


The task of treasury

The Treasurer's Challenge: managing value in today's rate environment. This series of articles is supported by The Royal Bank of Scotland. Previous articles in the series have explored issues such as risk management strategies in the current environment, case studies on cash management, and funding and borrowing options. In the last in this series, Peter Williams reports on a roundtable where treasurers and bankers discussed the issues raised.

Executive summary

- Highly leveraged loans may have had their heyday and the tide could be turning on unrestricted access to funds.
- Holding cash can be a concern but gives flexibility and headroom.
- Value at risk analysis is increasingly popular as way of correlating risks.
- Approaches to risk mitigation are changing.

The treasurer's job sounds pretty simple. It was succinctly put at the roundtable organised to discuss the issues in this series by Alison Dolan, Treasurer, British Sky Broadcasting. According to her, treasurers need to ensure the availability of adequate liquidity, which means that one of the treasurer's main roles is to ensure that the company is as well positioned as possible to access loan and capital markets when needed; after that, it is all about business risk. That's an interesting take from a treasurer whose company's recent bond issue raised £1bn.

Of course, as Dolan herself acknowledged, there is a little more detail involved. One of those key details is the relationship with banks. On the issue of the award of bank mandates, Dolan said: "It is difficult to differentiate between most of the large banks now – they have similar levels of expertise across all areas of corporate activity. Awarding mandates on the basis of expertise alone is no longer possible – it is more about relationships."

David Swann, Group Treasurer, British American Tobacco, has seen the same problem and responded by "trimming down" the company's core banks to 21. He divides these between tier-one banks, which BAT deals with on capital market issues, and tier-two banks, which are often geographically specific and able to provide certain functions (such as cash management facilities) in particular territories. "We are very explicit about migrating all the business we can to these banks," he said. "We are increasingly looking at areas peripheral to core banking, such as providing fund management services." Every bank that deals with BAT will be aware of all the business they are picking up from the company.

FUNDING OPTIONS John McCormick, Global Head of Sales & Marketing in Financial Markets, The Royal Bank of Scotland, acknowledged the issues from the treasurer's perspective but then added his own: "Putting our balance sheet on the table is often the entry ticket to talk about other things. Then it becomes about consistency, creative ideas, how we organise ourselves, and how we make ourselves relevant and applicable."

The idea of the treasurer/bank relationship – which both sides acknowledged should remain as important as ever – emerged from an agreement that the access to funds that treasurers currently enjoyed verged on the unreal. Although Matthew Hurn, Group Treasurer, DSG international, hinted the tide might be turning: "Banks will soon be more selective in the deals that they want to participate in and will probably start looking to reimpose more covenants – for instance, the fixed-charge coverage is a key one for retail. When negotiating terms on facilities, you can't take everything off the table; you are going to have to leave something there to keep the banks on side and bought into supporting the business over the longer term."

The treasurers were fascinated by current market conditions. For instance, referring to the recent private equity LBO deals, Dolan said: "It won't go on for ever."

They were also particularly interested in the idea of lending money for 30 years. Why, went the general sentiment, would anyone want to lend corporates 30-year money?

Swann said: "You can become seduced by looking at the high-profile opportunities at the long end of the market. You need to start to ask what the optimal debt maturity is overall. A 30 to 40-year debt is pseudo-equity; for a cash-generative group such as ours, we would not as a matter of course be issuing equity, so why issue 30 to 40-year debt?"

Dolan said that the tight credit spreads from the corporate perspective were "not totally undeserved". She added: "A few years ago, corporates retreated and spent a lot of time putting their balance sheet in order, working on issues such as working capital and financial controls. They are generally in better shape than they were three to four years ago."

Perhaps unsurprisingly, called on by the treasurers to explain the behaviour of banks in the current environment, McCormick acknowledged that banks "operate in an extremely competitive environment" but maintained that banks were as prudent as ever. "Behind the scenes we have a very strong credit process, with a credit committee chaired by an officer who is immersed in credit stewardship. We have house limits; we will look at all of the correlations. But then the bank has got to make up its mind and figure out what it wants to do."

HOLDING CASH At a time when borrowing appears to be the corporate equivalent of falling off a log, the treasurers were challenged whether holding cash was an embarrassment. Perhaps holding cash is about to become more embarrassing, as the soon-to-be-introduced Operating and Financial Review (OFR) requires companies to comment on their capital structure and discuss why they have chosen a particular capital structure.

"Is holding cash an embarrassment?" asked Hurn. "To a certain extent, yes as it may be considered to be shareholder value-destroying. Cash returns currently give a post-tax yield of around 3%, which may look strange when compared to a company's internal investment hurdle rate, which is likely to be closer to 10%, so what am I holding cash for? That said, cash gives you a lot of flexibility in pursuing your strategic objectives. Seeing businesses going into administration because they don't have the cash availability makes you realise that having cash balances or access to them gives you a degree of headroom and comfort."

