Changing financial strategies

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In the second of a short series of articles, RBS's Financing and Risk Solutions team reviews themes and trends in financing and corporate capital structure and looks at how financing structures are adapting to reflect new market conditions.

ANDREW WALKER, **SANJEEV KUMAR** AND **SASHA RYAZANTSEV** LOOK AT HOW THE CAPITAL MARKETS HAVE CHANGED.

Private equity (PE) fundraising increased every year between 2002 and 2007 and exceeded $100bn in 2006. This, and the availability of cheap credit, has provided significant capacity for PE, which has consequently played an active role in the M&A markets over the last few years. In fact, seven of the eight largest leveraged buy-out (LBO) transactions occurred during the 18 months preceding the credit crunch of August 2007. Since August, however, the leveraged markets have become more challenging, especially for larger transactions exceeding €1.0-€2.0bn. The fact that leveraged loans are trading well below par in the secondary market means that banks are finding it difficult to underwrite large primary transactions. At the same time, the mezzanine market appears less constrained given the increased returns available to mezzanine investors after a long period of margin compression driven by oversupply of senior debt.

In these conditions the quality of the asset and rationale for the transaction become more important than ever. For example, KKR's recent abandoned bid for Harman International Industries left the private equity firm with a $400m position in Harman's convertible bonds, which are deeply out of the money. On the other hand, the $120 per share bid looks expensive with the benefit of hindsight and the shares are now trading at $40. While some, like KKR, are fortunate enough to walk away from an expensive deal, there are still transactions which have strong rationale. These, as a rule, now require a significant increase in the equity contribution and/or vendor financing to support the deal structure.

HOW ARE CORPORATE FINANCING STRUCTURES ADAPTING TO NEW MARKET CONDITIONS?

(i) Maximising the value of disposals One of the consequences of the PE decline is the fall in the value of both traded assets (e.g. those with PE premia in the share price) and the assets held by industrial players which they may be willing to dispose of. Previously, corporates saw PE as an important source of liquidity when seeking to dispose of their non-core assets. Now, with the PE route less achievable, corporates may find that their strategic objectives are less easily achieved. There are, however, ways to deal with the withdrawal of PE when making disposals and we have seen a number of examples of how corporates can maximise the value of disposals in the new market conditions.

The Home Depot example shows that corporate sellers can enhance the structure by providing a degree of ongoing support to the asset sold. Home Depot initially agreed a sale of HD Supply to the Bain/Carlyle/Clayton consortium for $10.3bn in June 2007. The disposal was not conditional on financing, so when the consortium realised that the deal could not be financed on the initial terms, it was faced with either increasing equity to cover the debt shortfall or paying a $300m break-up fee to Home Depot. Home Depot, on the other hand, would have to retain an asset which does not fit within its corporate strategy.

To make the deal happen, the consortium and Home Depot amended the terms. The enterprise value of HD Supply was reduced to $8.5bn, and Home Depot agreed to invest $325m in a 12.5% equity stake in HD Supply (which, with associated expenses, reduced cash proceeds to around $7.9bn). Home Depot also guaranteed a $1bn senior secured loan of HD Supply, while the PE firms increased their equity contribution by $150m each from the original level. As a result, the amount of equity rose from $2.15bn to $2.6bn and debt fell from S$8.15bn to $5.9bn. In terms of debt/EBITDA, the opening leverage fell from 6.8x to 4.9x. Home Depot's presence in the financing made the deal do-able and maximised value in current conditions.

(ii) Benefiting from asset price correction and exploring partnerships with PE There are signs that corporates are rethinking their M&A

THE QUESTION THAT CORPORATES HAVE TO ANSWER IS: WHAT SHOULD BE THE APPROPRIATE BALANCE BETWEEN COST, RISK AND FLEXIBILITY WHEN DETERMINING THE OPTIMAL MATURITY PROFILE?

activity in the belief that they may be able to achieve better value. On 2 September, *The Financial Times* quoted Lufthansa's Chief Financial Officer Stephan Gemkow as saying that the German carrier may be interested again to make acquisitions as asset prices are "again starting to reflect strategic considerations and operating performance". He added: "From what we hear, it's practically impossible for private equity to finance anything over €1bn." This mood was mirrored by Douglas Caster, Chief Executive Officer of Ultra Electronics, a FTSE 250 defence equipment manufacturer. Ultra has been looking at acquisition opportunities, but in the past found it difficult to compete with PE players. Now Caster believes: "There are signs that PE is not as interested in fresh acquisitions as before, and as a result I would hope to see more reasonable multiples for acquisitions."

