HERBERT SMITH FREEHILLS

ACT TREASURY EXCELLENCE AS STANDARD

CORPORATE DEBT AND TREASURY REPORT

ISSUE 10

MAY 2023

Contents

Executive summary

- Unsurprisingly, nearly 80% of our respondents reported a neutral to negative business outlook. However, corporate treasury has remained resilient in these challenging times, having already built robust processes and debt strategies off the back of a number of economic shocks over the last few years. For many, dealing with uncertainty is now BAU. That said, the current uncertainty requires treasurers to be nimble in their debt strategy.
- Whilst banks remain the mainstay corporate debt provider, over time there has been a greater shift towards the DCM markets and, for unrated corporates, term loan private placement markets. Interestingly, this year there has been a jump in those expecting to increase net debt (to the highest level in five years), despite the increase in borrowing costs.
- Inflation and supply chain issues, coupled with the varying abilities to pass on input costs to customers, has resulted in significant increases in working capital for many corporates and therefore a greater need for debt. In spite of the neutral to negative business outlook held by the vast majority of our respondents, there are signs that corporates are in a bullish mood and respondents are anticipating higher organic investment in capital expenditure and are also projecting higher dividends and share buybacks for the year.
- There has been a mood shift on Sustainable Finance. Whilst it remains **the** talking point in treasury circles, it faces a number of headwinds. These vary from the pressure to get the deal done in uncertain times, the very real challenges in completing Sustainable Finance transactions from a multitude of angles and questions as to whether Sustainable Finance really moves the needle on a corporate's ESG journey making it a worthwhile pursuit. That said, there was certainly a strong cadre of those advocating for it and a sense that corporates would be required to meet broad ESG hurdles whether or not entering into Sustainable Financings.
- Views were polarised on the use of interest rate hedging in the current market. On the one hand, there is a case of those requiring certainty; on the other hand, there are those predicting that we've reached the top of the interest rate market.

About our research and report

This research comprises a survey of, and follow-up interviews with, finance and treasury professionals at 88 large UK corporates (primarily FTSE 100, FTSE 250 and equivalents) conducted in February to April 2023.

We hope you find these findings informative and would like to thank those who participated in our research. In particular, we are grateful to those who took part in our follow-up interviews to discuss the survey results. Their views added depth to the research findings and their input has been invaluable. Thank you.

If you have any feedback on the research or its results, we would be very happy to receive it. We would also be delighted to hear from you if you are happy to take part in our research next year as we aim to make this report as useful to the treasury community as possible.

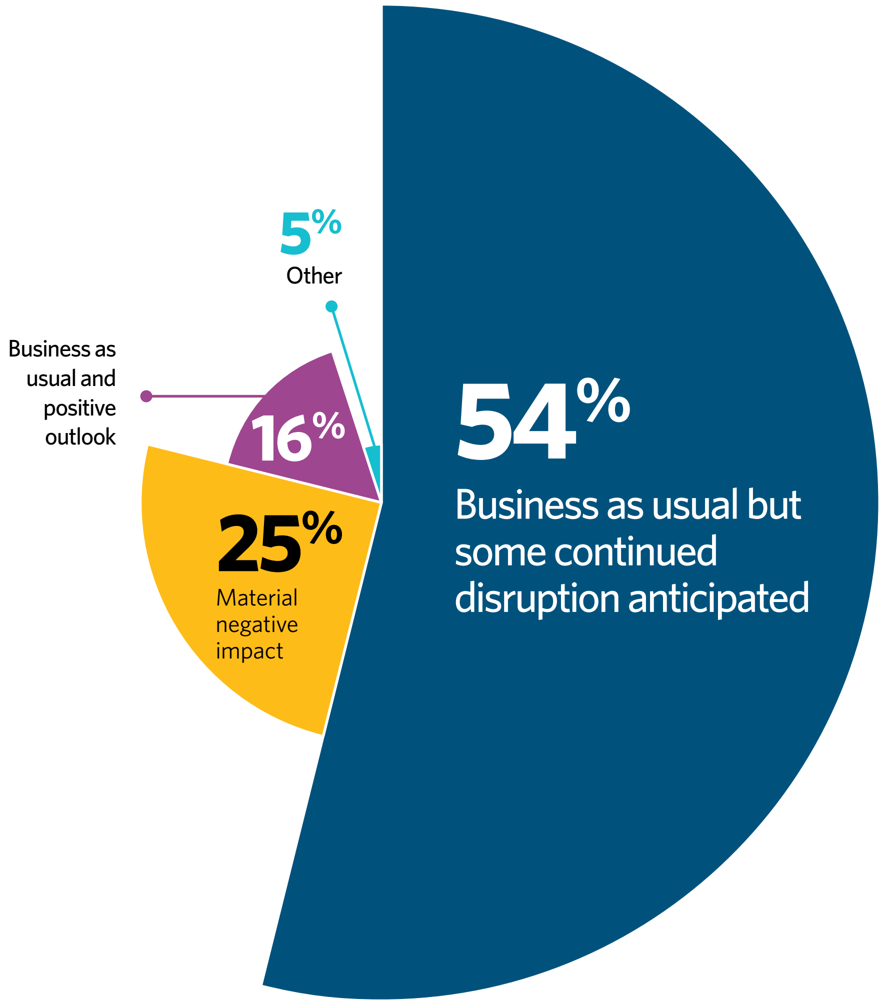
Some of the themes explored in this report are necessarily only addressed in headline terms. Over the course of the rest of the year, we will issue short form, practical insights on some of these issues and share views from other treasury professionals.
If you would like to receive those please email Rowena.Paskell@hsf.com.

1
MACRO-ECONOMIC AND SOCIAL/POLITICAL EVENTS

1 MACRO-ECONOMIC AND SOCIAL/ POLITICAL EVENTS

1.1 IMPACT ON BUSINESS

What is the impact of current macro-economic events and geo-political events (supply-chain issues, inflation, the invasion of Ukraine, etc.) on your business?



- The vast majority of respondents (almost 80%) reported a neutral to negative business outlook for this year, a rise from 70% in our 2022 report. This however is not surprising as concerns over the ongoing effect of the CoVid pandemic have been replaced with a multitude of issues ranging from the international (including the ongoing invasion of Ukraine and the increasing concerns that this could spill across other borders, tensions between a number of Western countries and China and fear of bank failures and contagion risk) and domestic (inflation in the UK soaring to 10.4%[1] (source: here.) and the Bank of England raising its base rate to 4%[2] (source: here)).
- It is perhaps more remarkable that 16% of our respondents reported a positive outlook for the year (2022: 23%). This may be explained by some respondents working in industries or sectors that have been less hard-hit by the macro-economic and geo-political events or those that have business-specific advantages; for example, those with significant US dollar earnings will have benefitted from a weaker Sterling during this time and those in certain extractive and related industries who have benefitted from higher prices.
- Notwithstanding industry, sector or business specific differences, in our discussions with interviewees, they generally felt that their businesses were more resilient to unforeseen shocks, potentially due to having ever more focussed and evolving risk management processes and having built larger liquidity buffers. However, some respondents questioned whether we have experienced the worse of what was anticipated or whether there was more negative drag on markets yet to come.

"Amazed ***[the number of respondents reporting a neutral to negative outlook]*** **wasn't more"**

"If you've been doing your homework, you're ready for volatility"

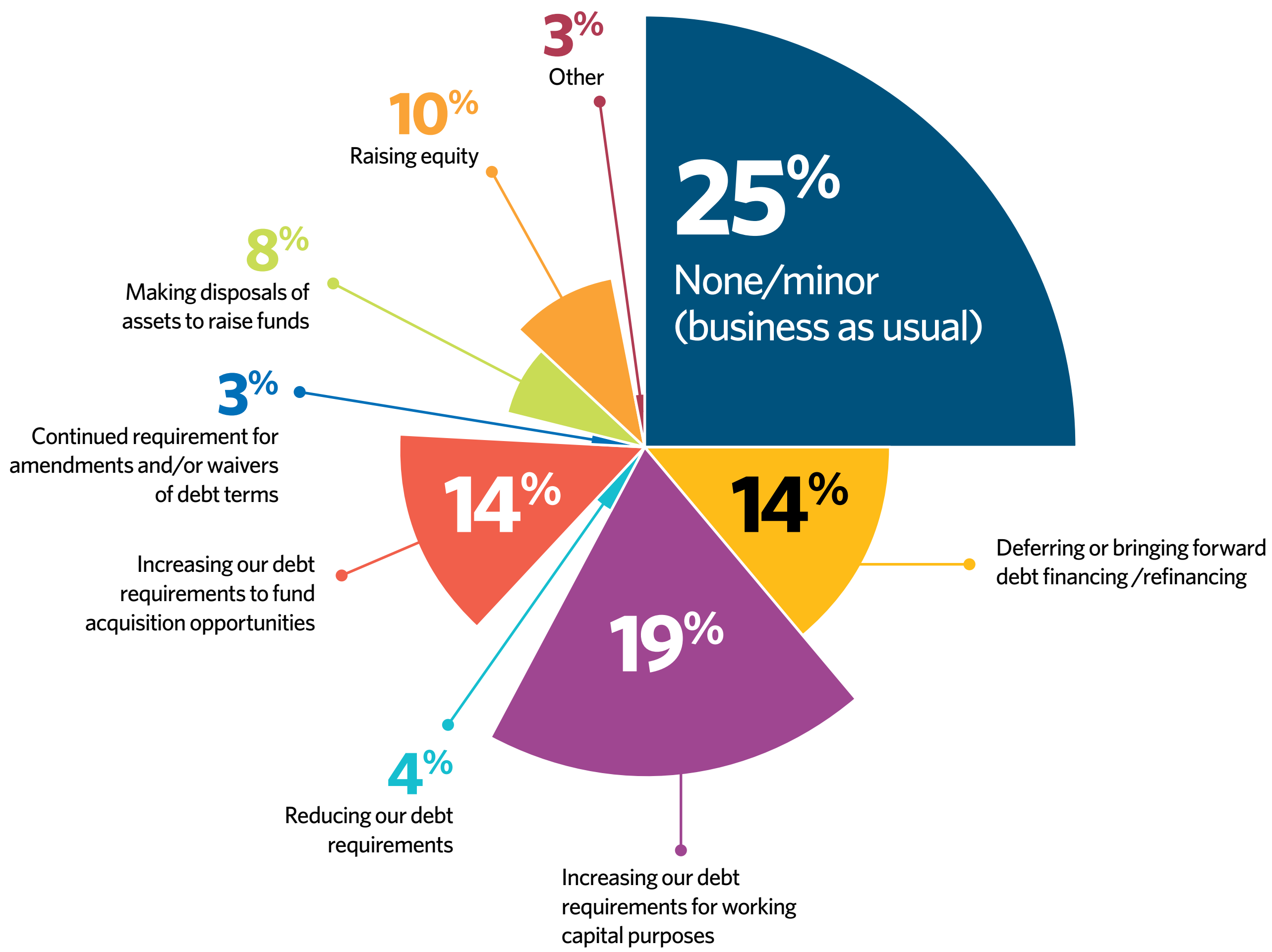
"Had expected the year-to-date to be more challenging than it has been but that is starting to catch-up. Is it better to borrow now than take a chance that things will be more difficult later this year or next year?"

