TRENDS IN
Australian corporate financing

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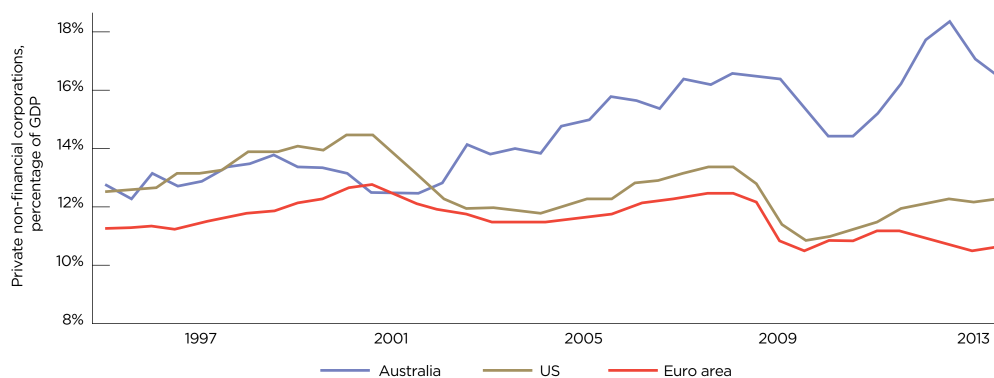
This paper examines recent trends in the corporate finances of Australian listed companies, with an emphasis on the experience since the onset of the global financial crisis. Over this period companies have relied primarily on internal funding to finance their activities. There has been a modest pickup in debt financing while equity raisings have remained subdued. The pattern has been driven almost entirely by the resources sector which increased borrowing during its investment boom. Companies outside of the resources sector have exhibited little demand for external finance, reflecting more muted investment behaviour which has sustained the asset base but has not driven expansion. An earlier version of this paper was presented to the 2014 Australian Centre for Financial Studies' Melbourne Money and Finance Conference.

Companies finance their business activity from a mix of internal and external sources. Internal finance flows directly from company operating profits. Funds are also sourced externally, from bank loans, the issuance of debt securities or the issuance of equity. The overall demand for finance reflects the investment decisions of the corporate sector. Internal finance is relatively stable compared to the use of external finance and tends to provide the bulk of funding for most activities.[1] External finance is often used to facilitate larger, discretionary investments, including corporate control transactions.

Since the global financial crisis, investment and corporate funding trends in Australia have been characterised by the divergent experiences of the resources sector and non-resources companies.[2] Resources companies have participated in an investment boom, which has involved substantial long-term commitments to investment projects. In this environment, companies have used debt to smooth over temporary bouts of weakness in operating profits. In contrast, investment in the non-resources sector has been much weaker, effectively limited to maintaining the asset base rather than expansion. Internal finance has been adequate to meet non-resources companies' net funding needs and the sector's capital structure has remained broadly stable.

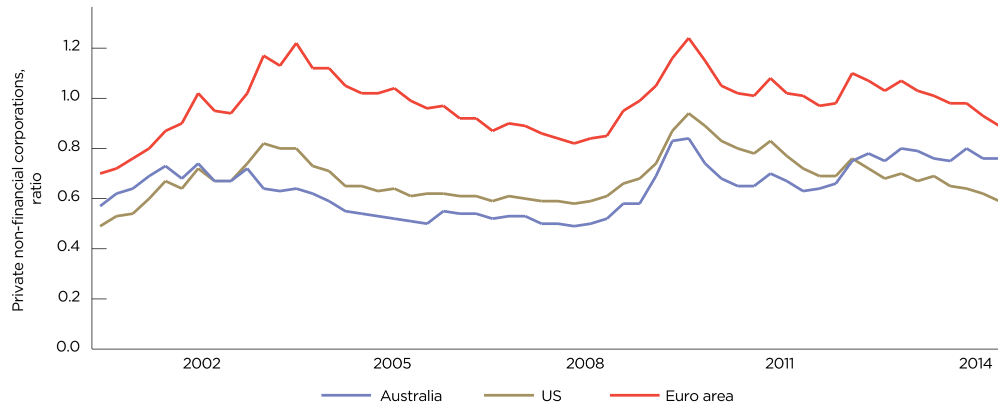
FIGURE 1: International corporate investment*



*Fixed gross private investment, excluding residential investment; Australian data exclude cultivated biological resource investment.

Sources: ABS, Eurostat, RBA, Thomson Reuters.

FIGURE 2: International corporate debt-to-equity ratios

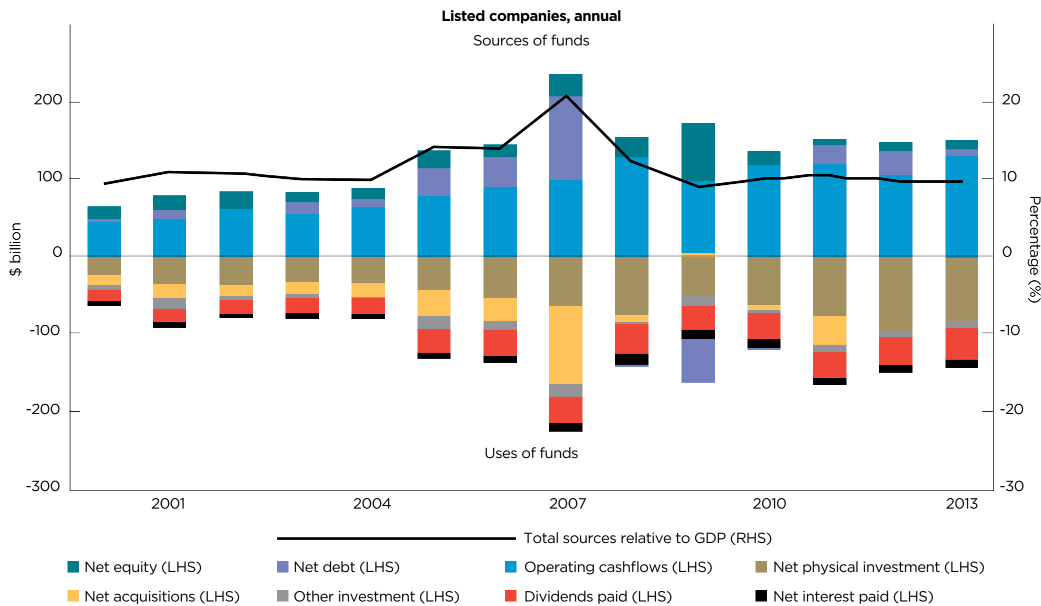


Source: OECD.

The resources investment boom has contributed significantly to the relatively favourable performance of the Australian economy in the post crisis period. Australian business investment has increased considerably as a result, unlike in many other developed economies where investment has been more subdued (Figure 1). The resources investment boom has similarly driven divergent experiences in funding markets and capital structure, with Australian corporate sector leverage increasing since 2010 as leverage continued to decline in many other developed economies (Figure 2).

