And the storm rages

Executive summary

- On the first anniversary of what has been dubbed the biggest shock to the financial system since the 1930s, even the government appears to be losing faith in its assertion that Britain is well placed to withstand the impact of the credit crunch.

One year on from the onset of the credit crunch, there are suggestions that business is over the worst – mainly because the central banks stepped in to offset fears of financial meltdown. But it is also evident that there will be no swift return to the era of cheap and easily available credit.

Businesses have been warned to expect a prolonged period of sluggish growth at best, with an increasing possibility that this could turn into recession. Conditions in the housing market have deteriorated more sharply and swiftly than analysts expected, household budgets are being stretched by accelerating food and fuel prices, and a pick-up in inflation appears to have dashed hopes of further interest rate cuts from the Bank of England. Talk has instead turned to possible rate increases, despite the further damage this would inflict on businesses.

Much of the fallout has yet to be experienced. The jobs market proved surprisingly resilient last year, but total unemployment and the number of people claiming benefit are now moving upwards and large-scale redundancies appear inevitable in sectors such as financial, retail and construction. But as the Confederation of British Industry observed last month, the deepening economic gloom owes as much if not more to the sharp spike in oil prices, and the majority of companies have not been significantly affected by tighter credit conditions.

The recent *Managing in a Downturn* report from PricewaterhouseCoopers points out tougher economic conditions will challenge many of today's executives, who have built their careers through a period of continuous economic growth since the early 1990s. At the same time, many experienced managers will have been removed from the corporate scene by natural attrition.

Media reports indicate that the rising cost of essential household purchases has already led to consumers dipping into their savings to maintain their living standards, so cuts in spending may come sooner and be more severe than anticipated, PwC suggests. A consumer-led downturn means that the most important question for a business will be determining whether its customers regard its products or services as discretionary purchases, or if it is threatened as a supplier to other businesses in the discretionary sector.

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Companies must also address strategic questions such as:

- How flexible is their business model, and will it allow a quick reaction to any change in the business environment?
- What is the long-term financial position and how significant could a loss of revenue be?
- Even if the company's products are of a non-discretionary type, could customers choose cheaper options?
- What are competitors doing, and could customers choose a cheaper option?

ALREADY TESTING The first year of the crunch has already proved testing. So what have been the experiences of corporate treasurers

GRAHAM BUCK ASKS TREASURERS HOW THEIR COMPANY IS COPING WITH THE CREDIT CRUNCH.

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over what has been a traumatic 12 months? Were they affected by the sudden drying up of liquidity? Do they believe that the worst of the fallout is now behind us, or do they fear worse to come? If so, what do they view as being the worst case scenario?

The Treasurer has been canvassing views and also attitudes to regulation. Do the near-collapses of US investment bank Bear Stearns and UK mortgage bank Northern Rock indicate a need for the financial services sector to be more closely regulated?

We contacted treasurers from a number of companies, ranging from FTSE 100 blue-chips to smaller entities, and inevitably found that many of their treasurers declined to comment, citing reasons such as pressure of work. However, a significant number admitted that it was a sensitive time for their employer, which made them reluctant to air their personal opinion on the state of the credit market; in some cases they had been told by colleagues that it would not be helpful if the company's views on the effects of the crunch were to be aired publicly.

In a couple of cases, the company had managed to escape the impact of the crunch altogether. For example, risk management, reinsurance and consulting group Aon says it is in the middle of a five-year plan and hasn't needed to access credit since conditions in the market deteriorated.

The responses that we were able to secure and which are given here are very interesting, but inevitably come from companies that are well placed to weather the storm. It would be fascinating to hear from treasurers at the UK's housebuilding groups, for example, where projects are being mothballed and major job cuts reviewed, or some of the high-street chains that rely on consumers' discretionary income remaining healthy. They undoubtedly also have a story to tell, although it's unlikely to be a very encouraging one!

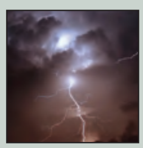
JUSTIN BESLEY, COMPASS GROUP:
"Compass has no significant refinancing requirements for 12 months or so, and a comfortable level of undrawn committed facilities, so we have not yet needed to test market liquidity. We are, however, likely to refinance well ahead of our debt maturities to ensure certainty of execution.

"We have been depositors of surplus sterling over the past year while completing our share buyback , so the spiking of sterling Libor rates has enhanced our investment returns. However, the general credit environment has caused us to review bank counterparty limits and credit default swaps more frequently.

