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# STROKE OF GENIUS OR STRATEGIC MADNESS?

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Delta Airlines bought an oil refinery. 80% of its jet fuel requirements should now be produced in the United States. Colas construction group also bought refineries in France and Malaysia.

## The strategic challenges are interesting.

From a financial standing point, these transactions can be seen as a trade-off between a supplier's margins and an investment price. Meaning this is merely all about a value transfer: value-creating synergies are difficult to imagine between an air carrier and a refiner.

We thus rediscover vertical concentration, dear to the late 19th century manufacturers. Just as if Nestlé bought farms or Globus produced its own fabrics.

Seemingly awkward today this was common at the dawn of capitalism.

It led large American groups seek a higher level of efficiency than provided by the market through their administrative structure. "Visible hand of management" were the words for it, as opposed to Adam Smith's famous "invisible hand".

When addressing vertical integration, academics readily evoke transaction costs and organization analysis. For practitioners, the issue is the "make or buy". Among rationales for such a strategic move, we may point at: purchasing economies, development synergies, supply control.

Remains of this fashion or logic can still be found today. Michelin, owns rubber plantations dedicated to its production. Somehow as if Nestlé bought its own farms...

The 1950s experienced a complete change of mind regarding vertical integration. Remember the craze for "pure players" and holding discounts measured on stock exchanges. The rationale it seemed straightforward. Stakeholders (investors ...) eager the kind of diversification offered by a conglomerate can achieve the same exposure by investing directly in securities of the holding's portfolio companies. Those not willing to undergo such a risk / return profile would refrain from investing in the conglomerate. At the end of the day, the stock's supply / demand balance is adversely affected by the creation of integrated conglomerates or diversified holding companies.

Yet today vertical integration becomes more and more frequent with large retailer. Zara is one of them. It is integrated, from styling to manufacturing of key products down to outlets. The guideline is "time over costs". And Zara's positioning is precisely based on the ability to capture trends (especially from "haute couture") and propose them to its customers in a limited timeframe. Mango followed. Similarly Decathlon the sports retailer, largely integrates design, innovation and production. A global retailer at its early stage, the company has gradually repositioned itself and sells now mainly its own brands. Not to mention IKEA, another famous integrated retailer. Coca-Cola and PepsiCo's back and forth regarding bottling companies' integration are striking too.

## What can be drawn from these seemingly anachronistic and incoherent moves?

1 / In business, as elsewhere, freedom of thought is essential. Dogmatism is a trap. "Nobody does it" is a good to know, but never a reason not to do.

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2 / Knowing why things are done. This may seem obvious, but experience shows that it is far from being the case. The reasoning needs to be continued down to conclusions. Clearly identify the lever on which to act in order to create value. In the case of Zara, timing comes before costs.

3 / Identify barriers. Airlines and refining are definitely different trades using different skills.

4 / Once decision is made, take all necessary measures to make it succeed. Delta Airlines hired a veteran of the oil industry to take control of its refinery. This decision is far from obvious, including for cultural reasons. Bouygues a building and construction group chose successfully a completely different option when taking over TF1, the French leading TV channel.

5 / Act boldly and go against the grain when needed: press and analysts have not been kind to the airline.

6 / Keep consistency in the implementation of strategic decisions. Decathlon took its decision in 1986 and could only implement it in 1991.

Value creation remains a lighthouse when corporate decisions making may lack consistency. What value creation objective is sought? Which path would lead to that goal? What resources and means are required?

More generally, the above examples show the complexity of today's business. This clearly puts a pressure towards moving beyond patterns and taking calculated risks. Thinking out of the box is a necessity to stand out and innovate. In short a matter of survival and development.

# THE SERIOUS CONSEQUENCES OF THE NEGATIVE INTEREST RATES

**Martin Hess,** Head of Economics, SBA

When the SNB lifted the minimum Swiss franc exchange rate in January, it kicked off 2015 with the economic event of the year. And once again, the banks will have to bear the consequences.
The decision announced by the SNB on 15 January 2015 to lift the minimum Swiss franc exchange rate was not detectable on any radar, nor could it be predicted by looking into a crystal ball, or reading tea leaves. From now on, weakening of the Swiss franc is to be achieved by means of negative interest rates for commercial banks instead of through foreign currency buying by the SNB.

## High costs for the banks

Banks are facing a multitude of problems following the increase in negative interest rates to -0.75 percent on SNB sight deposits and the further appreciation of the franc. The direct costs incurred by the negative interest rates, amounting to over a billion Swiss Francs, are only one part of the burden. A number of banks are not subject to negative interest rates due to the design of the exemption threshold. The burden placed on those banks that are affected is, hence, even greater.

## Negative interest rates curtail profit

Even more far-reaching overall, however, are the repercussions on the interest margin business, which is one of the banks´ most important sources of revenue. Negative interest rates have resulted in a direct decline in interest margins, and therefore in a decrease in profitability.

Competition between the banks and the option for clients to hold liquidity in cash do not allow for the negative interest rates to be passed on to individual clients.
Due to the significantly more negative interest rate environment, the costs for interest rate hedging in particular have risen. In some cases this has resulted in interest rate increases for mortgages and loans. As a result of cost savings on hedging transactions, banks have to accept high interest rate risks

## Widespread uncertainty

The new reality of negative interest rates on risk-free investments is also creating uncertainty in the markets, and this can take on a range of different characteristics. Risk-based pricing becomes more challenging.

Risiko gehört zum Markt und nicht zu Ihrer Bank.

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Insurance companies get a relative competitive advantage over the banks in the mortgage lending business, and the prevailing scarcity of investment opportunities for institutional investors is further exacerbated.