Listed non-financial companies' aggregate sources and uses of funds have been relatively stable in the post crisis period. Total sources of funds has remained steady at around 10 per cent of nominal GDP — close to the average since 2000 (Figure 3). The increase in net investment has largely been funded through internal sources and the use of external finance has remained modest.

FIGURE 3: Australian sources and uses of funding

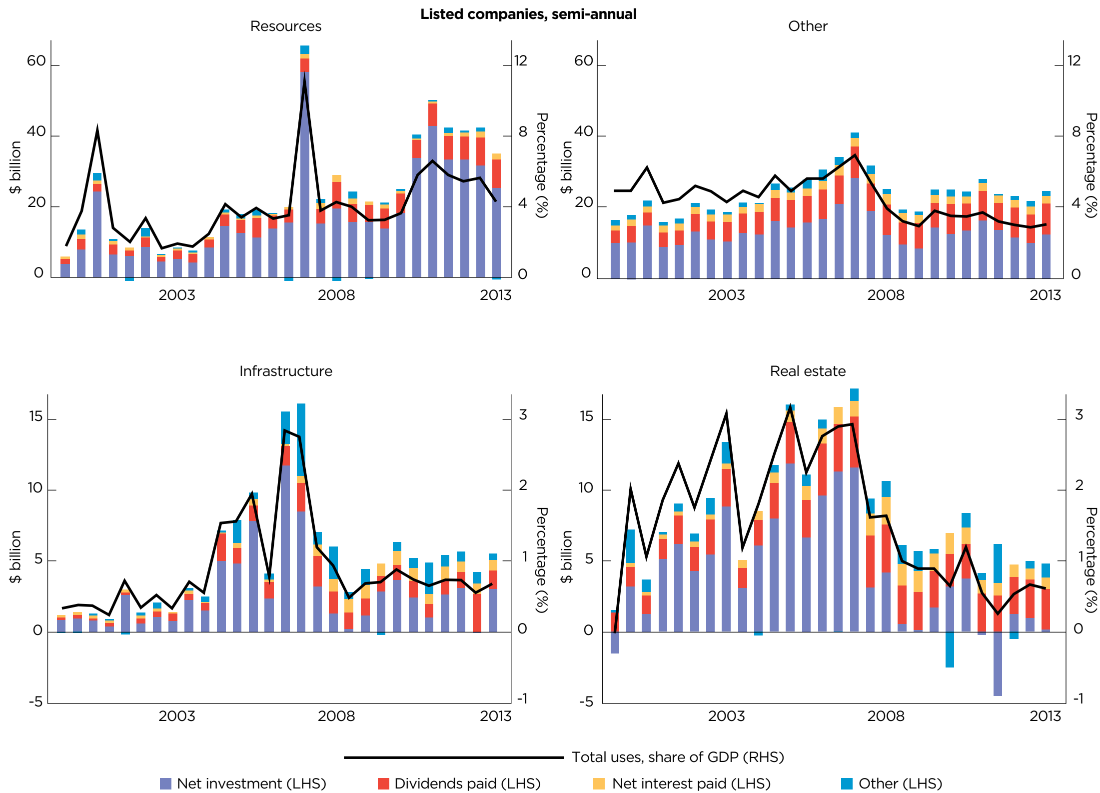


Sources: Bloomberg, Morningstar, RBA.

Companies' uses of funds

The modest increase in listed companies' uses of funds since the global financial crisis has occurred largely due to higher net investment (Figure 4). The other main trends evident in the uses of funds data over recent years include lower net investment outside the resources sector, notably in the real estate and 'other' sectors, and an increase in dividends paid.[4,5] Interest payments remain a modest component of the uses of funds and have decreased in aggregate since the sharp deleveraging that occurred immediately following the crisis, particularly as borrowing costs have declined.

FIGURE 4: Uses of funds by sector



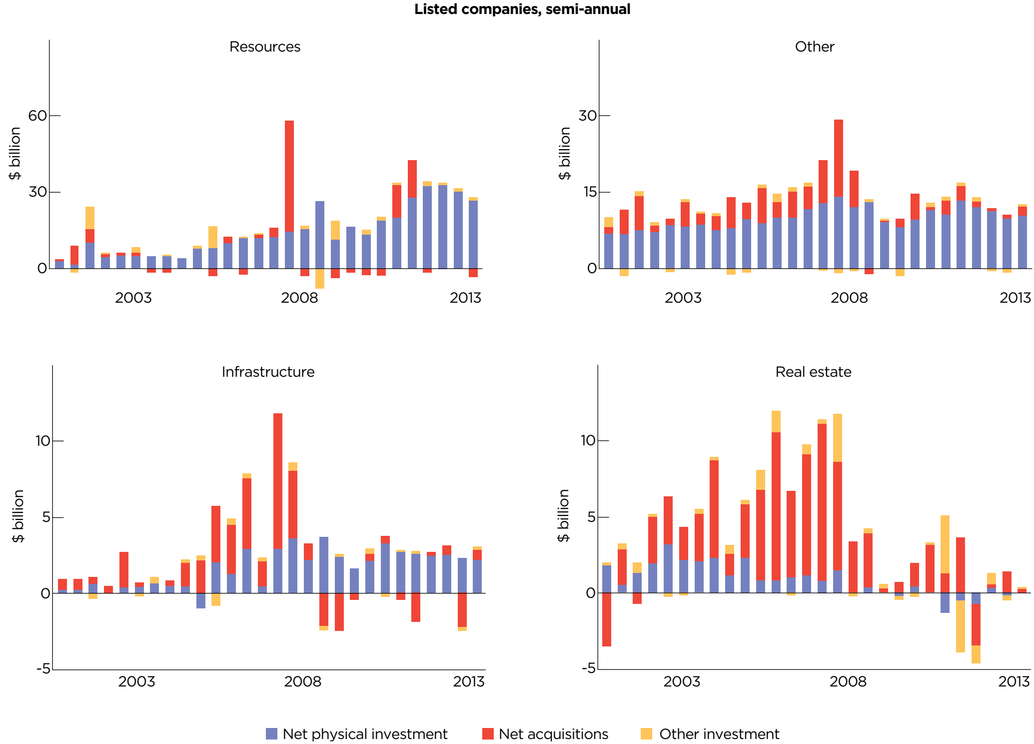
Sources: Bloomberg, Morningstar, RBA.

Investment

Net investment can be disaggregated into net physical investment, net acquisitions and other investment. The investment undertaken by listed companies differs considerably between the pre and post crisis periods.

Prior to the global financial crisis listed companies underwent a period of merger and acquisition (M&A) driven investment expansion, participating in the global wave of activity underway at the time (Figure 5). Much of the M&A activity was undertaken by non-resources companies, which were typically mature firms with fewer organic growth opportunities. M&A by companies within the 'other' sector accounted for a lower share of investment than either the real estate or infrastructure sectors, but the transactions were large and occurred within many industries.[6] Net acquisitions by resources companies typically accounted for a much lower share of net investment, due to the availability of organic growth opportunities. However, very large transactions have occurred sporadically in the sector, including Rio Tinto's $44 billion acquisition of Alcan in 2007 — the largest by an Australian listed company.