"It's a cocktail of problems... we are probably at the starting point of really feeling the financial impact"

1. Source: https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/february2023#:~:text=The%20Consumer%20Prices%20Index%20(CPI,of%200.8%25%20in%20February%202022
2. Source: https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/february-2023

1.2 IMPACT ON DEBT STRATEGY

What is the expected impact of such events on your 2023 debt strategy?



- Almost 10% fewer respondents reported that macro-economic events would not impact on their debt strategy this year compared to 2022 and a number in interview flagged that the debt markets were increasingly challenging for them. Treasurers are contending with higher interest rates and less certainty over preferred debt options, particularly with the perception that, with the collapse of Silicon Valley Bank, Signature Bank and First Republic and the emergency takeover of Credit Suisse, there is a risk of banks more systematically materially changing how they deploy capital. This is exacerbated by the risk of further capital adequacy measures being required for banks.
- For 19% of our respondents (up from 15% of respondents last year), the focus has been to increase net debt to fund the higher working capital costs.
- Other respondents are seeking to tap into capital through disposals (8% of respondents) or raising equity (10% of respondents).
- Respondents are administering ever greater cash management across their groups to ensure that debt is utilised as efficiently as possible and to reduce interest costs. For some this is a significant task, releasing cash reserved by local teams across the globe and dealing with sometimes complex rules relating to the repatriation of cash. Others are looking to broaden their banking syndicates and further diversify their debt capital structures (even at a material cost) to reduce funding source concentration risk.
- That said, it is worth noting that a significant portion of respondents have said that their 2023 debt strategy has not been affected by recent geo-political and macro-economic events, despite the number and implications of those events. This broad range of views was clear in our research and summarised by one respondent: *"treasury teams appear to have developed massive resilience to withstand such disruption and shocks"*. In many cases treasurers have already implemented, as far as possible, a debt strategy that builds in greater liquidity buffers and exercises more prudent risk management to provide insulation to 'known, unknowns'.
- A related theme emerged not only of treasury resilience and foresight but also of debt markets becoming less reactive to shocks and debt investors being more available throughout the economic cycle. This contrasts with the views of some other respondents and suggested that sector and/or covenant quality would solely dictate a corporate's experience in raising debt and that was inevitably feeding through to its strategy.
- A number of respondents queried the advance planning to raise equity. Whilst conventionally event-driven (either positive or negative) some queried whether we would see some rebalancing of capital sources, using equity to deleverage balance sheets.

"Whilst the world is wringing its hands, treasurers are nimble on debt raising"

"It is necessary to consider factors other than pricing... ***[we would need to]*** **sacrifice pricing to keep sources of funds available"**

"Disruption is now business-as-usual. Think back to the threat of Grexit and everything that has happened since then"

"Bank are tightening their belts"

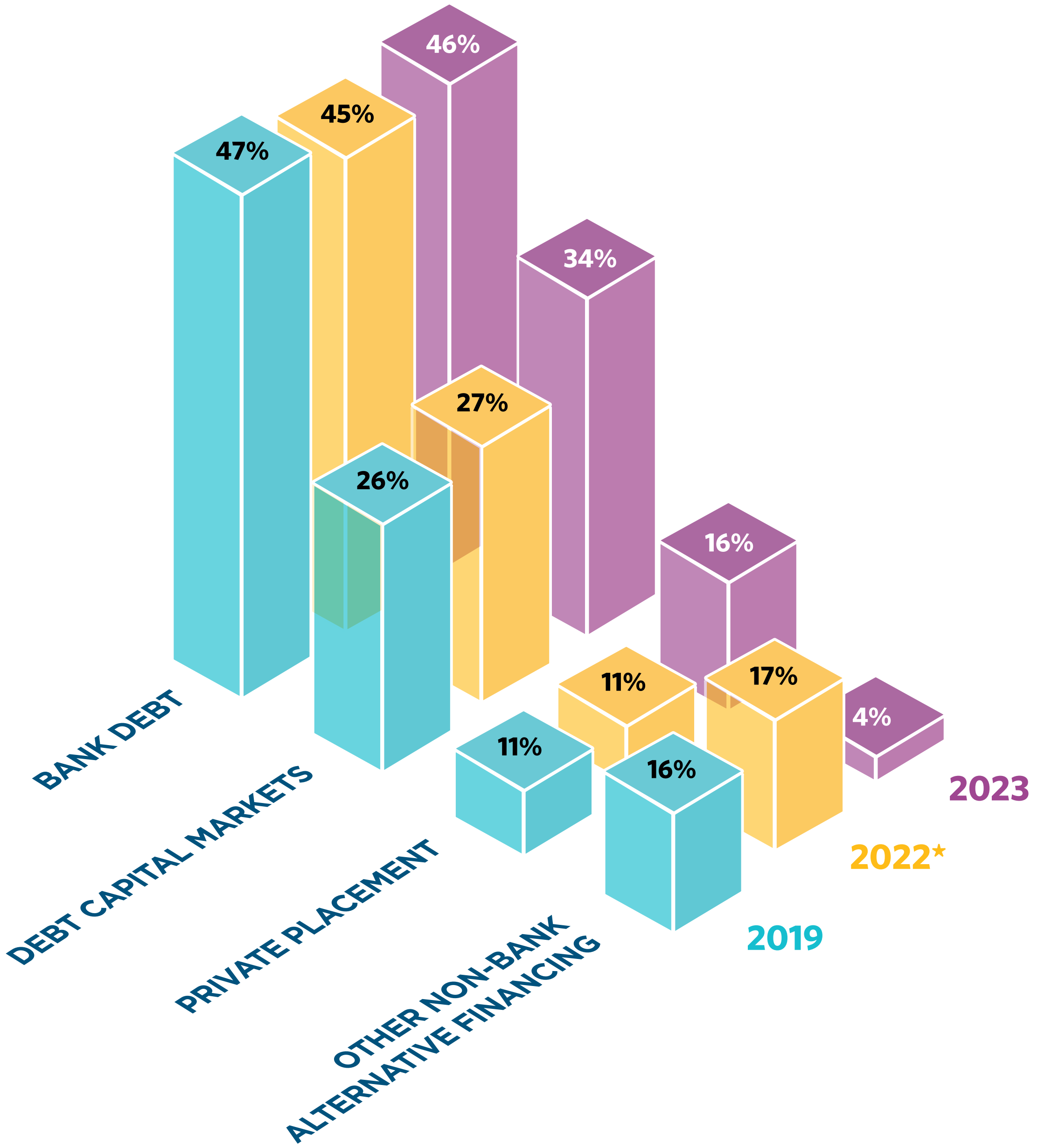
"Debt markets have become used to very strange things going on"

2
DEBT FINANCING

2 DEBT FINANCING

2.1 CURRENT DEBT FINANCING

At the start of 2023, approximately what percentage (%) of your total debt funding is provided by each of the following?



*Please note 2022 data is forecast data from 2019.

- Bank debt remains the mainstay of corporate debt financing with some respondents noting that bank debt has been surprisingly resilient given recent headwinds faced by banks. Some noted that the ease of putting bank debt in place was a significant advantage compared to other debt instruments. In recent years we have seen a significant increase in changes to the composition of bank syndicates; suggesting that banks are being more selective in their deployment of capital but also that there are alternative lenders to tap into to fill bank syndicates.
- Despite this, a significant number of respondents warned against over-reliance on bank debt and the need to challenge assumptions that bank debt would always be readily available in the amounts required by a business. One respondent noted the need to be careful to rely on warm assurances that were not credit approved, whilst others referred to the recent bank collapses as a reminder to ensure proactive management of bank exposures (both as deposit takers and as credit providers).
- Whilst private placements now play a greater role in corporate debt strategies, their use has not increased as much as anticipated. We query whether this is in part due to the availability of bank term loan debt, a focus on deleveraging and/or a reticence to engage in long term fixed rate covenanted instruments with a group of lenders who may be perceived as more 'relationship-remote' than their relationship banks with respect to issuers who do not regularly access the private placement market. Macro-economic and political events may also be factors in a fairly quiet US private placement market until recently, when issuers have started to feel comfortable with long-dated paper with inflation and interest rate hikes potentially reaching a plateau soon.
- Debt capital markets issuance has seen a notable increase. However, 34% of debt funding sourced from DCM is unlikely to be representative of listed corporates generally. Where a corporate has access the DCM markets it will likely make up the largest share of debt in terms of quantum but the pre-conditions which apply to accessing that market mean that it remains out of reach for many. For those with EMTN programmes who have been able to remain nimble and market ready without the need for marketing periods, the DCM market has been a good source of funding both at benchmark levels and reverse enquiry private placements, particularly in certain sectors. Those other corporates have instead turned to the USPP or bank term loan markets.
- Alternative lenders have not established themselves as a significant presence in the corporate debt market. Historically when we had asked this question in our research 4-6 years ago, the role of alternative lenders had been expected to rise but this has not materialised. That said, we see significant numbers of corporates accessing alternative providers for receivables, leasing and surety arrangements in particular but not conventional lending.

"A refinancing means a changing of the guards; banks are changing their strategies"

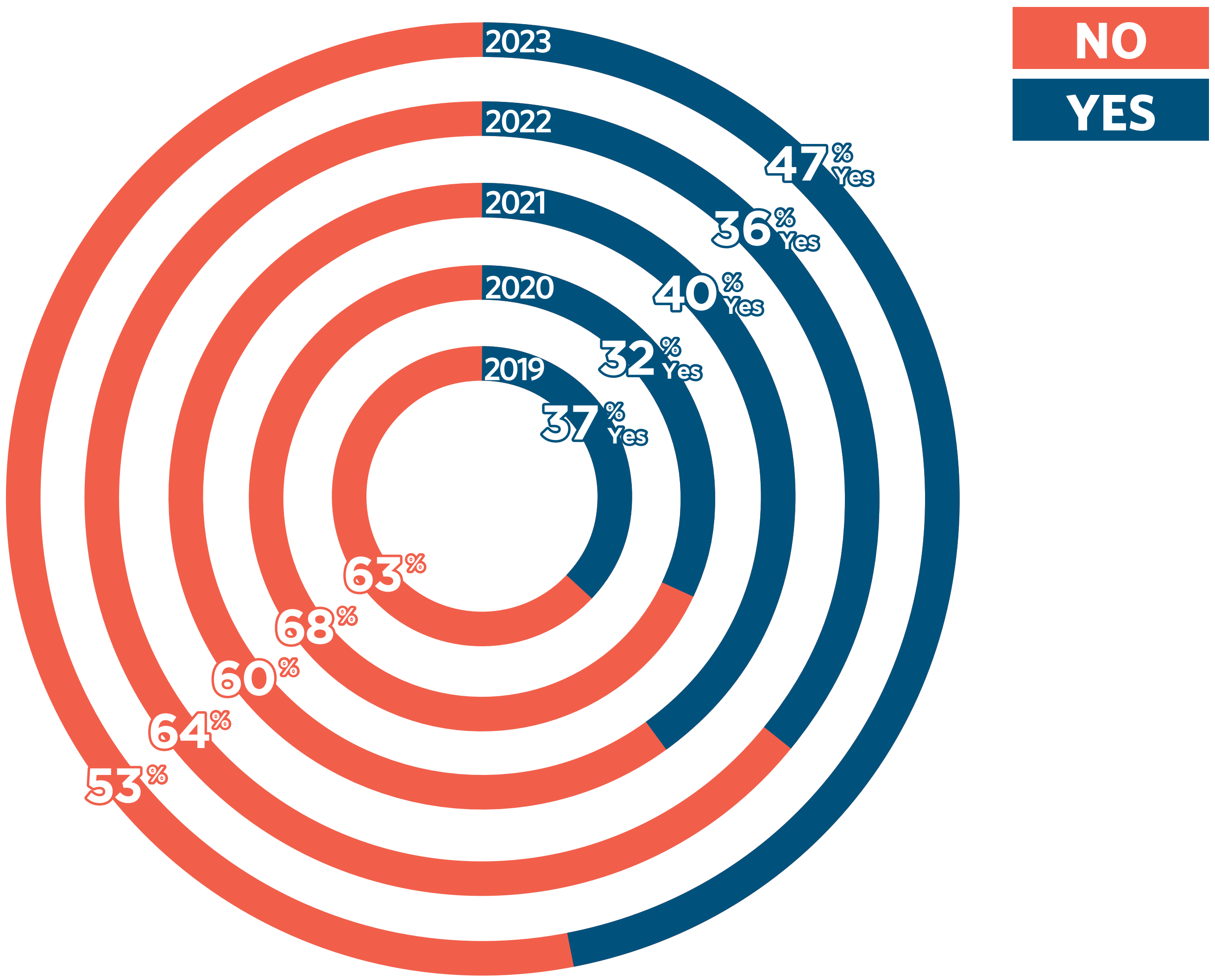
"Banks are going through their own pain, so it's interesting to reflect on how this will play out"

