Keeping active

In the first of a short series of articles RBS' Financing and Risk Solutions team reviews themes and trends in financing and corporate capital structure and suggests some considerations for treasurers and chief financial officers (CFOs) contemplating their effects on shareholder value.

ANDREW WALKER, **SANJEEV KUMAR** AND **SASHA RYAZANTSEV** LOOK AT MAXIMISING SHAREHOLDER VALUE BY ACTIVELY MANAGING THE CAPITAL STRUCTURE.

Have recent market conditions changed attitudes to risk and capital structure? Over the course of the last few months the world's credit markets have experienced significant problems. Problems that began in the US sub-prime mortgage market and fed through to the broader market as participants began questioning how structured credit as a whole is analysed and priced, culminating in a liquidity crunch with, for a while, uncertainty over who the credible counterparties were. This deterioration has manifested itself across the international financial system, including:

- losses at funds such as at Bear Stearns High-Grade Structured Credit Strategies Enhanced Leveraged Funds, which led to the Funds filing for Chapter 15 protection in August 2007;
- the need for KfW, a German State owned bank, to rescue IKB which faced losses and a significant liquidity drain as a result of losses in its Rhineland Funding Conduit which had invested in the US sub-prime market;
- the dislocation of the short term bank market whereby Libor settings exceeded the relevant fed funds or base rate by upwards of 150 basis points;
- the first big run on a UK bank (Northern Rock) since the Victorian era and the need for the UK government to guarantee deposits at Northern Rock after the liquidity crunch resulted in the bank being unable to refinance upcoming maturities;
- the Fed's "double" 50bps emergency rate cut on September 18th.

From a financing perspective, the credit deterioration has resulted in a re-pricing of risk and increased difficulty in accessing liquidity. This is particularly true for leveraged deals such as the banks failure to raise finance for Blackstone's acquisition of PHH with GE, as well as the failure of Freedom Communications to buy out private equity (PE) interests.

The early signs of recovery in the leveraged market in October-November last year (e.g. the initial successful placement of $9.4bn of the total $15bn First Data financing) have proved to be somewhat short lived and it now looks increasingly likely that PE houses will have to live with tighter lending standards for some time to come.

At the same time, there is a considerable backlog of issuance in the high grade market meaning that a large number of corporates may have to issue bonds in the first half of 2008 and thereby accept the new pricing environment.

Against this background of recent credit market turmoil and the resulting changed markets it is useful to understand how and why financing and risk management techniques are evolving and highlight what might be some of the issues affecting corporate capital structures in 2008, including:

- **Regulatory**: The introduction of Basel II means that it may be better for banks to lend to high-grade corporates than it will to private equity houses. As a result, we may see a change in exit strategies for private equity deals, where the exit becomes a trade sale to a high-grade corporate buyer rather than to another private equity/highly leveraged deal.
- **IPOs**: As an alternative to a trade sale, leverage deals may come to market via Initial Public Offerings (IPOs) as the preferred way of getting them off the private equity balance sheet. This raises the question of what should a balance sheet look like post-IPO to give shareholders maximum return?
- **Strategic risk management**: In order to increase financial flexibility to achieve business objectives, acquisitions etc, treasurers and chief financial officers (CFOs) are increasingly looking to use risk management in a strategic manner.
- **Pensions deficits**: So far equity markets have been nervous but haven't shown significant falls from the highs in mid-2007. Nevertheless, treasurers and CFOs need to be mindful of what

might happen to pension deficits in the event of significant equity market weakness, falling long-term interest rates, and another round of longevity adjustments.

THE EVOLUTION OF THE CAPITAL STRUCTURE

Corporate financing strategies continue to evolve, driven by the realisation that the financing strategy can create significant shareholder value, and that the view that debt is only a financing tool with tax advantages is outdated.

Traditional funding structures have been based on a large amount of equity, with debt represented predominantly by bank debt and a complementary mixture of public bonds or private placements for diversification and maturity purposes.

As financial markets have matured some classes of debt have assumed equity-like characteristics, and have increasingly been able to underwrite what were once risks that needed to be underwritten by equity.

