India calling

VODAFONE ESSAR TREASURER **IAN LOCKE** EXPLAINS THE WORK AND THE CHALLENGES OF THE TREASURY DEPARTMENT OF VODAFONE'S INDIAN BUSINESS.

Executive summary

- Vodafone Group has a centralised treasury that handles all funding, liquidity and financial risk management for the group, with a non-recourse concept where, depending on local requirements, risks and financial markets, a greater proportion of treasury activity is undertaken locally. This concept applies to operating companies in India, Egypt, Turkey and Albania and, for India, means that all operating company debt is raised locally and supported by the business with no explicit support from the shareholders. Surplus cash is not repatriated to the UK other than by way of shareholder distributions. Any hedging is direct with bank counterparties. This was not new to the Indian treasury team, but a longer-term approach to treasury management compared to the previous majority shareholder was.

As Treasurer of Vodafone Essar for 12 to 15 months, my objectives include refinancing and raising new debt, improving cash management, implementing shareholder-friendly treasury policies and developing a self-sufficient treasury team that will allow the group's involvement to be reduced.

FUNDING Vodafone inherited $2bn of debt on its acquisition of Hutchison Essar earlier this year, with $1.4bn at the operating company level. With acceleration in the rate of network rollout (capital expenditure in year one in excess of $2.0bn), debt is forecast to peak at a much higher level by March 2009. Three significant areas needed to be addressed:

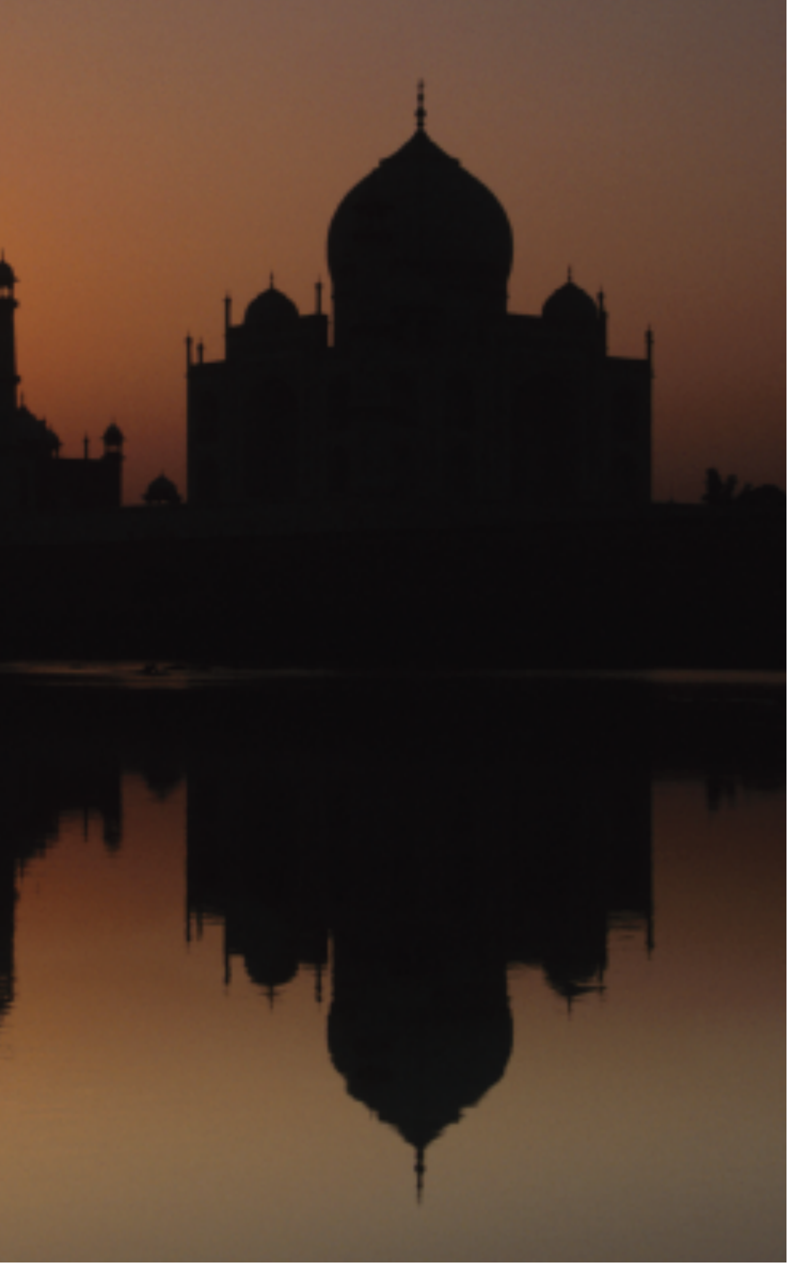
- exiting a corporate debt restructuring arrangement;
- optimising the split of onshore and offshore debt; and
- documentation.

