Investing for the future

THE ECONOMIC OUTLOOK REMAINS UNCERTAIN, BUT MORE COMPANIES HAVE STARTED TO INVEST FOR GROWTH AGAIN. DAVE DAVIES, ATIF MALIK AND HETAL POPAT TELL **GRAHAM BUCK** ABOUT THE RENEWED CORPORATE APPETITE FOR BORROWING.

As the second half of 2011 progresses, there is still volatility on both sides of the Atlantic. The US agreement to raise the country's debt ceiling was achieved only after a tense period of brinkmanship, while Europe's sovereign debt continues to unsettle the financial markets.

These events have obscured the fact that while times remain challenging, more encouraging news is also emerging, with the UK showing modest economic growth in the second quarter. Even meagre growth, provided it is consistent, encourages businesses to turn their thoughts to investment. Barclays Corporate has seen increased confidence among many of its clients, since the start of 2011, to borrow and invest for growth. There is much interest in the various funding options available and their respective benefits, with more types of funding on offer today than ever before.

CAPITAL INVESTMENT Business confidence remains vulnerable to several macro-economic issues, and so is tempered with a degree of apprehension. Corporates recognise that an unexpected event has the potential to change the mood and few executives have a gung-ho attitude.

But it is difficult for companies to sit on their cash reserves when yields are low, and difficult to justify to shareholders. Hence there is an ongoing consideration of share buybacks and returns to investors, on the basis that the net result is also positive for the company. A business and investment-led steady recovery is needed, to replace the credit-fuelled consumer boom.

Dave Davies, director, debt finance, at Barclays Corporate, says: "This means an increasing focus on manufacturers, whose fortunes are vital in rebalancing the economy. Many continue to invest and

are now confident enough, as well as ready and able to take on a certain level of debt, with some bullish enough to step up their capital investment. One of the key drivers for manufacturers' capital investment is to improve their margins over the long term."

A company's investment strategy will reflect its industry sector and where it is based geographically. It also depends on the attitude of the management team. For example, construction businesses are investing in their land banks for future growth and taking advantage of cheaper suppliers, producing tangible benefits in cost containment and cash management.

MAJOR NATIONAL AND INTERNATIONAL CORPORATIONS, PARTICULARLY IN THE SUPPORT SERVICES SECTOR, ARE INVESTING WORLDWIDE AS THEY ATTEMPT TO DIVERSIFY THEIR REVENUE STREAMS.

INVESTING IN PEOPLE A tangible effect of the downturn is that most businesses reined in spending and reduced costs, and those that navigated the downturn have emerged fighting-fit. Many have now reached a point in the business cycle when they need to put money into the company and are seeking investment solutions.

In many cases, corporates are now rehiring when employees depart, rather than leaving vacancies unfilled as many did during the downturn. The Recruitment and Employment Federation outlook in late July 2011 showed that nearly three in four employers expect to recruit staff over the coming quarter, and two out of three plan to do so over the next year. Encouragingly, as public sector and healthcare recruitment falls, the private sector is starting to take up the slack.

Hetal Popat, corporate director at Barclays Corporate, says: "There is increasing demand for individuals with compliance skill sets in professional services, such as audit, who are equipped for Europe's new regulatory regimes. Other sectors faring well are engineers for infrastructure projects and business support services. Facilities management is a growing market, as public sector contracts are outsourced to achieve cost savings. Recruitment by the technology sector also remains strong, particularly in the more complex areas, and was resilient even during the downturn.

"Call centres are increasingly being repatriated as companies work to improve service levels. While people activities can be offshored, the resulting fragmentation makes end-to-end process times longer. At the same time, increased staffing costs in many countries and high turnover rates, particularly in India, have reduced the benefits of outsourcing."

Inevitably there are exceptions. Retail, traditionally a tough sector, is affected by weak consumer confidence. And higher charges imposed by energy and utility companies are eroding the discretionary spend of both consumers and businesses. There is also evidence of a continuing regional division, with London and the South East enjoying more buoyant conditions than northern areas.

INVESTMENT OVERSEAS Major national and international corporations, particularly in the support services sector, are investing worldwide as they attempt to diversify their revenue streams. Civil engineers are looking to the developing world, while manufacturers have a growing interest in supply chains from China and other Asian countries. Despite volatility from the Arab Spring, the Middle East is among the regions favoured for investment, as are the rapidly developing economies of Brazil, China and India. Nearer to home, there are also attractive acquisition opportunities in Europe.

UK companies are thinking globally, helped by easier access to overseas markets. The global economy is increasingly reliant on China and India as the US's traditional dominance is eroded. This is evidenced by the £1.4bn trade agreement signed between Britain and China in June 2011, although many would argue this is nowhere near enough to drive the UK economic recovery at present.

There is also encouraging evidence of capital investment by manufacturers to improve their trading performance. Barclays Corporate has seen clients setting up significant export operations, and supporting them with further investment in infrastructure and information technology.

