Keep it flowing

IN EARLY NOVEMBER THE ACT FUNDING CONFERENCE IN MANCHESTER, SPONSORED BY LLOYDS BANKING GROUP, LOOKED AT THE ISSUES CORPORATES ARE FACING IN FINDING EXTERNAL SOURCES OF FINANCE. **PETER WILLIAMS** REPORTS.

Corporate treasurers have never had it so good. That at least was the suggestion of Tom Fallon, of the ACT North West Regional Group, who chaired last month's funding conference. The financial crisis has catapulted treasurers into the board's spotlight. Many in the profession had wanted a role which was highly visible. Fallon was once told there was only three things to remember about the treasurer's role: liquidity, liquidity, liquidity, and this served as a mantra for the whole conference as it explored how treasurers were going to secure funding for their companies when the economy was still in a delicate shape and the banks, despite the public exhortations of politicians, were really more interested in retaining earnings to improve the balance sheet and capital ratios.

The first session put the individual company's search for liquidity in a wider context by looking at the government's thoughts on how to finance the economic recovery. David Rogers, deputy director of business finance and tax at the Department for Business, Innovation & Skills, gave an overview of the changing funding landscape for businesses and examined the role of alternative funding sources, a topic of ongoing interest to the ACT. Earlier this year chancellor George Osborne and business secretary Vince Cable said that to finance a private sector recovery the government must ensure stable financial conditions for business, make the banking system more competitive and transparent and deliver sustainable and secure sources of finance for investment.

IT'S ALL ABOUT CHOICE The answer, says the government, is to diversify – ensuring there is greater choice and that businesses are better informed. Pre-2007 firms became over dependent on cheap short-term loans with the risk of short-term finance ignored in the pursuit of low weighted average cost of capital (WACC). Access to diverse sources of finance will enable businesses to select a suitable mix of products. The appetite for credit remains subdued but even with the expected upturn it is hard to see how smaller firms in particular will find the finance they are looking for.

If treasurers and corporates are going to have to compete in a tough world for limited supplies of finance, from whatever source, they may need to consider the mnemonic suggested by Martin Allison, PwC's head of debt advisory for the north of England, when searching for funding (see box).

He also pointed out that while gearing can magnify earnings, it should be used wisely. High financial leverage works if operating leverage is low (ie fixed costs are a small percentage of variable costs). But he suggests if both operating leverage was high (fixed costs are the highest percentage) and leverage is high (large proportion of debt to equity) then a company is in danger. Its financial structure has to support the business strategy and to achieve that optimal structure. Allison suggested:

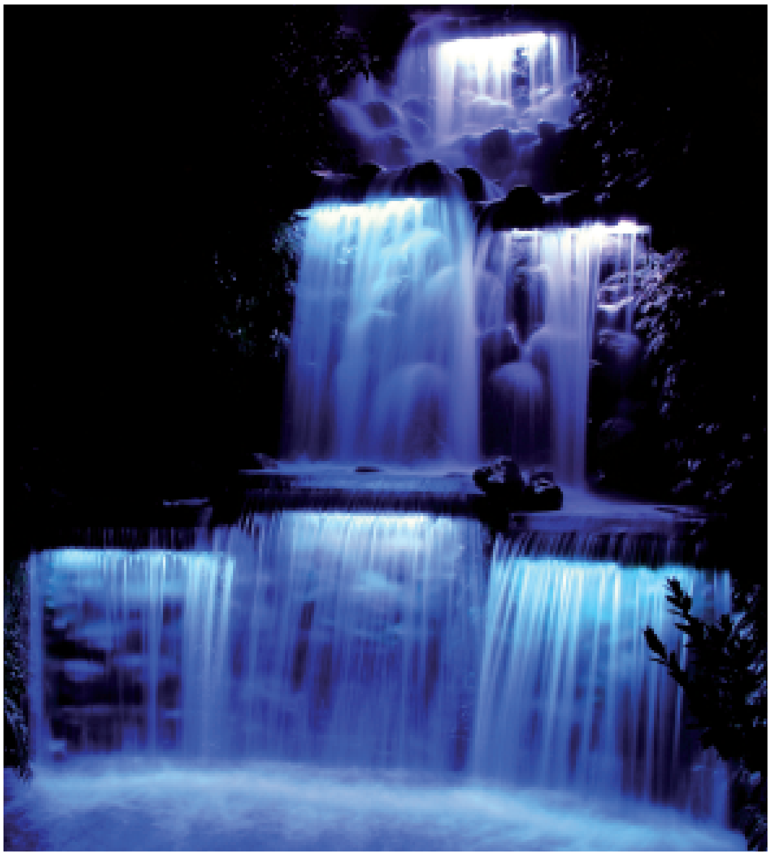
- A level of gearing is still appropriate because of the current low issue and servicing costs and tax benefits.
- For project appraisal use the marginal cost of capital but if no material change is caused use WACC.
- Do benchmark gearing levels and WACCs of peers and competitors.
- Keep abreast of market conditions and be prepared to take advantage of windows of opportunity.
- Be ready to take advantage of interest rate movements and reserve some borrowing capacity to retain flexibility.
- Too many banking providers can be cumbersome and slow, too few can lead to over-reliance
- Used sensibly, additional borrowing can signal to the market greater confidence in the future.

