Diversify or die

Back in the relatively trouble-free days of summer 2007, this magazine carried a piece on mid-cap corporates by Citi's Sean Hanafin, who observed: "The financing strategies of UK mid-sized corporates are set to change dramatically over the next 18-24 months." His message was that it would be prudent for mid-sized corporates to diversify their funding sources ahead of the credit cycle turning.

A year and a half later, his recommendation to diversify has been more than validated by events. As the economic downturn wreaks havoc on the earnings of companies across most sectors, some banks have acted to reassure business customers that they are committed to helping them survive testing times.

But not all banks have offered such words of comfort. With growing evidence to suggest that no improvement can be expected until well into next year, the question "Are you core?" is becoming increasingly relevant to treasurers, particularly those of smaller businesses.

Since the onset of the credit crunch, companies have been forced to reconsider the relationship they maintain with their banks. The latter have become selective in their lending policies, examining each company's credit ratings more closely than before and the potential returns offered by each business client. Some firms that would have been welcomed a couple of years ago are finding that the banks are far less accommodating as the recession tightens its grip.

In other words, is there the prospect of a prolonged recession resulting in banks unceremoniously dumping those business clients that aren't supported by a strong balance sheet? Could some companies find themselves homeless in a financial sense as ties are cut?

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Executive summary

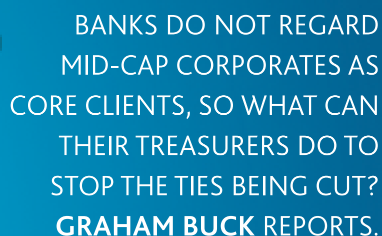
- **Banking relationships for mid-cap corporates may prove difficult during the downturn. With the availability of credit being the very life blood of existence for some, banks are likely to leverage this to secure ancillary banking business.**

SUPPORT MECHANISMS Some banks have offered reassurance to assuage fears that they might abandon their less important clients during the downturn. Lloyds TSB, for example, has been actively promoting its charter for small businesses and has pledged to help them survive challenging times. And NatWest/RBS announced in December that it was setting up a dedicated Business Lifeline freephone service that would be manned by a team of specialist business bankers with experience of working in various types of enterprise; the group also issued a "Trading Through the Economic Downturn" guide for its business clients with advice on topics such as managing cashflow, dealing with bad debts and managing risk.

Welcome as these developments are, it has been suggested that some treasurers have been slow to recognise the full repercussions of the credit crisis or its likely duration. As one banker observes, when the crunch began to manifest itself, companies were urged to refinance right away but most "were in a state of denial" or assumed that the disruption to the market would prove relatively short-lived.

Only a small number took the advice. AstraZeneca, for example, braved the debt capital market in September 2007 shortly after investor sentiment had turned.

A structural change has since been at work, as subsequent months provided mounting evidence that banks were not pricing debt appropriately, with interest rates failing to accurately reflect the risk or deliver an appropriate return. Now that the pool has become



BANKS DO NOT REGARD MID-CAP CORPORATES AS CORE CLIENTS, SO WHAT CAN THEIR TREASURERS DO TO STOP THE TIES BEING CUT? **GRAHAM BUCK** REPORTS.

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CHALLENGING TIMES For companies outside the FTSE 100, the challenge is even greater. "It's not so much that the bank market has contracted by 20% but that each company will now be considered on a case by case basis," says one banker. "The general trend is that the smaller the company and the less international and diversified it is, the less attractive proposition it presents to any bank."

It has been recognised for some time that smaller companies also have very limited alternative financing strategies. There is a real danger that some could be stranded financially where they have a less than strong relationship with their bank, a possibility that has been raised by François Masquelier, head of treasury at RTL Group and chairman of the European Associations of Corporate Treasurers.

"More and more, bank relationships are an issue and something you should manage carefully," he says. "Committed facilities are one thing, but it's never guaranteed. Some banks could transfer their risk to other banks."

Masquelier also says that banks are becoming more selective about their borrowers, and paying more attention to credit ratings as well as the returns on offer.

While more than four in five of the FTSE 100's blue chips are publicly rated and so can access debt from a variety of markets, no more than 15% of the FTSE 250's member companies hold a rating; as a result, the supply of debt capital to the FTSE 250 sector is largely the province of the banks. Hence the government's recent commitment via the taxpayer to guarantee bank lending to small and medium-size enterprises (SMEs). From the banks' perspective, these smaller clients still represent less attractive propositions because they are less likely to issue debt.

The options for these smaller companies are further limited if they lack knowledge or experience of the capital markets. This could, of course, provide the opportunity for younger treasury professionals with capital markets experience to step up to the role of treasurer if they can show themselves to be more knowledgeable about debt capital and equity markets than their more senior colleagues.