FIGURE 5: Investment by sector

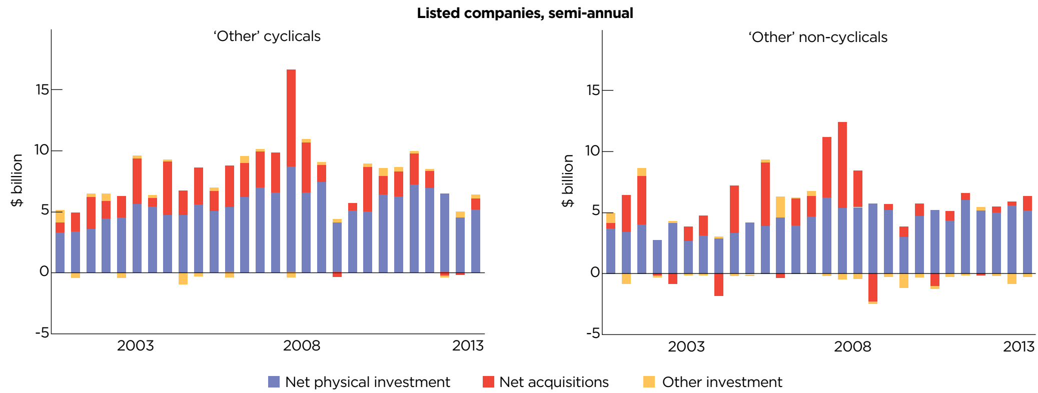


Sources: Bloomberg, Morningstar, RBA.

The global financial crisis marked a dramatic shift in corporate attitudes toward expansion, due to the heightened sense of uncertainty and weak economic outlook. This shift ushered in a period of cost restraint and capital expenditure discipline. The result has been a protracted period of subdued M&A activity by Australian companies, with the bulk of activity from a small number of resources sector transactions over 2010–11.[7] As a result, physical expansion by diversified mining companies has been a major source of net investment by listed Australian companies since the crisis. The elevated level of commodity prices over 2010–11 spurred mining companies to develop new projects and expand existing sites to upgrade production capacity, particularly for projects involving iron ore. Companies have also invested to expand coal production capacity due to robust foreign demand for its use in the manufacturing of steel. Physical investment in large scale LNG projects is also underway, although the true scale of these investments is not well represented by these figures due to foreign participation in the projects.[8] Over the past year, however, net physical investment in the resources sector has begun to slow as existing projects have neared the production phase. Uncommitted expenditure has also been deferred as a combination of lower average commodity prices and cost inflation has reduced the attractiveness of many projects.[9] Shareholder pressure to exercise capital expenditure discipline may also have contributed to this trend, particularly as companies have recorded substantial write downs of many assets acquired before the crisis.

'Other' companies have been the main source of net physical investment outside the resources sector since 2008, with much of the recent investment undertaken by companies with cyclical business activities (Figure 6). This has mostly involved net physical investment by resources related industrials, with the expansion and subsequent contraction of activity in the resources sector driving investment decisions.[10] 'Other' non-cyclical companies remain the most significant source of investment not directly related to the resources sector, largely reflecting sustaining physical investment by consumer staples and telecommunications companies.

FIGURE 6: 'Other' sector investment

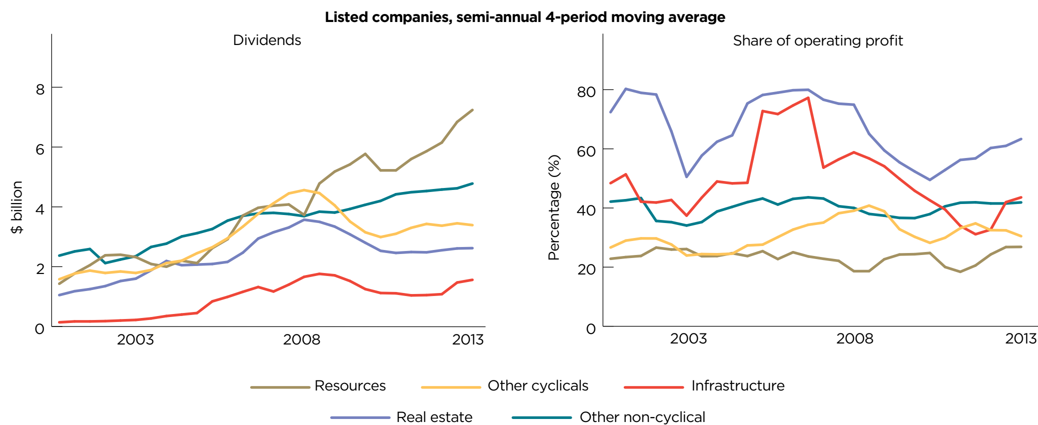


Sources: Bloomberg, Morningstar, RBA.

Dividends

After the reduction in dividend payments immediately following the global financial crisis, companies have generally increased the amount of capital returned to shareholders as dividends (Figure 7). Subdued investment by non-resources companies has coincided with an increase in the amount of dividend payments relative to total uses of funds, but dividends have generally returned to around their average proportion of operating profits. The resources sector has also raised dividends, despite substantial investment commitments. As a result, dividends have generally risen as a share of operating profits across all sectors, but remain well within historical norms. It therefore remains unclear to what degree the current level of dividends reflects heightened shareholder demands for distributions, unwillingness by companies to pursue growth options, or other factors.

