O'LEARY'S CREDIT ESSENTIALS: CONTINUING UNDERAPPRECIATION OF EQUITY CONTINUES

Disrepect for equity leads to "juicing" and other practices that hurt in the long run

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In last week's blog, we talked about the two forms of leverage employed in businesses-Operating Leverage and Financial Leverage. This week we will discuss Equity Capital, the partner of Financial Leverage, in how businesses fund themselves.

-Ed O'Leary

Capital has a number of definitions, but to me, a lifelong commercial banker, it means just one thing: equity.

In a double-entry bookkeeping system equity is the excess of the carrying value of assets minus the amount of contractual liabilities. It's the investment of the owners of the enterprise.

It's what's fundamentally at risk in the business as opposed to what may be invested by but owed to creditors.

Why that matters

Lenders need to understand that first and foremost, equity is what's available to cover shrinkage of the asset values of the business. If the assets of a business contract and its liabilities do not, then equity takes the hit. Balance sheets are supposed to balance and it's in the equity account that the balancing will ultimately occur in problem situations.

Any credit person today who was trained in virtually any big bank training program has learned to spread borrowers' statements. This is the laborious task of arranging business financial information in a side-by-side fashion to reveal trends and facilitate comparisons.

But when you learn to spread statements, you also learn how to reconcile equity. Virtually any arithmetic error you make while spreading shows up in the equity account. At The Bank of New York many years ago, we trainees were taught to reconcile equity. Our various supervisors and bosses always did it as a short-cut way of making sure that our work was accurate. It wasn't foolproof but it caught lots of errors.

So, we always reconciled the equity accounts before we took our work for review by our seniors. That's probably the source of my career-long respect for equity as the financial cornerstone of any business.

Why it should have mattered

Many of our banking colleagues, while professing to understand financial accounting, haven't always acted that way. Here's a scenario that you can almost believe happened at some banks, particularly those with aggressive lending philosophies, during the last business cycle.

Imagine that you have just come out of a meeting of your bank's credit committee. A number of loan charge offs were considered and recommended to the board.

Let's say that the total amounts to $1 million and, since balance sheets have to balance, you must now call your customers and explain to them that each depositor must bear a pro rata share of the charge offs.

Will you have a receptive and compliant audience?

I doubt it.

Then why don't we respect equity more than we seem to? More about that in a moment.

Twenty-five years ago, the industry, with a nod to international banking practice and increased coordination of capital standards of commercial banks among industrialized nations, moved toward a risk-based approach toward capital adequacy of banks.

What has evolved is considerably more sophisticated than our earlier efforts and the job is still far from done. The emphasis has been on minimum levels of acceptable capital and those concerns are as urgent today as they have been at any time in our modern economic history.

In some ways we're no closer to knowing what is enough than when we first started discussing this.

Where equity fits in the risk-based framework

We're going to have to live with some ambiguity. But what the discussion also needs, on the part of all participants, is a healthy dose of respect for the role that equity plays. It starts with its primary purpose, the absorption of loss. The greater the ability of the enterprise to absorb loss, the less risky the enterprise will be perceived to be by its creditor constituents.

Over the last business cycle, we lived through a massive leveraging of our financial system. Debt levels were increasing much faster than equity and imbalances in historical relationships between debt and equity were developing, becoming quite pronounced in many ways.

Some of this was seen and understood for what it was-a more risky business environment. Much of it was not seen and understood, and what we lost was our formerly fined tuned sense of the value of equity. In some ways, our attitude toward equity does not do justice to its function at a fundamental level.

Consider the following situations.

Real-world perspectives on risk and equity

Not too many days after the Comcast acquisition of NBC Universal from General Electric was consummated I heard an intelligent discussion of GE's business strategy in deciding to sell NBC. The business was and is profitable and prestigious. But it was not "core" or fundamental to the wide range of industrial sorts of business lines that the General Electric largely dominates.

GE viewed NBC's divestiture as an intelligent way to redeploy, in a more strategic sense, the equity locked up on NBC's balance sheet. It recognized that capital is a scarce resource and that no business enterprise can operate without it. But in recognizing its scarcity it then had to address the question of where might that capital best be employed. In the financial sense, the question can be stated, "What is the highest and best use of our equity?"

A good friend and colleague from The Bank of New York ultimately became treasurer of a Fortune 1000 company. He was imbued with the idea of using debt to juice up the Return on Equity (the net income divided by equity ratio) of his employer and was pretty typical of a very prevalent attitude among financial managers of that time.

To my friend, debt only enhanced the return on equity and in the arithmetic sense, he was right. But what did that attitude portend for the relationship between creditors and owners of the company-or any company?

Obtaining a high level of Return on Equity is more than just flogging the factors of production and adding new doses of debt to produce a greater return in absolute dollar terms. It also means employing capital, debt and equity, to grow individual businesses in different ways to match the evolving nature of businesses today. These are the points of view that tend to separate the numbers cruncher from the owner trying to build the long-term value of the enterprise. How often do we see these points of view in conflict? And when we do, so what?

GE concluded that NBC would never become a core business, unlike most of their industrial product lines. Even though NBC operations were a prestigious and profitable activity, it would fit better with different sorts of enterprises having similar operating characteristics, markets, and lines of business. So GE made a strategic decision and showed its owners and investors that it had their best interests in mind. GE elected to treat the equity in NBC as something to be respected, preserved, and enhanced through cultivation and careful attention and ultimately redeployment into another area of the business.

A basic that bankers should hold to

How many of our banks and bankers, having lurched through the last business cycle with bouts and binges of risk, showed as much respect for equity capital in their own businesses or those of their customers?

Their actions and attitudes, in hindsight, seem more aligned with what the sharp pencil numbers guys think of equity-as a tool to be manipulated in the end process of maximizing returns. Those days appear over, but they will likely return some day. We'll diminish our respect for equity all over again in the quest for return on equity and revisit some painful lessons.

Most anything of enduring value today is rationed, as it should be, befitting the status of a scarce or limited resource.

Equity should be rationed and placed in the service of productive, useful, and profitable enterprises. We seem to have lost our sense of that. We should find it again.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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