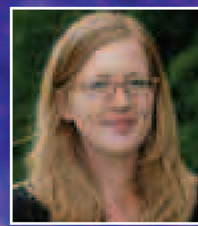
Hitting the radar



MICHELLE PERRY CONSIDERS THE POTENTIAL OF HYBRID CAPITAL AS THE BOOM TIME FOR BORROWERS COULD BE HITTING ITS PEAK.

"Let the good times roll on. Let's get the margins while they're there," Neil Sorahan, Group Treasurer of the Irish no-frills airline Ryanair, told treasurers at The Treasurers' Conference (TTC) in May, in reference to the availability of banking credit.

It's a line that treasurers have been relishing for a while but it's clear now that it's not one that will be echoing around the corporate corridors for much longer.

Corporate treasurers should indeed take advantage of the current climate which favours borrowers, but the cycle is probably hitting its peak about now. With the financing cycle due to change course, treasurers should be looking at other ways to finance for the future.

CASINO DEAL One such financing option raised among treasurers in recent months is hybrid capital. In January the French supermarket chain Casino successfully completed a hybrid capital transaction and bankers predict the popularity of such transactions will grow over the coming years.

But why now? It's not just the changing landscape of financing opportunities that is pushing the hybrid option onto the radar of treasurers, several other developments in the capital markets have made hybrid securities appear more attractive than in previous years.

There is of course the transition to the single set of accounting standards for use in cross border transactions, namely international financial reporting standards. "International Financial Reporting Standards (IFRS) makes it clearer and simpler to get equity accounting," says Vinod Vasan, Head of Capital Products Group, Debt Capital Markets at investment bank UBS.

The shake up in the rating agencies industry, making its ratings methods on equity credit more transparent, is also a contributing factor. Pressure from issuers and banks as well as heightened scrutiny by global securities regulators have galvanised the agencies to take pre-emptive action by being more open about the way in which they rate companies.

Robert Ritchie, Executive Director, Debt Capital Markets at UBS, says: "Corporates have been wary in the past of the ratings treatment for hybrids. UK plc will now be far more interested in the product. If you have clarity about what the agencies think about this type of bond, then the rationale to use them is clearer."

WHY NOW? The psychological aspect of attempting something different is also a factor. Ritchie adds: "Why now for corporates? It's partly cultural, partly psychological. There's always been some inertia."

Hybrid capital is effectively an equity-like credit, meaning that agencies will look at it favourably as a substitute for equity which does not increase leverage in the same way as a traditional bond issue.

Over the past three years an increasing number of UK companies have sought credit ratings, meaning that finance directors and treasurers have become more focused on how certain transactions they carry out will affect those ratings. Roughly 60% of the FTSE 100 have ratings now. Given that a company's rating is ultimately a measure of the business' credit worthiness, it's an issue treasurers and finance directors will be increasingly concerned about as the

Executive summary

- Developments in the capital markets have made hybrid securities more attractive than previously.
- Factors contributing to the rise of hybrid capital are the introduction of International Financial Reporting Standards (IFRS) and changes in the way equity credit is rated.
- An increasing number of companies have a rating and hybrid capital can contribute to maintaining the rating.
- Hybrid capital appears on the balance sheet as equity not debt and could be useful in merger and acquisition or in a share buyback.
- The use of hybrid capital will be event driven and careful communication would be necessary with the market.

financing climate changes. Although a downgrade can be sudden and rapid – Fitch recently downgraded Allied Domecq on the news of a takeover – getting agencies to upgrade companies can take a lot longer. This was a concern raised by Jane Pilcher, Group Treasurer, Anglian Water, at the TTC in May.

Ritchie argues: "If this product helps the rating then treasurers and FDs will be interested. A good rating enables them to raise bond finance quickly and that's what companies want to do generally. If you have an investment grade rating then you can do that."

"If you have a senior rating and you issue a hybrid it will assist that senior rating. It bolsters the rating, rather than damaging it," adds Vasan. This type of security can get between 50% and 75% credit by agencies, explains Vasan, who worked for six months on the final structure for Casino's transaction. "No one had achieved that before in a corporate security. With S&P Casino got 50% – the magic number. It got 100% with Fitch." Casino is not rated by Moody's.

There are three things, say experts, that the agencies look for from hybrid securities when assessing their "equity credit" and that the accountants also look for: permanence, no ongoing payments and subordination.

In the case of hybrid capital, it can also appear on the balance sheet as equity, not debt, and with the greater focus on balance sheets, it could be a good option for many treasurers.

Vasan says: "You can do a share buyback with this now. In an environment where there's not much bond issuance around, but we have low interest rates, it's a good opportunity to do this. They strike a chord with the markets."

"It can be useful if you want to do a merger or acquisition and you don't want to overstretch your balance sheet," adds Ritchie.

Jacques Tierny, Chief Financial Officer of Casino, says the motives for Casino using this security included: "selling risk-like paid up equities (perpetual, full subordination, coupon dependant on dividend), diversification of funding and good after tax comparative cost".

COMMUNICATION WILL BE VITAL Of course there are some downsides. This kind of financial instrument is more expensive than most other forms of debt. For the investor there are no clear timescales for receiving dividends, although when the company does pay out it is usually at a higher rate of return.

"From an investor's point of view it offers a better yield on their investment and from the ratings agencies' perspective it sends good signals because it shows the agency that a company is concerned about and thinking about the effect it will have on their rating," explains Ritchie.

Antony Barnes, Group Treasurer at GUS, the retail and information group, says: "Certainly for a company like us if there was some sort of acquisition opportunity which was going to stretch our current credit ratings, normally speaking we would wish to maintain the credit ratings that we've got, so we'd want to look at where we'd get equity credit. Now equity is itself expensive and in that sort of scenario a hybrid instrument might be appropriate."

But, Barnes says, he doesn't expect to see a stampede of treasurers taking up hybrid capital. "The issue with hybrid capital is that no instrument is going to be precisely the same as another one. You're going to have to work very carefully with rating agencies to get the equity credit that you want and I personally don't see it as part of a general financing strategy.

"I think it would be event driven and one would want the event to tell the story to the buyers."

Communication will be vital to any issuer considering this option, there are some concerns in the markets that if a company is seeking to strengthen its balance sheet, either with a hybrid or equity instrument, it may be perceived as a sign of financial distress.

"It's important that issuers communicate to the market the reasons for introducing a hybrid capital layer into their balance sheet and to emphasise that there is a coherent reason behind the issue and that this type of security is expected to form part of a long-term funding strategy," says Vasan.

Treasurers will need all the options available in the coming years – hybrid capital simply provides another tool in their armoury.

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