Lock and key liquidity

The rising cost of capital for banks and financial institutions is filtering through the system and translating into rising funding costs, not to mention a re-emphasis on de-leveraging. This has forced corporates to look for alternative funding sources, to be very agile when tapping funding markets and to refocus on refinancing risk and liquidity management. At the same time the surge in volatility has altered the risk-return equation in favour of minimising risk. But defining a suitable hedging policy for the business is as much an art as a science: there is unlikely ever to be one precise answer. With modern corporations exposed to a wide variety of risks from their underlying operations, an integrated approach to risk management should take into account all aspects of the underlying business spanning multiple asset classes. Examining each risk in greater detail helps ensure the hedging profile is consistent with the company's business strategy and capital structure.

FUNDING SOURCES NARROW Vanilla bank lending has been a consistent and resilient source of funds for most UK corporates. It has even crowded out other forms of financing at maturities up to five years. Clearly, this banking market has gone through a revolution in terms of availability of risk-weighted assets and lending fees/margins.

The capital markets have seen some shrewd moves by corporates dipping into the public bond markets stealthily to secure long-term funding at favourable pricing. The private market has also seen activity as buy and hold investors put cash to work outside the skittish public markets. Successful transactions in this space have tended to hinge on the strong relationships between some banks and institutional investors; some deals have been a direct result of reverse enquiries, where banks understand the individual needs of investors and structure corporate deals to suit them.

With a closing circle of debt providers in the market, companies are also looking at alternative forms of funding. For instance, asset finance is simple and relatively quick to deliver as it is a private loan secured against an asset or pool of assets. On a more immediate level, the liquidity crisis has meant that some sources of short-term funding for corporates, such as the commercial paper market, have at times virtually frozen, leaving corporates with fewer funding options at a time when working capital is being squeezed even harder. To counteract this longer cash cycle, schemes such as supplier finance (where payments are bridged by bank finance to free up cash) have become vital. In the same vein, receivables securitisation structures help to free up cash at the other end of the working capital cycle.

Executive summary

- **The current credit crisis has altered the risk-return equation in favour of minimising risk at a time when funding options for corporates are increasingly scarce. A two-pronged approach to hedging that optimises the capital structure while allowing the corporate to create real cash benefits from market opportunities should therefore be adopted. The value of this approach has never been as clear as in the current market environment.**

LEVERAGE, COVENANTS AND INTEREST COSTS In the current market, companies facing a refinancing event are particularly vulnerable. Where debt financing is available, the invariably higher lending margins ultimately hurt the bottom line. In response, highly leveraged companies are suspending dividend payments or considering asset disposals in order to reduce debt. Others are renegotiating banking covenants, which is likely to increase the monitoring of cashflows and cash interest coverage. The risk to an interest cover covenant comes from both higher interest rates and a downturn in profitability. But this also creates market opportunity.

One of the factors contributing to the uncertainty of future interest payments for corporates with (unhedged) floating rate bank funding is the rise in volatility of Libor rates. For corporates faced with a downturn in operating profitability, the Libor volatility has been a double whammy. While the economy is grinding to a halt and central banks have done their bit by cutting rates, with Libor remaining high those with floating rate funding have failed to obtain an offsetting reduction in interest expense.

Libor volatility has been more pronounced recently. So while three-month Libor averaged 5.43% in the three years to 15 September 2008 (the date that the collapse of Lehman Brothers sent shockwaves through markets), since then it has averaged 6.15% (estimate as of 10 October 2008). By contrast, the flight to quality has meant that the five-year sterling swap rate has rapidly come down, averaging 5.15% since 15 September 2008. This phenomenon is not limited to sterling markets, but can be seen across the board in all major currencies.

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EXPANDING THE LOGIC TO INCORPORATE INFLATION
Uncertainty regarding future inflation rates is another key risk that all corporates are exposed to, albeit to varying degrees. The surge in commodity prices over the last few years has propelled inflation in the UK to a decade high. However, with the trend in commodity prices reversing direction and economic growth slowing down, budgeting for future inflation is extremely untenable. This has implications for cashflow forecasting across industry sectors. For some such as utilities, the link to inflation is explicitly defined in the form of price regulation; for others the link is more subtle and implicit. Where management determines a strong correlation between underlying cashflows and inflation, the future cashflows can be immunised from inflation uncertainty by linking part of the interest payments to inflation.

Take a retailer, where the nominal value of future sales is linked closely to future inflation. A historical regression analysis between retail sales and RPI shows a positive correlation. Some of the income inflation exposure can be mitigated by linking part of the interest payments to RPI. If inflation rises, then interest payments also rise, but if the correlation holds, then the cashflows available to service the debt would also have increased, thus providing a proxy hedge.

Taking this logic a step further, a number of different asset classes can be incorporated to achieve a hedge for a wide variety of underlying business risks. Ultimately, what we are trying to do across the hedging portfolio is to look for creative ways to prevent cash shortfalls due to economic slowdown.

CONCLUSION If you couple this analysis with the knowledge that comes from a strong client partnership, then the bank has a very powerful set of tools at its disposal to help a corporate achieve that optimal risk profile and capital structure in the current environment. Drilling deeper into the detail of individual businesses gives a much clearer picture of its exposure along the risk spectrum and allows the implementation of a bespoke hedging policy to suit each profile, maximising visibility of cashflows while making the most of market opportunity. What's more, this hedging approach is arguably in more demand now because of investor aversion to highly leveraged balance sheets and the rising cost of debt for corporates.

Box 1: Case study

Consider a company that is currently in the middle of refinancing its debt facilities. Initial discussions with the banking group have revealed the prospect of the lending margin increasing to 200bp post-refinancing from 100bp currently. The company has just finished making its revised financial forecasts, and has discovered that the combination of the higher lending margin and elevated Libor rates could mean an additional £17.2m of interest expense per year on its £1.0bn debt portfolio.

Furthermore, stress-testing has shown that the company's interest cover covenant of 4.5 x is vulnerable to both an EBITDA downturn and a further rise in Libor. However, the divergence between Libor and swap rates means that by transacting a five-year pay fixed swap, the company not only obtains an immediate cash saving (assuming Libor remains flat), but also obtains greater headroom within its interest cover covenant. Furthermore, by fixing its interest cost for five years, the company achieves much greater cashflow certainty.

	Pre-refinancing	Post-refinancing	Post-hedging
ASSUMPTIONS			
EBITDA	£400m	£400m	£400m
Net Debt	£1,000m	£1,000m	£1,000m
BASE CASE SCENARIO			
Funding benchmark	3-month Libor	3-month Libor	5-year sterling swap rate
Reference rate	5.43% (3-year average to 15 Sep 2008)	6.15% (average settings since 15 Sep 2008)	5.15% (average 5-year mid-swap rate since 15 Sep 2008)
Lending margin	100bp	200bp	200bp
Effective interest rate	6.43%	8.15%	7.15%
Ann. interest expense	£64.3m	£81.5m	£71.5m
EBITDA/ interest	6.22 x	4.90 x	5.59 x
EBITDA downturn (10% stress)			
EBITDA (£ mln)		£360m	£360m
EBITDA/ interest		4.42 x (Covenant breached)	5.03 x
Interest rate stress (1% stress)			
Effective interest rate		9.15%	7.15%
Ann. interest expense		£91.5m	£71.5m
EBITDA/ interest		4.37 x (Covenant breached)	5.59 x

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