A POSITIVE ROLE FOR TREASURERS A positive aspect is that the role of treasurer is set to become more interesting and demanding, as the banks no longer prove sufficient and companies are obliged to access alternative forms of debt.

This will include SMEs taking advantage of windows of opportunity that may present themselves in the private placement market where there is not the same requirement for a company to be rated and its investors are usually there for the long term. The main downside is that private lenders are also more likely to demand their pound of flesh in situations such as covenant amendments than are the banks, which tend to take a more relationship-based approach. Companies taking the private placement route must also be careful to pitch their covenant thresholds at the right level.

So what do treasurers themselves think should form the basis of maintaining a good banking relationship during a downturn?

Andy Longden, executive vice president for treasury and corporate finance at Royal Dutch Shell, says that any good procurement strategy will review the issues of costs versus value at risk (in other words, how much the company is paying versus the value of the services being provided) and supplier vulnerability (how strong the supplier is and how the company would manage without it).

Treasurers should regularly carry out such an analysis to ensure they are comfortable with their supplier decisions. The findings may well influence the company not to choose the cheapest supplier, even though it is an outcome that some tendering processes may be biased towards.

"I don't think treasurers who have ruthlessly commoditised their banking services in a banking boom market, cutting costs to the bone, should be surprised to hear some bad news from bankers when these contracts come up for renewal," says Longden. "And in the meantime they may not get great service either."

Longden also believes that the current challenging environment raises the question of one-stop shopping – where, for example, global cash management is mandated to a single bank – which could prove excessively risky.

"What really would happen if – maybe even when – a global money transmission bank fails, carrying 100% of a company's cashflows?" he asks. "Could we afford what at best would be massive disruption? At worst there could be huge intra-day, multi-jurisdictional and legal entity exposures."

The availability of credit is also an essential element in a corporate treasurer's thinking, with some banks likely to leverage a lending

Every little helps

Even some FTSE 100 stalwarts, which typically use a mix of core and support banks, use fewer than before the credit crunch.

Tesco's group treasurer, Nick Mourant, says the supermarket giant's current relationships strategy goes back to 2005, when it compiled a £1.75bn revolving credit facility in which 15 banks participated.

The selection process involved rating potential names based on four criteria: geographic spread, credit quality, product specialisations and the strength of their existing relationship with Tesco.

Tesco wanted to extend the facility in 2007, and reduced the group of 15 to 13, but when an additional facility was put in last year Tesco looked again at extending the number. However, the total has remained at 13 – eight core banks and five in support (at the outset there were five core and 10 support banks).

"It's evident that, following the crunch, banks are very much looking to have a reasonable share of the corporate wallet plus any add-on business that is available," says Mourant. "We had expected our group of relationship banks to expand, but as a result of the crunch it has actually contracted. We are, though, still comfortable with the lower figure."

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facility to secure ancillary banking business. Longden says that for corporates, the availability of credit can be "the very lifeblood of their existence", so it is an absolutely critical issue and one that is likely to dominate relationship discussions. Treasurers, for their part, need to understand that the cost of capital has dramatically increased – a development that has to be factored into operational and investment decisions.

Andrew Griffith, director of treasury and M&A for Sage Group, believes that treasurers should focus ancillary business on lending banks, as well as communicating with the banks to keep them informed of business strategy so they have a view on where the relationship may be going.

"If businesses have services they require from banks which they are willing to pay for, then there will always be banks after such business," Griffith adds. "On the lending side, things are more difficult, but I think if companies can sit tight for this year, things will get better. Even this year, funding is available but it is the cost which is an issue."

NEXT STEPS With no great evidence as yet that government efforts to get the banks lending again has succeeded, diversifying the company's funding sources has risen to top priority. So treasurers need to deepen their knowledge of alternative funding sources, such as the capital markets, and to establish a funding strategy plan. This needs to gain the approval and the backing of the CFO before execution.

The next stage may well involve approaching the ratings agencies, provided that there is an awareness of what they will be seeking, and discussions with both the banks and potential investors, before the company taps the markets.

But companies seeking to obtain a rating would be well advised to hold off until 2010, despite the likelihood of little or no improvement in the business outlook. Even if the recovery proves more L-shaped than U or V-shaped, a strategy needs to be carefully put together rather than constructed in haste.

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Green shoots?

Somewhat overshadowed by all the news of bonuses and boardroom departures last month was the announcement that Royal Bank of Scotland, NatWest and Ulster Bank are to make an extra £3bn of funding available to SMEs across the UK in the form of 12 funds of £250m each that will be locally distributed by regional managing directors.

RBS UK chief executive Alan Dickinson says that the funds are designed "to give business customers the further confidence to focus on running their businesses rather than having to worry about their finances".

In addition to providing traditional debt finance, the funds are designed to allow businesses to postpone their capital repayments, to invoice finance products with optional bad debt protection, to release cash through using the assets owned by the business and to provide short-term trade finance to maintain imports and exports.