

# Determining an Ideal Capital Structure

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Optimizing a company's capital structure is critical to its ability to achieve near-and long-term growth objectives. The optimal capital structure should ensure companies retain sufficient capital levels during both good times and bad. Many companies are challenged to create a structure that will be workable through multiple business cycles. Macroeconomic conditions are stabilizing, but as the past few years have demonstrated, it is not always simple to predict cash flows, especially in a volatile economic climate. There are critical issues executives should assess in order to help them formulate their company's optimal capital structure, which proves to be an especially important process for companies looking to make acquisitions as they tackle valuation and integration issues.

## Understanding the Financials

Before determining the dynamics of its optimal capital structure, a company needs to have a comprehensive understanding of its financial position.

An analysis should include a review of how operating and financial leverage will affect the company's ability to make loan payments. In addition, finance executives should focus on all cash requirements, including short and long term capital needs. To determine if the company's working capital projections are reasonable, a sensitivity analysis is critical, which can help business leaders understand the impacts of their financial decisions and projections by incorporating fluctuating variables. For example, in the case of a manufacturing company, it's possible that excess inventory and the ability to collect receivables can become more challenging, especially during a recession, ultimately impacting financial leverage.

Fixed assets should also be at the center of the analysis, which are needed to support sales growth, since these represent long term investments which typically result in greater principal and net obligations. A thorough weighted average cost of capital analysis is another effective exercise, which takes into account financing resources and interest to determine the feasibility of a particular growth strategy, such as a merger, and associated risks with that strategy.

Additionally, when considering a company's financial position, the assessment should include a close look at capital expenditures needs, the cost of responding to new regulatory requirements, and possibly even the company's income tax rate in future years.

Finally, once a company decides to access the capital markets, it needs to be educated as to the various capital providers and to appropriate market terms and pricing in each layer of a capital structure.

## Managing Cash Flow and Debt

The ability to cover financial obligations out of cash flows in both good and bad times should be considered as part of the determination of borrowing capacity.

In the simplest terms, a company's debt capacity comes down to its ability to repay debt and to support ongoing working capital. Certain types of businesses might be subject to a higher level of uncertainty concerning their cash flows, and should consider their ability to meet future interest and principal repayment obligations. Ultimately, companies with extremely unpredictable cash flows will typically lower their reliance on debt as a percentage of total capital. For rapidly growing, early-stage companies that do not produce positive cash flows, the additional net working capital and other assets needed to support sales growth often exceed profits. Many of these companies are forced to finance their growth with private investments usually in the form of equity, but they should be aware that even that source of cash may become harder to come by during certain business cycles. However, in some situations these companies may be able to raise subordinated or mezzanine debt, structured equity or arrange for an asset-based loan if there are unencumbered working capital assets.

- Companies with cyclical sales should be particularly conservative, since an unexpected drop in revenue can quickly impact earnings and available cash.
- Companies that are exposed to significant commodity risks, with large price swings, might also have less predictable cash flows.

## Managing Through Unforeseen Events

Predictability of operating expenses is another issue companies should consider, especially acquirers. For industrial companies, for example, there is the possibility that at least a portion of projected, improved manufacturing efficiencies may not be achieved, or may be delayed. As the past year has demonstrated, unforeseen natural disasters can also have a serious impact on operating expenses and timetables for these companies.

Almost every type of company needs to take into account cash flow swings and credit issues that are caused by macroeconomic factors.

Since the inception of the financial crisis, it's evident that practically no company is immune from large drops in demand or a global credit crunch. Therefore, when evaluating debt capacities or examining restructuring options, companies and potential acquirers need to conduct a sensitivity analysis that takes into account the possibility of what may appear to be unlikely economic outcomes.

## Anticipating Interest Rate Change

Interest rate risk serves as another factor that needs to be considered when determining optimal capital structure. It's important to pose the question: Is the company or acquirer assuming a fixed rate, a floating interest rate or interest rate floors? Even if a company achieves most of its forecast assumptions, a significant increase in future interest rates could adversely affect its ability to cover its financial obligations.

## Conclusion

All of the aforementioned factors should be explored to assess the risks facing a company and its lender. Although it may seem almost impossible to gauge, ultimately, a company needs to determine if it has adequate levels of equity and cash reserves available for unforeseen needs and opportunities.

Forecasting cash flows is challenging because of the existence of so many dynamic factors, some of which may be very difficult to predict. However, several leading practices can aid the process. Forecasts and sensitivity analyses should be as comprehensive as possible. Additionally, it is advisable to have a methodology in place for evaluating such forecasts and assessing the risks associated with borrowing. A better understanding of the various sources of risk and the capital markets can lead to a more appropriate loan structure, support and pricing model.

Determining an ideal capital structure is a crucial step for companies and potential acquirers. The ideal structure not only can limit the risk of default but may also substantially increase profitability and shareholder return. In order to get it right, companies and acquirers should understand the particular macro-and microeconomic risks that might affect them and their industries. A thorough analysis that examines all relevant factors and includes unexpected events is advisable and should occur on a regular basis. Companies will then be better equipped to quickly respond to both positive and negative forces in the marketplace.

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