Is your balance sheet sound?

Executive summary

- Macro-economic dislocations make financial forecasting a nightmare for businesses. But practical steps can be taken to assess the strength of the corporate balance sheet and shore it up if necessary.

Many CFOs could be facing a quandary over the next few months. Put simply, are their balance sheets sound enough? They will have to give a categorical yes or no to their board colleagues, and the non-executive directors will undoubtedly need persuading.

We appear to be through the first phase of adjustment arising from the credit crunch, with some major banks having been bailed out and some large groups recapitalised. But uncertainties remain, such as:

- How much more bad debt needs to be written off across the financial sector?
- What should be the political and regulatory responses to the financial crisis and how might the financial sector be reshaped to prevent a similar crisis in the future?
- What will be the economic impact of quantitative easing in some countries, and how should the unwind process be managed to avoid inflationary shocks?
- How resilient are the major economies (particularly China and India) and what are their growth prospects over the next few years?
- Is there a threat to world trade and a possible increase in protectionism?
- What can be done about the high levels of consumer debt in some jurisdictions and the risk of high unemployment?
- How can government deficits in countries such as the US and the UK be financed and reduced?

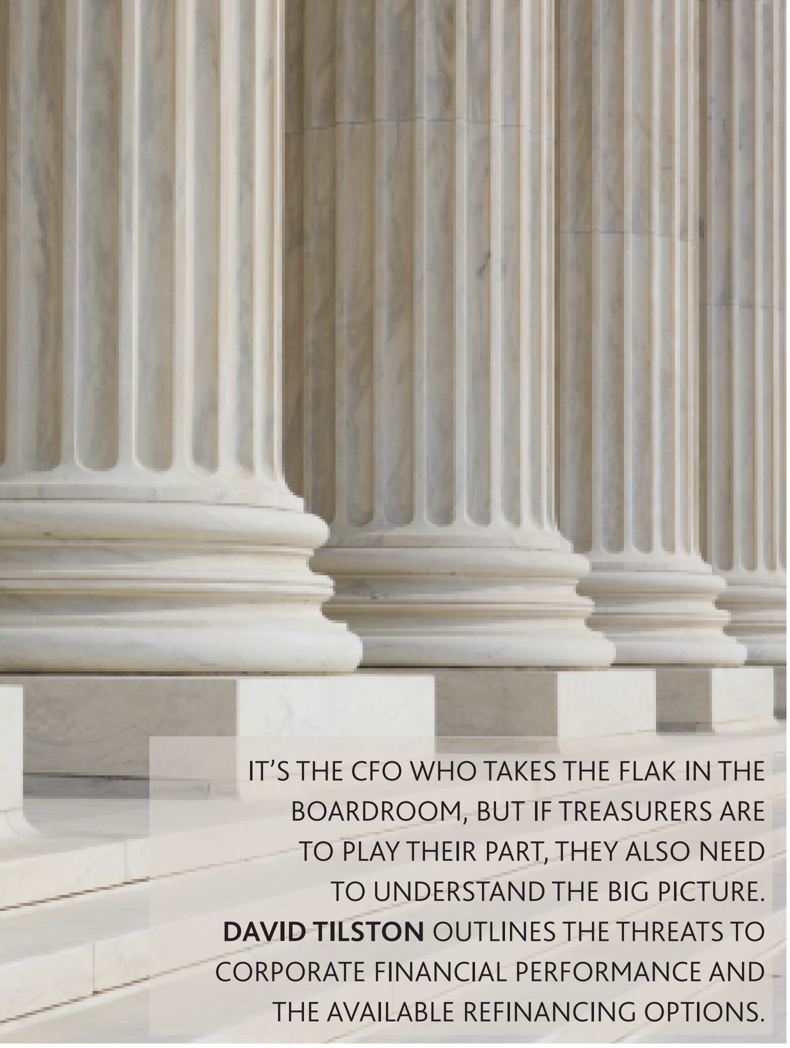
There is, in short, considerable uncertainty over the outlook, with much comment about V, W and L shaped recoveries and tentative green shoots of recovery being spotted, only to be subsequently squashed underfoot. There have been major dislocations of many markets simultaneously (credit/banking, equity, foreign exchange, commodities, and so on), all of which are interlinked.

Given the above, it seems impossible for any CFO to forecast with their usual degree of confidence their financial performance over the next 24 months. Consequently, the best approach is probably to assess with the board a range of scenarios (along with prospective responses) which might cover the internal consensus view of the likely outcome; an upside view, with a more rapid return to growth and markets moving favourably (which might require increases in working capital); and a severe downside scenario, with operating performance much worse than planned and markets conspiring to move against the interests of the business.