These examples demonstrate that while some corporates find new market conditions threatening, others are prepared to actively explore them to their advantage. On top of this, some corporates believe that acquisition premia have come down given the reduced affordability for PE and that the probability of a successful deal for corporates has increased.

Another issue that often holds corporates back is that targets are not always a perfect fit. Many acquisitions therefore are dependent on successful disposals of non-core assets of the target, and PE has historically provided an important source of liquidity and price tension for such disposals. Clearly, with PE players' capacity reducing, corporates find that they may have to participate in financing to enable the sponsor to participate in the transaction.

(iii) Achieving strategic objectives by accessing alternative sources of liquidity At a time when traditional PE activity has fallen, large quasi-government Middle East and Asian investors can use this situation to their advantage and continue to complete deals. For example, according to *The Economist* magazine, sovereign wealth funds have spent $69bn on recapitalising the world's largest financial institutions. Both corporates and financial institutions can benefit from the liquidity available in the Middle East and Asia by attracting a strategic investor from the region to participate as an equity partner in acquisitions and/or investments. We have seen examples of this in Dubai World's strategic investment in MGM Mirage; and a number of investments by sovereign wealth funds in the world's largest financial institutions, including $21bn in Citigroup and Merrill Lynch in January. The presence of Dubai World in MGM supported the share price and secured funding for a joint venture project. For the banks, the equity investment supported the banks' balance sheets following the announcements of write-downs, and when an equity placing or rights issue in the market would be extremely challenging. On the other hand, the sovereign wealth funds are also facing a potential backlash from national governments and public opinion and it will be interesting to see if a sovereign wealth fund would be allowed to participate in any "rescue" of SocGen.

While the above examples demonstrate how corporates can benefit from strategic investment by Middle East and Asian sponsors, the Nasdaq bid for OMX provides an example of a corporate accessing this source of liquidity to help it implement its corporate strategy of European acquisitions. Nasdaq agreed to transfer its 28% stake in LSE to Borse Dubai in exchange for a 20% stake in Nasdaq itself and Borse Dubai's stake in OMX. This deal creates a strategic alliance between the US exchange and Borse Dubai, which will now be rebranded as a Nasdaq operation and will seek to apply Nasdaq's trading platform to its market. The investment is strategic for Dubai as it enhances its position as a major financial market in the region. It also provides Nasdaq access to Dubai's considerable financial resources.

HOW CORPORATES' VIEW OF THE OPTIMAL CAPITAL STRUCTURE IS BEING INFLUENCED BY NEW MARKET CONDITIONS

(i) Alter maturity profile in order to minimise dependence on market provision of liquidity As a general rule, the maturity profile of core debt should be driven by matching the assets and liabilities of the issuer, as well as refinancing risk and cost of funding. In the last few years, issuers' focus has shifted towards the latter, which led to shorter average maturities designed to achieve a cheaper cost of funding. This has led to some corporates (and indeed financial institutions) becoming very dependent on the commercial paper (CP) market. There are also a number of examples of corporates financing jumbo transactions via short-term bridge facilities, which now need to be refinanced at much higher rates.

The overreliance on CP and other short-term sources of financing, such as bilateral loans and short-term bridge facilities, has created an imbalance between the assets and liabilities of some issuers. When demand for CP dried up, many faced liquidity concerns and had to draw on their bank lines instead, putting bank liquidity under more pressure.