"The group's credit ratios have improved significantly over the past 12 to 18 months, but our credit spreads have widened by over 150bp. My view is that this liquidity premium has probably peaked for investment-grade companies. Banks are in the process of strengthening their balance sheets; as this continues, confidence will return to the capital markets and spreads should ultimately tighten. It may be some time before they reach pre-crunch levels again, if indeed they do.

"The credit crunch has resulted from lenders making fundamentally bad credit decisions. Northern Rock compounded its ills by funding in a way that most corporate treasurers would not consider prudent. If taxpayers are to underwrite failing banks, then governments need to regulate to protect taxpayers.

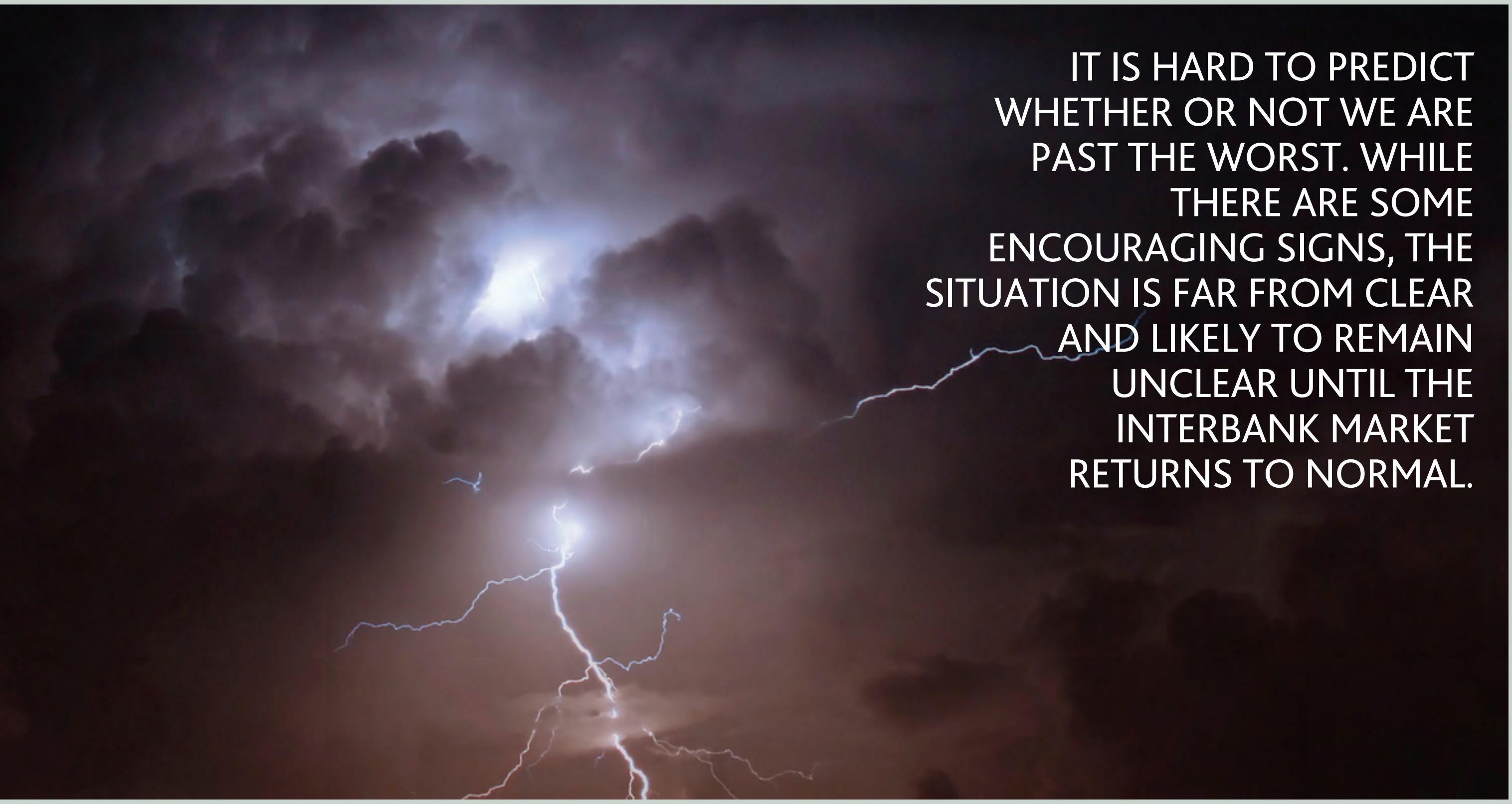
"However, if governments regulate the way banks fund themselves, shouldn't other corporates be regulated in the same way? My view is that they should not, and that businesses which pursue the higher rewards that come with taking greater risk should bear the consequences."