THEMES AND CONCERNS IN THE DOWNSIDE CASE One of the best indicators of the health of a company is its ability to generate free cashflow to meet its financial obligations, finance investment for the future and pay dividends to shareholders. In a downturn, cash generation may be muted or even reversed. The question which should then be asked is how strong the balance sheet is to withstand such (hopefully temporary) pressures.

The major determinants of balance sheet strength are likely to revolve around an assessment of:

- whether there are any major risk items on or off balance sheet that could adversely affect cashflow;
- the level of cash immediately available and redeployable around the group (and note that minority interests in subsidiaries may restrict the ability to redeploy cash internally);
- debt and committed facility maturities, and the ability to refinance as required;
- the ability to meet all financial covenants and the degree of downside risk that could be absorbed before the first of these is triggered;
- risk of downgrades by credit rating agencies; and



IT'S THE CFO WHO TAKES THE FLAK IN THE BOARDROOM, BUT IF TREASURERS ARE TO PLAY THEIR PART, THEY ALSO NEED TO UNDERSTAND THE BIG PICTURE. **DAVID TILSTON** OUTLINES THE THREATS TO CORPORATE FINANCIAL PERFORMANCE AND THE AVAILABLE REFINANCING OPTIONS.

THE PENDULUM HAS SWUNG ON PRICING. AT PRESENT, IT IS THE MOST FAVOURABLE IT HAS BEEN TO BANKS DURING OUR WORKING LIFETIMES.

- risk of withdrawal of trade credit insurance (leading suppliers to require earlier cash payments) which is a particular concern in the retail sector.

There may also be a number of lesser risks to the group, individually insignificant in themselves but which when combined simultaneously may produce an unwelcome cocktail of problems.

There is not space in this article to deal with all the risks noted above, so it will concentrate on refinancing risk given its potential impact on a group's liquidity position.

REFINANCING AND PROBLEMS IN THE BANKING MARKET As most borrowers know only too well, the world of easy credit, where the relationship bank group would normally be there to meet a company's debt requirements on a reasonable basis, has gone, for the foreseeable future at least. The pendulum has swung on pricing. At present, it is the most favourable it has ever been to banks during our working lifetimes. The reasons for this lie in a variety of already well-reported factors, including:

- banks' losses and their need to rebuild and increase capital adequacy ratios beyond previous norms;
- banks' preparedness to take harder decisions over pricing of debt than in the past and walk away from uneconomic clients (particularly where ancillary income from banking services do not adequately compensate for traditionally low loan margins); and
- a consequent significant reduction in competition in the banking arena (as balance sheets are being shrunk and there are limited benefits in dropping pricing to compete at present).

Perhaps one of the most significant changes is that many banks have now become very inward-looking and considerably more risk-averse. They are husbanding their balance sheets much more towards lower-risk domestic exposures, partly for economic reasons and partly because of political pressures. This is producing some notable changes in the market which will take many more months to flow through.

Bank of England statistics (see Figure 1) show that between 2005 and 2008 the major UK-owned banks expanded their lending in the UK by 33%, compared with 28% by foreign lenders. As noted above, foreign lenders are already repatriating capital to their domestic markets. International banks with an ongoing commitment to the UK market may be reducing their exposures by a third. Other and weaker international banks are likely to reduce their exposure by considerably more.

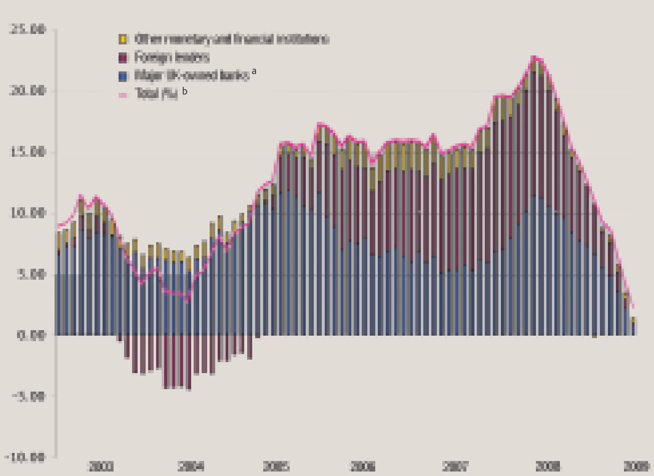
This means that corporates seeking to refinance may find there is insufficient capacity in the banking market to refinance existing bank facilities over the next couple of years. Quite simply, it is not clear that the major UK banks have sufficient capacity to meet any shortfalls arising from the exit of international banks. While refinancing is a difficult exercise at present, it will remain a challenge for some time to come.

