully competitive tool when the growers own their own marketing and processing organization.

This pooling concept reduces working capital needs. It has allowed the Bank to consider financial leverage ratios of debt to equity greater than 1:1 in some new-venture cooperatives.

While high leverage reduces working capital needs and may be acceptable in the early stages of a business, it should never be used as a permanent strategy. If so, the firm could be unable to take advantage of its future growth or expansion opportunities. High leverage in new-venture cooperatives may be an acceptable starting position, but if an unplanned growth opportunity occurs too early in its business life it may be unable to grasp it without additional capital investment by the owners. It will have to pass and allow a business that is financially better positioned to handle it.

Although debt-to-equity ratios in excess of 1:1 have become a benchmark of new-venture pooling cooperatives, such a ratio is on the high end of the acceptable leverage range and should not become a permanent objective. The key ingredient to reaching even this level of leverage is justification of the purpose of the debt and the plan to return to more comfortable leverage levels. Again, the higher the leverage position the higher the opportunity cost and return on investment needed to justify that risk level.

The Competitive Advantage

Studies of manufacturing firms reveal wide variations among industries and, to a lesser degree, among firms in the same industry. Within a given industry firms tend to cluster about a certain financial direction. An earlier study indicates that the manufacturing industry has a debt-to-equity ratio of .25 to .35, the utility industry has 1.4 to 1.5, and trade industries .3 to .4. While these levels may or may not track with current companies in those industries, the relationships are still valid.

Be careful when comparing companies in different industries. What may appear on the surface to be low leverage in one company may actually be a high-risk position because of its industry.

In addition to knowing the overall industry leverage position it is also important to know the competition and the leverage position of the competitors. It is not unlike being chased by a bear. It may

not be crucial that you can run faster than the bear, but it is crucial that you can run faster than the guy next to you.

It is important to be aware of your lender's knowledge and confidence in your industry. In some respects, a lending relationship is a form of "partnering" with bankers. The borrower should let the lender know what is going on in the company and industry. The lender should dedicate resources to understanding the borrower's industry and company as well as informing the borrower of what is going on in the bank and the financial industry. This takes trust, commitment and a willingness to take reasonable risk.

Lenders who take an interest in and understand a business and industry are better positioned to support "higher" leverage and "longer" repayment periods when justified. Lenders who have neither the interest nor the understanding are much less able to build the kind of relationship that meets long- and short-term needs of the customer.

No magic leverage position applies to every cooperative. Each must evaluate its cost of capital needs, its business cycle, its owners' philosophy and commitment, and its competitive advantage in its industry. Most important of all is evaluating the ability of the business to generate cash flow. Only then can it determine the appropriate financial leverage.

Lee Estenson is a Vice President and Lending Team Manager for the St. Paul Bank for Cooperatives, St. Paul, Minnesota. In this position, Estenson manages the Processing and Marketing Credit Team serving the Bank's dairy, animal agriculture, sugar beet and corn sweetener processing/marketing, and specialty grain processing/marketing segments of the Bank's loan portfolio.

This material has been reproduced in electronic format with the permission of Year in Cooperation.