In terms of the cash that Hurn does hold, credit quality is key. "There is no key performance indicator in terms of interest performance," he said. "We do take a longer-term view and rather than chasing yield we look to diversification of risk."

Dolan shared Hurn's lack of concern about holding cash. "It is the natural consequence of creating a certain amount of leverage," she said. "Yes, there are costs to that, of course. But there are significant benefits in terms of flexibility and the opportunity to move quickly and to move ahead of the competition. It is possible to change aspects of strategy without having to go and embark on a funding issue. That is understood and supported by the shareholders."

There are some eternal pressures in terms of how treasurers relate to certain groups of people: bankers, equity and fixed income analysts are the usual suspects. But the internal audit committee is also starting to influence the way treasurers operate.

The issue of cash backs into the search for the ideal capital structure. Probably none of the corporates would meet all the requirements of the textbooks on that subject. Dolan said her company had a cost of carry in the balance sheet in the sense of holding cash at the same time as being a net borrower. "A lot is happening in our sector and we value a capital structure which offers a lot of financial flexibility," she said. "We try to manage rather than reduce debt, and we try to justify and minimise the cost of carry. It is an interesting position to be in because you would never recommend reducing your borrowing to zero even though you could pay off all your debt tomorrow."

Hurn pointed out that companies and investors needed to be clear about the meaning of capital structure. He said: "As a retail business we have significant leases, so although we appear to have net cash in, from a credit perspective, if you were to capitalise the leases we would be in a net debt position.

"The business has leases on its stores portfolio and these have to be treated as credit rating agencies treat them: as synthetic debt obligations. If you looked at the face of the balance sheet, you would say that the company looks undergeared and operates with an inefficient capital structure. To have the complete picture, you have to adjust for both leases and any pension deficit. The holistic view is somewhat contrary to the traditional view."

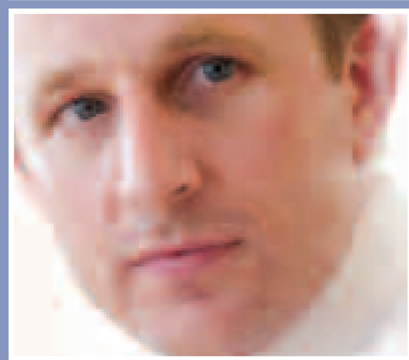
THE RISK STRATEGY If there was one theme that ran through the roundtable it was the treasurer's approach to risk and how that relates to other business activities. Swann described his role with BAT: "In terms of targets, the business is driven by earnings per share." BAT has told shareholders that it will look to achieve high single-digit earnings per share (EPS) growth. Swann said: "Our treasury strategy is first maintaining liquidity and second managing risk. That means all aspects of risk but more specifically what is the risk to EPS arising from foreign exchange (FX) and interest rates."

With help from his team and some key banks, Swann has performed a "very close and thorough" value at risk (VAR) analysis to create a risk profile expressed in terms of EPS at risk. Swann said: "One of the issues that has interested me for a long time is getting a handle on the relative importance of the risks across the group. Are we prioritising the right risks? Are we targeting enough resource behind the really important areas?"

The VAR analysis gave Swann some interesting results – for instance, placing in context the key risk drivers of FX, interest rates and pension liabilities. Although the company has decided against trying to hedge FX translation of overseas profits.

BAT is unusual because of the litigation threat. In May 2003 a

Roundtable attendees
Alison Dolan,
Treasurer,
British Sky Broadcasting



Matthew Hurn,
Group Treasurer,
DSG international

John McCormick,
Global Head of Sales
& Marketing in
Financial Markets,
The Royal Bank of
Scotland

Martin O'Donovan,
Technical Officer,
ACT Chair

David Swann,
Group Treasurer,
British American
Tobacco

Box 1. The pension risk in the corner

No meeting of treasurers is complete without a discussion of the pension problem. The roundtable was divided between Hurn who, although not a trustee, was proactive in establishing an investment committee on which he participates, and Swann, who said he enjoyed the role of chairing the trustees, especially as it helped in reaching agreement between the company and the trustees. Hurn said that generally trustees needed to be educated in areas of financial risk management, which is a key skill set for a group treasurer, and to look at not just asset and liability modelling but also cashflow risk and the correlation of the asset allocation to the liability profile. "Most pension deficits can be broken down into three areas – interest rate risk, inflation risk and equity risk – and trustees need to be shown the impact of all three and the correlation between them," he said. "Treasurers are well equipped with the knowledge and ability to be involved discussing with the trustees on exploring ways of minimising the deficit risk."