"Debt diversification is key... traditional bank financing is no longer always the most appropriate debt or most cost-efficient form of debt"

"One reason to move away from bank debt is to get rid of covenants"

2.2 INCREASE IN NET DEBT

Do you plan to increase your net debt this year (other than as part of usual seasonal adjustments)?



- There is a significant increase in respondents who are looking to increase net debt this year, to the highest level in five years, despite the increase in borrowing costs. Some respondents noted that this was likely to be primarily driven by working capital increases, particularly where corporates are unable to pass on increased costs to customers, and the need to cover inefficiencies in their supply chains.
- Respondents noted that today's high interest rate environment is something that many treasurers have not experienced before, with one respondent commenting that it necessitates *"a complete change in mindset"*. Once immediate funding requirements are met, it will be interesting to see whether (and how) debt strategies adjust in response to this.
- Some respondents queried whether concerns of another 'credit crunch' may start to emerge given higher pricing, recent bank failures and market conditions generally driving some corporates to increase net debt. However, those raising such concerns were in the minority with many respondents noting the particular circumstances affecting those recently affected banks and also the regulatory response to dealing with them. That said, the position is evolving quickly.

"People have become hooked on leverage"

"It's hard to believe that in a higher interest rate environment that raising debt is a strategic choice"

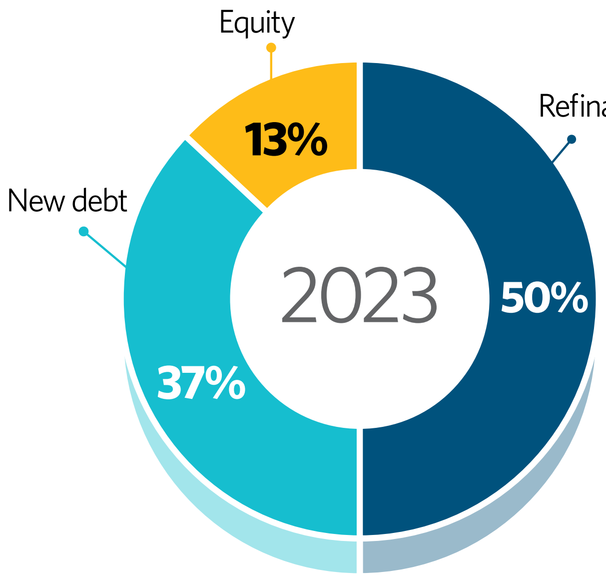
"There's too much uncertainty in the markets right now"

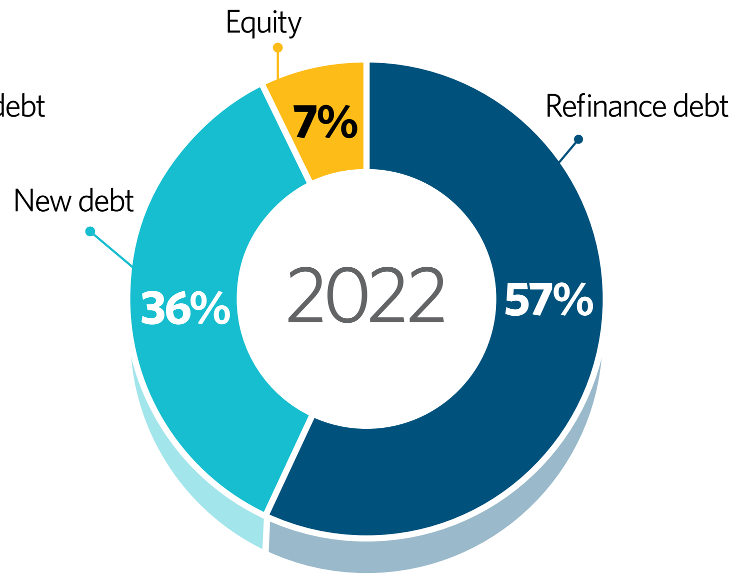
"Previously, you could obtain debt with the click of a finger"

2 DEBT FINANCING

2.3 FINANCING

Do you plan to raise new capital this year?





- There has been a notable increase in respondents planning to raise equity capital this year which surprised some respondents given: *"it's the most expensive form of capital [for shareholders]"* and the fact that equity capital is typically raised for specific (event driven) purposes. However, this may reflect the fact that debt capacity is constrained in certain sectors of the market and also, anecdotally, we understand that a number of corporates are seeking to accelerate the deleveraging of their businesses (both to reduce debt refinancing risk and also to be able to build debt capacity if needed in the medium term).
- Perhaps surprisingly given the results of the previous slide, the percentage of respondents looking to raise new debt is almost exactly the same as last year. One respondent noted that this may be a reflection of the fact that many corporate liquidity facilities have been put in place over the last couple of years, and so corporates are now potentially utilising those facilities to a greater extent rather than looking to obtain additional debt facilities.
- A number of respondents noted an increasing attractiveness towards convertible bonds in the current market. Others noted that they did not have sufficient experience in relation to them or adequate line of sight as to how this might impact on their other capital options in the short, medium or long term.

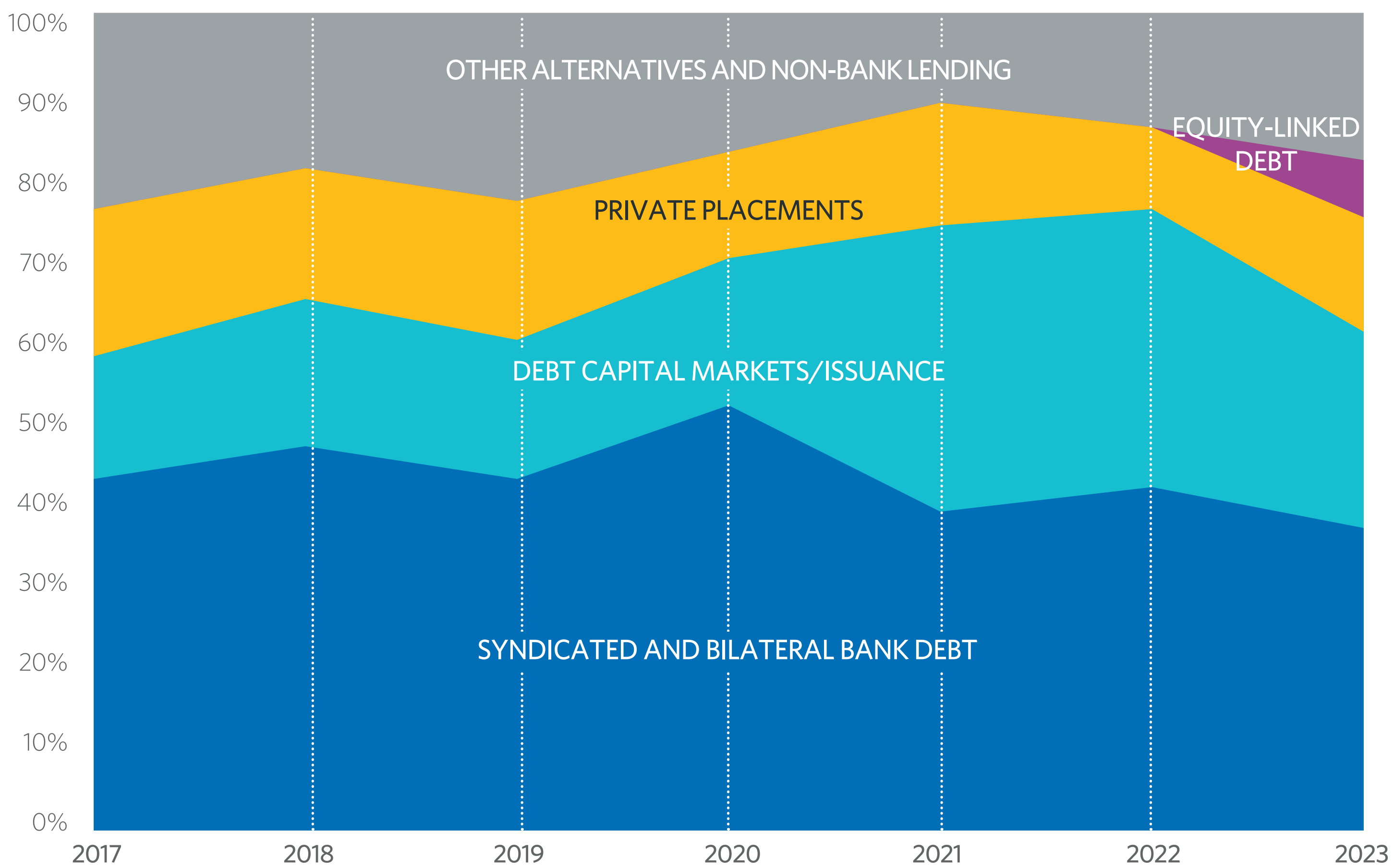
"This generation of treasurers are not used to this environment of high interest rates and high inflation"

"You need a good reason to do an equity raise given the negative connotations it can have"

"We have higher business risk across the board, across many sectors, and we have a rising interest rate environment. It therefore seems odd to voluntarily increase debt"

2.4 SOURCES OF ADDITIONAL DEBT

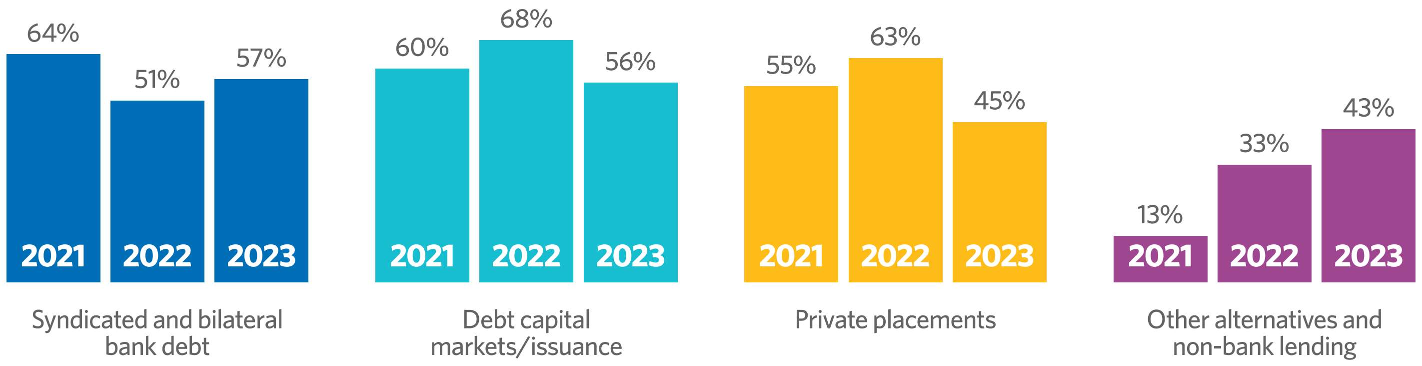
If you plan to raise new debt or refinance existing debt in 2023, how will this be achieved?