FIGURE 7: Dividends by sector



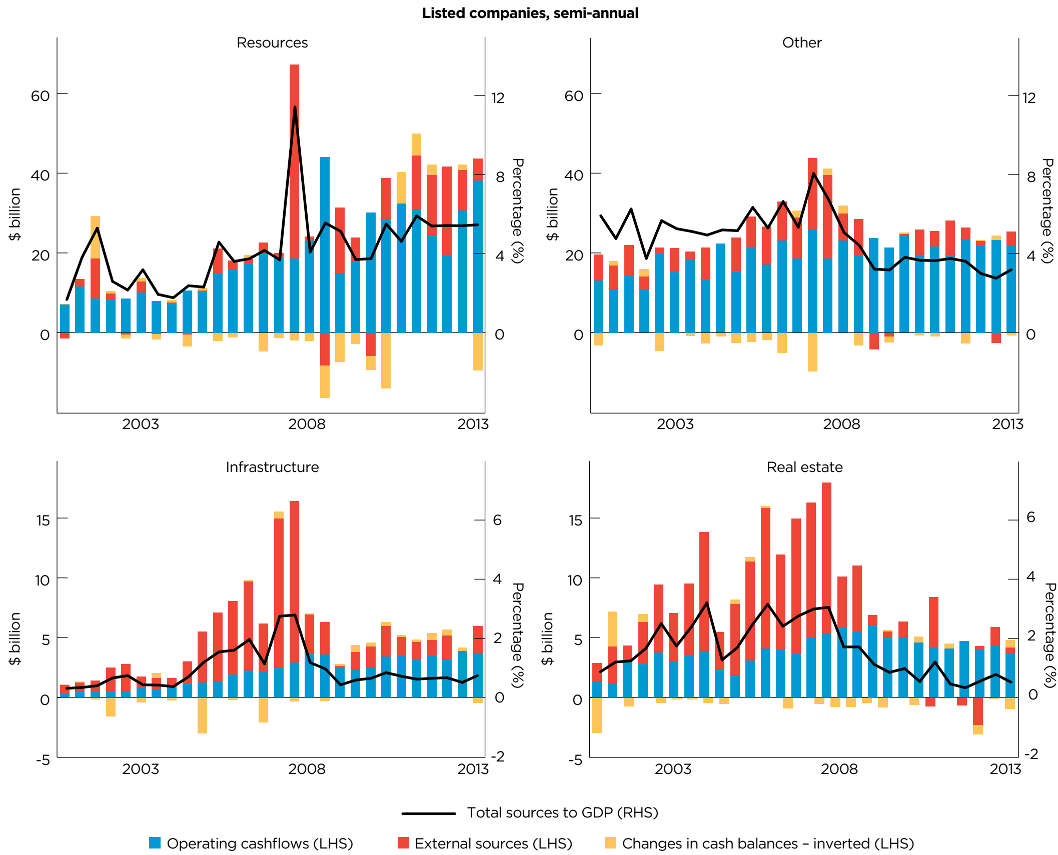
Sources: Bloomberg, Morningstar, RBA.

Funding the listed corporate sector

The business activities of Australian listed companies are mostly funded from internal sources, effectively recycling returns on previously invested capital to sustain operations and undertake new investment. Internal funding has accounted for around two thirds of total funding since 2000, although the pre and post crisis periods produced two distinct funding phases. The expansionary phase preceding the crisis was characterised by a steady increase in the availability of internal funding, particularly within the resources sector as rising commodity prices drove substantial growth in operating profits. Non-resources companies funded much of their acquisition-driven expansion through external sources, a response to the substantial size of transactions relative to internal funding.[11]

The post crisis phase is characterised by the moderate use of external funding across listed companies (Figure 8). This has consisted mostly of resources companies sourcing external finance to meet committed physical investment outlays during periods when lower commodity prices have affected operating profits. Meanwhile, non-resources companies have had little demand for net external funding.

FIGURE 8: Sources by funds by sector

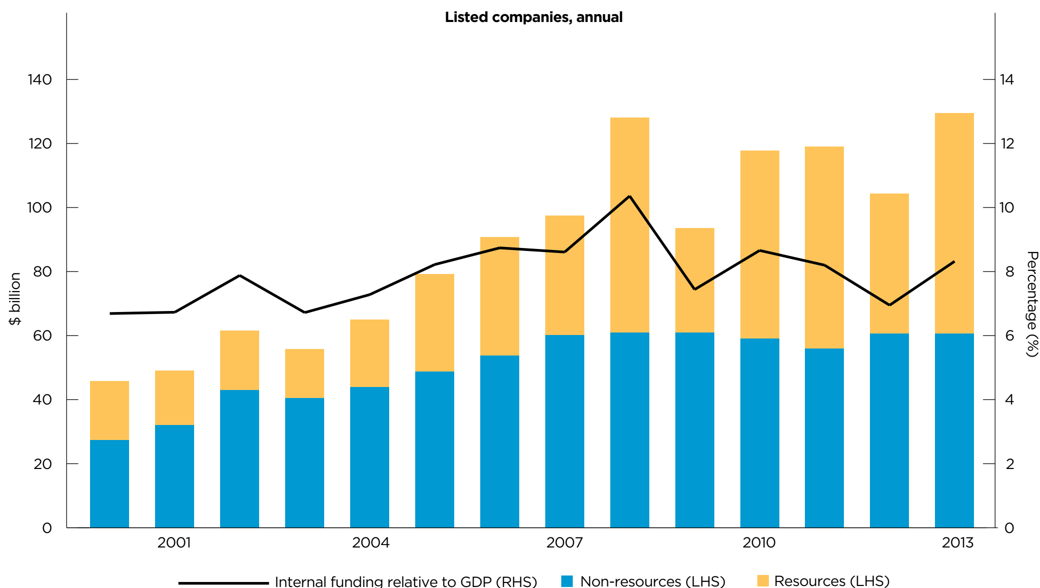


Sources: Bloomberg, Morningstar, RBA.

Internal funding

The ability of companies to fund themselves internally from current period operating profits has risen modestly since 2000, to slightly above 8 per cent of GDP (Figure 9). This has been a broad trend for both resources and non-resources companies. However, resource companies have become an increasingly important source of profit generation in the Australian listed sector over the past decade and now account for half of total operating profits. This has added to the volatility of internal funds because resources companies' earnings have significant, unhedged exposure to commodity prices.

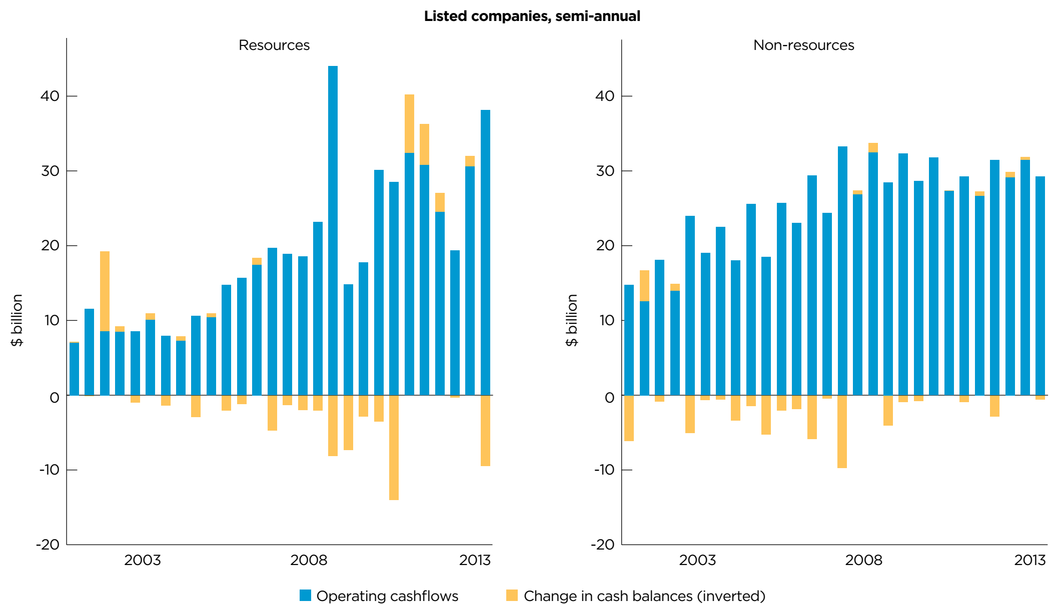
FIGURE 9: Internal funding



Sources: Morningstar, RBA.