### Strength of the franc is a burden on the economy

The impact of a strong franc on economic growth and therefore on the corporate clients business will likely be less dramatic than initially feared. This is also underlined in the monetary policy assessment recently issued by the SNB, which forecasts growth of just under 1 percent for the Swiss economy despite adverse conditions. There is a tendency, however, to forget that a large number of banks themselves also belong to the country's traditional export industry. The whole export industry is negatively impacted by the strong franc because the Swiss franc ratio is significantly higher on the cost side than on the revenue side. The lower foreign currency valuations result in decreasing assets under management and as a consequence, to lower revenues.

### From sweet poison to a bitter pill

There is no use in complaining that the SNB did not take the appropriate action. To date, no one has come up with a convincing suggestion for a sustainable alternative approach. The interest rate decision also has positive effects on the banking sector, such as additional revenues in the trading business, an increased demand for hedging, or the stronger franc as a sign for foreign clients of the stability of the financial centre. But the SNB must now demonstrate just how the negative interest rate strategy can effectively have a dampening effect on the franc and that the approach it has chosen is efficient.

Further to this, the switch from sweet poison (unlimited central bank liquidity) to the bitter pill (negative interest rates), is also causing upheaval in the political arena. This usually goes hand in hand with a strong appetite for intervention, which could endanger those few advantages that currently exist for the financial sector.

# FRANCE: NEW OPPORTUNITIES FOR DONATION-SALE OPERATIONS

**Alain Moreau,** Partner FBT Avocats Paris, Geneva

*In a recent decision, the French Council of State clearly established the conditions governing donation-sale operations, creating new opportunities for the structuring of such operations.*

In France, the sale of movable or immovable assets is in principle subject to taxes on capital gains.

Once the sale is made and the tax on capital gains is paid, the balance of liquidity resulting from the sale, transferred for no consideration by the seller, notably to his children, are then taxed a second time, this time on the donation (gift tax).

Taken together, these two successive taxes may result in a tax burden on the "saledonation" up to 80%.

In order to address this fiscal disaster, practitioners have been advising, for many years already, to revert the chronology of these operations and to set up an operation of donation of the assets followed by the sale of the latter by the donees.

Indeed, the articulation of the operations in this sense would trigger the payment of gift taxes on the gift in accordance with ordinary law, i. e. in direct line a tax burden between 20% and 45% (depending on whether the gift taxes are borne by the donor or not).

However, it would allow the donee to immediately sell the assets received free of taxes on capital gain. In fact, the previous donation, duly taxed, will have allowed to increase the acquisition price of the assets sold, completely neutralising the capital gain value, which corresponded to the difference between the input value and the output value of the assets of the seller.

By simply reversing these operations, the tax burden on this type of operations may be reduced by almost a half, i.e. around 40%.


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In order to further optimise this tax burden, it is also perfectly possible to provide for the donation of the bare-property to the children, the parents retaining the usufruct of the property donated. In this case, gift taxes will be calculated according to the age of the usufructuary according to the scale provided for in Article 669 of the General Code of Taxes, which would allow once again to considerably reducing gift taxes.

The tax administration does not look favourably at the sale-donation tax optimisation schemes; for more than 20 years, it has regularly been attempting to requalify these operations based on the abuse of right, considering notably that the donations made were fictitious and aimed exclusively at mitigating the taxation (exclusively fiscal nature).

Hopefully, the Committee on Tax Law Abuse (Comité de l'abus du droit fiscal - CADF) as well as the Courts have regularly decided against the claims of the tax administration.

Thus, the Courts systematically examine if the material element of the donation (the irrevocable and definite dispossession of the donor) and the moral element (the liberal intent) were characterised in the cases submitted.

To counteract this case law too favourable to the taxpayer, the Legislator tried to charge the donor with the tax on capital gains if the latter transferred the assets received through donation within a period of two years (3rd Amending Finance Law for 2012).

However, this time the Constitutional Council censured the draft law in its decision of 29 December 2012.

Finally, on April 9, 2014, the Council of State, the highest authority with regard to direct taxation, has put an end to the debate when it decided against the administration, in a clear and detailed manner, on a case where one could question the real intention of the taxpayers. Indeed, the parents had donated the bare property (retaining the usufruct) of shares of companies to their three children, having provided for some restrictive provisions in the deed of gift, i.e. the prohibition for the children to alienate the shares and their duty, at the first demand of their parents, to bring these shares to a holding company created to this effect. The children had then brought their shares to a financial holding company which sold them a short time after they were brought to the company. The proceeds of the sale had been jointly reinvested in securities and capitalisation bonds and the income resulting thereof was to be paid to the parents/usufructuaries. Since the deed of gift had resulted in an immediate and irrevocable dispossession of the donors/parents, it had not been possible to implement the abuse of right procedure, despite of the restrictive provisions on the property, the rapid sequence of operations and the managerial and decision making powers of the donors/usufructuaries provided for in the articles of association of the holding company.

## Perspectives

The decision of the Council of State of April 9, 2014 provides the huge advantage of clearly determining the conditions governing the donation-sale operations. It results therefrom that (i) when a donor is willing to make a donation, (ii) the donation is materialised prior to the sale (despite of the short timescale) and (iii) the donor is definitely and irrevocably dispossessed of his assets, the tax administration is not entitled to requalify the operation, even if substantial agreements have been made between the donor (the parents) and the donees-transferors (the children). Thus, it is now possible to perform short-term donation-sale operations while providing for some agreements between the parties, notably parents and children, so that the parents "keep a hand" on the assets given to their children and be able to ensure a proper management of the assets given as well as of the income and proceeds resulting from the latter. The possibility to provide for inalienability and prohibition of pledge clauses as well as for a specific policy governing the distribution of profits to the parents/usufructuaries in the event of dismantling, or the duty to reinvest in a holding company, etc., are some examples of these agreements.

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