- This year we have included data for equity-linked debt for the first time and it is notable that 7% of respondents are looking at raising such debt. One noted that equity linked debt is typically more popular at times when other debt options are more limited or in a higher interest rate environment, where equity values are somewhat suppressed. The significant number of respondents looking at equity-linked debt may also be potentially explained as a reaction to the present high inflationary environment feeding through to higher funding costs.
- Respondents noted an increased focus on alternative debt and non-bank lending. Anecdotally, we do not see a significantly higher presence of non-bank lenders in the investment grade loans market and so this may reflect an increase in corporates looking at alternative debt products (for example, for receivables, leasing and surety arrangements as noted above).
- In a reversal of recent trends, those reporting accessing the DCM markets have declined. This may not be surprising given the inflationary and macro-economic environment and related uncertainty in the DCM markets for much of 2022.

2 DEBT FINANCING

Sustainable Finance* as a percentage of new debt/refinancings



- Much of this data is at odds with the general market shift and focus on sustainability-linked and ESG related lending. Whilst there has been more support than last year for sustainability-linked loans, appetite has not returned to 2021 levels. Some respondents noted that, in the context of harder market conditions, the focus has been to secure liquidity as efficiently as possible and to put off sustainability-linked loans for now and to return to them in more benign times. However, in the next section, we will comment on the current state of flux in the UK sustainability-linked loans market and the new headwinds that have materialised that are causing some to put this on the backburner regardless of wider market conditions.
- The one exception to this is in the alternative non-bank lending space though there was remarkably little commentary on this in our research. It will be interesting to see how this develops this year.

"The banks want you to keep doing *[a sustainability-linked loan]*"

"It isn't the case that no ESG/sustainability features means no debt availability so borrowers can consider this a 'nice to have'"

"Those *[sustainability-linked loan]* financings are damn hard"

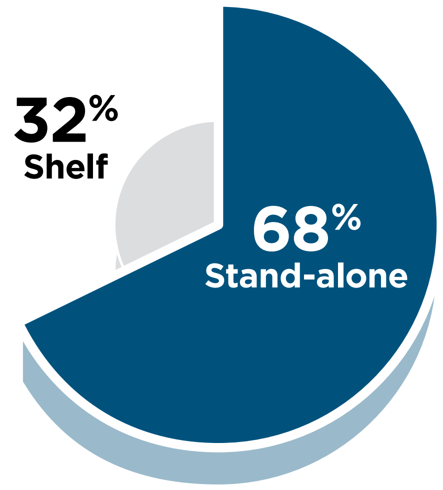
"Banks are very aware and smart on ESG points but they are trying to invert the priorities in a financing, trying to make ESG the main point of the transaction instead of the cherry on the cake"

*For simplicity, we use the term Sustainable Finance to cover the plethora of ESG, sustainability-linked, green and other related financings.

Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

2.5 PRIVATE PLACEMENT ISSUANCE

In relation to any private placement issuance, would this be a stand-alone issuance or via a shelf facility?



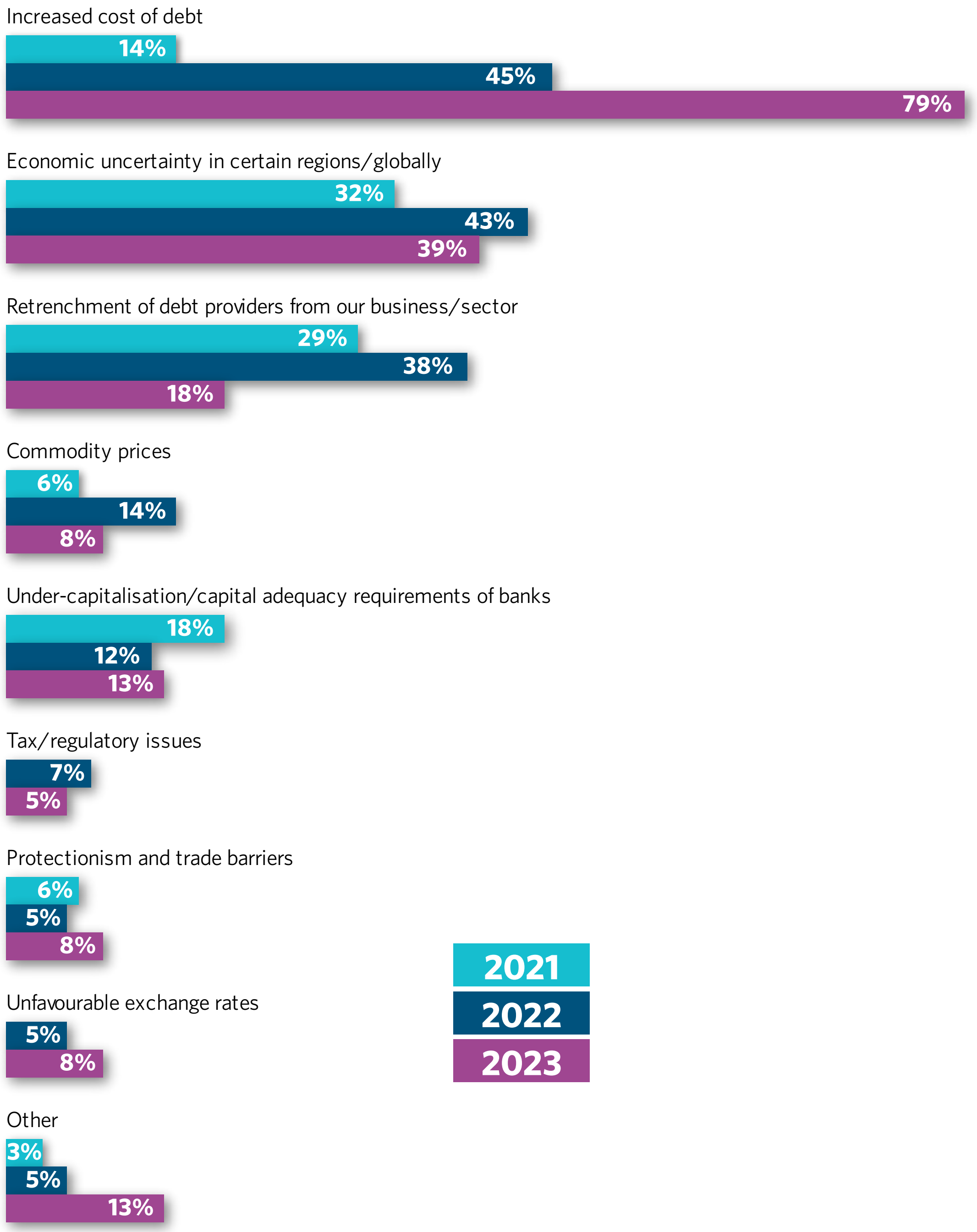
- Of the respondents that were considering a private placement issuance, 68% stated that they would raise private placement debt using a standalone issuance (as opposed to setting up a shelf facility). Some respondents noted that a shelf facility was not necessary for their business, as they didn't have a need to access the US private placement markets with short notice. Another respondent commented that a shelf facility would only be attractive for "*frequent issuers who don't want to – or are otherwise unable to – tap into DCM markets*".

Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

2 DEBT FINANCING

2.6 IMPEDIMENTS TO DEBT RAISING

What do you consider to be the major impediments to raising debt in the year ahead (if any)?



- Year on year, the increased cost of debt is the most widely reported impediment to raising debt and is significantly up on last year. Whilst this does not appear to be preventing corporates from raising debt, anecdotally it is increasingly a factor in broader business decision-making ie whether to pursue a particular debt funded transactions at this time.
- Some respondents noted that the composition and size of syndicates was relevant to the pricing of their bank debt though concerns were expressed that some banks were becoming less competitive than others due to their regulatory capital regimes. Overall, we saw a polarisation of views on banks making sufficient liquidity available, sometimes drawn on sector or size of business lines. This led to many respondents reporting movement in their syndicates on refinancings and therefore the need to ensure that there were more than sufficient banks involved in refinancing exercises.
- The percentage of respondents citing retrenchment of debt providers as an impediment has fallen markedly. Respondents did not expect that the recent bank collapses would see a return of retrenchment by banks to home markets.
- Unsurprisingly, economic uncertainty continues to be a significant impediment to raising debt.