Companies may also use their cash balances as a source of internal funds. Changes in cash balances arise from the difference between total sources and uses of funds. Falls in cash balances may therefore be considered as a secondary source of internal funds. Nevertheless, for both the resources and non-resources sectors, current period operating profits form the bulk of internal funding (Figure 10).

FIGURE 10: Internal funds

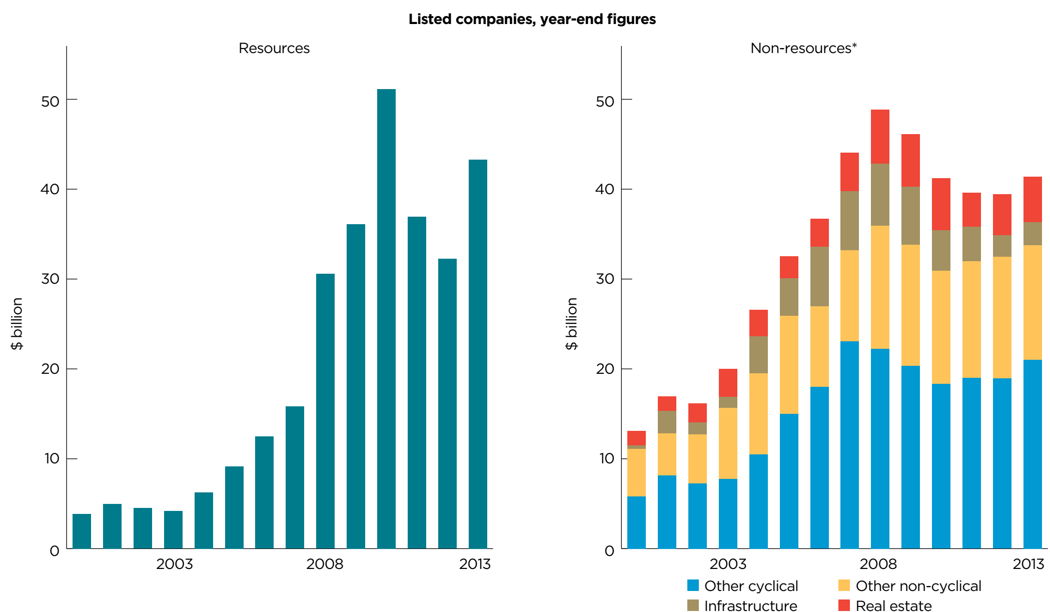


Sources: Morningstar, RBA.

The global financial crisis and concerns around European sovereign debt in 2010–11 coincided with a pronounced increase in cash balances for resources companies, consistent with decisions to curtail investment expenditure. The subsequent recovery in commodity prices in 2011 and the related recovery in net investment were then funded in part by a reduction in resources companies' cash balances. Despite this reduction, cash holdings relative to assets remains above pre-2008 levels.

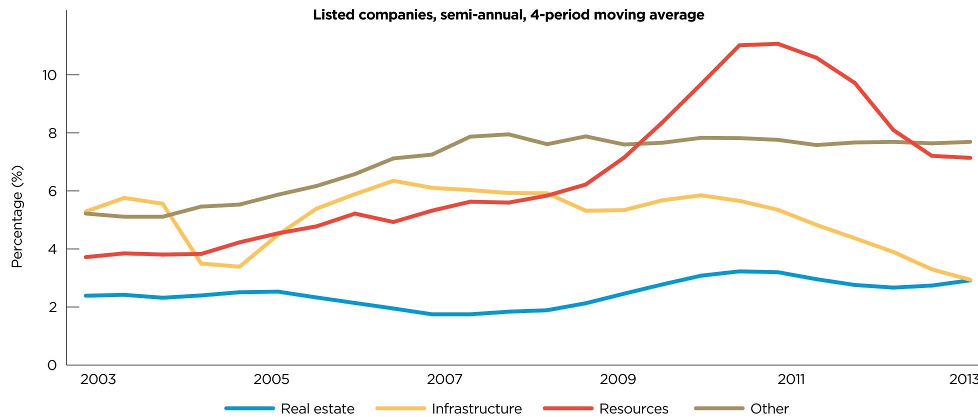
For non-resources companies, there was a less pronounced increase in cash balances immediately following the crisis and, over more recent years, balances have generally declined or remained steady in dollar terms and as a proportion of assets (Figure 11 and Figure 12).

FIGURE 11: Cash holdings by sector



Sources: Bloomberg, Morningstar, RBA.

FIGURE 12: Cash holdings relative to assets

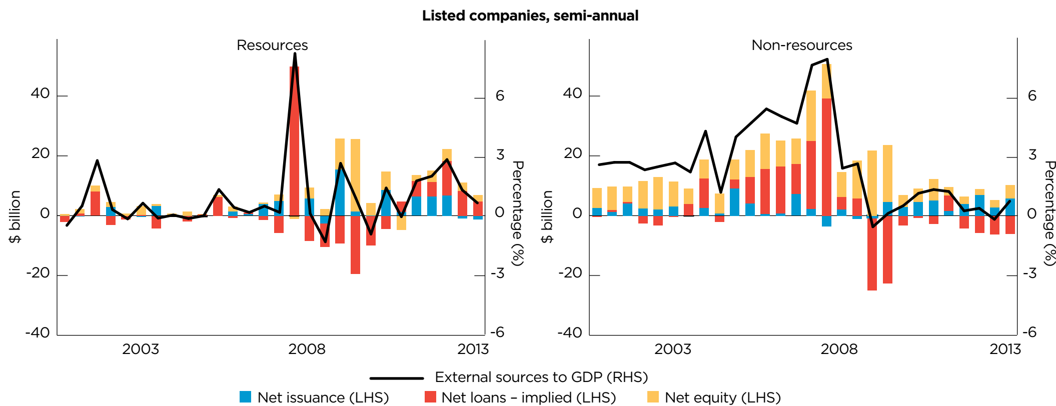


Sources: Morningstar, RBA.