GERRY BACON, VODAFONE GROUP
"Margins have widened considerably in the last 12 months but what has really caused this? Returns should recompense any investor for the risk of losing their investment, represented as a credit spread over a risk-free bond. If 1% of loans, of a certain class, default over a given period but with a typical 40% recovery rate, then the margin should be 60bp, spread over the same given period.

"Clearly, the expected risk of certain financial institutions defaulting has risen due to Northern Rock and Bear Sterns, but maybe not as much as predicted by widening financial credit margins. For non-financial institutions we have also seen margins widening, even though many non-financials have spent the period since the dotcom boom deleveraging. Current margins are way above historical default rates, so if the true expectation of default for corporates has not changed why have spreads widened?

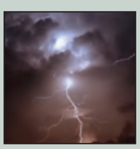
"In reality, what is happening is that credit is being priced according to lenders' liquidity rather than estimates for corporates' default risk. Many banks have depleted their capital base as a consequence of sub-prime and related write-downs. Those with stronger balance sheets are having to make choices about where to



deploy their capital and the lack of banks' supply is moving margins up. Link this to high credit costs for banks funding themselves and it means wider margins for all.

"Vodafone has seen its spreads widen and, other than a €1.25bn two-year bond issue in June 2008, has been able to avoid raising money in the bond markets since May 2007, having borrowed heavily in the US and European bond markets prior to that date.

"Further, we have been pleasantly surprised at the liquidity in commercial paper markets. As a prime 2 issuer we would expect markets to be a little tricky at present but the euro market has provided us with almost $4bn at a few basis points over Libor for periods of three months and more. The US commercial paper market is also open for reasonable size but at a higher cost and shorter periods."



TOM GREENE, SHIRE PHARMACEUTICALS

"The last year has seen a dramatic change in the financial markets. Shire is in the fortunate position of having refinanced its debt in the first half of 2007 and has not needed to go back to the markets.

"Access to capital remains key to Shire. With little early-stage research, our strategy is to supplement our product pipeline by in-licensing or acquiring assets and intellectual property.

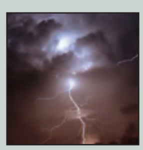
"It is therefore important to stay in touch with debt market developments. The reduction in liquidity and increased volatility in credit spreads means this takes considerably more time than in previous years when liquidity could, almost, be taken for granted.

"Cash management is also taking up significantly more time. We manage just under $1bn and have been impacted by falling yields as the Fed has cut rates in response to the liquidity crunch and by worsening counterparty credit quality.

"Most of our cash is in money market funds and bank deposits. Principal protection has always been key, but is receiving more focus with less reliance placed on funds' ratings. We conduct more frequent reviews of underlying holdings and regularly meet with managers to understand their investment policies.

"It is hard to predict whether or not we are past the worst. While there are some encouraging signs, the situation is far from clear and likely to remain unclear until the interbank market returns to normal. There is also the uncertainty about developments in the real economy. I expect the difficulties to continue into 2009. Even then, I do not anticipate returning to an era of cheap and easily available credit any time soon."

I EXPECT THE DIFFICULTIES TO CONTINUE INTO 2009. EVEN THEN, I DO NOT ANTICIPATE RETURNING TO AN ERA OF CHEAP AND EASILY-AVAILABLE CREDIT ANY TIME SOON.



DAVID BRENT, BAE SYSTEMS

"The credit crisis or crunch as it has become known first began to impact the BAE Systems treasury function last summer. At the time the company had a maturing term deposit with Northern Rock, Northern Rock's share price was £7 and its credit rating was low single A. In the intervening year much has happened but our company has been in the fortunate position of not needing to access either the bank market or the capital markets due to the twin impact of strong cash generation in recent years and a prudent financing strategy. I have therefore no first-hand funding experience to share. However, I can share with you the steps the treasury function took to protect the company's surplus cash as well as offer some personal opinions on where the crisis might be heading.

"For a number of years we have managed counterparty credit risk through limits based on credit ratings. The demise of Northern Rock and the problems in the banking sector generally led us to block all available limits with institutions rated at or below the then Northern Rock level.

