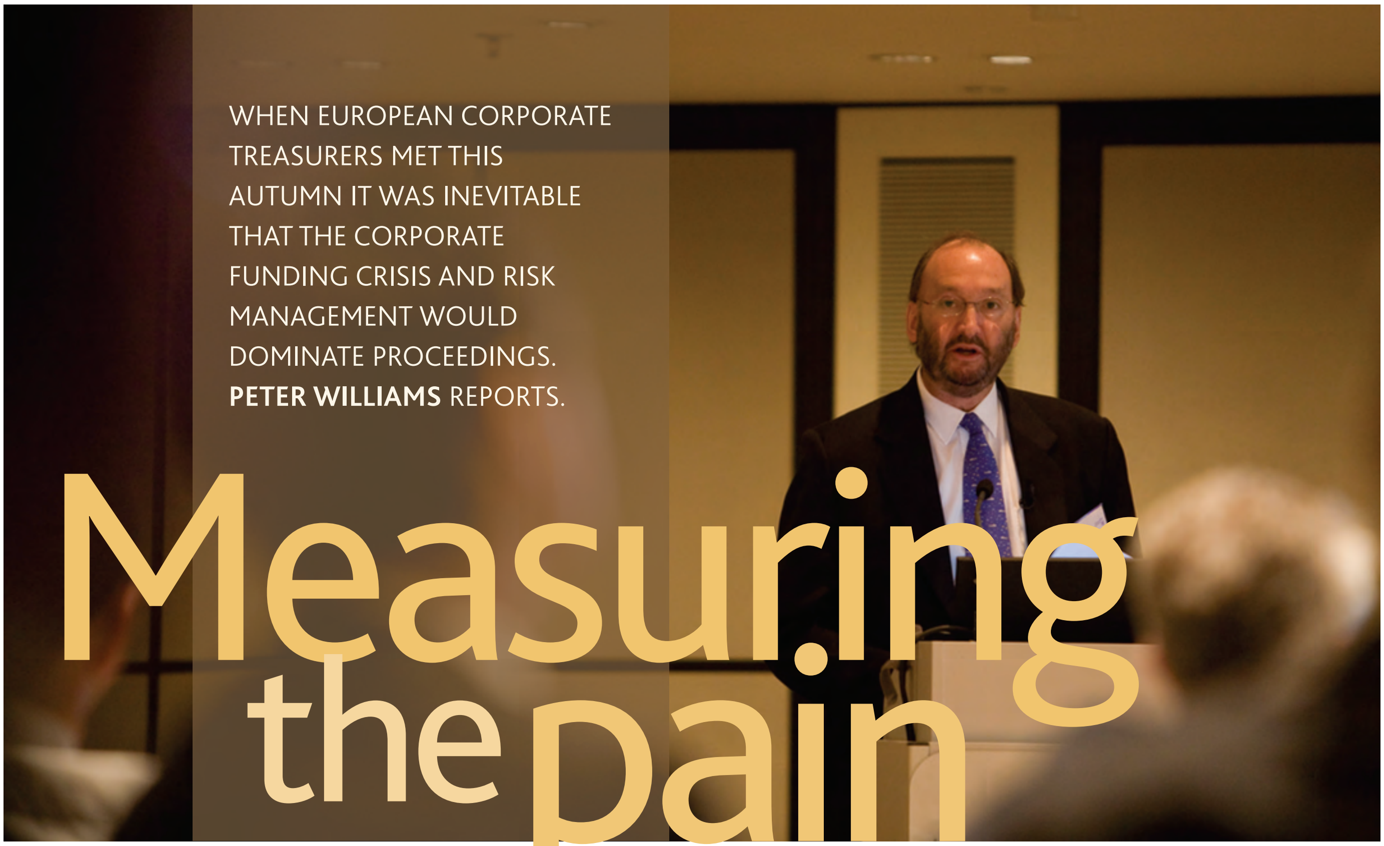

WHEN EUROPEAN CORPORATE TREASURERS MET THIS AUTUMN IT WAS INEVITABLE THAT THE CORPORATE FUNDING CRISIS AND RISK MANAGEMENT WOULD DOMINATE PROCEEDINGS. **PETER WILLIAMS** REPORTS.

Measuring the pain

With the banks themselves fighting for liquidity it is reasonable to assume that corporates will have felt the impact of the credit crisis on their liquidity risk management and corporate funding strategies. Gerry Bacon, group treasurer of Vodafone, chaired and introduced the session on this topic. Panel members included Erhard Wehlen, group treasurer of Linde, Graham Wood of the supervisory board at E.ON International Finance, and Henryk Wupperman, head of capital markets at Bayer.