External funding

Use of external funding increased considerably during the pre-crisis expansionary phase but moderated over the post-crisis period (Figure 13). Debt is typically the preferred source of external finance and was used extensively to fund the wave of M&A activity prior to 2008, causing net debt flows to peak at 14 per cent of GDP in 2007. Since the financial crisis, the net external funding needs of listed companies have largely consisted of the debt raised by resources companies to fund committed physical investment, although this too has begun to slow in the past year. Limited net investment by non-resources companies has meant that internal funds have mostly been sufficient to meet expenditure, particularly given the absence of M&A since 2008. Net equity raisings have been modest, abstracting from the surge in issuance which coincided with the peak in equity prices before the global financial crisis and the subsequent equity-funded market-wide deleveraging which occurred during 2008–09.[12]

FIGURE 13: External funding by sector

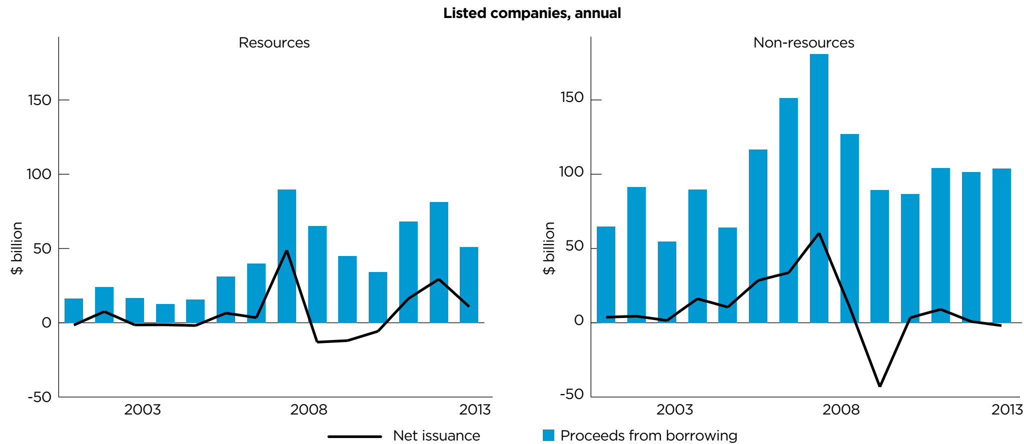


Sources: Bloomberg, Morningstar, RBA.

Debt funding

The debt burden of the resources sector is relatively modest compared with that for the non-resources sector, where the stability of *net* debt raisings masks the extent of refinancing activity; each year non-resources companies refinance around $100 billion of debt (Figure 14).

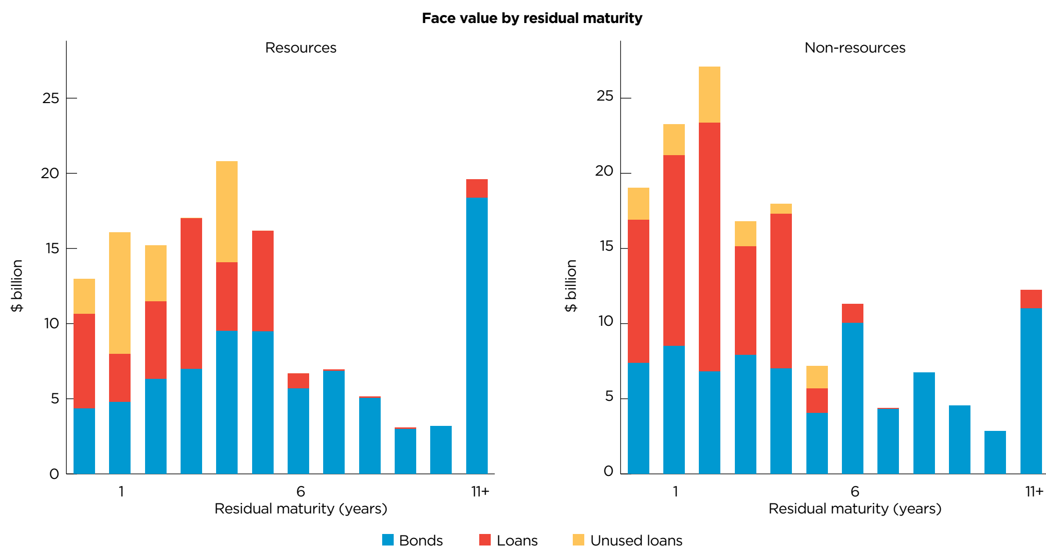
FIGURE 14: Debt proceeds by sector



Sources: Bloomberg, Morningstar, RBA.

Most corporate debt is in the form of loans, which comprise around three-quarters of economy-wide debt finance for non-financial companies, reflecting the dominance of the major Australian banks as suppliers of capital. The available data for the debt structure for ASX 200 companies (as at end May 2014) suggest that loans tend to be used to complete funding requirements at shorter tenors, consistent with the preference of banks' to lend for terms of between three and five years (Figure 15).

FIGURE 15: ASX200 companies' debt composition*

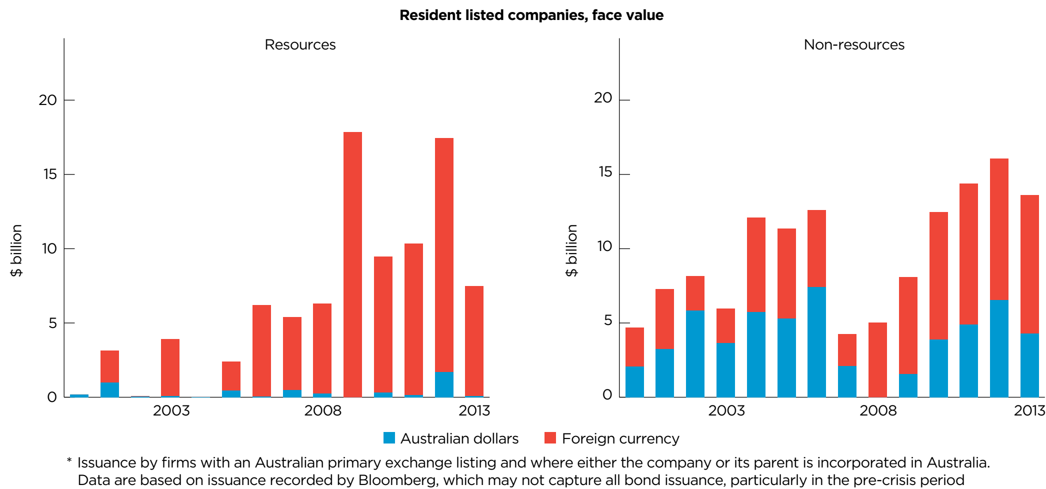


Sources: Bloomberg, RBA.

Many listed companies also find it attractive to issue bonds. Resources companies, particularly the major diversified mining companies, regularly raise debt through bond issuance due to their large borrowing requirements and relatively high credit ratings (Figure 16). Issuance by resources companies is typically undertaken offshore and mostly denominated in US dollars, given the ability of companies to issue greater amounts and at longer maturities, which more closely reflect the lifecycle of investments in natural resources projects. Foreign-denominated bond issuance also serves as a natural hedge for commodity export revenues which are typically denominated in US dollars.

Non-resources companies also access bond markets to refinance their large volumes of outstanding debt, often using the domestic corporate bond market. The main issuers are large companies with lower earnings volatility, particularly those in the defensive consumer staples, telecommunications and utilities sectors.