As a result, a number of corporates have moved towards financing structures that involve more granular tranching within the debt-equity spectrum and more transparent identification of key risks. For example:

- the use of subordinated debt/hybrid capital by well rated corporates e.g. Siemens, Henkel and less well rated or unrated corporates e.g. TUI and Voestalpine;
- the issuance of index-linked and covered bonds (e.g. Veolia Environnement);
- realignment of corporate risk layers (e.g. changing the pension seniority by Pernod Ricard); and
- the tailoring of risk transfer so it more exactly meets the corporate's specific requirements rather than purely market norms (e.g. Tesco property sale & leaseback).

More recently corporates have begun to review whether even this tranched balance sheet represents the most efficient financing structure, or whether further shareholder value gains might be derived from financing individual assets or individual businesses separately – the "Multiple Corporate Financing Approach" – driven by the following types of consideration:

- Could the assets be "sweated" more if they were financed separately, even on a non-recourse basis, rather than on a combined basis in order to boost return on equity (RoE) or increase debt capacity for (further) strategic moves?
- Would separate financing allow greater visibility to the market of the value of assets and hence encourage a re-rating of value by the market?
- Could separate financing of certain assets or businesses also act as a "defence mechanism" against corporate raiders or activist shareholders by removing this avenue of re-structuring from their arsenal?

This quest for increased financial flexibility now uses techniques originally developed and used in particular sections of the financing world including, such as, non-recourse project finance, infrastructure finance, removing explicit market risks from property finance, and strategic risk management to reduce cashflow uncertainties in leveraged situations.

MOTIVATIONS TO OPTIMISE THE CAPITAL STRUCTURE

There has been increased pressure from shareholders and boards on treasurers and CFOs to determine whether their company's capital structure has been optimised for a number of reasons including:

- they may become a bid target where PE firms or competitors reap "super-normal" rewards by optimising the balance sheet structure "after the event";
- they may find their own ability to complete strategic corporate actions thwarted by competitors or PE firms who are using balance sheet structures more aggressively and are thus able to improve their bid prices; and
- the share price may not be maximised due to factors such as lower RoE growth and an inaccurate perception of the value of certain assets/businesses (which could be corrected via financing).

There are increasing signs that the question of "the amount of debt" is better understood, with corporates increasingly moving away from the AA/A type leverage profiles (e.g. Schneider Electric, Health Medical Associates, and, to an extent, Nestle).

More aggressive corporates are already moving further in this direction to review the gains that cannot only be made from tranching within the capital structure (e.g. hybrid debt) but also by using the Multiple Corporate Financing Approach. Importantly, this is happening across a range of sectors.

The Multiple Corporate Financing Approach is being considered and used by companies with assets such as property, vehicles, and intangible assets too.

Those companies that either avoid the capital structure question altogether or that limit the discussion to the amount of debt, may find themselves under increasing pressure from shareholders, corporate raiders or private equity interests. They may also find that they fall behind their competitors and the wider market in terms of delivering increases in shareholder value.

IMPROVING RETURNS ON EQUITY

RoE can be improved by increasing operating margins, asset turnover, or leverage according to the DuPont equation. RoE has been a key chief executive officer (CEO) focus over the last five years. Arguably, the improvement in RoE that we have so far witnessed has been primarily driven by the first two parts of the equation as highlighted by the 22 consecutive quarters of margin expansion in the US (achieved on the back of an extraordinary period of cost control) and the low capex/GDP ratios in US and Europe over the last few years.

Leverage has increased but it still remains the case that most corporates are over-capitalised – as evidenced by default rates still being close to all-time lows.

A number of companies have already begun to realise the RoE gains that can be derived from reduced asset investment or asset divestment and cost control.

Intercontinental Hotels Group, for instance, is potentially moving into the final straight on asset efficiency, with its announcement in 2003 about selling hotels and focusing on managing and franchising versus owning – an asset-light strategy which has been executed in stages with proceeds returned to shareholders.

A further example is United Utilities disposing of electricity distribution assets to North West Electricity but retaining an operating contract.

