A TALE OF TWO CONTINENTS

ANDREW PILSWORTH, A RECENT MCT GRADUATE, TALKS TO SHEELAGH KILLEN ABOUT HIS ROLE AS TREASURY ACCOUNTING MANAGER IN THE LEISURE GROUP SIX CONTINENTS.

In October 2002, the leisure group Six Continents PLC (Six Continents) announced its plans to divide its core businesses between two new, highly focused, listed companies. The UK-based pubs and restaurants business, which owns brands such as O'Neills, Harvester, Browns and All Bar One, was to be demerged to form a retail pub and restaurant company. The international hotels business (which would also retain the soft drinks business, Britvic) would continue to own, manage and franchise leading global hotel brands such as InterContinental, Crowne Plaza and Holiday Inn.

In March, it was announced that the retail company would be called Mitchells & Butlers PLC (MAB) and the hotel group would be named InterContinental Hotels Group PLC (IHG). The separation of the two businesses finally took place, on the date originally planned, 15 April, and as part of the separation around £700m was returned direct to shareholders.

Now that they are separately listed businesses, both companies are looking to the future. Both firms intend to exert downward pressure on operating costs. For example, IHG predicts that up to a further $100m of value to shareholders per annum will be generated by efficiency savings. The Six Continents' share price rose with the announcement of the demerger strategy in October last year and this shareholder support was confirmed by the vote in favour of the demerger and the share price/performance of MAB and IHG in recent weeks.

A CHALLENGE FOR TREASURY. The uncertainty overshadowing Six Continents' future was one more hurdle for the Group Treasury function as it pursued a challenging timetable of preparations for the demerger. Andrew Pilsworth, Treasury Accounting Manager at IHG (who was then in a similar role in the Six Continents' Group Treasury (SCGT)), has been contributing to this work for much of the past nine months. In the days immediately following the demerger announcement, Andrew was busy managing the Six Continents 30 September 2002 accounting year-end close for SCGT. Indeed, he recalls with good humour working until 10pm for rather too many nights in a row in the weeks before taking the train from Burton-on-Trent to London to sit his MCT finals in October 2002. However, since then, his role has demanded close involvement in projects to finalise documentation for the demerger and to address the strategic and operational logistics of splitting the group treasury function between the two new businesses.

INTERCONTINENTAL HOTELS GROUP

Summary of the separation of Six Continents PLC into Mitchells & Butlers PLC (MAB) and InterContinental Hotels Group PLC (IHG)

- Started work July 2002.
- Announced 1 October 2002.
- Posting of Shareholder Circular and Listing particulars on 17 February 2003.
- Shareholder approval given at EGM on 12 March 2003.
- Separation date 15 April 2003.
- 50 MAB and 50 IHG shares for 59 Six Continents shares (based on closing prices at 13 February 2003).
- Return of 81p cash per share (around £700m in total).

IHG corporate milestones

1777
William Bass establishes brewery in Burton-on-Trent.

1876
The famous Bass 'red triangle' becomes first UK-registered trademark.

To 1967
Acquisition of Tennents Caledonian and Mitchells & Butlers.
Merger with Charringtons.

1989-91
Statutory controls on number of brewery tied public houses introduced.
Acquisition of Holiday Inn International.
Acquisition of Holiday Inns of America Inc.
Holiday Inn Express launched. >>

PAPERWORK. The initial announcement of the Board's plans for demerger set in train a demanding schedule for the preparation of both the Shareholder Circular to existing members and the Listing Particulars for the two new listed companies. This included disclosures as to the working capital position of the group. As Andrew had day-to-day responsibility for treasury reporting, he was well placed to co-ordinate much of the information flow between the treasury function and the reporting accountants and professional advisers for the transaction. This was particularly demanding because it was essential to ensure that "all sets of documentation remained consistent" when the details of the planned steps to execute the demerger were still being fine-tuned, both within treasury and elsewhere in the organisation.

Six Continents was listed in New York and so there were also significant US regulatory disclosure requirements (20-F forms), much of which was on a pro-forma basis for the new businesses. Andrew comments that, in addition to the pressure of additional reporting and an accelerated timetable, there was the supplementary consideration that this was the company's first set of reporting submitted since the introduction of the Sarbanes-Oxley Act 2002. This US legislation puts increased responsibility on senior directors to ensure that all financial and regulatory reporting is complete and correct, and carries severe penalties for breach.

BRIDGING THE GAP. In addition to ensuring that all documentary requirements were met, SCGT also had the equally important responsibility of ensuring that the group's funding was realigned with the demerged structure. One of the foremost tasks to be addressed was the renegotiation of the Six Continents syndicated loan facility. This was a $3bn facility dating from 1998 and maturing on 13 February 2003. As Andrew explains, in normal circumstances, negotiations for the renewal of a loan facility would commence well in advance of the expiry date. However, because of the ongoing strategic deliberations at Board level, it was not possible to commit the company to a substantial new term borrowing facility until the commercial plans for the business had been finalised.