In 2003, one of Vodafone Essar's subsidiaries' debt had been restructured, with the lenders granting a moratorium on interest payments, and rebased but increasing interest rates matching the expected improvement in business performance. In return, lenders were given enhanced rights on default and a minority of seats on the board. Negotiations for exiting the corporate debt restructuring arrangement, including structuring replacement facilities, had commenced well before Vodafone became involved but it was still possible to redirect aspects to ensure exiting lenders were acknowledged for their support and patience, while new facilities reflected that the Indian business was worthy of corporate credit financing rather than project financing.

Regulations issued by the Reserve Bank of India required the corporate restructure debt to be refinanced onshore. The Reserve Bank of India restricts the end-use of offshore debt (external corporate borrowings) to imported capital expenditure or refinancing of existing offshore debt. All external corporate borrowings must be approved by the Reserve Bank of India and, to be granted automatic approval, there are further rules about the size (up to $500m), tenor (at least five years) and interest margin (250bp maximum). Any exceptions must be specifically approved by the Reserve Bank of India through an approval route.

End-use restrictions were tightened in August 2007 to require that funds be parked offshore and never remitted to India. Corporates throughout India will generally prefer to raise funds through external corporate borrowings due in part to significantly lower interest rates (three-month Libor rates are well below onshore short-term rupee rates), even after hedging costs and grossing up for withholding taxes.

Onshore debt has its own rules. Banks are restricted in how much of their balance sheet they can lend to an individual company or group of companies, depending on industry. For Vodafone Essar, this is 20% per company or 50% for the group (the company's Indian group is formed of eight operating companies). Restrictions also exist on the value of total unsecured lending that a bank can commit across all clients. There are a lot of banks in India, but many are regional and have small balance sheets. It is therefore likely that funding will be from a larger number of banks than would be the case in Europe.



THERE IS ONLY LIMITED USE OF ELECTRONIC BANKING; NOTIONAL CASH POOLING IS NOT PERMITTED; INTRAGROUP LENDING (OTHER THAN FROM PARENT TO SUBSIDIARY) CAN HAVE NEGATIVE TAX CONSEQUENCES; AND NO SIGNIFICANT INTEREST IS PAID ON BANK ACCOUNT BALANCES.

Over the last few years Vodafone Group has been consolidating its debt in the centre and on standard documentation, but it was clear early on that India's existing documentation was not of the same quality. Understanding that there are strong market norms, attention was focused on key areas most at odds with Vodafone's standards in order to reach an agreed mid-point for new facilities.

As Vodafone Essar was now a corporate credit, specific limits on the total amount of debt have been removed or watered down; covenants look at debt/EBITDA and interest cover rather than tangible net worth and debt/equity; prepayment break costs are based on economic costs rather than a fixed percentage penalty charge; and the business now has more flexibility to grow under the direction of its own management team rather than the banks'.

CASH MANAGEMENT Vodafone Essar has active operations in 16 of the 23 geographic licence areas (circles) and has network rollout plans for the remaining seven. There are more than 700 bank accounts across 50 (mainly regional) banks. There is only limited use of electronic banking in the group; notional cash pooling is not permitted; intragroup lending (other than from parent to subsidiary) can have negative tax consequences; and no significant interest is paid on bank account balances.

Circle-level management's focus had been on running the operations and not managing the cash efficiently, so idle cash balances were significant. Even if surplus cash could be identified in a timely manner and then consolidated in a few places, bank deposits are regulated to a minimum duration of seven days and there are few alternatives yielding a reasonable return with greater liquidity. Coupled with relatively poor (if improving) short-term cashflow forecasting, more efficient cash management across the whole cycle (forecasting to investment) is a top priority.

A four-pronged solution is being developed.

First, get systems in place to identify all cash balances on a daily basis and allow treasury to transfer those funds, but without using 50 different banking systems (a number of banks provide multi-bank portals with front ends to the Swift network).

Next, improve the quality of 30 to 60-day cashflow forecasting. This forms part of a wider-ranging review of the finance function's structure and processes.

Once the location and value of surplus cash has been established together with where it is needed in the short term, an overlay pooling structure will be established, subject to regulations. This may result in each of our legal entities having its own mini-pool, which would be a significant step forward.