As for Swann his view is that traditionally little notice has been taken of the asset and liability position. He said: "This is the one advantage of having a treasurer on the board of trustees, because the nature and riskiness of the liabilities are one of the first things that we are taught to think about."

Treasurers are also taught to look at cashflows as well as market values. It seems likely that treasurers will be increasingly involved in derisking the pension problem.

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newspaper report of a US court case that did not involve BAT nevertheless contributed to a two-notch downgrade from its rating agency. Swann said: "It is a newspaper headline risk. We have looked at the volatility in our rating agency ratios because that ultimately drives our access to liquidity. If our ratings bomb we can't fulfil our first task of treasury: access to liquidity." Swann said it was still early days in terms of ascertaining how VAR would impact on the day-to-day management of risk.

Increasingly it appears that treasurers are involved with ensuring that corporates correlate risks. For instance, corporates examining their interest rate risk need to ascertain if there is a negative correlation on their pension fund. Swann said: "As interest rates rise, the cost of my debts increases but the present value of the liability in the pension fund falls; the correlation effect across all the categories of risk is quite marked."

While VAR analysis is clearly proving an increasingly popular technique, Hurn advised caution. He raised one specific example: "We have predominately euro-denominated debt. Euro interest rates have been flat for a long time, so the implied volatility is very low. If you extrapolate forward using the historic volatility, statistically the VAR would be very low, implying that nothing is likely to happen, but you know with reasonable certainty that euro interest rates are going to rise." But Hurn did agree that a VAR approach worked well within the business because people from different disciplines could understand the concept.

RISK MITIGATION McCormick agreed with Hurn's assessment that there was a need to look at what McCormick called the "jump risk or event risk". He said: "Sometimes markets become uncorrelated for many reasons that are not within our control. We as a bank do sit around and think what two or three uncorrelated events could happen that would really hurt us. You look at the history of hedge funds where they have the best brains on the planet and have still come unstuck. No matter how well you do your sums and Monte Carlo simulations, at the end of the day to transact in a marketplace you need liquidity and someone to be on the other side of the transaction at the size and point in time you want to do it."

Much of Hurn's treasury strategy is about risk mitigation, although

his approach has changed. "We have moved away from managing absolute amounts of risk to a more statistical approach", which he believes provides greater shareholder value and protection. "Managing risks on notional values is too restrictive and doesn't provide the certainty that is desired, so we have implemented a value at risk/cashflow at risk approach. Our main aim is to protect ourselves within a tolerance prescribed by the board using a cashflow at risk evaluator. This gives a more active approach to managing the interest rate risk or in fact any other treasury risk. This approach is more than just asking, do I need to put on more fixed or floating rate contracts? Instead, we are looking at the yield curves of the various currencies we hold and the impact to the group as a whole from movements in rates and the correlation on other currencies using a portfolio approach."

Peter Williams is Editor of *The Treasurer*.

For further information on the issues raised in this series, please contact RBS Financial Markets, Iain Boot (020 7085 3332, iain.boot@rbos.com) or Peter Ryan-Bell (020 7085 1548, peter.ryan-bell@rbos.com).

From previous articles:

IN A STRANGE PLACE

At the moment there is an oversupply of money being offered by lenders to would-be corporate borrowers. One reason for the low level of interest rates is unusually weak demand for credit from the corporate sector driven by the low-growth prospects. Treasurers should consider constructing risk management policies for interest rates, which while low may be subject to volatility. It remains to be seen whether treasurers will rediscover an appetite for debt.

BUILDING THE PERFECT BALANCE SHEET

If an organisation can find its optimal balance sheet structure then it can maximise its returns to shareholders. The ideal balance sheet structure will depend on whether a company is growing organically or is in an acquisition phase. Having decided on the amount of debt a company can manage, the treasurer has to decide whether to borrow short or long, whether to fix or float. A company that achieves lower cost of debt today must realise that the trade-off could be more volatility in the long term.

IN A TIME OF PLENTY

Due to a variety of circumstances many corporates are faced with higher surplus levels of cash than previously experienced for which they need to seek an adequate return. Investments are likely to be short-term and for most treasurers the priorities will be security, liquidity and yield. A variety of investment options are open for treasurers, depending on their risk appetite.

PICK YOUR OPTIONS

Treasurers need to check that their funding policy and interest rate risk management guidelines are up to date and in line with current business objectives. Treasurers are in a position to define and manage funding and interest rate management strategies which are optimal in respect of the profile of the business. Companies should look at the mix of funding options available to ensure that they are taking full advantage of current conditions.