As soon as the demerger was made public on 1 October 2002, SCGT moved swiftly to secure committed funding, on a bridging basis, for Six Continents to cover the period between the maturity of the existing syndicated loan and the final separation date scheduled for 15 April 2003. A 364-day revolving credit bridging facility of £3bn was signed on 3 February 2003. It was always intended to cancel and repay this facility on the separation date by drawing on new facilities for IHG and MAB, which were finally signed on 13 February.

DEBT REPAYMENT. The other key action for the re-structuring of Six Continents debt was the launch of a programme to repay a large portion of the company's medium term notes (MTNs). On 5 December 2002, Six Continents announced a tender offer for three MTN issues: £10m Notes due 2004, €25m Notes due 2006 and £250m Notes due 2007. Acceptance of the tender offer by note-holders resulted in 100% of the first two issues and 92.6% of the latter being repurchased. A balance of around £18m remains on the 2007 Note.

Following discussions with a committee of the Association of British Insurers, it was also decided to repay £250m 10 3/8% debentures due 2016. Stockholders approved a resolution passed on 14 January 2003, requiring the firm to redeem the stock no later than 31 May 2003. The price for redemption was set at a yield of 100bp above the UK Treasury Stock 8% 2015. Six Continents subsequently redeemed the issue on these terms on 27 February 2003. Lastly, the $300m 6.625% bond due on 1 March 2003 matured as scheduled.

LEVERAGING VALUE. Following the separation, the leverage of IHG and MAB is greater than that of the old Six Continents entity. Back on 30 September 2002, net debt in Six Continents was £1,177m and

>> 1994-96

Launch of Crowne Plaza hotel brand.
First O'Neills branded pub opened.
Acquisition of Harvester.
Launch of the All Bar One brand.
Strategic alliance with Carlsberg-Tetley blocked by competition authorities.

1997-99

Disposal of Gala Bingo and Coral bookmakers.
Sale of public house leased estate.
£1.75bn acquisition of InterContinental Hotels.
Acquisition (with Punch Taverns) of pub estate of Allied Domecq.

2000

Acquisition of SPHC hotel group in Australia and the Bristol hotel group in the US.
Sale of Bass Brewers for £2.3bn.

2001

Rationalisation of public house holdings to eliminate outlets not suitable for branding.
Acquisition of Posthouse chain.
Acquisition of InterContinental Hotel, Hong Kong.
Bass PLC renamed Six Continents PLC.

2002-03

Demerger of Six Continents PLC into Mitchells & Butlers PLC (retail) and InterContinental Hotels Group PLC (hotels and soft drinks).

Andrew Pilsworth: career profile

1996

Graduated in Economics from Nottingham University
Joined Deloitte & Touche, Nottingham, in November 1996 as Trainee Accountant (audit).

1996-1999

Audit experience in manufacturing and service sectors, ranging from small companies to major enterprises.
Qualified ACA in December 1999.

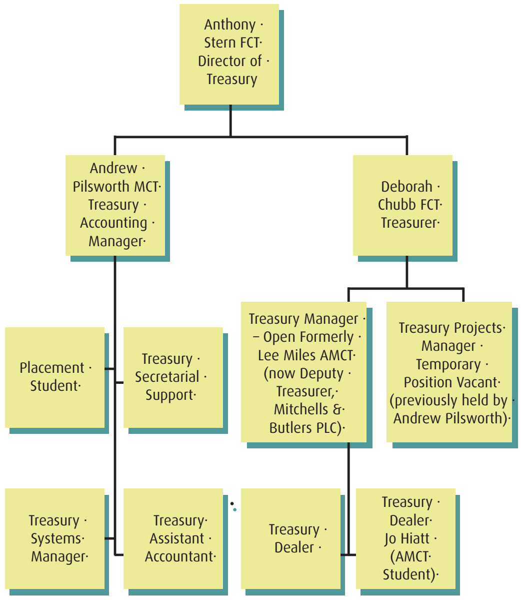
2000-2001

Completed six-month secondment to treasury at Bass PLC.
Joined Bass as Treasury Projects Manager.
Qualified AMCT in October 2001.

2002 to date

Promoted to Treasury Accounting Manager at Six Continents.
Qualified MCT in October 2002.
Appointed Treasury Accounting Manager, InterContinental Hotels Group PLC, in April 2003.

FIGURE 1
SIX CONTINENTS GROUP TREASURY ORGANISATIONAL CHART.



it had a long-term rating of A- (Standard and Poor's) and A3 (Moody's), and short-term ratings of A2 and P2 respectively. According to the Listing particulars, as at 30 September 2003, IHG was looking to achieve a rating of BBB/Baa2 (which was confirmed in April 2003) and anticipated debt levels at September 2003 of £1.2bn.