Finally, a portfolio of investment products and counterparties will be collated, enabling Vodafone Essar to improve the yield on investments and use higher-rated counterparties without restricting the business's requirement for liquidity.

TREASURY POLICIES Vodafone Essar needed the ability to manage its treasury activities within a framework designed to accommodate the specifics of India. Local policies complying with the spirit of Vodafone Group's policies, with permitted variations for non-recourse subsidiaries covering interest rate management, bank relationships, counterparty exposures, have been prepared. Maintaining debt in the currency of the cashflow that services it stays, as does the approach to identifying and hedging a foreign exchange exposure, subject always to local restrictions.

Vodafone Group keeps interest rates on a floating rate basis unless the interest charge is material or rates are historically low. Vodafone Essar will keep interest rates fixed, to the extent that fixed rates are available. This approach gives greater certainty over funding costs in a group that is not used to double-digit interest rates and, to the extent that rates can be fixed below those assumed in the acquisition business case, locks in additional shareholder value. It also reduces the impact of a tightening credit policy by the Reserve Bank of India and a spike in interest rates at the end of March each year which can last for anything from two weeks to two months.

External corporate borrowings are priced at a margin over Libor and can easily be swapped, but the absence of a widely accepted rupee

A LACK OF AVAILABLE HIGH-RATED INSTITUTIONAL MONEY MARKET FUNDS INCREASES THE EXPOSURE TO LOWER-RATED COUNTERPARTIES, LEADING TO LIMITS NEEDING TO BE SET LOCALLY IN ORDER TO RETAIN FLEXIBILITY.

interest rate benchmark results in many domestic loans being fixed at the time of drawing by mutual agreement. Protection from lack of transparency can be gained by having more than one source of finance and remarkable decreases in quotes have been secured with this alone. Going forward, Vodafone Essar will have a portfolio of medium to long-term core fixed-rate debt, with short-term funding managed through a combination of committed revolving facilities and uncommitted pass-through certificates (debt issued to a bank which is then sold down into the market).

Vodafone Group's relationship banks have been waiting for an opportunity like India for a while. Those with no onshore presence have opportunities surrounding expected external corporate borrowings over the next 18 months, the resulting cross-currency swaps and any refinancing of the holding companies. Those with an onshore presence will have an eye to local funding plus a significant amount of work on cash management.

For the plans to be successful, they will be joined by Indian banks whose involvement will ensure treasury can support all aspects of the business across India. Indian banks lending at the highest level will rank alongside the group's existing relationship banks in competing for new business in India.

Credit ratings of Indian banks are based on a local scale. India itself has only recently regained full investment-grade status of Ba2/BBB-/BBB- for domestic issuance. Management of counterparty exposure limits therefore requires more flexibility than at the group, which uses values assigned on international ratings above A-.

Similarly, a lack of available high-rated institutional money market funds increases the exposure to lower-rated counterparties, leading

THE DEAL

Speaking at the ACT Mergers and Acquisition Masterclass, Gerry Bacon, Group Treasurer of Vodafone, explained the mechanics of the deal behind Vodafone's acquisition of Indian telecommunications company Hutchison Essar from Hutchison Telecom International (Hutch), a Hong Kong-listed entity.

Hutch put up for sale its interest in Hutchison Essar in December 2006. The process took place through sealed bids and sparked interest from Hutch's existing 33% partner (Essar), a competitor called Reliance Communication, and a wealthy Indian family, as well as Vodafone. The successful bidder had to be aware of, and follow, the local rules in relation to Indian ownership regulations. There was also a requirement for Vodafone to comply with its existing shareholder agreement with Bharti, in which Vodafone had an interest, as Bharti competed with Hutchison Essar. The agreement had non-compete clauses, requiring the disposal of part of Vodafone's existing 10% interest in Bharti.

Between 2006 and 2010 Indian's telecoms market is expected to grow from \$22.6bn to \$43.6bn, a compound annual growth of 18%. India is the world's second most populous country (behind China), but mobile penetration is low. In December 2006, the figure stood at 13% – compared with 108% in Europe, 77% in the US and 41% in China. Penetration is expected to reach 40% in India by the end of 2012 and exceed 50% in the longer term.

Half-a-dozen key players existed in the Indian mobile market: Bharti, BSNL, Reliance, Hutchison Essar, Idea and Tata. India is the world's second-fastest-growing major economy. GDP real growth between 2006 and 2015 is predicted to be 6.9%, just behind China at 7.3% but significantly ahead of Russia, Brazil, US, Europe and Japan. The acquisition of Hutchison Essar met Vodafone's five strategic objectives – in particular, the one delivering strong growth in emerging markets.