Corporates are looking at using leverage to continue the RoE improvement and also investigating whether alternative financing structures can further boost RoE. It is via this holistic view of how financing affects RoE that the Multiple Corporate Financing Approach may be able to provide benefits beyond traditional approaches. For instance:

- the multiple approach increases the scrutiny and visibility on returns for each business thereby potentially improving investment decisions and hence RoE. Many companies, such as Siemens, look at performance metrics such as Weighted Average Cost of Capital (WACC) or Economic Value Added (EVA) per business. However, often the individual business WACC is calculated by adjusting the group-wide WACC by a risk factor associated with the business. The Multiple Corporate Financing Approach should provide a clearer ability to calculate these metrics on a business by business basis, thereby leading to improved investment decisions and RoE. In fact, it is often because there are businesses that are less visible or where a group-wide approach misses the intrinsic value, that frequently private equity/corporate raiders are able to extract value (a Multiple Corporate Financing Approach should alleviate this problem);
- In certain circumstances, the Multiple Corporate Financing Approach can enable the investment to stay "off-balance sheet" hence further boosting RoE;
- Rating agencies do not always follow the accounting treatment and may bring the assets financed on this basis on to the balance sheet;
- The approach can also potentially increase debt capacity and/or reduce cost of debt.

There are other emerging corporate financing strategies that corporate issuers have developed to achieve their strategic objectives in the new market environment. These strategies include methods to:

- **Benefit from asset price correction and explore partnerships with PE**: Many corporates want to acquire assets now and exploit the difficulty facing PE to enter deals on the favourable terms that markets were providing before the market turmoil. In addition, in some situations, corporates want to acquire assets in partnership with PE for a variety of reasons including (a) they don't want to buy the whole asset but don't want to sell non-core assets to their strategic competition, and (b) the corporate has finite debt capacity and doesn't want to or cannot issue equity. As a result, corporates are also developing financing strategies that allow PE to enter deals and achieve the required internal rate of returns by using the corporate's involvement to either reduce cost of funding for PE or to facilitate the finance-ability of the overall structure by using the corporate's own liquidity.
- **Access alternative sources of liquidity**: There are still investors, notably quasi-government entities in the Middle East and Asia, which do not have liquidity constraints and see current markets as an opportunity to acquire international assets. Corporates should consider the potential for this liquidity to create momentum in their share price by encouraging these investors to take strategic stakes in their company (e.g. the Temasek and China Development Bank investment in Barclays), or by tapping this liquidity and investment appetite in order to act on strategic moves (e.g. Nasdaq/ Borse Dubai and OMX).
- **Minimise dependence on the market provision of liquidity by altering their maturity profile**: Corporates have always tried to find the optimal maturity profile that would provide the right balance between risk, cost and flexibility. Given the reasonably long period of benign credit environment over the last few years, some corporates (and financial institutions!) have developed a mismatch between their assets and short-term liabilities. This was highlighted by the over-reliance by some on commercial paper (CP) and other short-term sources which provide the lowest cost in exchange for the highest refinancing risk. When the CP market experienced difficulties corporates active in this market had to review their strategy and term out to longer maturities (e.g. Safeway Inc's $500m bond issue to term out CP on last year).
- **Improve overall balance sheet efficiency**: Although the threat of being taken over by PE may have receded, many corporates still feel that sub-optimal capital structures will be targeted by

shareholder activists such as Knight Vinke, or by other sponsors such as the previously mentioned Middle East and Asian wealth funds. As a result, a number of companies announced significant share buyback programmes in Q3 last year, though notably, these were mainly overcapitalised and cash-rich corporations. Others, whose balance sheets are not as inefficient, now seem to be adopting a "wait and see" approach to understand how the market downturn will develop and what liquidity position (and, perhaps, acquisition opportunities) they will have going forward before committing further funds to share buybacks.