Before the demerger was made public, treasury staff organised meetings with the rating agencies and provided detailed information for the indicative review which would determine the likely credit rating of IHG. The Board was keen to ensure that IHG should be regarded as investment grade and this was a factor in setting the level of the funds to be repaid to shareholders.

While increased leverage was part of the strategy to return cash to investors and to enhance shareholder value, it was important for SCGT to negotiate appropriate covenants for borrowings in the new entities to ensure that commercial activities were not restricted. The importance of ongoing monitoring of covenants is also expected to be paramount in the more highly-geared environment in MAB and IHG going forward. For this reason, the two new treasuries have also been charged with ensuring that a comprehensive approach to hedging policy remains in place. This is particularly relevant in respect of foreign currency movements in IHG.

PROTECTING THE BALANCE SHEET. Back in June 2000, the sale of the Bass brewing business had generated some £2.3bn of cash. Following this transaction the name of the ultimate holding company of the group, Bass PLC, was changed to Six Continents PLC. There was some speculation that the proceeds would be used as a war chest for future acquisition, probably in the hotels market. However, pending any strategic opportunities of this kind, the decision was taken to utilise the funds in the short to medium term to pay down debt of the Six Continents group, which was still in a net debt position. A substantial percentage of the economic assets of the hotels division are in the Americas. A significant proportion of total net debt was therefore dollar-denominated to provide a translation hedge against dollar-denominated assets and income streams. The SCGT was therefore faced with a sterling cash asset and substantial US dollar liabilities. Short-dated rolling GBP/US$ cross-currency swaps were put in place and the initial exchange of cash on the spot leg used to make dollar debt repayments. This use of short-term off-balance sheet swaps offered a high degree of flexibility in allowing Six Continents to repay dollar debt while maintaining the translation hedge.

On demerger, the currency swaps stayed with the hotel business. The assets and cashflows of the pubs and restaurants business are almost entirely sterling-based. However, Andrew sees that issues may arise for IHG in connection with existing hedging techniques when it is obliged to report under IAS 39 in 2005 (comparatives from 2004). Based on an analysis of the present form of IAS 39, hedge accounting is not usually available where a derivative is used to hedge another derivative. Interest rate swaps are currently used to hedge the interest rate risk arising on interest paid on the cross-currency swaps.

This group of interest rate swaps will not qualify for hedge accounting, and changes in their mark-to-market value will therefore be reflected in the profit and loss account. This would create profit and loss volatility in respect of instruments which are, to all intents and purposes, a component of an overall hedge of dollar borrowings. In this instance, there would need to be a policy decision as to the relative cost/benefits of protecting the balance sheet and potentially introducing increased earnings volatility.

This issue has highlighted one point which Andrew sees emerging in the role of the treasurer. He says: "An understanding of accounting is becoming more and more crucial with developments in financial reporting such as IAS 39. You need accounting expertise in treasury – you just can't leave it to the accounts team anymore. Accounting is affecting strategy."

DIFFERENT STROKES. The demerger of MAB will have a significant impact on the everyday operational aspects of IHG's treasury, particularly as the former hotel and retail divisions have strongly contrasting cashflow and risk management profiles.

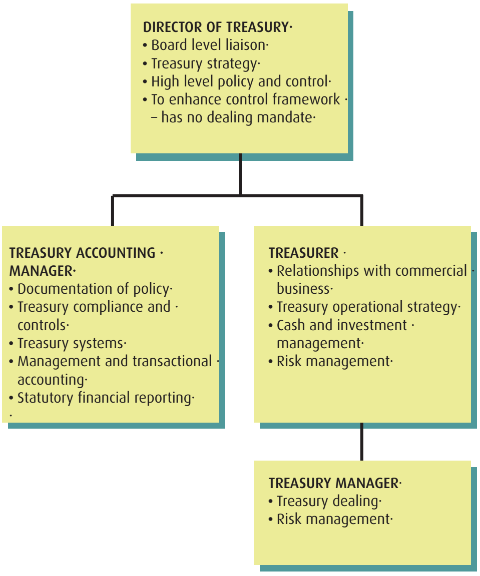
The hotel business can be relatively asset-intensive. For certain upper upscale hotels such as the InterContinental brand portfolio, the hotel real estate may be owned by IHG.

This permits the strict control of service and maintenance standards required to secure an enduring perception of luxury accommodation. For other premium-branded properties (including selected InterContinental sites, as well as flagship Crowne Plaza sites), the company prefers to retain the management contract, while not necessarily owning the hotel buildings. The mid-scale brands are mainly driven through a less capital-intensive franchising approach (except in the UK). While cashflow from franchising fees depends on rooms revenue not operating profit and provides a stable platform of income, profits from the owned hotels can fluctuate with the economic cycle.

