Financing the strategic plan

JOHN GROUT REPORTS ON THE MIDLANDS REGIONAL GROUP'S CONFERENCE AND NETWORKING EVENT, FUNDAMENTAL TREASURY TOPICS, HELD IN SOLIHULL IN MARCH.

Helping to shape financial policy is normally a crucial role for holding company treasurers, but the ownership of the company and major past decisions can restrict financial policy choice.

THE STANDALONE Acquisitions were the focus for **Howard Kimberly**, Finance Director of Hampson Industries in his presentation, 'Financing and Execution Issues in a Cross-Border Acquisition: A small-cap view'. Hampson, a high-tech aerospace components business, has a market capitalisation of £120m and has recently completed four acquisitions – two at the same time – for $145m. Strategic thinking and financial policy had to be clear and the acquisition process well thought out.

When considering acquisitions, Hampson calculates its rating on the basis of: strategic fit; the target's products having crucial, unique and strong inputs and applications; and strong earnings before interest, tax, depreciation and amortisation (EBITDA). The company evaluates acquisitions on the basis of a steady-state, 50/50 debt/equity split, but finances on a 65/35 debt/equity split for faster earnings enhancement. Undertaking two acquisitions at the same time – class 1 transactions requiring shareholder consent and subject to US law and US defence regulations – while replacing/expanding the company's bank credit lines was a major test for the company's three group finance professionals.

PRIVATE EQUITY Private equity-controlled companies have less choice of financial policy. **Andrew Foulkes**, Group Treasurer of Linpac group, reprised some of the themes of his presentation, 'Managing Treasury in a Leveraged Buyout', to the North of England Regional Groups conference (see the March issue of *The Treasurer*, page 14).

Linpac turns over about £1.2bn. Previously family-controlled, it was bought by Montagu Private Equity, the spin-out from HSBC.

Private companies don't reveal much about the state of the business. Listed public companies reveal more, conduct investor relations and focus on the share price.

Buyout companies comply with obligations and constraints in loan and buyout documentation, keep lenders and the private equity owners informed and focus on the exit value. Constraints mainly come from the acquisition financing, which, not negotiated by the company itself, requires positive co-operation from managers throughout the group, worldwide. Cash and the banks' security are king.

WHOLE BUSINESS SECURITISATION Andrew Vaughan is Group Treasurer of Mitchells & Butlers, a £3bn market cap company with financial policy set for many years by its own past choices. It has 2,000 pubs and restaurants (mostly freehold) under management.

On its demerger from Bass in 2003, Mitchells & Butlers reviewed its balance sheet and funding. Straight bank finance ensured business and financial flexibility but was expensive and did not raise enough. More and cheaper finance from directly using the freehold estate as security reduced flexibility. Sale and leaseback raised most at lowest cost, but was too inflexible.

Executive summary

- The conference looked at financial policy and financing the business's strategic plan from the perspectives of companies with different financial history and different ownership structures. Like the first ACT regional half-day conference in Huddersfield in November, this excellent event was supported by Lloyds TSB. Lee Miles, Deputy Treasurer of Mitchells & Butlers, took the chair.

Mitchells & Butlers therefore decided to provide the bulk of the business's debt funding with whole business securitisation of most of the freehold estate. The trick was to keep the ability to buy and sell, refurbish and build new pubs and so on, while giving security to lenders for long-term finance at low cost.

It raised initially £1.9bn – about five times EBITDA, at fixed rates (average 6% annually), in tranches ranging from AAA to BBB+, with terms from 11 to 26 years. A later slightly cheaper, tranche took them to six times EBITDA. About £1bn was returned to shareholders.

More recently, Mitchells & Butlers raised a further £1.4bn (fixed sterling or swapped into it) at low cost by AAA notes with a monocline insurance wrap by Ambac. Vaughan discussed how to undertake these transactions while retaining the ability to grow the business, make acquisitions and so on and to get operational management to live within the restrictions imposed.

CURRENCY AND COMMODITY EXPOSURES Alan Semple is Deputy Group Treasurer of engine maker Rolls-Royce. Airframes and their engines may take 10 years to bring into production, be built for 20 years or more, and remain in service for as long again. Wherever engines are built or serviced, revenue will often effectively be US dollars.

Strategically (slowest and most complex to achieve), the company looks to the location of some operations and sourcing of parts to reduce its net US dollar exposure. It also looks at non-dollar suppliers' own US dollar costs and pays them for those in US dollars, which also helps them limit their own exposures.

Shorter-term, it can try to increase the profit cushion against risk by cutting costs. Quickest and simplest to achieve, it can use financial hedges – which it does to around three years out although it does not adopt hedge accounting under IFRS.

Semple discussed many of the operational details of coping with these long-term, strategic exposures. For example: what exchange rate do you use to evaluate a one-time choice between two suppliers based in two different countries which will supply for decades?

Rolls-Royce has many commodity exposures but the availability of hedging instruments means the treasury uses financial hedges for only two: jet fuel (out to about four years, the effective limit of cover availability) and nickel.

BASEL II Chris Hutchison, Head of Risk Management at Lloyds TSB, in a presentation 'Basel: Opportunity or threat?', reminded attendees that new regulations on bank capital will be effective in two stages in 2008 and 2010. Currently, banks hold regulatory capital at the same rate for small, struggling small and medium-size enterprises (SMEs) as for strong global corporates. Basel II allows differentiation by risk, not just counterparty type.

A bank will make two judgements about customers: probability of default (2008), and what its loss will be if there is a default (2010).

Banks have been using the new approaches for internal decision-making for some time, permitting them to choose within an 'originate, hold, distribute' model, slicing and dicing risk and improving their own portfolio management. While some clients may lose from this, others will gain. If there is a threat, it is to the banker-client relationship, but Hutchison's view is that "the banker/customer relationship is at the heart of it all".

PENSION ISSUES David Richardson, Managing Director Commercial and Corporate, Midland and East Region, at Lloyds TSB, chaired a panel consisting of IMI Group Treasurer **Greg Croydon**, Mitchells & Butlers Group Treasurer **Andrew Vaughan**, Arla Foods Group Treasurer **David Adams**, and DLA Piper Partner **Helen Miles**.

Miles noted that new regulations had been designed to protect not pensions, but the Pension Protection Fund, and that requirements for agreed scheme-specific funding would require a meeting of minds between trustees and the employer.

The treasurers were most concerned about trustee conflicts of interest. Raising with trustees corporate developments which may affect the company's covenant can be a sensitive area. A confidentiality agreement with all trustees is essential. When telling trustees of a development, the company needs to make specific proposals on how to deal with any problems; the trustees' own advisers will then focus on that, rather than expensively developing ideas of their own.

Treasurers are usually company employees, ultimately beneficiaries under the pension scheme, and may have non-public relevant information. The majority of treasurers on the panel were, nonetheless, trustees. Not being able to be told before other trustees, they cannot be involved as early as most treasurers would be in some corporate actions, potentially restricting their ability to do the full treasury job.

One treasurer felt that if his scheme fell into significant deficit, he would probably have to resign as a trustee due to the conflict. Another said his trustee board had a policy of not asking any trustee to advise the trustees as a whole from their own expertise, but to ask expert trustees to help them understand the advice of external experts.

Speakers at other ACT events have taken the view that, at least until they retire, treasurers cannot be trustees, although in many cases they are invited to attend all trustee meetings to help trustees understand information and advice received.

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