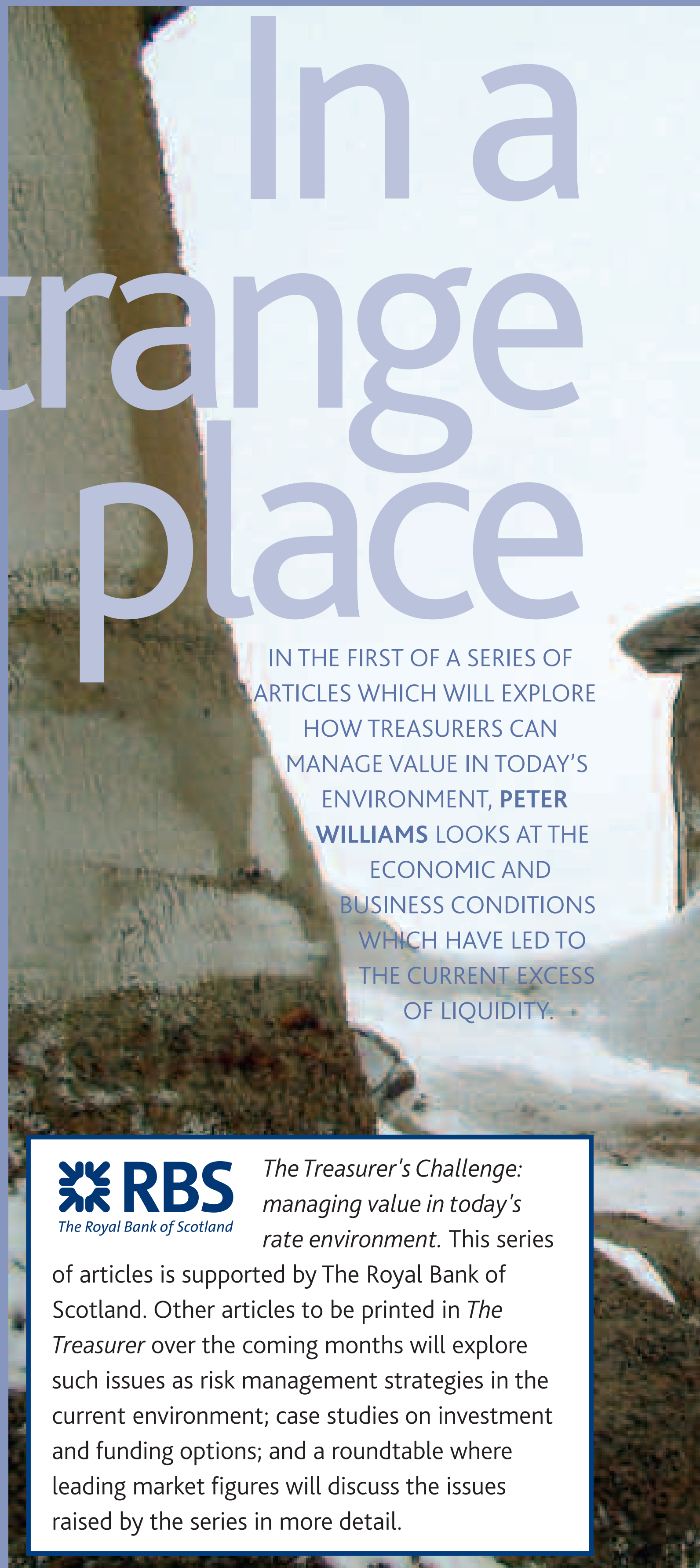

# In a strange place

IN THE FIRST OF A SERIES OF ARTICLES WHICH WILL EXPLORE HOW TREASURERS CAN MANAGE VALUE IN TODAY'S ENVIRONMENT, **PETER WILLIAMS** LOOKS AT THE ECONOMIC AND BUSINESS CONDITIONS WHICH HAVE LED TO THE CURRENT EXCESS OF LIQUIDITY.

Perhaps unkindly, one treasurer compares the current corporate lending scene to the Buy One Get One Free (Bogof) offers which have proliferated in supermarkets over the last few years. The treasurer's view is the only reason shops have Bogofs is that they have too much stock which they want to shift. And at the moment there is an over supply of money being offered by lenders to would-be borrowers. Over the last few years, the absolute level of interest rates has been falling and that has been mirrored in the bond market with credit spreads also being squeezed.

The interest rate picture differs across regions. Interest rates in the euro zone are certainly at historically low levels where base rates of 2% seem to have been unchanged for an eternity and the next move for the European Central Bank could actually be lower. UK interest rates at 4.75% are capping out. As for the US, interest rates have picked up from the 1% lows following September 11 and short-term rates have nudged up as the economy has shown signs of recovery. But you wouldn't label them as high. Treasurers cannot fail to have noticed that the environment is very liquid. For treasurers as borrowers – and the typical corporate is, historically at least, a borrower – the current market circumstances makes this a great time.

