In search of diversification

Executive summary

- Corporates would have been foolish not to take advantage of liquidity and pricing in the bank market in the last few years but would now be prudent to diversify their funding sources ahead of the credit cycle turning.

The financing strategies of UK mid-sized corporates are set to change dramatically over the next 18-24 months, according to treasurers and bankers who attended The Treasurers' Conference (TTC) in Edinburgh last May.

While 82% of FTSE 100 companies are publicly rated today and access debt from a variety of markets, only 14% of FTSE 250 corporates currently hold a rating and traditionally rely on banks to provide their debt capital. This lack of funding source diversification is increasingly seen not only as a financing risk by FTSE 250 chief financial officers (CFOs) and treasurers, but also as a competitive disadvantage.

A survey of more than 100 treasurers and bankers at this year's TTC indicated that 54% of FTSE 250 corporate treasurers were looking beyond the bank market to access capital in the next 18 months. More interestingly still, 72% of bankers – almost exclusive providers of debt capital to these companies up to this point – agreed that these corporates should be accessing other markets.

Banks are increasingly concentrating on generating appropriate returns from corporate lending activity, as well as avoiding concentration risk. This is in part a result of historically tight margins, as well as Basel II, which comes into force in 2008 and will require more accurate reporting of banks' risk and return positions, focusing senior management more closely on clients who fail to deliver the appropriate relationship returns.

Both treasurers and bankers overwhelmingly agreed that the US private placement (USPP) market presented the most obvious evolution for corporates seeking to diversify funding sources beyond the bank market, given the lack of rated UK mid-cap issuers today. This market has grown from 11 USPPs issued by UK corporates in 2005 to 26 in 2006, and growth is set to continue.

Of all USPPs issued by UK corporates in 2006, 92% were unrated and 95% awarded either NAIC 1 (the National Association of Insurance Commissioners' credit assessment of an issuer, which equates to a public rating of single A or above) or NAIC 2 (equating to a BBB range rating) designations.

CONFIDENTIALITY AND LIMITED DISCLOSURE The USPP market offers issuers the benefit of longer maturities than bank debt but still provides a high degree of confidentiality and limited disclosure, relative to the public debt capital markets. Although once considered a rigid and inflexible source of capital, a USPP has become much more issuer-friendly, with investor demand for paper significantly exceeding supply. Recent innovations include:

- Callable floating rate notes (FRNs), offering issuers the ability to prepay around par early in the life of the transaction;
- Multi-currency private placements, with investors, rather than issuers, entering into swaps, so the latter don't have to utilise credit lines or consider accounting issues;
- Deferred funding, so issuers can effectively prefund to secure financing or lock in attractive levels up to six months in advance (or three to four months without premium, avoiding any cost of carry); and
- Covenant-lite structures, where private placements have few or no financial covenants, although investors may have 'most favoured lender' protection (giving them the right to such covenants that other creditors may be granted at a future point).

There is also a generic trend towards joint lead placement agents (the USPP equivalent of joint bookrunners), subject to deal size, as corporates seek to share ancillary business with more than one bank.

The UK is already the largest source of issuance outside the US and the premium for non-US issuers has now been eliminated (as has the traditional illiquidity premium) as investors have become comfortable with the UK's high governance standards.

In addition, as a result of strong investor demand and tighter USPP arrangement fees on the one hand and higher disclosure costs and rating agency fees on the other, the all-in cost of a USPP can be cheaper for corporates than the public capital market alternatives of equivalent maturities. In many cases, the USPP market may also offer cheaper financing than the bank market for similar maturities.

Corporates that don't wish to obtain a public credit rating are not limited to the USPP market. Alternative funding sources include the

SEAN HANAFIN LOOKS AT THE EVOLVING FUNDING STRATEGIES OF MID-CAP CORPORATES.

convertible market (76% of European issuers were unrated in 2006), and more bespoke financing solutions such as asset financing/ securitisation and receivables financing (where a corporate arbitrages the credit rating of its customers against its own). Many borrowers are already exploring innovative funding techniques, sometimes just for discrete business units, where benefits are available in terms of overall cost of funds and increased financing flexibility.