"I do think watching the banks is important. We will think very carefully about what markets we go to"

"There hasn't been any suggestion that banks on the whole are closing their doors and there being nowhere else to go"

"Will this stop us raising debt? No. Will this stop us refinancing? No"

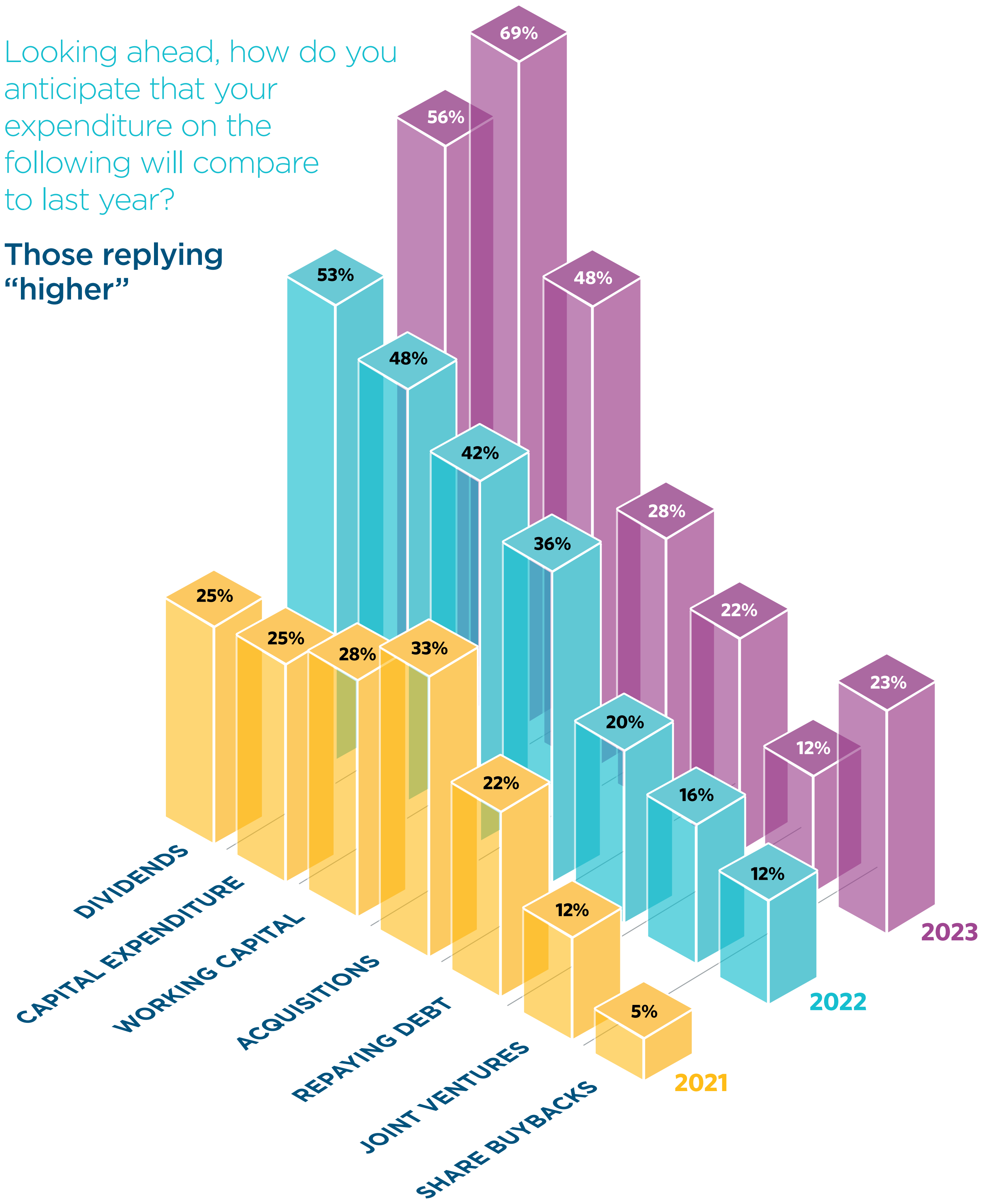
"Banks themselves are the biggest impediment to raising debt. Banks are more wary about where they distribute capital."

CORPORATE DEBT AND TREASURY REPORT
HERBERT SMITH FREEHILLS

2.7 EXPENDITURE

Looking ahead, how do you anticipate that your expenditure on the following will compare to last year?

Those replying "higher"



- Continuing the trend from last year, significant year-on-year increases in expenditure are predicted. Of particular note is the strong increase in forecasted capital expenditure. Whilst a component of this is linked to high current inflation, it more significantly suggests that corporates are focussing on organic growth and therefore are optimistic about their business's performance. The "super-deduction" capital allowances regime (now replaced by the 3-year expensing regime) supported an increase in capital expenditure (up 13.2% year-on-year to Q4 2022 – see further ONS Data Business Investment in the UK: Oct/Dec 2022) and we query whether the new regime and the expectation of some further Government support to encourage additional investment to drive higher productivity will also influence a corporate's decisions to invest.
- Interesting observations were made as to the role and impact of ESG on capital expenditure. On the one hand, such expenditure could help drive delivery of a company's ESG strategy but with the other it might act as a brake (for example, if the rollout of relevant green technology was some way away a corporate might decide to invest in existing (less green) technology with a long life cycle rather than put off the investment).
- More positively, increased dividends and share buybacks are typically an indicator of positive market sentiment and several respondents noted these results with enthusiasm.
- The fall in acquisition-related expenditure is consistent with the themes raised elsewhere that businesses are focussing on expanding organically and meeting working capital requirements and reflect our observations on the market currently and a gap between buyer and seller price expectations.
- Higher rates of inflation continue to feature from our 2022 report and that, allied with widely reported supply chain issues, was seen by respondents as driving higher working capital.

"Dividends, capex and share buybacks usually signal an expansionary phase of the cycle"

"I've been through recessions and this doesn't feel like one"

"Encouraging responses; everyone is investing"

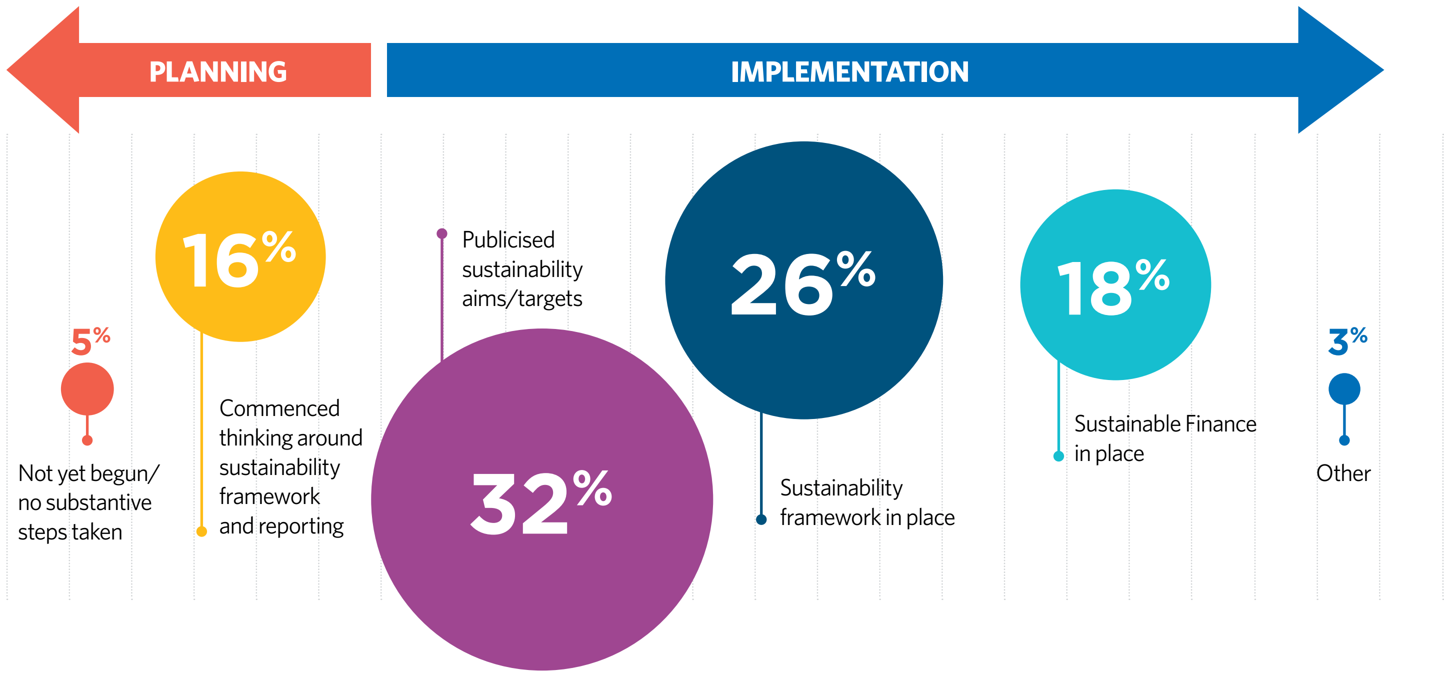
Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

3
ESG AND SUSTAINABILITY

3 ESG AND SUSTAINABILITY

3.1 THE ESG/SUSTAINABILITY JOURNEY

At what stage is your business in its ESG/Sustainability journey?



- In this section, for simplicity, we use the term Sustainable Finance to cover the plethora of ESG, sustainability-linked, green and other related financings.
- Despite the ongoing focus on Sustainable Finance those who have either issued Sustainable Finance or are in a position to do so (as they have either a sustainability framework in place or publicised targets) remains flat year-on-year. It remains the case, as it was last year, that ESG and Sustainable Finance is **the** topic of conversation in corporate treasury circles and is likely to be discussed (whether or not incorporated) in any financing.
- However, contrary to predictions last year where 70% of last year's respondents expected to enter into Sustainable Finance, this year fewer respondents reported having a sustainability framework in place (26%, down from 29% last year) and fewer reported having Sustainable Finance in place (18%, down from 20% last year), which seems to signal at best a stalling in what many had anticipated would be a persistent continual upward trend for Sustainable Finance (noting that changes in the composition of respondents year-on-year will of course impact the data).
- That aside, the results might be explained by a change to the debt market landscape; treasurers may be prioritising conversations on pricing, liquidity and speed of execution to secure funding ahead of incorporation of ESG and sustainability features as noted above.
- In relation to sustainability-linked loans ("SLLs"), the market continues to adapt and evolve in some ways positively (for example in bank lending, including the sustainability architecture in a facility agreement and agreeing the KPIs later which was a challenging task in 2021 now has much greater market acceptance) but, as time has gone on, the overlay of risk and regulatory concern has meant that Sustainable Finance terms have proved a drag on deal timetables and have resulted in increased costs (both external advisory and in terms of internal information gathering and reporting). We reported on some of these themes in our research last year but the last 12 months have seen an explosion in the growth of bank policies, ESG committees, KPI verification processes, KPI negotiation and a raft of additional contractual rights and protections. The view of many respondents is that the approach has become too heavy-handed and disproportionately burdensome for what is intended to be achieved.
- Reflecting on this, a number of respondents queried whether now was the right time to embark on Sustainable Finance. Both the observations above and their own reputational concerns around accuracy of reporting (and the risk of allegations of '*greenwashing*') are causing corporates to pause and to ever more carefully consider next steps. For example, whilst Scope 1 and Scope 2 emissions continue to be one of the most popular KPIs, KPIs and targets incorporating Scope 3 emissions are proving challenging for corporates to commit to given that it captures emissions up and down the value chain (ie up to suppliers and down to customers.
- There was also a sense that companies which had made significant strides on ESG before implementing Sustainable Finance were now "*being punished*" as the incremental gains to be made were smaller than banks were pushing for. In addition, there was a sense amongst respondents that there was still insufficient clarity and consistency of approach on the 'S' and 'G' KPIs and that agreeing those was incrementally difficult. Aside from that some banks were pushing for different KPIs to that contained in the borrower's sustainability framework; described as, the proverbial '*tail wagging the dog*'.
- Those who have already implemented Sustainable Financings are more optimistic for the future of Sustainable Finance with some predicting It would become BAU. That said, those early adopters are now refinancing facilities or incurring additional debt are being brought into the same discussions as new Sustainable Finance borrowers and it will be interesting to see how this develops over 2023.

