EXPLORING DEBT AVENUES

NIGEL ASTBURY OF PMC CORPORATE TREASURY CONSULTANTS FOCUSES ON FIVE DIFFERENT ORGANISATIONS TO FIND OUT HOW THEY HANDLED THEIR REFINANCING CORPORATE DEBT NEEDS.

If you are responsible for achieving optimal management of your company's liabilities then a few minutes invested in reading this article may uncover some new ideas. These, in turn, may support your efforts to save your company money in interest and fees over an extended period of time.

What follows examines the process of raising corporate debt to refinance both bank borrowings and capital markets issues for companies with an annual turnover of between £25m and £1bn. We will focus on the negotiation, pricing and process side of this exercise and, in that context and based on a variety of transactions over many years of experience, we will endeavour to offer practical guidance to treasurers and finance directors engaged in this process.

WHY GO TO THIS TROUBLE? All but the most unusual businesses use debt to finance at least part of their working capital and fixed assets. Debt can be non-interest bearing, say, from suppliers (providing they are paid within or reasonably close to agreed terms) or interest bearing, for example, from banks and bond holders. Diligent liability management in this area of corporate life is like gardening – there are no quick results, few of us are really good gardeners, but we can all tell a good garden from a bad garden.

The process of raising new corporate debt is typically event-driven rather than time-based and is therefore unpredictable. As a result, it frequently makes unanticipated demands on company resources.

Even more perplexingly the need for new finance can arise just as easily from a failure to achieve performance targets as from financial achievement well in excess of those targets.

A company may find itself needing to use debt to fund what it hopes are temporary losses to stay in business ahead of a projected turnaround; alternatively a company may find itself in urgent need of working capital to fund a larger than expected order book. In either of these circumstances, raising new interest bearing debt from a bank or a bondholder could be most desirable.

The following case studies are based on recent, actual transactions, but, to some extent amalgamate experiences from other similar transactions we have worked on.

☐ CASE STUDY 1 – £50M DEBT: THE DEVELOPMENT OF PRICE COMPETITION BETWEEN LENDERS

How would you like to have more money from fewer banks with less restrictive covenants and lower pricing than you now pay? That's just what happened last year for a successful UK retailer. The company's finance team is well-managed and highly professional. Because of its strong business model and unlike a number of its competitors the company had come through difficult trading conditions in 2000 essentially unscathed.

The finance team recognised the business had an opening in 2001 to improve the terms on which it was borrowing from its banks. To exploit this, the team prioritised what the firm wanted from its banking relationships, in addition to the debt being raised. It then designed an optimal structure for the debt itself and short-listed a small number of appropriate banks. The team prepared and used a targeted information memorandum to present its case to prospective lenders. The resulting 16-page document was supported by financial projections and analyses. This allowed the borrower to present its plans to prospective lenders with structure and clarity. In particular, the strengths, weaknesses, opportunities and threats that characterised its business – and hence the lending opportunity for the banks – were addressed in a professional and organised way.

The big surprise was the difference in the pricing and security demands between banks active in the corporate lending market. With different terms on offer from banks that, superficially at least, appear quite similar, there were clear advantages to this borrower in shopping around. It was, at first, a puzzle to work out why this was the case. Investigation revealed that each of the competing banks was at a different stage in its own corporate life cycle. The winning bank had just re-staffed its regional office and was enjoying success in integrating its London-based specialist lenders with its colleagues in that regional office. The losers realised – after making a strong bid in their opening presentation – that the sector in which the firm operated was unacceptable to the bank; their advertising 'hype' and their true credit criteria were a long way apart.

☐ CASE STUDY 2 – €100M DEBT: EXTRACTING VALUE FROM A RECEIVABLES PORTFOLIO

Leveraged buy-outs invariably start their new life with a mixture of equity and debt. Frequently, the debt has a moderately 'plain vanilla' structure. Equally frequently, the debt no longer fits the company after two or three years into this new period of its new operation. This is simply because these companies, by definition, have no independent track record from which to build reliable financial projections and, at the same time, none of us can predict the future with sufficient accuracy for this not to be a problem.

When leveraged buy-outs are successful, the negotiations for new finance are generally based around seeking improved borrowing terms and a larger, longer-term debt structure. When performance after the buy out is not successful other issues, problems and solutions emerge. Take, for instance, a well-established high tech business with global market reach, a strong brand but tough challenges in areas such as competition and raw materials' prices. Quickly you can end up with a situation whereby the company's receivables are of much higher credit standing than the company itself. So, how best to extract value from that receivables portfolio?

'LIQUIDITY IS NOT, HOWEVER, A SUBSTITUTE FOR PROFITABILITY. ULTIMATELY, INTERNALLY GENERATED CASHFLOW IS THE ONLY SOURCE OF LONG-TERM SURVIVAL THAT ANY COMPANY CAN HAVE'

Liquidity is essential to corporate life and can be generated from receivables in the ways outlined below. It is not, however, a substitute for profitability. Ultimately, internally generated cashflow is the only source of long-term survival that any company can have.