FIGURE 16: Gross bond issuance*

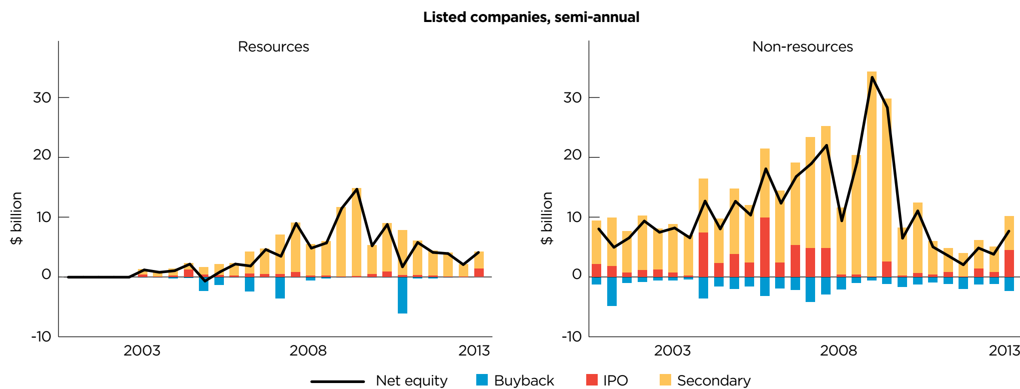


Sources: Bloomberg, RBA.

Equity funding

Net equity raisings are a modest component of listed companies' external financing mix and activity has been very subdued since the post-crisis deleveraging period (Figure 17). The increase in issuance to the end of 2013 reflected a tentative pick up in initial public offerings (IPOs), particularly in the non-resources sector. Private equity interests have been involved in many of these IPOs, with owners taking advantage of favourable market conditions and resurgent appetite from institutional investors, particularly for non-cyclical companies. The amount of equity raised by the resources sector has been modest and issuance tends to be concentrated among junior exploration companies, which rely almost exclusively on equity financing due to the speculative nature of their activities (Williams 2012).

FIGURE 17: Equity capital raisings

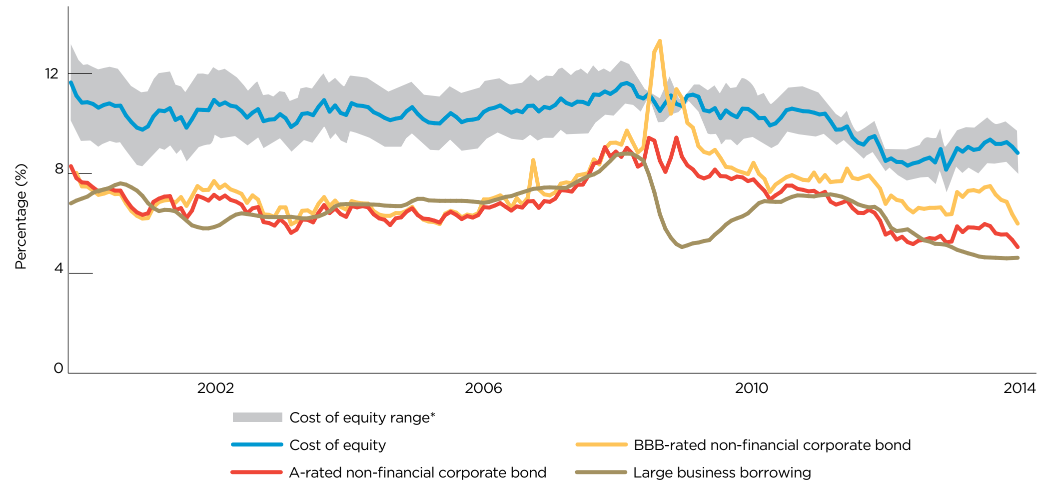


Sources: ASX, RBA.

Cost of external finance

Companies' external funding choices are influenced by the relative costs of funding sources (Figure 18). A number of methods are used in practice to approximate the cost of equity because it is not easily observable. However, these approximations generally calculate a cost of equity that is higher than that for debt, consistent with the existence of an equity risk premium and the general preference among companies to raise debt before equity.[13] Figure 18 shows a range using two simple approximations for the cost of equity compared to observable costs for debt funding.[14] This exercise generally supports the intuition that the relatively low cost of debt in recent years may partly explain the use of debt by resources companies. In general the higher cost of equity funding has meant that companies have found it most attractive to raise equity in order to deleverage or where access to debt markets is constrained, due to unfavourable market conditions or existing debt burdens. This was evident in the 2009 equity-financed deleveraging which occurred against the backdrop of a significant change in the relative costs of debt and equity.

FIGURE 18: Australian funding rates



* Cost of equity range implied from a dividend yield measure and a long run constant equity risk premium (assumed to be 6 per cent) plus the risk free rate

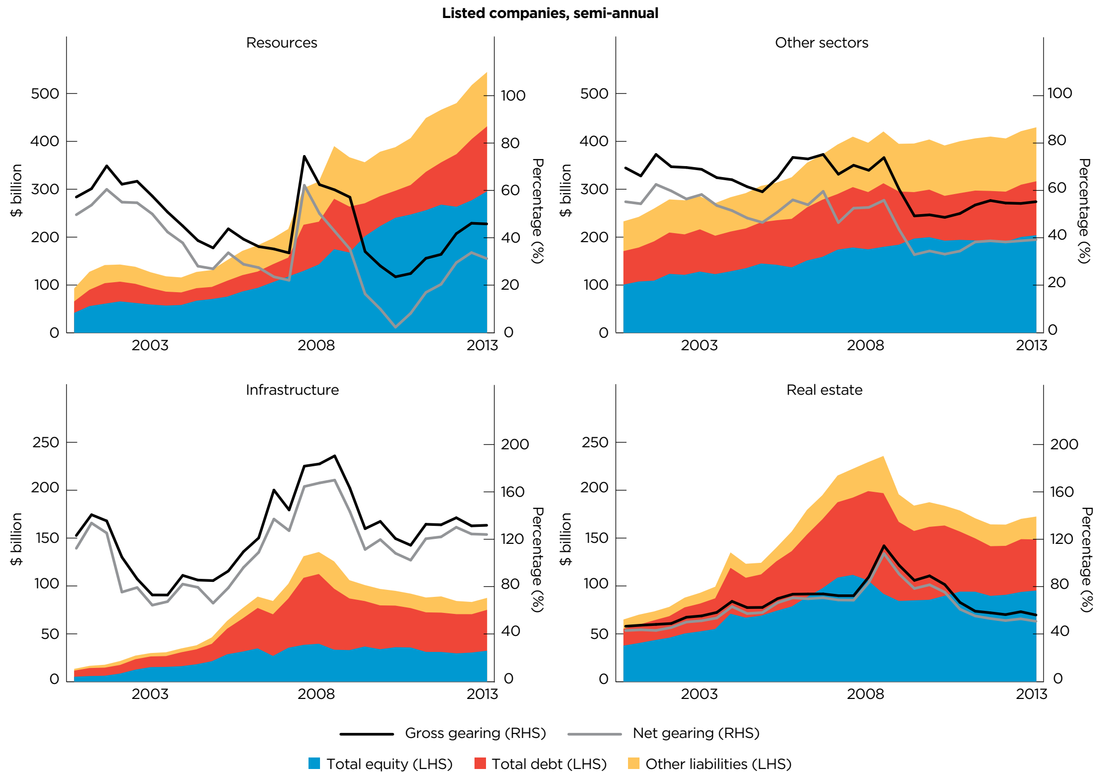
Sources: RBA, Thomson Reuters.