"When the market is more normalised we might try again"

"It's only going to go up over the longer term. If you don't do it, you'll be left behind. ESG is here to stay and we will ramp it up"

"Banks have included it *[SSL terms]* for the sake of it. You might as well not bother given the effort it takes and the value it has"

"It's a bit of we have to do it because everyone else is doing it. If it wasn't already there, we wouldn't think to do it"

"It was a shiny new toy, innovative and easy. It was a margin adjustment with reporting around the edges... There is increasing noise that it is a bit of a side show, not worth it"

"It's more of an investor relations story than a treasury story"

"We decided we would be tied up in knots trying to work through it with the banks"

"People are reading the reports that we produce and are hanging their hats on the data, so we need to get the data right. If you think about Scope 3 emissions it is very difficult to ensure that the data is correct"

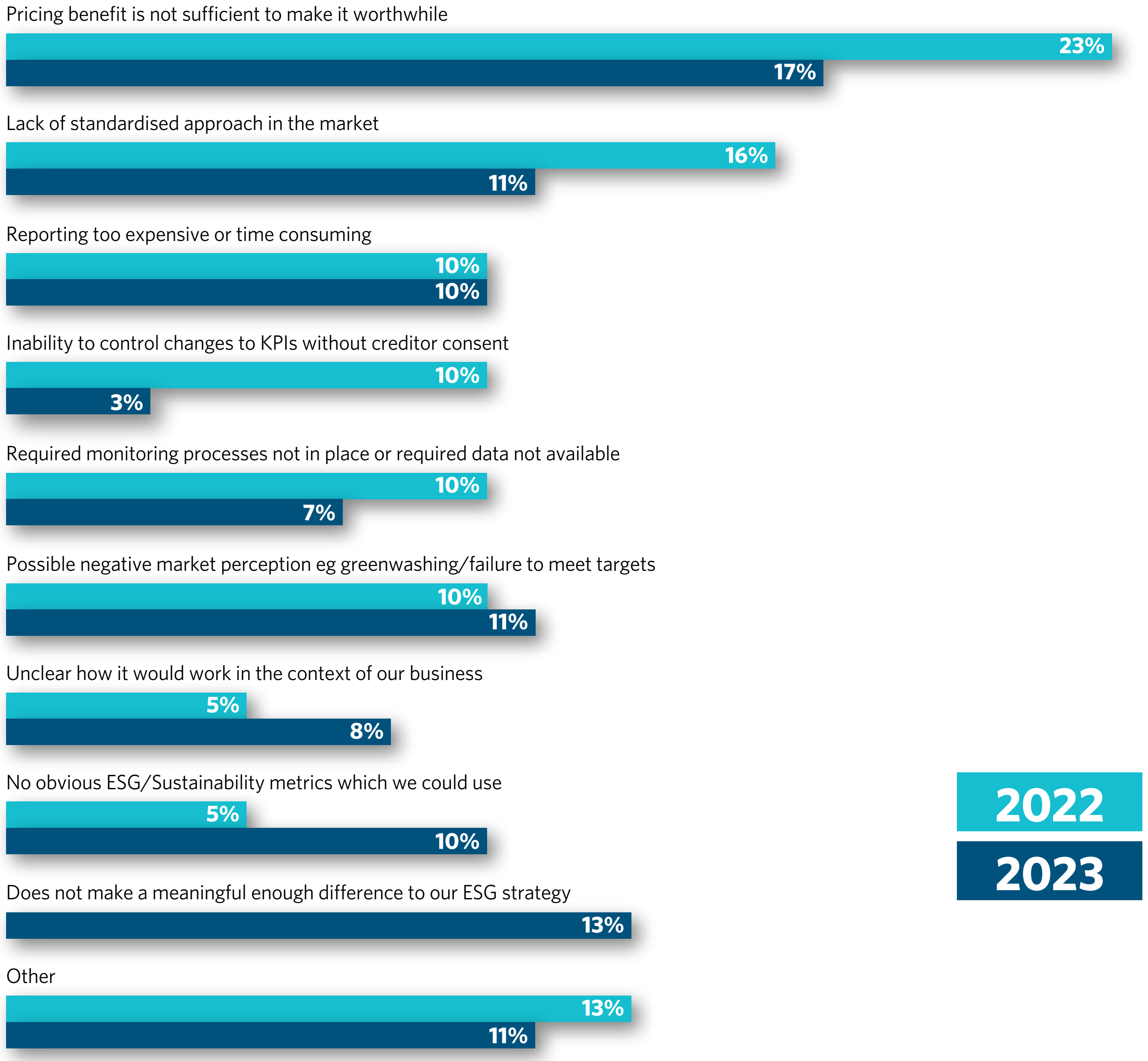
Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

CORPORATE DEBT AND TREASURY REPORT
HERBERT SMITH FREEHILLS

3.2 IMPEDIMENTS

To the extent that you haven't incorporated ESG/Sustainability elements into your financings, what are the impediments to doing so?



- Building on the general themes above, the Sustainable Finance market has deepened over the last few years and it is clear the market hasn't yet reached maturity. We are seeing corporates, banks and other participants still grappling with certain elements of the process. Whilst the impediments are generally softening, we note the theme above that Sustainable Finance is not making a meaningful difference to a corporate's ESG strategy. A few years ago some thought that treasury would help drive the sustainability agenda within organisations but it has become clearer that that's not the case though it is an outward looking arrangement with a third party to reinforce delivery of that agenda with pricing implications.
- Corporates will likely have ESG teams dedicated to driving the ESG agenda for the company and that forward momentum is not necessarily influenced (or at least not to a great degree) by whether or not Sustainable Finance has been issued but rather by market-facing, publicised ESG targets and investor and board expectations.
- Over the last year, we've seen a much greater focus from banks in the sustainability-linked loans market on the contractual SLL terms. It is beyond the detail of this report to describe the detail of the evolution of Sustainable Finance contractual rights and protections that banks and other debt investors currently seek to include. However, in our experience it is this, alongside the challenge of agreeing KPIs, that is forcing corporates to pause. Having early clarity on both is critical in order to be able to evaluate whether this is the optimal option to pursue.
- The hurdles flagged under question 3.1 above should not be under-estimated.
- At the time of writing, the LMA (representing the lender community) has just published its SLL rider; it will be interesting to see the extent to which the sentiments raised by respondents here have been reflected in that. On a related note, a number of respondents flagged that ESG was being increasingly woven into credit decisions (and so forming part of the binary decision whether or not to lend at all) and queried whether this was the future direction of ESG in debt finance (rather than margin adjustments).

"Every bank had its own ESG questions and this approach made it more challenging to agree targets"

"If a company has an established ESG strategy then they may include ESG/sustainability features in their debt but the possibility of having ESG/sustainability features in debt instruments wouldn't persuade a company to embark on the establishment of an ESG strategy"

"It *[agreeing SLL terms and KPIs]* has got to be proportionate and it's got to be simplified"

"My home is carbon neutral but I wouldn't want my mortgage provider to have any say in the matter!"

"The extra complexity of the documentation is something to avoid unless the organisation wants to tick every green box"

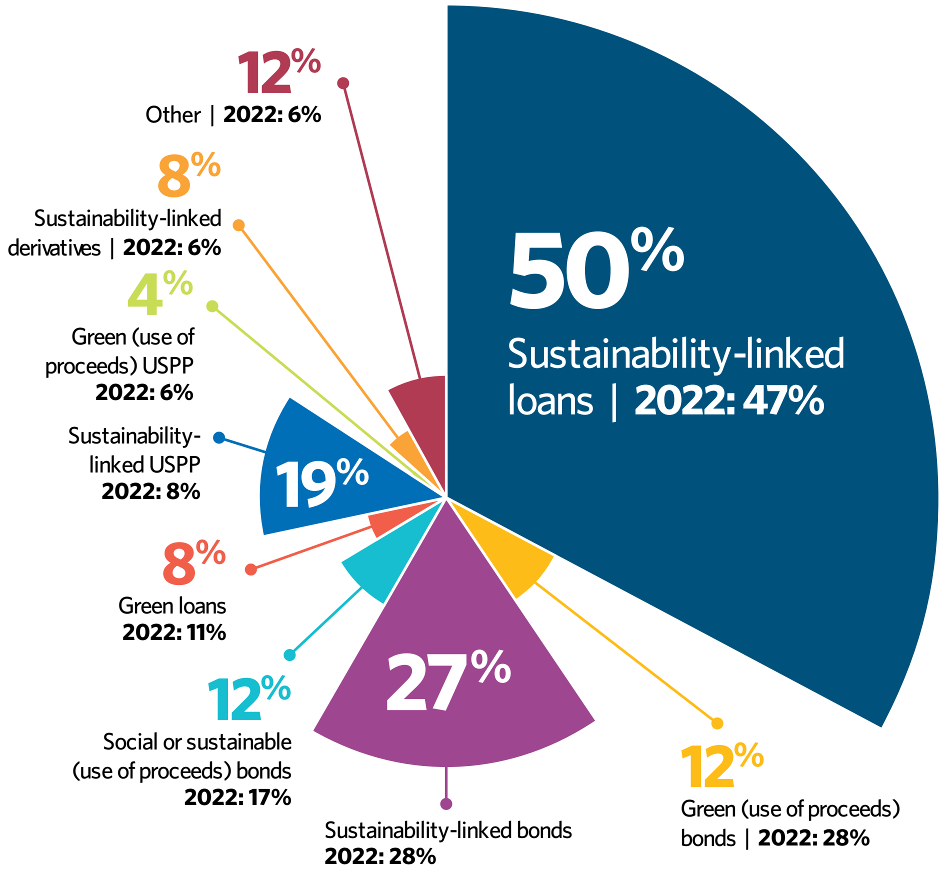
Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

Quotes are direct quotes from respondents | Percentages may not total 100 due to rounding

3 ESG AND SUSTAINABILITY

3.3 NEXT ESG/SUSTAINABILITY-LINKED FINANCING

Which of the following ESG/Sustainability linked financings are you likely to enter into in the next 12 months?