The benefits of unlocking cash from receivables therefore need to be linked with ways of improving the company's profitability. In the case of a company performing strongly, a receivables securitisation can reduce the cost of raising working capital dramatically. This provides an immediate and positive contribution to the profit and loss account. In the case of a company performing less strongly, then the alternative of a receivables financing, such as undisclosed factoring, can offer both a breathing space in which to implement a profit improvement programme and the cash with which to make investments in fixed assets and to negotiate discounts from suppliers. Again, the creation of liquidity is simply a stepping stone to future profitability.

The company on which this case study is based has a very strong receivables portfolio – well spread, but including excellent clients with high credit ratings. The choices open to the management were to put all its eggs into one basket, with an off-balance sheet securitisation, or to go for a more expensive but more flexible solution of arranging individual on-balance sheet receivables financings for key territories. At this stage of the company's life cycle, the latter solution offered the company both price competition and product choice. It will almost certainly become desirable to replace these financings with alternatives as profitability improves.

☐ CASE STUDY 3 – £5M DEBT: ASSESSING THE AVAILABILITY OF OTHER SOURCES OF FINANCE

Even at this comparatively low level of funding, the challenge of ensuring that the finance to which your company has committed itself truly fits the business can be a headache.

A specific problem when dealing with relatively small amounts of debt is how best to generate competitive interest among prospective providers. In this situation, the likeliest providers of straight debt as an alternative to existing borrowings are probably the high street banks. But lending to a marginally profitable business with little ancillary business to boost the return on the loan is often not attractive for that category of lender.

The answer for the borrower is often to look for some form of 'equity play'. This can encourage the providers of funds to look beyond an interest rate on its own. Choices can range from:

- inviting bids from new financial institutions;
- using a mezzanine structure;
- forming equity alliances with industry partners – possibly suppliers; or
- simply 'toughing it out' with existing lenders and venture capitalists.

For this latter approach to work you need to feel confident that an improvement in performance is sufficiently close at hand to allow the status quo to continue for the time being.

☐ CASE STUDY 4 – £25M DEBT: NEGOTIATING IMPROVED TERMS WITHOUT CHANGING BANKS

This company is operating successfully in the technology, media and telecoms sector, is well established and has a strong track record of successful performance. The relationship with its UK bank began when the company was acquired by venture capitalists. A few years later the financial performance of what had by then become a small group attracted the attention of a leading US company and an acquisition deal was struck allowing the venture capitalist to exit.

As time passed, two issues began to bother the CFO. First, he believed, quite rightly as it turned out, that the historical borrowing terms on which the company had established the relationship with its bankers were no longer in line with the company's credit standing. Second, he did not want either to go to the trouble of changing banks or to alienate his existing bankers by overtly threatening to do so.

The solution lay in making an internal re-evaluation of the company's financial strengths and then individually highlighting and quantifying for the existing bankers each area of improvement in the company's creditworthiness. The company then asked the bank to submit an offer of new facilities to replace their existing borrowings. Given that the bank was never likely to take this initiative voluntarily, it was not surprising that it dragged its feet. However, with a bit of benchmarking to demonstrate that he knew what was on offer elsewhere in the market, the CFO was able, first, to reduce the cost of his company's borrowing materially (in the range of 100bp a year) and, second, to configure the new facilities in a manner much more consistent with current and future needs.

☐ CASE STUDY 5 – £10M DEBT: REPLACING A VENTURE CAPITALIST WITH EQUITY-LINKED DEBT

Venture capitalists invariably have their eye on how and when to dispose of their investments. This well understood agenda does sometimes throw up conflict within the company itself.

One such recipient of venture capitalist funding found itself liquid and solvent, but with flat sales and stagnant profitability. As a comparatively small manufacturer of intermediate industrial products much of its performance was dictated by larger and more powerful suppliers and customers. Nevertheless, it still enjoyed a strong niche. Room for manoeuvre in terms of taking radical action to improve results was, however, limited.

To make matters worse, the company's perspective was that improved performance would be achieved in the longer term by continued application of a series of small improvement initiatives; but the venture capitalist was essentially 'out of time'.

The solution was to refinance the company's entire funding package, replacing old debt with new debt and the venture capitalist's stake with convertible debt. The management's minority interest suddenly became 100% control – much to their delight – and the new bankers can look forward to an equity play being realised at a future date.

SO, WHAT ARE THE LESSONS HERE? The common theme running through all of these case studies is the need to develop and maintain price competition and a choice of funding products as an integral part of corporate liability management. All financing packages become decreasingly optimal with the passage of time. The judgement issue is when to take action to replace or restructure them. If you do it too soon, you will be causing yourself unnecessary work for only marginal benefit. If you do it too late, you will waste opportunities.

'THE MODERN BANKING ENVIRONMENT IS HIGHLY COMPETITIVE. ALMOST WITHOUT EXCEPTION YOU WILL BE ABLE TO FIND ALTERNATIVES TO THE STATUS QUO'

One issue is certain. The modern banking environment is highly competitive and there will always be new banks ready to compete for your business and with your company's existing lenders. Almost without exception you will be able to find alternatives to the status quo and thence improvements to your company's borrowing position. The key to success lies in careful development of a borrowing strategy and detailed preparation and presentation of the company's plans. This approach needs to be linked with a considered selection of prospective lenders. The borrower can then demonstrate to those institutions that it is clearly in the driving seat.

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