Capital structure

The aggregate capital structure of Australian listed companies has varied considerably over time reflecting the investment cycle and shifts in the use of the different forms of external funding. Nevertheless, listed companies have historically maintained average gross leverage of between 50 and 60 per cent, with considerable differences present between sectors (Figure 19). Resources companies maintain relatively low levels of gearing, reflecting a desire by firms to ensure the serviceability of debt burdens due to the volatility of earnings within the sector. The recent debt-funded increase in net investment by resources companies has raised leverage to 46 per cent, which is around the long run average and a two-fold increase since 2010. Over the same period, assets within the resources sector have increased by 40 per cent due to net physical investment.

In contrast, moderate net investment by non-resources companies has resulted in a period of relative stability in capital structure, with leverage of around 50 per cent for most sectors since 2008. 'Other' sector leverage has remained around 55 per cent as many companies have undertaken only sustaining physical investment to maintain their asset base. The more highly levered companies in the real estate and infrastructure sectors have steadily reduced their assets, while maintaining or slightly reducing leverage in recent years. Infrastructure companies remain geared above 100 per cent of equity, consistent with the defensive characteristics of these firms' assets (including their long-term, tangible asset base and relative stability of expected earnings).

FIGURE 19: Corporate gearing and balance sheets*



* Total assets is the sum of total equity, total debt and other liabilities. All items are measured in book-value terms.

Sources: Morningstar, RBA.

Conclusion

The experiences of the resources and non-resources sectors have produced distinct trends in the corporate financing of Australian companies since the global financial crisis.

Resources companies have driven an increase in net investment which has primarily been funded through internal sources. Net external funding in the post crisis period has been very modest, and largely confined to debt raisings by resources companies as variability in commodity prices over recent years caused fluctuations in the availability of internal funding. Capital structure within the resources sector has changed modestly as a result, raising leverage to around its average level since 2000, consistent with the low relative costs of debt compared with equity issuance.

In contrast, net investment by non-resources companies has been mostly confined to sustaining the existing asset base. Internally generated funds have been sufficient to meet this expenditure, causing net external funding, and therefore capital structure, to remain stable in recent years. These companies have lifted dividends though not beyond historical norms as a proportion of earnings. Signs of slowing net investment by the resources sector highlight the importance of non-resources companies in driving future investment and demand for external financing. At present, these companies generally appear financially well-positioned, given their robust earnings and relatively low leverage but, as yet, they seem to have lacked the necessary catalyst to undertake this expansion.

Notes

1. The tendency of companies to finance a large share of their investment from internally generated sources of funds is a widely reported empirical observation (see, for example, Myers 2001; Arsov et al. 2013; Debelle 2013). One explanation for this outcome is a desire by firms to reduce information asymmetry between managers, suppliers of capital and investors (Myers and Majluf 1984). Further, the tendency to raise internal funds may facilitate better monitoring and improve the efficiency of resource allocation within the firm (Gertner et al. 1994).
2. See Black et al. (2009) for a detailed account of developments in the sources and uses of funds by Australian companies preceding and during the global financial crisis.
3. Examining the components of companies' cash flow statements provides a useful way of examining trends in real activity among listed companies. Cash profits are not always the same as accrual based accounting profits which can be impacted — at times significantly — by non cash items such as asset revaluations. Similarly, examining cash inflows can provide information about the preferred sources of financing at different stages of the business cycle and the resulting shifts in the capital structure of Australian companies. For more detail and background on the sources and uses of funds, see Black et al. (2009).
4. The broad sector classifications adopted in this analysis are resources, infrastructure, real estate and 'other', which in aggregate allow for comparison with the Australian Bureau of Statistics definition of private non financial corporations. The infrastructure broad sector includes companies from a number of industries, including industrials and utilities. The 'other' broad sector can be further decomposed into cyclical and non cyclical components. Cyclicals refers to companies in sectors that are typically more sensitive to economic conditions such as consumer discretionary, industrial and IT sectors. In contrast, non cyclicals are less sensitive to economic conditions and include consumer staples, health care, telecommunications and utilities companies.
5. This analysis discusses net investment categories in the context of a cash flow statement so that investment expenditures are offset by the proceeds from sales; net investment in this analysis does not reflect economic depreciation.
6. A number of notable transactions occurred during this time, including Toll Holdings' $6 billion acquisition of Patrick in 2006, Wesfarmers $22 billion acquisition of Coles in 2007, Primary Health Care's $3.5 billion acquisition of Symbion in 2008. The restructuring of the Australian media industry occurred in 2007–08, with the creation of Seven Group Holdings and the spin-off of its media assets, along with the demerger of Publishing and Broadcasting Limited into Crown and Consolidated Media Holdings.
7. These include Newcrest's $10 billion acquisition of Lihir Gold in 2010 and BHP Billiton's $11 billion takeover of Petrohawk Energy in 2011.
8. This analysis focus on Australian resident listed companies. Foreign listed companies own large shares in many LNG projects run jointly with Australian companies. Around four fifths of funding for physical investment has been sourced from offshore, meaning the associated investment outlays of foreign companies are omitted from this analysis (Arsov et al. 2013).
9. For example, in late 2012 BHP Billiton deferred an estimated $50 billion in planned investment at its Olympic Dam and Port Hedland sites. Expenditure on a number of major LNG projects has also been curtailed, including Woodside's announcement to defer investment in its Pluto LNG project in late 2012 and postponement of around $40 billion in investment for its Browse LNG project in 2013.
10. For the purposes of this analysis, companies included in the definition of 'other' cyclical companies are industrials, consumer discretionary and information technology GICS sectors. 'Other' non cyclical companies include consumer staples, health care, telecommunications and utilities GICS sectors. Both categories exclude companies already captured within the infrastructure sector, which affects a number of companies in the industrial and utilities sectors.
11. Increased use of external financing in the pre crisis period is also consistent with literature suggesting firms attempt to time their capital structure decisions to raise equity when market values are high relative to book values (see Baker and Wurgler 2002).
12. For further discussion of the 2008−09 equity-financed deleveraging see Black et al. (2009).
13. This outcome is also consistent with the pecking order theory of capital structure which suggests firms prefer internal funding, followed by debt, and will raise equity last if required to finance investment (see Myers 1984; Myers 2001; Myers and Majluf 1984).
14. This analysis approximates an upper bound for the observed cost of equity using the long run Australian historical equity risk premium of 6 per cent plus the risk-free rate approximated by the 10 year Australian government bond yield (see Brailsford et al. 2012 for further detail on calculation of the equity risk premium). The lower bound for the cost of equity is implied from a simple dividend discount model (Gordon growth model), which approximates the equity risk premium using the dividend yield (for the MSCI Australia index), assuming a constant rate of dividend growth into perpetuity (Damodaran 2013). Many approaches exist for estimating the cost of equity and the measures shown in this analysis are purely for illustrative purposes.

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