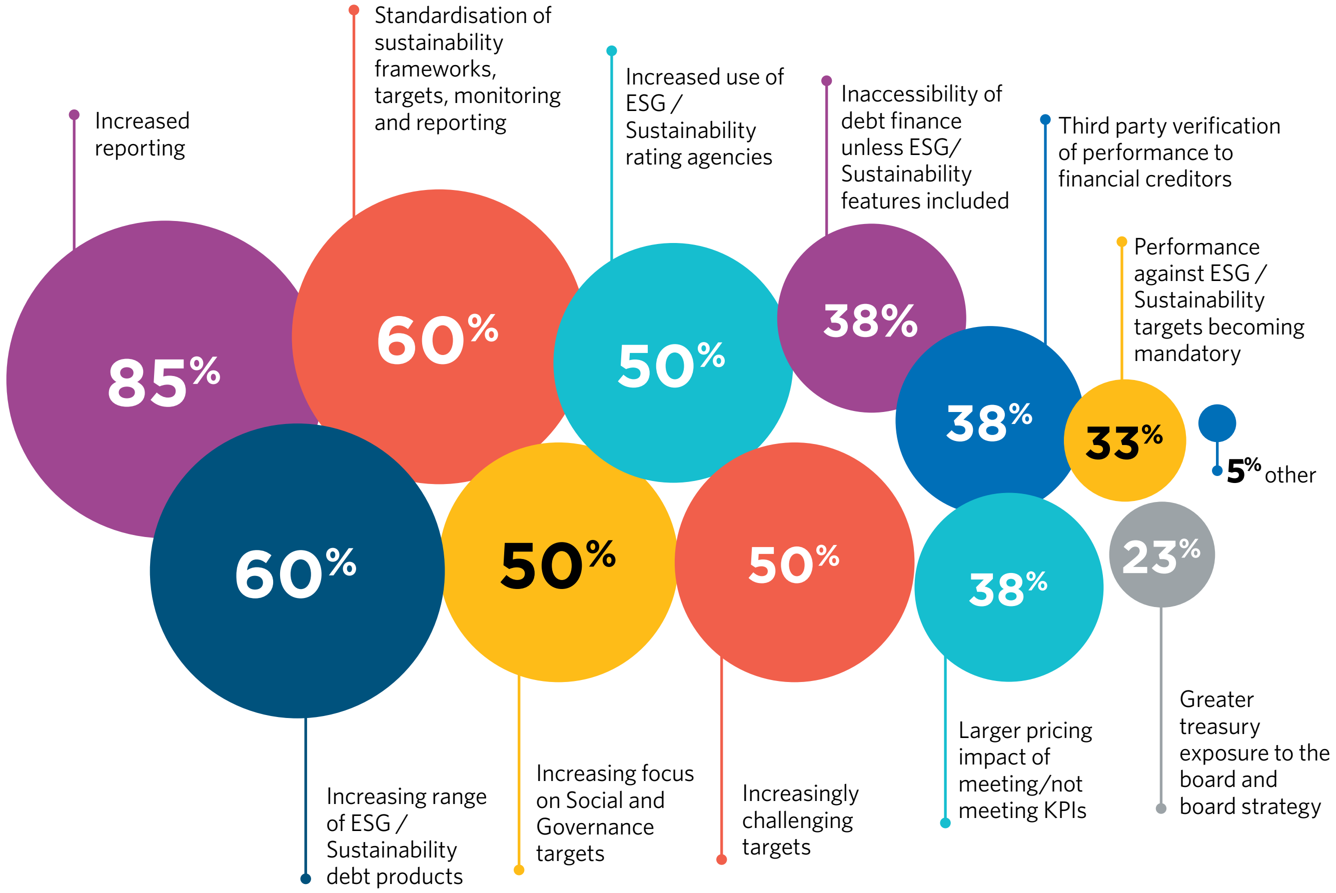


- SLLs remain the mainstay of Sustainable Finance. This reflects the flexibility of such loans versus a use-of-proceeds arrangement and also shows that, despite the impediments and difficulties highlighted above, there is still a sense of momentum and enthusiasm behind this market.
- There was a noticeable drop in the proportion of respondents reporting that they would be expecting to enter into ESG use-of-proceeds bonds (down to 12% this year from 28% last year for green bonds, and down to 12% from 17% for social or sustainable bonds), which could be due to the overall drop in volumes in DCM during the year whereas the number of respondents reporting that they would be expecting to issue sustainability-linked bonds has remained relatively constant. This may also be due to the fact that the sustainability-linked bonds market has become more developed and allows corporates to offer an investment opportunity that provides for an measurable impact on climate performance.
- There is also a sense of momentum behind the Sustainability-Linked USPP market which 19% of respondents (up from 8% last year) suggested that they would enter in the next 12 months. This is an interesting development as US markets have been perceived to be lagging behind their UK and European counterparts in the Sustainable Finance space. The momentum may be due in part to a continued push by issuers to align the sustainability/ESG features in their USPPs with features in their bank loans and other debt products. The need to negotiate (in general) with multiple holders to amend KPIs over the life of USPP notes may also play a role in driving issuers to incorporate mechanisms to permit amendment of KPIs over the life of the USPP notes, including requirements for "good faith" negotiations with the noteholders over a set period of time. Anecdotally, any hesitation of respondents to implement ESG features into new US private placement issuances may be, in part, driven by larger macro-economic conditions and other priorities.
- Aside from the above, the expected split of Sustainable Finance remained consistent year-on-year.

"Treasury can be stuck in the middle between the banks and the company's ESG team"

3.4 THE EVOLUTION OF ESG/SUSTAINABILITY IN CORPORATE TREASURY

How do you see ESG/Sustainability evolving in corporate treasury?



- The graphics illustrates the continuing state of flux in Sustainable Finance with a number of different factors at play. Whilst the increasing range of Sustainable Finance products is welcome, the negative factors illustrated above continue to weigh heavily on the majority of respondents. Regulation is not, as yet, reducing this uncertainty.
- An overwhelming 85% of respondents this year have said they anticipate and/ or are seeing increased reporting requirements to be the biggest impact on the corporate treasury function as a consequence of the evolution of the Sustainable Finance landscape. Respondents noted the amount of documentation that was expected to be produced for their creditors, in addition to the corporate's own ESG reporting compliance requirements, was staggering. As noted above, as ESG performance becomes part of a lending decision process, not pursuing Sustainable Finance does not avoid dealing with due diligence questions on it. Treasury teams are feeling the strain as they would be expected to synthesise financial and accounting data for the purposes of ESG reporting for their creditors from their ESG colleagues. Some respondents noted that the evolution of TCFD (The Taskforce on Climate-related Financial Disclosures) might drive a single set of standardised reporting to alleviate this.

"I suspect unless corporates meet the required broad "ESG" hurdles, access to funding will be restricted and pricing higher. I see a move to companies being penalised if they aren't good ESG citizens and away from favouring those that have ESG financings."

"It took a Herculean effort to put the sustainable financings in place... banks have additional ESG/reputational committees so the process takes a long time. Borrowers will be asking themselves "is it necessary to do this?""

"You don't avoid the bank DD requests about ESG by not including SLL terms!"

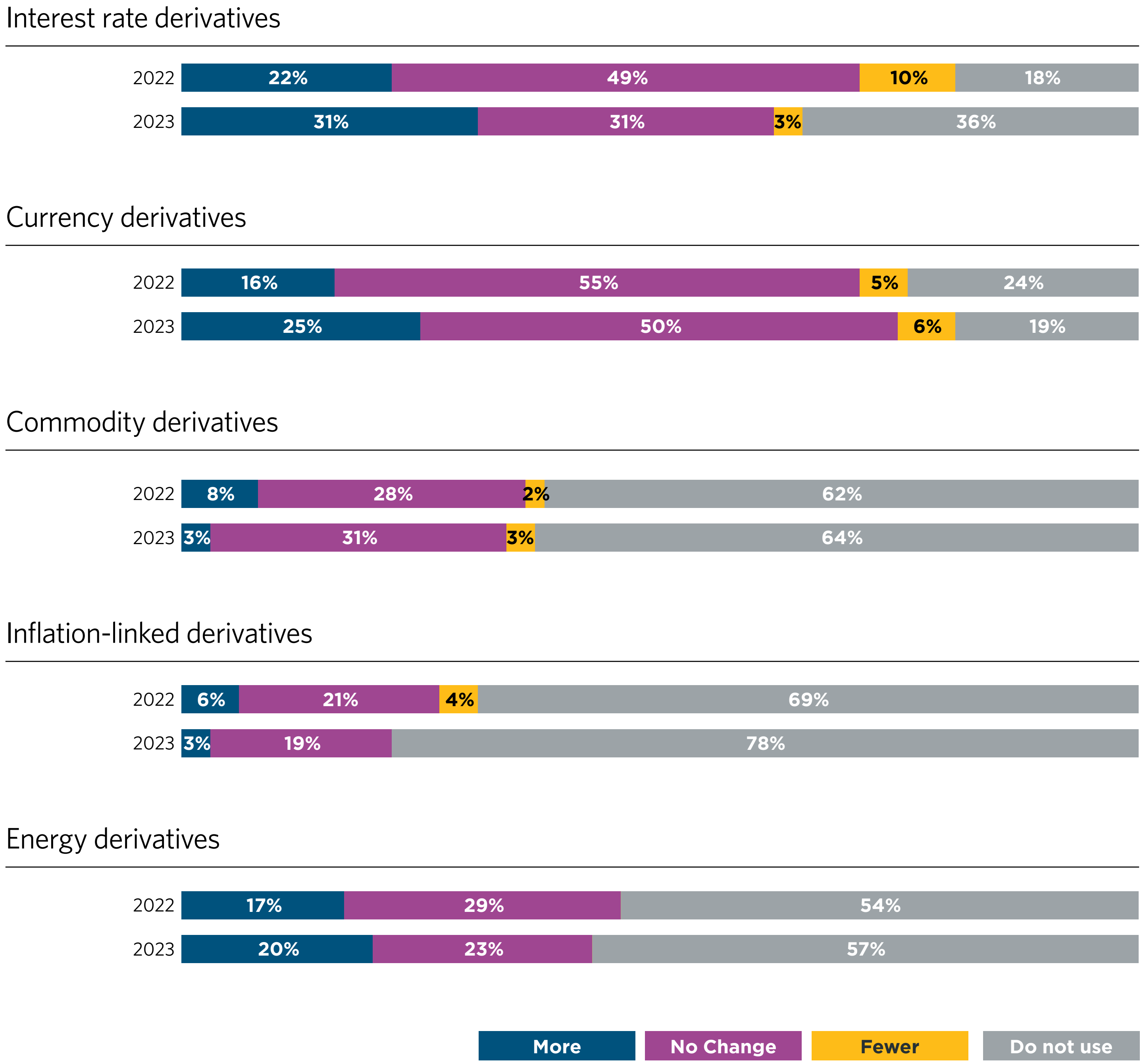
4

DERIVATIVES AND FIXED RATE DEBT

4 DERIVATIVES AND FIXED RATE DEBT

4.1 2023 DERIVATIVES FORECAST

Compared to 2022, do you anticipate that you will enter into more or fewer of the following treasury products in 2023?



- The survey results show a marked decrease in the number of respondents indicating "no change" in their approach to interest rate hedging (49% in 2022 to 31% in 2023), which indicates the impact of interest rate volatility over the past few years, and the resulting need for corporates to consider their interest rate hedging strategy.
- Linked to this, there is an interesting split in the increase in the number of respondents more likely to use interest rate hedging (which has increased by almost 10%, from 22% in 2022 to 31% in 2023), and respondents who do not use interest rate hedging (which has doubled from 18% in 2022 to 36% in 2023). This split perhaps reflects the fact that interest rates have already risen significantly, and so by early 2023 the opportunity to lock in rates at attractive prices may well have passed. This is reinforced by the fact that a number of respondents expressed the view that rates are likely to have plateaued at their current level, and so the need to hedge against future rate raises has decreased. Whether this turns out to be the case remains to be seen.
- Some respondents also noted that low interest rates had been entrenched for well over a decade, meaning that many treasury teams are inexperienced when it comes to interest rate hedging. This combines with the fact that corporates that did use interest rate derivatives did not benefit from them during the era of low rates, with a number of respondents commenting that the high number of corporates who did not use interest rate derivatives indicates that some have likely been "*burnt*" by them in the past.
- 2023 also shows an increase in the number of corporates using foreign exchange derivatives, rising from 16% in 2022 to 25% in 2023. This increase is unsurprising and is likely driven by currency volatility driven by macro-economic events such as the war in Ukraine and increases in inflation across global economies. Respondents also indicated a number of event driven needs for FX hedging (for instance, M&A activity), while others focusing on the continuing need to manage FX exposures in connection with the accounting and balance sheet treatment. As one interviewee noted: "*We do…FX hedging… because of the accounting treatment. If we didn't …then the accounting treatment would require we take the FX risk into our P&L. For us, and everyone else, the accounting treatment artificially determines what we do.*"
- The survey also demonstrates the number of corporates using commodity and inflation derivatives has slightly decreased in 2023 when compared to 2022. This seems a surprise, given the significant price increases in these areas over the period, although it perhaps reflects the fact these product types are less well known or available to most corporates. This is an area to watch over the next 12 months, as increasing inflation continues to push up commodity prices to levels which are hard to sustain for long periods.
- 2023 again demonstrates that the number of corporates using energy derivatives is greater than other asset classes such as, inflation and commodity derivatives. However, notwithstanding the significant price pressure in the energy markets over the period, 2/3 of respondents had not changed their hedging strategy as a result. Some respondents noted that, for certain sectors such hedging was business as usual in any event whilst for others there has not been sufficient forewarning in order to put in place hedging at then attractive rates.