There is also the issue of funding a continuous programme of maintenance and upgrade to ensure that the value of properties is maintained and that occupancy rates are underpinned in the longer term. All these factors, coupled with the fact that the hotels business is a global one, lead to considerable complexity both in forecasting and in treasury and risk management.

In contrast, while it does have operations outside the UK, on the whole, the retail business generates a reasonably predictable series of

FIGURE 2
SIX CONTINENTS GROUP TREASURY KEY MANAGERIAL RESPONSIBILITIES.



sterling cash inflows. A key challenge for treasury here is to maximise efficiency in handling and utilising cash receipts. As Andrew describes it: "It is principally an exercise in getting sterling cash out of the pub tills and into centralised cash accounts." However, he adds that, "the new MAB treasury is also now dealing with the complexities of putting together a securitised debt facility."

DIVIDE AND RULE. In the combined treasury function, the reliable receipts of cash from the retail business could, to an extent, offset the volatility of receipts from the hotels business. Spread savings could also be achieved by centrally netting cash amounts such that, for example, retail receipts were channelled into funding planned refurbishment programmes when hotel occupancy was quiet. This is not the case in the divided entities and revised procedures have been devised to fit with the individual demands of each business. In respect of MAB, this has involved the development of a new treasury policy, appropriate to the treasury management of a largely UK-based retail business.

Even though the operational characteristics of the MAB and IHG treasuries may be diverse, it is expected that both treasuries will maintain a conservative approach to risk. The SCGT function was a "cost-saving" treasury which was mandated to achieve optimum performance within predetermined risk parameters, including a guideline that between 25% and 75% of borrowings should be at fixed interest rates. This mainly centralised approach to treasury management is set to continue in the demerged businesses, although, in particular, the impact on treasury guidelines of the recently announced securitisation of MAB will need to be considered by the MAB Treasury team. In IHG, regional cash centres are used, which report into country based commercial management, and local operating conditions dictate that some minimal trading is done in the divisions under advice from IHG Group Treasury (for example, in Hong Kong dollar). However, the majority of "value adding" discretionary treasury management continues to be handled from the central function in Burton. This includes the risk management role, all external funding transactions and agreement of loan documentation.

COMMON KNOWLEDGE. With this centralised approach in mind, prior to the demerger, a key issue for treasury was the optimum allocation of existing treasury expertise and knowledge across the new entities. Because of the complexities of the hotels business, and the way that separation was structured, the majority of the existing SCGT team remained with IHG. Accordingly, it was important that existing knowledge was transferred to staff destined to work in the treasury team at MAB. This has been facilitated by the appointment of Lee Miles, formerly Treasury Manager at Six Continents, as Deputy Treasurer at MAB.

In addition to his treasury accounting specialisation, on first joining Six Continents (see page 19), Andrew was employed as the Treasury Projects Manager and has worked on a number of key operational initiatives, including integration and automation of the cash pooling arrangements in Europe.

He therefore has some useful insights into the establishment of sound cash management processes and other treasury issues, which he was been working to pass on to colleagues on the retail side. To this end, prior to demerger, Pilsworth took time out of his schedule on a weekly basis to arrange coaching sessions and discussions with the newly appointed back office and reporting staff at MAB. This is over and above the work his team has done towards ensuring that treasury infrastructure was in place for both post-demerger companies. This involved setting up new bank accounts and establishing separate procedures, controls and treasury management systems in each entity. "There has been a certain amount of support and interaction, at least initially, but for governance reasons there is a limit to the sharing of facilities between two listed companies. After 15 April, each team has needed to do things for themselves," says Andrew.

EXECUTIVE EDUCATION. Yet education does not stop at fellow treasury staff. With the split of the company, new Board members have been appointed in IHG and MAB. These directors may not yet necessarily be familiar with treasury operations, so it is important for the respective treasuries to continue a policy of discussing with senior management the risk framework and the role of treasury in managing exposures. This is one key area where Andrew recognises the value of his ACT treasury education. "When I first moved into treasury on a six-month secondment from audit, I was introduced to a whole new language. AMCT helped guide me through that terminology," he explains. He is now able to use this experience to explain treasury concepts to others, whether in audit, treasury or at executive level.

However, in the midst of all this hard work, his own learning and development are also continuing. Andrew recently passed his MCT examinations, receiving distinctions in two subjects. "MCT has really consolidated on learning from AMCT," he explains. "As you can imagine, leading up to the demerger, there was a lot of talk within Six Continents about corporate finance. Whether I have been doing the work or involved in the periphery, MCT has given me a core understanding of the techniques we are discussing for real right now in our business." Treasury management in theory and practice.

Andrew Pilsworth is Treasury Accounting Manager at IHG.
Andrew.Pilsworth@ichotels.group.com
www.ichotelsgroup.com