Seeing the opportunity

Executive summary

- Sappi's experience shows that it is not so much the cost of funding that matters, but the availability of debt markets. When bond and bank markets close, cost is less relevant as liquidity becomes crucial.

Sappi's treasury department is centralised in Brussels where a team of 12 looks after all the global paper manufacturing group's fundraising activities, cash management, foreign exchange and commodity risk, and an insurance captive. Its other key function is to manage the group's banks, bondholders and rating agency relationships. Debt is taken out internationally and (for local funding purposes only) in South Africa.

According to group treasurer Jörg Pässler, the company's business fortunes tend to correlate closely to the general economic cycle, and this particular downturn is no exception. Demand for Sappi's products has dropped by over 20% in some of its markets. The business tries to manage carefully the supply of paper to the market: a key mantra is, don't make paper you can't sell. But the business tends not to hedge commodities; instead, it chooses to take the fluctuations that occur with the natural market cycle, thereby matching input cost cycles with profit cycles.

FUNDING THE BALANCE SHEET Pässler says that between 2001 and 2005 the company got it right in terms of its funding strategy: "We made sure that we had a good long maturity profile: we took up 10-year bonds, we took up 30-year bonds, and we had a five-year revolver from 2005. The balance sheet looked very healthy."

In May 2007, before the credit crunch kicked in, the company was close to a major acquisition with a funding requirement of some $2bn. The plan was to finance the purchase with $150m of equity, new bonds and a hybrid bond. Pässler says arranging the funding was pretty straightforward in the market conditions at that time. However, the deal fell through right at the last moment and the funding was not required.

Fast-forward a year to May 2008 and the company was attempting to complete another deal, the purchase of M-real's coated paper business. As Pässler drily puts it: "In those 12 months, the world had changed."

From a funding and a treasury perspective, Pässler and his team had to change gear completely. "Not only did the hybrid market disappear, but essentially the whole bond market disappeared for non-investment grade issuers. And as we were about to discover, the bank market for bridge loans was about to disappear too with the collapse of Lehmans and the worsening financial crisis."

Pässler and his colleagues spent the summer putting together a funding structure for the M-real coated paper acquisition. Sappi is sub-investment grade and at that time was rated BB. The transaction made strategic sense and the deal was given support by the rating agencies. The challenge turned out to be the funding with the unprecedented events of 2008.

Pässler spent the summer talking to Sappi's key relationship banks about the structure of a bridge and then a 12 to 18-month take-out period in the capital markets. "Post-Lehman, our banking group told us there was no way they could put $1bn on the table as a bridge. This was partially a function of their own difficulties in markets where liquidity dried up. Also, it was not just because of the short-term nature of bridge facility but because of the expected difficulty of the take-out in the capital market." For 18 months the high-yield bond market in Europe was closed.

Sappi's board was in agreement with the finance team that from the corporate's perspective it couldn't take the risk of holding a bridge with no clear exit in sight. "It would have been reckless to have exposed the company to all those uncertainties."

However, as the board remained keen to do the deal, which still made strategic sense, the treasury department and the company had to change gear once more. With the bank and bond market closed, the company turned to the equity market and the seller for a restructured transaction.

Traditionally Pässler focused on debt relations while his colleagues in investor relations looked after equity. However, in the prevailing market conditions equity investors naturally become more interested in the company's debt position. At that point Pässler became

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IN THE TEETH OF THE CREDIT CRUNCH, WHILE THE DOORS OF THE BOND AND BANK DEBT MARKETS SEEMED FIRMLY SHUT FOR BUSINESS, PAPER COMPANY SAPPI SECURED FUNDING FOR A €750M ACQUISITION. **PETER WILLIAMS** LEARNS HOW SAPPI DID IT.

involved in explaining the debt and liquidity situation to equity investors. Sappi CEO Ralph Boettger and his investor relations team went on a roadshow to talk to the company's top half-dozen shareholders (between them they owned about 60% of the total shareholding) to test whether they would support up to 75% of the funding needed for the acquisition. The response was very positive.

The net result was that the M-real acquisition was funded completely outside the debt capital and bank markets. Instead, Sappi bought company's coated papers business through a combination of an oversubscribed equity placing in difficult market conditions in December 2008 and a four-year vendor loan note from M-real. The cash part of the deal remained unchanged.

As soon as the acquisition funding was secured, Pässler turned his attention back to the company's maturity profile and short-term debt. Bonds and bank debt issued in 2002 and 2003 were fast approaching their maturity between 2010 and 2012. "As a BB company you have to address your maturities well in advance," says Pässler. "High-grade companies don't need to worry so much: their refinancing can be usually achieved much closer to maturity."

THE BANKING GROUP Managing the bank group has been an interesting exercise over this time. Two syndicated loans were due to mature in 2010. Pässler says: "It's a different world today. If, for instance, you have maturities next year you probably already have banks that have decided they want to get out."

Out of 29 banks spread across two syndicates, Sappi has parted company with nearly half the group.

"We initially started work on a forward-starting concept which has become quite popular." But Sappi went further. In the new revolving credit facility (RCF), the company offered to reduce the banks' exposures by downsizing the facility and to shorten the maturity from the usual five years to three. Having recently completed a successful bond issue, Sappi no longer needed a revolver at the old size. The company recognised, though, that the pricing would have to rise. "The deal in 2005 was frankly at a great price for the company, which was just not viable in the current climate."