**FAVOURABLE TERMS** Banks are clamouring to lend and investors are keen to buy bonds. When treasurers do decide to borrow they can secure favourable terms and conditions. Covenants are not onerous, indeed some treasurers say they refuse to give covenants. Due to supply and demand, where bank facilities were typically locked in for five years treasurers can now negotiate a seven-year deal. Even so, these low prices don't appear to be tempting corporates.

One of the reasons for the low level of long rates is unusually weak demand for credit from the corporate sector. For instance, in the US corporate liquidity has increased sharply as sales increased while firms secured enormous productivity gains by cutting back investment spending and staffing levels. With internally generated funds on hand, the demand for credit declined sharply. Rising corporate deposits plus a low demand for credit are recipes for a low level of interest rates.[1]

Whatever the reasons, from a treasurer's perspective the current level of interest rates impact on the funding/borrowing and on the risk management approach. For some time treasurers have heard the message from banks that there has never been such a good time to borrow. Even so sentiment from the corporate sector suggests that there is no great appetite for raising more debt. Treasurers point out that on any new bond mandate there is a material amount of upfront costs, refinancing crystallises those expenses and treasurers at the moment don't see the need or feel they can't afford the transaction cost.

**RISK MANAGEMENT** Most companies are likely to have significant interest rate exposures linked either to debt positions or investment portfolios and should have risk management policies in place to help determine how these will be managed.

Currently there is potential for some rate volatility, particularly in the UK and US while the euro rate environment looks more benign. Historically the correlation between actual interest rates and forward implied rates has proved to be relatively low. Treasurers should therefore contemplate the risks they will run should the rates implied over the next few years not materialise and how this will affect the risk profile of their company. Such analysis will determine what hedging strategy they should consider if treasurers need to protect the level of

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## Executive summary

- At the moment there is an over supply of money being offered by lenders to would-be corporate borrowers.
- One reason for 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 that although may be low, may be subject to volatility.
- Treasurers should be reviewing whether they have the correct working capital management policies and balance sheet structure in place.
- It remains to be seen whether treasurers will rediscover an appetite for debt.

interest costs or investment returns. This is not about beating the market, it is about providing certainty. Banks are increasingly interested in adopting a more strategic and analytical approach for their customer's risk management issues be that for debt or investment portfolios. In addition they can assist clients understand and manage potential accounting issues as a result of IAS 39 *Financial Instruments: Recognition and Measurement*. This is becoming increasingly important as more corporates are looking to manage the real underlying economic risks and need to understand the potential effect of a strategy that will not attract hedge accounting in the new environment. In addition as more corporates become familiar and gain confidence under the new International Financial Reporting Standards (IFRS) regime the use of structured ideas to enhance income or reduce expense should become more prevalent. This will be especially true should the interest cycles become less pronounced.

**LENDERS' PERSPECTIVE** Banks are well aware of the forces that are impacting on their corporate customers' appetite for borrowing and hence on their lending portfolios. While headline inflation is low, inflationary pressures in terms of oil and commodity price rises are being absorbed by the corporate sector. The labour market is now global and the ending of local labour markets has kept a lid on wage inflation. The lack of wage inflation means corporates can't pass on commodity price increases to consumers and has led to goods price deflation over several years. Treasurers may not like to hear it, but from the banker's perspective one reason why they can't lend money is that corporates don't know what to do with it. Look at UK retail where capacity has increased dramatically but the consumer has fled – and at the moment they don't have the appetite for aggressive expansion – whether organic or though acquisition – so they don't need to borrow. In the short term it is hard to see that changing.

As well as the wider business issues, for corporates there is a further downside to this low interest rate environment. Treasurers have always ensured that their organisation secures the best interest rate on surplus funds. But with such a low level of interest rates, is it worth setting up complicated arrangements to move money across countries to earn a better rate of interest, if that rate is trivial? So should treasurers be more concerned with, for instance, managing trade debtors and trade creditors rather than chasing after a few more basis points?

On a more strategic level, treasurers need to be assessing whether they have the correct structure for their company's balance sheet. Is the debt/capital appropriate for the business? The current market conditions allow for a larger proportion of debt to capital and some corporates are taking advantage. We are seeing a substantial increase in the debt to earnings before interest tax deprecation and amortisation (EBITDA) ratio which lenders are prepared to stomach.

Those corporates gearing up are in the minority. Overall it is doubtful whether the low interest rate environment and the sluggish economic outlook will spur treasurers to raise further debt. The price of money will not trigger that, rather when such a move happens it will be the result of overall confidence levels in the economy.

*1 Long-term US interest rates– outlook and risks from RBS Group Economics, published March 2004.*

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**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) or** visit www.rbsmarkets.com.

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