Having won the bid process, in February 2007, Vodafone signed a deal with Hutch to acquire part of Hutchison Essar for \$11.1bn, giving an implied 100% enterprise value of \$18.6bn. This included net debt assumed of \$2bn. Hutchison Essar's earnings before interest, tax, depreciation and amortisation (EBITDA) amounted to \$511m.

Vodafone also offered to buy Essar's 33% stake at the same price per share as agreed with Hutch, which was later declined.

One characteristic of the deal was a memorandum of understanding between Vodafone and Bharti for infrastructure sharing which is expected to materially reduce the cost of delivering telecom services, bring mobile communication to rural areas in India and expand network coverage more quickly.

The final piece of the deal saw Bharti granted an option to buy Vodafone's 5.6% stake in Bharti for \$1.6bn, subject to the completion of the Hutchison Essar transaction. Vodafone would retain its 4.4% indirect interest in Bharti underpinning the two organisations' ongoing infrastructure relationship.

For the year ending March 2007, the Vodafone Group had revenues of £31.1bn with reported free cashflow of £6.1bn. Net debt at that time was £15bn, while pro forma post the Indian transaction, which closed in May 2007, it stood at £24bn. The post-deal credit rating was A- (S&P)/A- (Fitch)/ Baa-1 (Moodys).

DUE DILIGENCE ISSUES Treasury due diligence centred around five issues: debt, risk hedging, cash, bank relationships, and other. Debt in the acquired entity amounted to \$2bn, mainly denominated in Indian rupees, but spread across the 23 operating companies (called circles) and holding companies – with margins varying between 40bp and 99bp.

All debt was floating rate with the exception of \$450m fixed. Most non-rupee debt (dollar and yen) were hedged into rupees with the exception of to limits needing to be set locally in order to retain flexibility. Exposures can be mitigated by maintaining a rolling portfolio of redrawable short-term debt and by consolidating and circulating operating cashflow around India (although this is restricted to a great extent) thereby reducing the total amount of surplus cash. Using counterparties that have signed a 2002 ISDA provides some documentational protection.

PEOPLE The existing treasury team of five was doing a great job in a difficult climate as required by the previous shareholders. One of my objectives is to ensure that in a year's time when I leave India, the remaining team is technically stronger and able to focus on key issues and decision-making rather than processes which should be automated. As is common throughout the organisation, the team is very resourceful and innovative and has stepped up to the mark to tackle the changes ahead of them.

Studying for the ACT's examinations and certificates is an important tool in the team's development. Further, Vodafone Group encourages development through its Finance Academy, which gives all financial professionals in the group access to a range of training and development material covering personal development, technical skills and the Vodafone approach to financial management. With tuition provided face-to-face or by e-learning, the Indian finance team will be able to take advantage of the Academy.

Ian Locke is Treasurer at Vodafone Essar.
ianlocke@vodafone.com
www.vodafone.in

$140m owed in dollars. The company had little hedging of forward foreign purchases.

In terms of cash the company had $200m with local banks and there was enough liquidity for six months as long as newly negotiated facilities were signed. Cash pooling across the 23 circles was not permitted and the capability of the cash management systems was limited. With the local banks there was crossover with existing Vodafone relationship banks. A further issue to be resolved was a corporate debt restructuring going back to 2003. Of the other issues, the most significant items were $400m of guarantees and $140m other debt liabilities, mainly finance leases, pension liabilities and share options.

Prior to signing the deal to acquire Hutchison Essar, Vodafone presented to five relationship banks, in January 2007, to explain the rationale behind the deal. Vodafone's existing sources of funding at that time amounted to $18bn, consisting of $7bn cash resources and $4.5bn from commercial paper (dollar and euro), so leaving $6.5bn available to draw from an $11bn revolving credit facility, also used to support outstanding commercial paper.

To ensure an increased level of available cost-effective funding, Vodafone decided to secure commitments for a new $3.5bn 18-month credit facility from its five relationship banks. The company stated at the time that it planned to repay the facility with proceeds from subsequent bond issues by Vodafone Group. The terms of the $3.5bn 18-month credit facility were entirely consistent with Vodafone's Group's revolving credit facility due 2012. The price at 17.5bp was based on a credit grid when drawn and would remain unadjusted throughout the life of the agreement.

One element of the integration was the agreement that Vodafone's Deputy Group Treasurer, Ian Locke, was to be seconded for 12 to 15 months as Treasurer for Vodafone India, based in Mumbai.