Why not leverage your company to the hilt?

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Unused debt capacity and excess cash represent financial reserves provide protection against uncertainty. But there is a cost attached to these reserves. Companies must be clear about the implicit and explicit costs of holding such reserves, the risk that the reserves protect against and the amount of cash needed in a worst-case scenario.

Equity is more expensive than debt for two reasons. Equity holders expect more return for the risk they are taking. Unlike debt, equity does not enjoy tax shields.

The cost of financial reserves is the difference between the marginal cost of equity and the marginal cost of debt. By reducing its financial reserves, a company can create value for shareholders. Moreover, unused debt capacity and excess cash can also make the company a takeover target. In case of private and closely held companies, the owners can diversify their risk by investing their money in other enterprises.

On paper, financial reserves protect a company against possible bankruptcy. But in reality, for a failing business, reserves can only postpone and not prevent bankruptcy.

Financial reserves are needed to the extent that during tough times, the company will find it difficult to access equity. It is only the danger that equity financing will not be available at a reasonable price that justifies the cost of carrying financial reserves.

In view of the substantial costs of maintaining reserves, large established companies should consider taking advantage of their available debt capacity. Insurance against the risk of not being able to tap the equity markets, when funds are needed, is more applicable to privately held companies, small companies whose stock is thinly traded and growth companies whose perceived value depends upon expectations about future profits. In the case of these growth companies, stock price volatility increases the risk of being unable to raise equity when the demand arises.

High stock price volatility in general means that the market is finding it difficult to value the company. During periods of difficulty in the past, the stock price might have fallen by more than what the market thought was justified. If investments are unconventional, a good example being intangible assets, analysts may again find it difficult to understand the company’s strategy. In all these situations, financial reserves can provide protection against the vagaries of the stock market.

How much reserves?

Instead of keeping excess reserves, companies must try to make a more accurate estimate of the protection needed by maintaining a combination of reserves:

Coverage reserves: These ensure that interest payments can be made without any problem.

Operating deficit reserves: These enable the company to meet normal operating expenses during lean times.

Bottom fishing reserves: These provide the ability to take advantage of attractive investment opportunities when the industry is going through troubled times.

Development reserves: These ensure that attractive projects do not go unfunded.

Buyback reserves: These enable the company to repurchase shares when the prices are low.

Cash or unused debt capacity?

Financial reserves can be held as cash or unused debt capacity. Reserves held as unused debt capacity have lower risk adjusted carrying costs than cash. Maintaining unused debt capacity is like the company lending money to itself. This will usually generate more returns than keeping cash and investing it in some risk-free securities.

The main disadvantage of unused debt capacity is that it might evaporate when the company gets into trouble. The availability of cash gets around this problem. In general, companies with shaky credit ratings should keep more of cash while those with mortgageable hard assets can depend on unused debt capacity.

To arrive at an optimal balance between cash reserves and unused debt capacity, companies must have procedures and controls to estimate:

- The maximum borrowing capacity
- The amount of cash needed for purely transactional purposes
- The degree of stock market risk
- Future cash needs under adverse conditions
- Optimal size of buyback and other reserves
- Composition of liquid investments
- Costs of cash and unused debt reserves