As a result, many corporates have sat on their credit lines in the last few months, refusing to enter the debt capital markets at much

higher spreads compared with pre-July levels. Many, however, are coming under more pressure to term out their short-term and bridge facilities and raise longer-term debt financing. Going forward, we may see a higher supply of new issues leading to continued price volatility, but corporates willing to raise funds should be able to find windows of opportunity to issue in the current market, albeit at a higher cost, as evidenced by HeidelbergCement's January 2008 bond issue.

Clearly, the question that corporates have to answer is: what should be the appropriate balance between cost, risk and flexibility when determining the optimal maturity profile? This would typically include matching the maturity profile with the profile of underlying assets/cash flows and considering the optimal risk reward balance between the cost of funding, due to both interest rates and credit spreads, and the refinancing risk.

(ii) Improve balance sheet efficiency Good macro-economic conditions and absence of large shocks since 2001 have resulted in relatively low corporate debt levels. Some corporates prefer to maintain conservative financial policies, but there has been a trend towards more active balance sheet management. For example, one of the few remaining corporate AAA issuers until recently, Nestlé, chose to change its financial policy in the middle of the credit market turmoil and give up its AAA status.

The most common reasons for corporates choosing to lever up are to increase shareholder value derived from tax shields associated with debt financing and to avoid the threat of shareholder activism and PE. While the threat of PE may have diminished, we continue to see some shareholder activism. For example, Knight Vinke's call for a review of HSBC's bank activities and management structure, and Colony and Bernard Arnault's successful pressure on Carrefour to change its capital structure and to release value from the company's property portfolio.

However, there are a number of considerations for treasurers and CFOs looking at balance sheet efficiency, including:

- **Capital structure**. Treasurers and CFOs will be asking themselves whether current market conditions are likely to persist, leading to higher cost of funding within a generally weaker economic environment. Should this be the case, is the capital structure that was appropriate in July 2007 still the right one for the new market conditions? With equity markets experiencing a period of weakness and falling interest rates, some of the corporate pension funds which have been relatively well funded in the past may now show larger deficits, potentially reducing the company's financial flexibility.
- **Liquidity**. Even if it is believed that the optimal capital structure view that drove the share buyback decision before July/August was right, the corporate may have debt maturities in the near term and other funding requirements originally anticipated to be refinanced in the debt capital markets. These may now have to be accommodated within the company's own sources of liquidity, such as cash and bank lines. Larger share buyback programmes were expected to be financed in the debt markets, which may be less available or more expensive to the company.
- **Acquisitions**. With PE finding it difficult to fund transactions of larger than €1.0bn-€2.0bn, at least in the short term, and depressed valuations for certain assets, corporates have a window of opportunity to revisit acquisition ideas. Treasurers and CFOs may be looking at these acquisition opportunities as an alternative use of cash previously earmarked for share buybacks.
- **Share price**. It would arguably make more sense to complete share buybacks at lower prices after stock markets undergo a correction.

We may still see cash-rich corporates taking a long-term view on their capital structure and embarking on share buyback programmes. However, those with reduced liquidity or potential acquisition opportunities may prefer to wait for capital markets to improve.

STRATEGIC BENEFITS Changing market conditions since 2007 have pushed corporates to review how the optimal funding strategies and the choice of financing structures available to issuers are evolving. While markets as a whole have been faced with severe liquidity constraints, some issuers, such as cash-rich corporates and certain financial sponsors, especially from the Middle East and Asia, are able to reap strategic benefits from their strong liquidity positions. For some, this involves boosting their share price with share buybacks or earnings per share-accretive acquisitions at attractive valuations. Others have found ways to provide liquidity to the buyers of their non-core assets.

As well as liquidity constraints and the implications of getting deals financed, there is the question of the cost of funding. This cost can be improved by a corporate or a financial sponsor willing to provide liquidity to its subsidiaries or associated companies, which otherwise would find it difficult to raise the necessary quantum of funding at an attractive cost.

It is clear, though, that whatever the market conditions, market participants will continue to seek alternative sources of funding that can help them achieve an optimal structure in terms of cost, risk and flexibility, and further fulfil their strategic objectives.

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