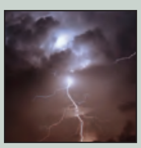
"In addition we ceased depositing with the pure investment banks whatever their rating. We shortened maturities, redeemed our investments in money market funds, began to actively monitor bank credit default swaps and generally moved up the credit curve. Mitigation of risk has taken priority over return generation.

"Where do I see the credit crisis heading? I feel that we are entering or have entered a second stage of a two-stage process. The first involved banks unwinding their structured vehicles, progressively writing down asset values (although there may be more to come), generally conserving capital and repairing their balance sheets, and reshaping their businesses to meet perceived priorities. Credit has been repriced in the capital markets and, although markets have been volatile, funding has been available for investment-grade credits. However, bank lending has been rationed and prioritised.

"In this second phase we will see what effect these decisions will have on the wider corporate community as well as on the individual. Banks are being more discerning. Anecdotally, I understand long-standing relationships are being terminated, financing terms and conditions being drawn more tightly, margins increasing and credit committees less predictable.

"In the slightly longer term there is the spectre of the leverage loan market and whether the loans of the last couple of years will be capable of being repaid from cashflow generation or refinanced. We are seeing certain sectors harder hit than others as banks and capital markets investors discriminate.

"How far this spreads is far from certain but conditions are unlikely to improve quickly."



MARY FINN, BURTON'S FOODS

"As Burton's Foods was sold in March 2007, the longer-term funding requirements for the business that were put in place at that time avoided the reduced credit supply when the credit market turmoil erupted in August 2007.

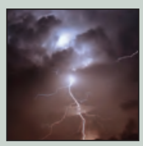
"Although a number of banks have already declared sizeable write-offs as a result of poor investment decisions in the US sub-prime, there are likely to be still some further reverberations to come. How big and how sustained they will be is difficult to forecast especially when the possible secondary shocks are taken into account.

"This has led to a general nervousness within the financial community, with a concern as to whether there are likely to be further declarations of write-downs as a result of these exposures. This has led to a lack of liquidity in the financial markets which in turn has resulted in Libor being well above UK base of 5%, as reflected in the current 12-month Libor rate of 6.44%. The banks' appetite for deposit taking is not only evident in the corporate sector but also on the high street.

"The impact of the credit crunch in the corporate sector really became apparent to me when I attended the ACT conference in Edinburgh at the end of April. During my networking discussions with a numbers of banks it became crystal clear which side of their balance sheet they were looking to develop and it was predominately about attracting deposits from corporates rather than lending. Historically, the converse has been the case.

"Is tighter regulation required in the financial services sector? I feel the answer has to be yes, without a doubt. Investments made by these organisations should take account of their role as custodians not just as profit generators. This sector is very important to the UK economy not only as a provider of financial services for corporates and individuals but as a provider of financial services worldwide. Confidence in this sector is crucial to the wealth and standing of the UK in the world and it is very important it is not reduced in any way."

IN THESE MARKETS I THINK THE WINNERS HAVE BEEN THOSE CORPORATES THAT UNDERTOOK SUBSTANTIAL REFINANCING AHEAD OF THE CREDIT DOWNTURN AND HAVE THEREFORE BEEN ABLE TO LIMIT THEIR NEED TO ACCESS DEBT MARKETS IN THE PAST YEAR.



JON DROWN, REXAM

"There has been a transformation in financial markets since last summer which I suspect has left no one in the corporate space completely untouched. The past year has been characterised by significant volatility, dramatically wider spreads and reduced access to liquidity across all debt markets.

"Debt is now being priced as a function of the liquidity of lenders as much as, if not more than, a function of corporate default risk, and margins have risen significantly across the board as lenders' balance sheets have weakened and market confidence has evaporated. In addition, the credit curve has steepened significantly with those corporates in the sub-investment-grade space now paying a relatively higher price for debt when compared with 12 months ago.

"In these markets I think the winners have been those corporates that undertook substantial refinancing ahead of the credit downturn and have therefore been able to limit their need to access debt markets in the past year. Additionally, lenders are increasingly focused on relationship strength when deciding how to allocate their capital, with those corporates who have strong longstanding relationships clearly ahead in the queue for available liquidity.

"Looking forward, it is difficult to see what is going to trigger a significant improvement in debt market conditions in the near term. Certainly, it would be a brave individual who would predict when we will return to market conditions comparable to those seen in the first half of 2007. I suspect that liquidity will be uppermost in treasurers' minds and refinancing will tend to be done further ahead of time as visibility of future market conditions is so poor."

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