Running just to stay still

PETER WILLIAMS REPORTS ON THE ACT'S CORPORATE FUNDING CONFERENCE.

James Douglas, Debt Advisory Partner at Deloitte, looked back to the summer of 2007 to see what had happened and why (see his longer article below).

Ian Weldon, Group Treasury and Tax Director of FirstGroup, told the conference that his group's overall financing strategy was to maintain financial strength and deliver shareholder value, and funding had to be kept flexible to stay with that.

To set a funding strategy, he said, treasurers had to look at issues such as whether the business and financial profile was stable, and be aware of external factors such as the macro economic outlook weakening and the response of the bank sector. Weldon said corporates had to take account of the present fragile state of the bond market, assess all possible funding sources, including possible bank finance – syndicate versus bilateral – and be aware of the banks' strategies in terms of the geography/industry/sector which they want to focus on.

Richard Bartlett, Head of Corporate Debt Capital Markets at RBS Global Banking and Markets, looked at how the markets had remained resilient despite the turbulence. He warned that spreads were likely to remain at their current levels for the foreseeable future and highlighted the changing investor base in today's markets and the issues that were important for them. Sales techniques which had worked prior to the credit crunch would not work at the moment; roadshows should be to update investors, not to discuss specific deals because the execution risk was just too great. Treasurers should also look at the alternative markets: private placement, hybrids, puttable callable reset bonds and raising funds in local markets such as the Swiss franc.

A banking industry perspective was offered by Clare Dawson, of the Loan Market Association, who said that credit committees would continue to have more clout and that credit, quality, relationship and structure would all be important. Corporates should expect to see smaller deal sizes than has become the norm with greater focus on transfer flexibility.

JAMES DOUGLAS LOOKS AT THE CHALLENGES FACING TREASURERS FROM THE CREDIT CRUNCH.

According to the latest Deloitte quarterly business confidence survey, 87% of chief financial officers surveyed thought that credit market events would have negative implications for their businesses. All agreed that the UK economy would be adversely affected by the credit crunch.

The question for treasurers is how to deal with the resulting challenges. What is clear is that whereas in the recent past a downturn in trading could be dealt with by tapping the debt markets for extra liquidity, that option is now ever more difficult and complex.

THE CREDIT CRUNCH The first sign of the impending credit crisis was the implosion of two Bear Stearns' hedge funds in early summer 2007 following the bursting of the US housing bubble and the rapidly increasing pace of sub-prime mortgage defaults. Mortgages had previously been provided to higher-risk borrowers at low initial teaser rates with a subsequent step up in borrowing costs. Through securitisation, the risk and rewards of these mortgages were passed onto institutional investors by way of collateralised debt obligations (CDOs[1]) and structured investment vehicles (SIVs[2]).

Current estimates of the default rates on the paper issued by SIVs during 2006 and 2007 are being revised upwards on an almost daily basis, with Moody's warning that losses on these supposedly investment-grade assets could reach 30%. The fear of these losses, and who they would hit, rippled through the financial markets like a tidal wave. The resulting loss of confidence led to an astonishing breakdown of the inter-bank market, as supposedly well-capitalised AA-rated banks were simply not prepared to lend to one another.

One of the most important indicators of the debt market's risk appetite, the iTraxx Crossover Index, which measures the credit spreads of European high-yield companies, is now trading at all-time highs. Specific concerns over further sub-prime losses, monolines, credit default swap counterparties, sovereign wealth funds, leveraged buy-outs and even corporate cash holdings should be at the forefront of treasurers' minds (see *Figures 1* and *2*).

Executive summary

- Funding is still there for the right proposition at the right price. That was the clear conclusion of the ACT Corporate Funding Conference, sponsored by RBS, and held in London at the end of January.

MONOLINES The credit crunch has now hit monoline insurers such as MBIA, Ambac, SCA and FGIC, with MBIA the only one to have sustained its AAA rating from all three rating agencies. But the monolines are not the only ones fighting hard to avoid further downgrades of the insurers; Goldman Sachs estimates that the total counterparty exposure of credit derivatives written by monolines runs into tens of billions of dollars, which would give investment and commercial banks further significant problems.

SOVEREIGN WEALTH FUNDS Once derided by western financiers for their ambiguity and lack of transparency, sovereign wealth funds have recently stepped in to provide crucial capital to sub-prime-exposed banks. Despite their stabilising role, there is increasing speculation that this option may be losing viability. In China the sovereign wealth funds which invested directly in the Blackstone IPO have come under increased pressure to stop providing "dumb money" to cash-strapped Western banks.