Sappi agreed a three-year revolver rather than the usual five-year transaction. Pässler says: "We put together a deal which we thought would tick all the boxes for the banks and we have had a fantastic response from the core banking group."

Sappi's bank syndicates now look quite different. The traditional structure of a small group of mandated lead arrangers and a larger syndicate has been replaced with the majority of participating banks being in the mandated lead arranger group, as this core banking group has strongly supported the transactions.

"We managed to renew the €400m maturity next year and the RCF," says Pässler. "While it was tough to lose a number of relationship banks I am not uncomfortable in principle with a smaller banking group. On a day-to-day level you have only so much business and you can't meet all the banks' expectations for additional transactional business. The present number of banks I can keep happy with FX, deposits, derivatives and cash management."

The other element that has changed is that whereas the banks' fees used to be a quick discussion between treasurer and banker, now they are given much more weight. Pässler says: "It used to be a question of come into the deal and we'll discuss the ancillary business. Now there is much more detail about what and when before banks commit to a transaction." The bank and bond transactions worked well together, as the total return for participating banks could be seen as a package deal across three different transactions.

Sappi had two maturities falling due in 2010 (one mid-year, one at the end). In January and February this year the high-yield bond markets were simply closed, the one exception being an issue by 2008 Deals of the Year winner Fresenius.

Recent events have confirmed the opinion of some treasurers that banks won't take a company to the market if they think there is a chance that doing so would damage their own reputations. Pässler, a former banker himself, takes no side in that discussion, but says that from his discussion with his advising bankers it was clear that bondholders would want to see the issue of the maturing loans addressed before they would commit five-year money, even though the events were 18 and 24 months down the road. The company took the advice on board.

So from February through to May this year Pässler looked to get Sappi's bank group to agree to extend the maturities. Once that was closed, the plan was to approach the re-opening bond market. Pitching to the banking group about the 2010 maturities proved to be a fascinating experience.

It is clear that treasurers have got to be flexible and move with the

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market. In June Sappi had to change its strategy fast even by the standards of the previous hectic 24 months. By May the company already had substantial commitments from the banking group, by which time the bond market was hotting up.

"The number of issues by the end of May had already exceeded the whole of 2008," Pässler says. "We got to the stage where we had to go to the bond market even though we hadn't done the bank deal. The market was there for us right then and we were aware that when it shut last time, it shut for 18 months."

Decision made, Sappi fast-tracked the process, organising a bond deal roadshow in June and after a good response launched a bond issue in mid-July. The company also fast-tracked some thinking about its pitch. "We always knew the bondholders wanted the 2010 maturities addressed, so we said to them we are coming earlier because we see that the conditions are good, but we want to address your concerns, so once you commit we will place the funds in escrow until the bank deals are finalised."

The result was a bond issue that was well oversubscribed. In the end a $300m tranche and €350m tranche were issued, a significant achievement for a high-yield name going to the European market for the first time. Having completed the bond, Pässler and his team used the following weeks to finalise the bank transactions and by the end of August the bank deals were completed and the bond funds released from escrow.

In summary, questions over Sappi's maturity profile have been addressed, the bonds issued and the majority of short-term debt and the M-real vendor loan note repaid. Apart from one bond maturing in 2012, which is planned to be paid back out of cash, the maturity profile has been pushed out to 2014.

All this has come at a higher cost of funding, but it is one Pässler is prepared to pay and one that he thinks treasurers should be prepared to accept in current market conditions. What the last two years have taught treasurers is that it is not so much the cost of funding that matters, but the availability of debt markets. When bond and bank markets close, cost is less relevant, as companies need liquidity.

Pässler is not surprised prices have increased for BB companies. He knew the deals being offered pre-credit crunch were too good to last. "Well done to all those companies that took cheap money in 2006 and 2007," he says. "We didn't need it at that time as we were cash-rich and had no upcoming maturities, but it was obvious that liquidity was going to shrink and prices were going to adjust."

From his recent experience and in today's environment, Pässler's view is that it's all about keeping your finger on the pulse of the market, being flexible and moving fast.

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Box 1: Sappi snapshot

Sappi has two main business areas: it is the world's biggest producer of coated wood-free paper and chemical cellulose.

Coated wood-free paper is the high end of the paper market, typically used in the printing of glossy fashion magazines, coffee table books and expensive marketing literature.

The chemical cellulose is another tree product (a tree consists of 40% wood fibre, 40% chemical cellulose), which can be dissolved and then spun like cotton to be used in textiles. A viscose shirt, for instance, is typically made from chemical cellulose. Sappi has the world's biggest chemical cellulose plant in the world in South Africa and around 18% of the global market share for the product following a recent expansion.

A global operator, Sappi faces different local competitors in regions such as Europe and the US. As a consequence its treasury has the challenge of being in many currencies, dollar, euro, rand, yen.

The company still has its head office in South Africa – it has a stock market listing there as well as secondary listings in New York and London – but the treasury department is based in Brussels, reflecting, says Pässler, the need to be in Europe to manage key relationships with the banks, bond holders and rating agencies. The treasury centre has been in Belgium since 1997 – a reflection of Belgium's tax-friendly regime for treasury centres.

A local treasury operation in South Africa deals mainly with local funding and foreign exchange requirements. Communication with Johannesburg is painless, with Pässler reporting, and so speaking, to the company CFO on a daily basis and taking trips to head office very regularly.