Bacon reviewed the loan market starting with the much publicised problems in the US sub-prime market that marked the beginning of the end of a five-year boom in liquidity. The sub-prime problems have adversely affected credit markets; leaving banks fighting for liquidity and investors taking the opportunity to push out spreads on the basis of concerns over counterparty risk. Loan volumes have declined significantly since June 2007, with the global market falling between 40% and 50% in the first half of 2008, and markets remaining highly volatile. Despite substantial intervention by the Fed, the European Central Bank and to a lesser extent the Bank of England (in a bid to improve liquidity), the prospect of poor earnings across the financial sector funding remain a challenge.

THE CHANGING FACE OF THE MARKET PLACE BBB-rated corporations have been affected the most by this downturn but even strong AA-rated corporates are being hit. Transactions now have to meet a higher hurdle rate, and if banks do lend, then corporates will be expected to deliver on their undertaking to grant ancillary business. Banks, said Bacon, were being much more rigorous in terms of what they had won, not what they might win in the next 12-18 months. Given the conditions it is not surprising that treasurers are shying away from refinancing where possible. Corporate merger and acquisition (M&A) activity is the key driver partly due to the tailing off of the leverage market and partly because of the return of attractive valuations.

Another change corporates have noticed is in bank documentation. The days of covenant-lite are over. The banks continue to feel the pain as their cost of funding has increased considerably. Bacon said that while the European loan market was open it remained challenging. Transactions are being underwritten by bank syndicates but there is far greater selection. Pricing is higher as each transaction comes under greater investor scrutiny. Treasurers are seeing a reduced appetite for underwriting risk with larger lead bank groups, and price flex is a requirement for underwritten transactions. Structural flex is also making a return.

Executive summary

- In early September, the ACT and the Verband Deutscher Treasurer (VDT) jointly organised TalkingTreasury, the fifth in the European-wide thought leadership series. Sponsored by RBS, the one-day conference, held in Dusseldorf in Germany, examined the key issues facing treasurers today. The forum focused on three key themes:
  - the impact of the credit crisis on corporate funding strategies;
  - strategic risk management; and
  - treasury as an integral part of the business.

THE FLEX CLAUSE E.ON's Wood surveyed the scene since the onset of the credit crunch. Prior to this there had been a trend for large corporates to gear in order to obtain a "more efficient" balance sheet. The two principal tools used to ensure this greater efficiency were greater debt and share buyback programmes. The other feature of the corporate finance scene prior to July 2007 was a record level of M&A activity, which included significant involvement of private equity. Lenders used aggressive tactics to participate in the booming debt markets. There were even stories that mortgages were given on the back of looking at houses on Google Earth.

It was, said Wood, a very liquid and fluid market. When the market change happened it did so quickly. Treasurers know that a lack of liquidity is one of the most critical risk factors for any corporation. So it proved for Enron back in 2001 in different circumstances and it did so again for Northern Rock. This crunch has had different effects on various markets although no sector has escaped. The financial sector was hardest hit and has seen failures, rescues and government support across a number of countries.

Perhaps the problems in the financial sector have been most clearly demonstrated by the changes in personal mortgages. In the UK, for instance, the Council for Mortgage Lenders says the number of new loans granted has fallen 30% from their height and that the number could fall even further. This lack of finance to stimulate the housing market is having a significant impact on the general economy. The retail and building sectors have been hit hard and there has been a general flight to quality by lenders but still with (from the borrower's perspective) worse terms.

As can be seen from the credit default swap (CDS) market, spreads are more volatile and wider, reflecting the impact of the increased cost of financing on corporates. As Wood remarked: "Treasurers are really earning their money now." Wood emphasised Bacon's point that the return of flex clauses in loans meant that treasurers were dealing with uncertainty even on finance in place. The flex clause is just one sign that lenders are becoming more demanding. We are moving from the era of covenant-lite to an era of covenant-heavy.

One example of this is in the retail sector where fixed-cost covenants are being introduced by the banks in a bid to ensure that at least the borrowers will be able to pay the rent. Another clause becoming common in sectors such as retail and building is cashflow covenants. A more general trend is for lenders to seek lower exposures to individual companies and sectors. The return of the club deal has happened. The economic slowdown means that cashflows are being hit and constant monitoring is of critical importance. Wood said that far more renegotiations on issues such as covenants were currently being undertaken than had reached the public domain.