Finance raising FACTORS

- Flexibility
- Assess and Amount
- Cost and Covenant
- Tenor
- Ownership
- Repayment and Reason
- Security

After the view from the government experts and the consultant, Andrew Hughes, group treasurer of Bodycote, examined the impact of volatile markets on balance sheet management. The thermal processing services company has two major businesses – aerospace, defence and energy, and automotive and general industry – and has 170 plants in 27 countries. Despite this wide geographic spread it has limited transactional foreign exchange (FX) risk but there is a translation risk. Now the company has a centralised treasury function which, from the head office in Macclesfield, Cheshire, controls over 70% of the group's cash on a daily basis. It has limited visibility in terms of business outlook but an ongoing requirement for capital expenditure. The company is highly operationally geared so, Hughes says, it is vital that it does not combine that risk with high financial gearing – hence the company's conservative financial structure.

COMBATTING CHALLENGES In the last couple of years Bodycote has coped with the economic downturn, a significant disposal, sharply weakened sterling and credit market turmoil, and refinancing of the core revolving credit facility (RCF).



In early 2008 it announced record results. The company had five years of growth, comfortable gearing (EBITDA/Net debt of 1.4) and a bank group which matched the international nature of the business (four international banks and four UK clearers), plus a three-year strategic plan which identified a funding requirement of £125m. It had no capital market debt but committed facilities maturing in two tranches, 2010 and 2013. The aim was to reduce refinancing risk through diversification of course and a wider range of maturities. But how could a company achieve that objective?

As part of his presentation of the company's funding history over the last two years, Hughes looked at the options for a mid-sized corporate.

For instance Bodycote looked at the idea of asset lease finance for furnaces and property but rejected the idea because of the high operational gearing and decided against fixed cost lease rentals because of the inflexibility they would create in managing the business through the cycle. In addition the prospect of leases going on balance sheet by 2012 was a presentational disincentive.

As for a public bond, the company was not keen on managing a rating and because of its size, the board thought it may be rated sub-investment grade which was not where it thought the bank group saw the company. And it may not have met the minimum size requirement of approx £150m for a high yield bond issuance.

The company also looked at non-public capital markets but it felt it lacked the household name recognition/ brand required for the European private placement market. So the only realistic option was the US private placement (PP) market. Hughes said that PP investors allowed borrowers like Bodycote to tell their story and provided long term funding at a price more akin to the banks. However there are risks for corporates using the market. The long term nature of the investment ("put it in the drawer and pull it out at maturity") that the PP investors want – 10 or 12 years – is difficult to achieve for many companies faced with business cycles. And so getting the investors to approve a change– whether for positive or negative reasons – is difficult there is not the same ongoing relationship as with the banks. For instance, even getting a waiver for something as simple as an accounting standard change can result in an extra covenant and payment of fees. So while the PP market is competitive, liquid and diverse, and a good source of finance for treasurers of medium-sized companies, it is imperative to know potential downsides. There has been a recent trend to self arrange PPs but a placement agent should be able to guide a company through the pitfalls. Whatever finance option is best for a company Hughes said that it was important to end up with gearing that was right for the business and not subject to corporate fashion. It is vital to ensure that the documentation was always right and to aim for simplicity whenever possible and that the best result take teamwork among the treasury professionals and the CFO and CEO.

For many, loans are a bedrock of the financing mix and, according to David Cleary, director of corporate debt capital markets at Lloyds Banking Group, conditions have improved noticeably in the loan market for corporates especially since the summer break. However, corporates continue to de-leverage, with the cancellation rate of investment grade loans outstripping issuance over the last couple of years. Cleary attributed this to a continued lack of demand and investment alongside a notable lack of merger and acquisition (M&A) activity. Banks have been stretched but this is not the case as the moment. And while pricing has improved for borrowers, A-rated borrowers are enjoying margins of 50 basis points, tenors are also stretching out to the five year mark. This sunny outlook is set to continue at least for the short term for investment grades with strong competition between banks to lead loan refinancing. They all want to get to the top of the lending league tables. But there are potential clouds: the depth of liquidity will only become clear with a return of M&A and the market remains fragile. An external shock – like problems with a sovereign issuer in the eurozone– could quickly affect the whole market.

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It is a different story in the leveraged loan market. Spreads are at an all time high reflecting the financial crisis and the banks' prevailing cost of capital. According to Cleary, the Collateralised Loan Obligation (CLO) model continues to struggle and the recovery in the debt market will be muted without its resurrection. A rational market will keep loans margins high as the banks' cost of capital is unlikely to fall to pre-crisis levels in the near to medium term.

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