Many corporates are looking beyond outsourcing to overseas markets, by adding a local presence enabling them to sell more effectively in those countries. This is occurring both in the main economic powerhouses and the next wave of low-cost economies, such as Indonesia and Vietnam.

This rebalancing of activities is reflected in more limited investment at home, where companies are responding to a shrinking number of public sector contracts by refocusing on the private sector. Activity in the mid-market has been seen in the defensive sector, such as pubs, where businesses have looked to expand on the basis of ongoing demand and have added to their presence with several acquisitions.

MERGERS AND ACQUISITIONS After a two-year low, merger and acquisition (M&A) levels showed significant recovery last year. Dealogic reports that with a total value of $183bn, the UK's M&A market was the world's most active after the US.

Atif Malik, debt finance syndicate director at Barclays Corporate, says: "There has been renewed corporate activity in key sectors, such as energy and natural resources, and more selectively in others.

"While volumes remain above 2008-2009, the macro picture is also important to continuing this trend, in a context where organic growth is likely to remain subdued in the near term for most companies. Subject to those parameters being positive, and valuations still being attractive, more M&A deals could be likely."

Facilities management businesses are among those that represent attractive bid targets. In addition to holding key assets, they have a stream of lucrative 12-month contracts, which are usually transferable.

Barclays Corporate is actively working with a wide range of companies from SMEs to FTSE-listed corporates on possible investment opportunities. Businesses with retained sizeable cash piles and robust cashflows are ready to exercise that strength over weaker competitors.

LIQUIDITY MANAGEMENT Corporates have become more adept at managing their cash to maintain liquidity. Typically they will conduct considerable pre-planning before taking on debt. The right working capital facilities are essential, particularly for companies that are trading overseas.

Malik says: "Treasurers and their colleagues have become far more cash-focused and carefully scrutinise what the company is spending. Everyone is seeking to manage working capital better and is keen to have their medium-term debt and capital in place."

In the larger corporate space, the first half of 2011 was dominated by refinancings, with loan volumes up by 39% on the first half of 2010. Many companies that struck deals in 2007 and 2008 have refinanced well ahead of schedule to take advantage of favourable conditions. In the first half of the year, Barclays Corporate saw businesses utilise their available capacity to reduce borrowing costs and return to the market.

"Trade invoice discounting has been widely adopted and corporates are more adept at managing their debtor books," says Popat. "At the start of the downturn, Barclays Corporate saw a strong increase in demand for credit scoring products – an effective tool to provide SMEs with credit evaluations and ratings on their counterparties."

Barclays is seeing many plc clients primarily concerned with securing liquidity to ensure that they do not encounter "going concern" challenges with auditors.

Despite the prospect of record low interest rates extending into 2012, hedging strategies remain an important tool for any company. While various options are available, capped rates – which basically operate in a similar way as for mortgage products – are now one of the most popular.

FUNDING INVESTMENT Choosing whether or not to invest at the present time is a tough call. The decision is largely determined by a corporate's financial headroom, or its ability to absorb the peaks and troughs of the business cycle. Corporates require a large degree of financial flexibility so that they do not get caught out – should a customer fail to pay on time, for example.

Asset finance, traditionally embraced by larger corporations, has gained in popularity as a means of funding capital investment by spreading the cost of funding and conserving cash. Trade products, where the bank guarantees that the business will still be paid if the supplier defaults, are also in demand.

Davies says: "A number of corporates have opted for invoice discounting, which can free up two to three times the amount of cash from the debtor book, compared to typical overdraft-based products. Cash-rich businesses, faced with a prolonged period of low interest rates, have sought to enhance yield through structured or equity-type bonds.

"For private businesses the main concern is whether they have funding to build new plant or re-equip their fleet in the face of a challenging economic environment."

An interesting resource for SMEs seeking to invest is the Business Growth Fund. This is a £2.5bn equity investment capital fund, principally for those with annual sales of £10m to £100m and seeking financing up to £10m. Backed by Barclays and four other major UK banks, the fund is an attractive addition to the armoury of smaller businesses with limited debt capacity which are keen to avoid having private equity wielding control.

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Malik says: "A noticeable trend in the large corporate space over the past 18 months has been bond investors' readiness to support corporates as they look to diversify their funding sources. This complements the loan market, which has strengthened as liquidity has improved over the same period. While the large corporate space in the UK market has increased the proportion of bond finance in the overall capital raising paradigm, it still remains heavily weighted towards loan finance."

Many well-known companies have issued high-yield bonds during 2011 to benefit from the increased flexibility they can offer. The appetite for them has been strong as comparative rates are low, but demand remains heavily affected by the macro-economic picture. There have been some unrated public bonds, but these are few and far between. The US private placement market remains active and provides attractive financing, primarily for listed borrowers. In the current challenging economic climate, corporates are taking measured steps towards investing for future growth, while continuing to conserve cash.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org