"In a very low interest rate world, you didn't need to think about it. Now you have to dust out playbook of using interest rate derivatives"

"Treasurers can't sit on the fence anymore" *[on interest rate risk strategy]*

"The ship has sailed. We are hoping that later on this year there will be a peak or a small decrease…so we haven't looked at fixing rates at the moment. We should have done it 9 months ago"

"This is an opportunity to raise with boards energy derivative strategies that treasurers have been considering for a while. Your strategy should have been right at the outset!"

4 DERIVATIVES AND FIXED RATE DEBT

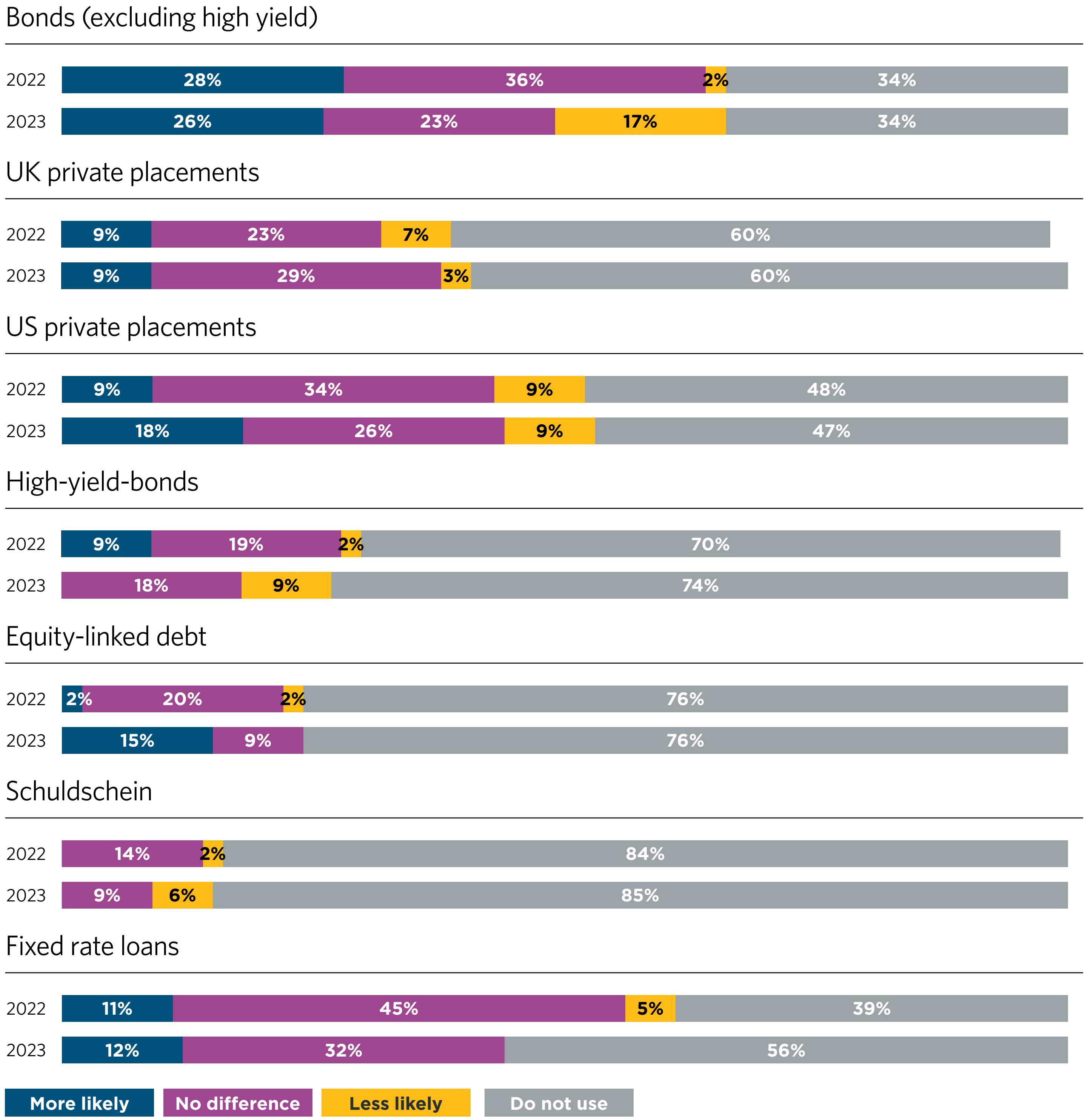
4.2 HAS THE RECENT RATE AND ENERGY MARKET VOLATILITY CAUSED YOUR BUSINESS TO CHANGE ITS HEDGING STRATEGY?

67% NO

33% YES

4.3 FIXED RATE DEBT

Compared to 2022, are you more or less likely to consider the following fixed rate debt products in 2023?



5
INFLATION

5 INFLATION

5.1 CHALLENGES

What do you see as the primary challenges posed to your business as a result of ongoing higher inflation?

- Unsurprisingly, the impact of persistently high inflation rates on corporates generated a large number of responses, with a range of issues identified. Some respondents noted their business was naturally hedged against inflation increases or had protective measures in place, such as index linked pricing mechanisms, however the overwhelming sentiment was the negative impact high inflation has across the corporate sector.
- A common theme respondents highlighted is the impact of high inflation rates on their customers, and in particular the difficulties for corporates to pass on higher prices to customers, with the consequential impact on demand and drop in margin returns.
- Another common theme was the internal impact of inflation on businesses, including increasing wage demands from employees and supply chain risks as increased inflation hits smaller suppliers. The broader societal impact of inflation was also commented on, with one respondent highlighting the impact on increased costs of living on employee wage demands and staff attrition levels.
- The survey also demonstrates the broad range of steps corporate treasury teams are taking to address the impact of inflation. Some see inflation as a business or operational risk, as opposed to treasury risk, and so an area for the business teams to manage by focusing on efficiency programmes.
- Others highlighted more proactive steps taken by treasury to mitigate the impact of inflation, such as increasing hedging and prepaying debt. One respondent highlighted supply chain financing solutions as a means to release cash trapped in the working capital cycle of the business, with that cash being put to use elsewhere and therefore driving efficiency and reducing costs. Yet other respondents highlighted the importance of index linked contracts, with those that have them seeing significant benefits and others highlighting the need to remain engaged on the issue.

"Increased commodity pricing impacting our margins, with inability to pass on price increases given the lower consumer confidence"

"Ability to pass through costs increases to customers could be limited, leading to margin erosion"

"Our biggest impact are wage inflationary pressures"

"Potential for input costs to increase at a much faster rate than we can pass pricing on to customers. Wage inflation putting pressure on overheads"

"In terms of our treasury policies, inflation has not drastically changed *[our]* way of thinking"

"Increased dialogue with business on key new contracts – ensure inflation clauses included where feasible"

5.2 ADDRESSING THE CHALLENGES

What treasury-related steps have you taken to address higher inflation?

6

PRIORITIES AND THE EVOLVING ROLE OF TREASURY

6. PRIORITIES AND THE EVOLVING ROLE OF TREASURY

What three things are currently most important to you to focus on this year in relation to your debt capital structure?

KEY CONTACTS

Kristen Roberts
Partner, Head of Corporate Debt
T +44 20 7466 2807
kristen.roberts@hsf.com

Gabrielle Wong
Partner, US Finance and Debt Capital Markets
T +44 20 7466 2144
gabrielle.wong@hsf.com

Amy Geddes
Partner, Debt Capital Markets
T +44 20 7466 2541
amy.geddes@hsf.com

Nick May
Partner, Derivatives
T +44 20 7466 2617
nick.may@hsf.com

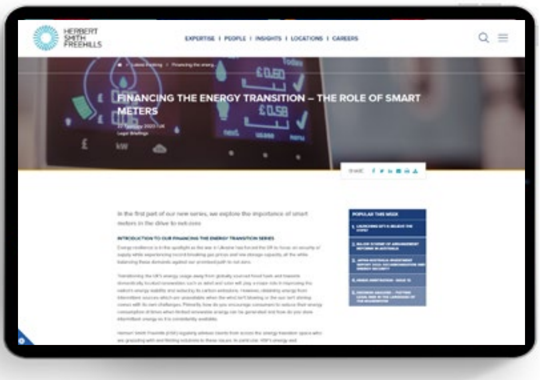
Stacey Pang
Senior Associate, Finance
T +44 20 7466 2514
stacey.pang@hsf.com

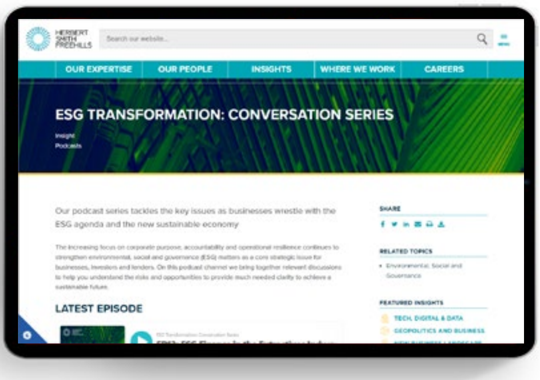
Oliver Henderson
Senior Associate Finance
T +44 20 7466 2317
oliver.henderson@hsf.com

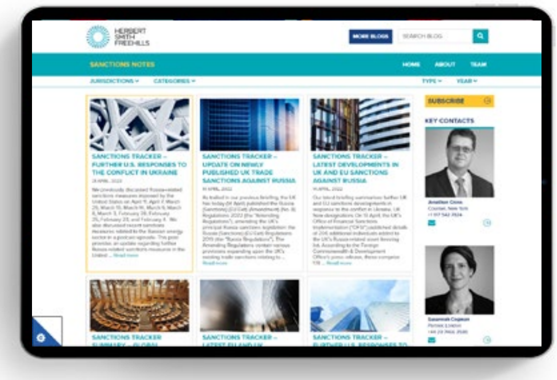
Chelsea Fish
Senior Associate (US) Finance
T +44 20 7466 3848
chelsea.fish@hsf.com

OTHER PUBLICATIONS OF INTEREST

A selection of our most recent publications are shown below which may be of interest to you. You can access each report by clicking on the image.







For a full list of our global offices visit **HERBERTSMITHFREEHILLS.COM**