LEVERAGED BUY-OUTS Before the credit market turned sour, a favourite game was to guess which would be the next big leveraged buy-out. These days speculation is more likely to surround when the first buy-out blow-up could happen. Pricing in the secondary loan market has already factored in recession-level default rates, far above the current historical low rate. But despite the number of distressed investors currently in the market there is as yet little sign of them entering and providing a floor to the market.

CORPORATE CASH HOLDINGS The impact of the credit crunch continues to spread beyond the financial sector. Pharmaceutical company Bristol-Myers reported a fourth-quarter loss from the impairment of investments of $275m, equivalent to 5% of revenue in the fourth quarter. Like many cash-rich companies, Bristol-Myers invested some of its surplus cash in triple-A rated marketable securities to achieve a better yield than simply putting the cash on deposit. The company had $811m of such securities at the end of 2007 but was unable to sell some of them due to liquidity issues in the market. The company is "now moving to a safer interpretation of what triple-A means", a statement that neatly captures two of the key underlying issues: bond insurance provided by monoline insurers

Figure 1: Volatility in cost of protecting against defaults

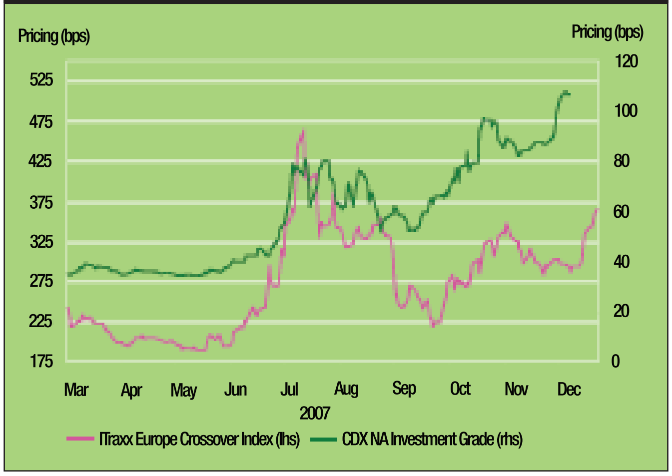
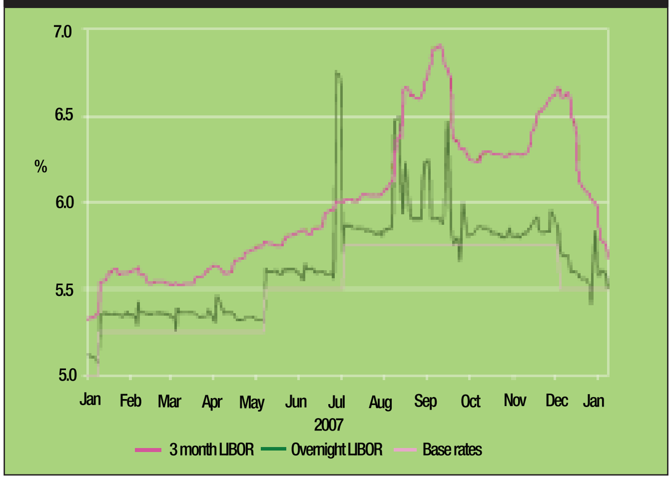


Figure 2: Dislocation in the inter-bank market



which may now default, and structured finance ratings based on apparently flawed analysis.

CENTRAL BANK REACTIONS The US Federal Reserve is looking increasingly active. Having cut the fed funds rate by 75bp in between scheduled meetings, Fed boss Ben Bernanke promptly cut rates by an additional 50bp the following week and announced $150bn of fiscal stimulus to try to pull the US economy from the brink of recession.

WHERE TO NOW? The crisis has emerged as a result of mis-pricing of debt imprudently lent, but with US and Europe consumer confidence falling and further losses likely to be announced by banks and insurance companies, the credit woes look far from over.

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[1] *CDOs are a securitised pool of diversified debt assets ranging from sub-prime mortgages to leveraged loans.*

[2] *An SIV is an investment company that generates returns through yield-curve arbitrage, effectively purchasing highly rated asset-backed securities with lower-cost short-term senior debt instruments such as commercial paper; the credit crunch has forced SIVs to liquidate their investments to meet their debt redemptions.*