Furthermore at present it is difficult to achieve bank facility maturities beyond three years, which in practice means the group will face the same refinancing risks again 18 to 24 months into any new facility (as it should be refinanced well before maturity).

OPTIONS So what are the main options that can be pursued and how do you make the right choice?

In the current market conditions the pragmatic answer is it depends what is actually available and can be achieved rather than a theoretical optimum. However, different options are available to different groups of borrowers, and there may be a need to refinance

Figure 1: Who lends to UK corporates?



[a] Includes consolidated banking groups of Barclays, Lloyds, HSBC, Nationwide and RBS
[b] 12-month growth rate in the stock of lending

Source: Bank of England

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in ways which are more complex than used in the past.

First, however, the group should already be exploring what options are available to reduce its debt requirements and boost liquidity by means under its own control. Working capital needs to be a focus. Extending supplier payment terms may not be a simple solution as the suppliers may not be able to fund this requirement themselves. Working co-operatively to reduce inventory in the pipeline between raw material supplier and final customer may be both hard and boring, but treasurers may be able to generate useful benefits in this area. More strategic approaches may involve the disposal of non-core cash-absorbing businesses and deferring major investment programmes.

Many large groups, particularly in the banking, property and housing sectors, have returned to the equity markets to strengthen their balance sheets either to fund past write-offs or to help them acquire assets at historically low prices. The equity markets also appear to be open to mid-sized groups with solid track records and good growth opportunities. As a variation on this, the convertible debt market appears to be making a resurgence, and this is another opportunity which could be explored.

- **Large groups** Large credit-worthy entities probably have the biggest range of options available to them. But even here there are suggestions that some banks that have recently grown through acquisition are interested in reducing their exposure, so refinancing syndicated debt with the same group of banks may not be possible. And if the bank group is too large, the amount of ancillary business available may be insufficient to attract all the existing banks to participate in such a refinancing. As noted above, some international banks may seek to withdraw anyway.

Although there is a cost to it, the process of negotiating forward start facilities, if you have the flexibility, will give advance notice of the likely predisposition of banks in your bank group and allow you to plan for the inevitable.

A significant opportunity for large groups (especially those with credit ratings or good name recognition) is the use of the capital markets for bond issues. This helps to diversify away from undue reliance on bank finance, particularly in the current uncertain environment, and can be managed to create a spread of maturity dates and reduce refinancing risk.

- **Medium-sized groups** Medium-sized groups may not have access to the capital markets and may therefore have little alternative but to deal with existing bank relationships given the difficulty of attracting banks into new relationships in the current environment. Do not be surprised if the banks want to reduce their commitments!

Creative thinking may be required. Rather than trying to renew financing on existing terms, it may be necessary to consider less attractive structures to get deals done. This could involve giving security, invoice discounting or leasing arrangements. If international banks are withdrawing, it may be necessary to try to finance larger elements of debt requirements locally for overseas subsidiaries. This may involve a reverse of past initiatives to centralise debt financing but may be necessary to find acceptable arrangements in the current markets.

- **Smaller groups** Unfortunately these groups are likely to remain at the mercy of their limited number of relationship banks and will find themselves in a very weak negotiating position.

OTHER DEVELOPMENTS There is an increasing need to find new ways of recycling funds held by long-term investors (such as pension funds and insurance companies) to mid-tier and smaller companies. Developments include the emergence of new private placement-type market opportunities to rival funding options available in the US private placement market.

One example is the UK Companies Financing Fund set up by Prudential and M&G (see the March 2009 issue of The Treasurer, pages 18-19) which focuses on the needs of mid-cap companies.

SOME PRACTICALITIES While it is possible to finalise some transactions faster, it can easily take a few months to complete many. Also, deals with banks are taking much longer to complete than in the past because of greater due diligence and internal process demands. Any CFO considering a possible financing should ensure they plan well in advance and have sufficient time and staff/adviser resources to manage any slippages in the process to ensure there are no effects on reporting requirements (such as going concern comfort). There could be a rash of refinancings in the next few months driven by both corporates and banks and this could easily create a logjam.

Finally, the CFO should be considering how and when to brief the board on the scenarios discussed at the beginning of this article to ensure there is sufficient time for internal challenge and debate before the important decisions need to be taken.

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