Zachary Scott
INVESTMENT BANKERS

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Capital and Uncertainty

"Capital goes where it's welcome and stays where it's well-treated."

by Michael T. Newsome

Since the days of the 18th century neo-classical economists, Adam Smith and David Ricardo, it has been understood that there are factors of production—the fundamental resources required for the generation of goods and services. These are generally categorized as labor (human resources), land (real property and natural resources), capital (money and man-made resources), and enterprise (the entrepreneurial catalyst that shoulders the risk of employing the first three factors in pursuit of profit). In spite of some assumptions to the contrary, none of these resources are free. All have a cost that must be paid. Yet, of these fundamental factors, only the cost of labor (and land, if rented) is explicitly reflected as an expense in the financial accounts of a business. The compensation for capital and enterprise must come from profits.

Fundamental Resources for Generating Goods and Services

Labor
(Human Resources)

Land
(Real property and natural resources)

Capital
(Money and man-made resources)

Enterprise
(The entrepreneurial catalyst that makes it all happen)

THE ROLE OF CAPITAL

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"Economic activity is the commitment of existing resources to future expectations." By definition, this is a pledge to assume risk and uncertainty in a wide range of circumstances. These include the risk of unforeseeable external events; of shifts in markets, distribution channels, or consumer sentiments; and of the inexorable changes in technology, regulatory, and competitive landscapes. The odds of consistently navigating all of these risks unscathed are low. Invariably, every business stumbles in some manner. Capital is essential to survive, adapt, or grow. Given the tumult in recent years, businesses with an adequate capital cushion survived and, in many cases, emerged stronger. Those without such a cushion struggled, and some have failed.

More often than not with privately held businesses, profitability has been the key factor to build and access capital. Though not the sole source of capital, earnings, whether retained in the enterprise or distributed to shareholders (returned to the capital markets), are the principal underpinning of capital formation. These are the resources that underwrite the expansion and/or modernization of productive assets, the hiring and development of new employees, and creation of reserves.

THE COST OF CAPITAL

Unless the providers of capital receive a return equal to or superior to what investors perceive other investments with similar risk characteristics can deliver, capital will evaporate. As Walter Wriston, the iconic CEO of Citicorp in the 70's and 80's, observed, "Capital goes where it's welcome and stays where it's well treated." This may be a fundamental tenet of business finance, but a surprising number of business owners and managers are not certain whether or not that cost is being covered. This problem is born in the fact that "accounting profit," as reported at the foot of any company's profit and loss statement, assigns no cost to non-interest bearing capital employed by the business. Yet, an inability to cover the cost of capital is no different than failing to meet payroll or paying vendors. In the absence of earning the cost of capital over time, no value is being added to the business. In fact, it is being dissipated.

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the concept of interest, but in contrast, there is no simple index to determine the rate, only mechanisms to estimate it. The applicable rate is different for virtually every firm because of differences in the underlying economic risk, or uncertainty, of the business, due to industry, business size, and market position, as

(continued p.2)

well as the amount of leverage employed, that puts stress on the equity capital.

ECONOMIC PROFIT

Efforts to estimate a cost of capital for a company are necessary so that company owners and management can determine if their business is earning "enough" profit. Calculating Economic Value Added ("EVA"), which differentiates between accounting profits and economic profits, allows one to determine how much value is being created or destroyed by the operation of the business. We have written previously about the application of EVA to privately held businesses (see ***"EVA for Middle-Market Companies"***, Spring 2004, and ***"The Corporate Imperative--Building Economic Value"***, Fall 2005).

The bottom line is that business owners should not only want to know if and how much profit is earned, but whether profits are sufficient to maintain or increase the value of the business. Only by taking into account the cost of capital employed to make the business run, can business owners determine if their businesses are adding or subtracting from their net worth. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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