Lower M&A activity is largely the result of private equity and infrastructure funds being less able to gear up. Few M&A deals in 2008 have reached the €1bn level and there has been a return to more traditional activity. The lack of activity by private equity and infrastructure funds is affecting companies' abilities to dispose of assets while institutional investors are becoming more choosey. Once the credit crunch kicked in, the institutional investors quickly realised they held the power once more. For companies the relationship with these investors has assumed a greater significance.

With the onset of the credit crunch and the volatility in equity markets the question of pension deficit and underfunded company pension schemes has become more prominent. The equity market in particular is beginning to see problems with pension deficits. Wood said the present situation reminded him of the old saying about stable markets: "Borrow when you can, not when you have to." If you have to borrow now, you have to pay the current price. Wood suggested that it would be better for treasurers to pay 10 or 20 basis points more than they were used to to ensure that the funding strategies of their companies was right.

Away from the capital markets, Wood said that the liquidity squeeze had put a greater focus on cash and cash management. He called on treasurers to drive billing and inventory efficiencies by more effective internal management. Companies can seek to raise funds through asset disposal but treasurers should realise that the frothy days of asset values have gone and are unlikely to come back for a while. Companies need to accept that when they are making disposals.

THE DAYS OF COVENANT-LITE ARE OVER. THE BANKS CONTINUE TO FEEL THE PAIN AS THEIR COST OF FUNDING HAS INCREASED CONSIDERABLY.

DIVERSIFICATION IS KEY In the discussion after the formal presentations the panel agreed that diversification was key for all companies seeking to access funding. It was important said Linde's Wehler to have a variety of banks. Wood added that it was important to look under every stone. For instance, treasurers should think about buying back their debt as it was likely to be cheap at the moment. Sometimes treasurers need to see themselves as investing rather than funding.

A key role for treasurers under current circumstances is liability management, and treasurers in large organisations could learn lessons from treasurers in smaller companies, who have better insight into debtors, creditors and stock. Wood acknowledged that treasurers in large groups often found it hard to pass messages down about the need to control cashflow. As a result internal management reporting within groups was happening on a profit and loss basis not on a cash basis.

Bayer's Wupperman pointed out the need for corporates investing cash to be aware of the increased credit risk they were running.

Box 1: BP risk management in practice

Foreign exchange
- US dollar functional currency, central netting.
- Only hedge capex and material flows.

Pension assets
- Target 100+% funding/super-funded strategies.
- Equity bias on investments: long-term returns.

Insurance
- Preference for self-insurance.
- Manage risks on balance sheet.

Interest rates
- US dollar borrowings and swaps.
- Floating bias (fixing premium over long term).

Credit risk
- Centralised governance and control.
- Group-wide settlement netting.

WHAT IS THE PURPOSE OF CORPORATE RISK MANAGEMENT? Strategic risk management was the focus of the afternoon session. The discussion was chaired by Andrew Walker, global head of corporate risk and financing solutions at RBS global banking and markets. He was joined on the platform by Michael Rauch, corporate director for corporate finance at Henke; Dev Sanyal, group vice president and group treasurer at BP; and Stephan Scheller, senior vice president of treasury, corporate treasury and finance at Bertelsmann. Walker posed the question, what is the purpose of corporate risk management? Is it strategic or tactical? The session also looked at whether corporates should hedge.

Rauch placed Henkel's risks into two broad categories: operative and functional. Under the operative banner were areas such as purchasing, production, sales and customers, while under functional came IT, HR, logistics, R&D, legal, environment and finance. One of the finance risks which the company had spent time on was the pension risk and Rauch described how Henkel had managed its risk in this area by using a contractual trust arrangement as a platform for its pension finances. The pension liabilities were shifted from the company into a Henkel contractual trust, matching those liabilities with cash and marketable securities, and leaving smaller pension liabilities with the company.

Examining BP's approach to strategic risk management, Sanyal said that BP shareholder expectations drove risk, strategic risk management and risk management practices but that these had to be recognised within a prevailing context. He split risk management into five key areas (see Box 1).

Scheller explained how the executive board at Bertelsmann set out its risk management framework for the group, management and global divisions. He said while it was important to uphold the autonomy of the corporate divisions it was also important to practise and report risk management according to consistent principles. These rules cover corporate financing, investment practices, rental and leasing agreements, derivative transactions and corporate insurance.

Walker suggested that, at heart, strategic risk management was about loss prevention and risk optimisation, which meant finding a position that was getting close to something that wasn't too bad. And perhaps in this climate that's the best that any treasurer, corporate or financial institution can hope for.

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