Nonetheless, mid-sized corporates with aggressive growth strategies are likely to need public ratings at some point in their growth paths for financial flexibility and to gain timely access to a large pool of capital to fund acquisitions or drive organic growth.

BENEFITS OF CREDIT RATINGS The benefits of credit ratings most obviously include efficient access to deep and liquid capital markets, which in turn can provide diversification of funding sources and maturities. A public rating also automatically confers an NAIC designation for the USPP market, hence removing potential uncertainty for a potential 'cross-over' credit. It also fully opens up sophisticated funding alternatives such as the hybrid capital market, which can represent a more attractive form of funding than equity issuance, when corporates have already tapped other debt capital markets or face a ratings downgrade. A number of European issuers, including the UK's Rexam have successfully accessed this market to fund acquisitions and support other strategic activity.

Credit ratings can also bring discipline to the financial strategy of a business and help increase investor awareness and raise the profile of the company to all stakeholders.

But a public rating is not without cost. Both financially and in terms of management time, obtaining and maintaining a rating can be expensive and must be weighed carefully against the benefits – both tangible (access to a wider pool of capital, potentially reduced cost of debt) and intangible (financial discipline, stakeholder perception) – it can bring. As Standard & Poor's Senior Analyst Simon Redmond notes: "Ratings increase both primary and secondary market liquidity in a debt issue, and raise the profile of the issuer among credit investors and the wider market."

Intuitively, if a rating is being obtained to access the public debt markets, then considerations around investor relations and the behaviour appropriate for a company with publicly tradable debt, increased disclosure and the possibility of more heavy scrutiny should all be carefully weighed. In addition, the ratings 'scale' factor, which penalises mid-cap companies on the basis of size, should be carefully considered. The best time to obtain a rating is likely to be based around a strategic event, which requires access to additional funding sources and transforms the scale of the company. It is also worth noting that forward planning, to ensure ratings are in place comfortably ahead of a specific acquisition, will minimise the consumption of management time at critical strategic moments. A corporate should carefully consider all these factors before proceeding with a rating because investors do not consider it acceptable to discontinue a rating while public debt remains outstanding.

On balance, the continued strength of mergers and acquisitions and boards' desire to avoid shareholder dilution when arranging acquisition financing are likely to be the catalysts for the increasing trend for mid-cap corporates to seek public ratings, and capital markets are likely to see the arrival of mid-cap corporates with aggressive growth strategies over the next few years.

In a market that has historically been the domain of the UK clearers, major international banks with access to international capital markets believe this evolution plays to their strength. The US – where the typical mid-sized corporate has moved away from reliance on banks alone, through the private placement market and, in the case of growth companies, to the public capital markets – is a leading indicator of what will happen in the UK over the next few years.

SOPHISTICATION Given that debt constitutes a greater proportion of the FTSE 250's capital structure than it does for the FTSE 100, CFOs and treasurers are focusing on the shareholder value that can be created by adopting a more sophisticated approach to debt capital. To create value, reduce financing concentration risk, spread debt maturities and maximise access to acquisition capital at short notice, the diversification of funding sources is becoming an increasingly important theme.

So what does all this mean for the mid-cap corporate treasurer? Certainly, a treasurer needs to become the capital structure expert within the organisation – fully capital markets-literate, with an understanding of alternative markets. The treasurer should also have a full appreciation of the costs and benefits associated with public ratings and with a detailed understanding of what is required to maintain an ongoing dialogue with the agencies. To add real value, a treasurer should be fully abreast of the agencies' generic ratings drivers, as well as those specific to their sector and have a clear understanding of how and why peers are rated on a relative basis.

In short, should a company opt to obtain a rating and diversify its funding sources, the treasurer should aim to lead both the relationship with rating agencies and the company's ongoing debt investor relations effort. Life is certainly not about to get boring.

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