CONSIDERATIONS WHEN OPTIMISING THE CAPITAL STRUCTURE

There are a number of issues for treasurers and CFOs involved in determining the optimal capital structure. These will have to be tailored to the specific situation, and aligned to the strategic objectives of the corporate and market conditions at the time. Here we take a look at some of the key ones:

- **Credit/ratings**. It is important to ensure that ratings are optimised before deciding to go ahead with a transaction. For example, there have been inconsistencies in the way rating agencies have treated subsidiary investment and debt. Typically, the rating impact would depend on the value of the subsidiary in the context of the group, its strategic importance, name relationship and the likelihood that the corporate would support the subsidiary in the event of default. Should the corporate guarantee some of the debt of the subsidiary/associate, this debt could be fully/partly consolidated for rating agency purposes. Is a formal rating advantageous or would it be better to be un-rated?
- **Accounting impact**. The choice of financing structure can significantly alter the balance sheet impact for the corporate. The specific situations (and jurisdictions) will drive the structure that produces the most advantageous accounting treatment.
- **Impact on other stakeholders.** Interaction between corporate and financial sponsor. The corporate will have to understand its own and the sponsor's exit strategy for the asset and may enter into call and put arrangements to allow for that. This would have implications for both accounting and ratings but also may potentially create conflicts of interest between the partners.
- **Shareholder activists**. Whilst the markets may be more difficult now and may force corporates to delay shareholder-friendly actions they will have to balance this against potential pressure from shareholders.
- **Treatment of existing debt holders**. The consequence of leverage existing closer to an operating company/asset is that it may lead to subordination of existing debt holders. If this is not handled appropriately, it may jeopardise the distribution process/liquidity of the debt of the new business/asset, as well as negatively impacting future debt issuance when the old "now subordinated debt" is due to be replaced. Similarly, equal attention will need to be given if covenants such as negative pledges are in the documentation.
- **Pension funds**. The effect of securing debt against some assets is in effect to make the defined benefit pension scheme now have a layer of claim above it. This may therefore require some degree of quid pro quo with the pension trustees and/or the regulators.

WHAT DOES THIS MEAN FOR TREASURERS AND CFOS?

The corporate finance world has become much more pro-active with corporates regularly leveraging, acquiring, disposing, and re-engineering their balance sheet in efforts to maximise shareholder value. The range of financing structures available is increasingly wide and sophisticated. Consideration of how some of these financing techniques can be combined has sometimes lagged behind the ways in which the more aggressive users have adopted and are developing the ideas.

WHILST THE MARKET CONDITIONS MAY CHANGE THE FUNDAMENTAL QUESTIONS THAT TREASURERS AND CFOS SHOULD BE DISCUSSING WITH THEIR BANKS WILL REMAIN THE SAME.

PE and shareholder activists are an established reality and few corporates are immune from takeover. Accordingly, treasurers and CFOs should follow carefully not only what their competitors across the globe are doing but how. In particular, they should be looking at the sort of deals that their competitors are doing and the financing techniques and risk management tools that they are using which are making them, or have the potential to make them, more of a competitive threat.

Treasurers and CFOs need to ensure that they fully understand the options available to them to improve shareholder value through the capital structure e.g. for strategic acquisitions or in the case of an unsought for approaches. Banks have particular expertise in the financing and risk management areas which can and should play a valuable part in the overall strategic corporate financing approach. Those banks that can combine their particular expertise in the financing and risk management spaces as an integrated whole can help the treasurer or CFO make sense of the options available to deliver that shareholder value. While it is understandable that corporates are often reluctant to discuss such questions nevertheless they do need to be addressed, and more importantly the treasurer and CFO can make a significant contribution to determining the answers by having sound advice and a coherent view on how these financing structures may fit into their overall financing strategy.

We will have to wait to see the actual developments in 2008 but, while the market conditions may change, the fundamental questions that treasurers and CFOs should be discussing with their banks will remain the same.

RBS
The Royal Bank of Scotland

Andrew Walker, Sanjeev Kumar, and Sasha Ryazantsev are in the Financing & Risk Solutions team in Sector Corporate Finance, RBS Global Banking & Markets.

Andrew.Walker@rbs.com
Sanjeev.Kumar@rbs.com
Sasha.Ryazantsev@rbs.com
www.rbs.com/gbm