FIT FOR PURPOSE

EACH FINANCING SOLUTION HAS ITS PROS AND CONS. RICHARD LUKE EXPLAINS HOW TO MAINTAIN A FLEXIBLE TOOLKIT

Creating financial flexibility can be fundamental to a company's strategy. By one definition, this means having access to sources of financing at all times, with various repayment terms and in quantities sufficient to ensure that any strategic or tactical initiatives can be successfully undertaken. It is important that the company has access to sources of finance both for time-critical asset acquisitions or to provide a safety net for unexpected negative events.

Financing toolkit

Firstly, it is key to determine what financial tools are available to the company considering its size, cash flows and risk. Debt finance is generally less expensive than equity finance and provides the ability to harness future cash flows. The high cost of equity means that, generally, it should be considered only when debt-financing options have been exhausted. What exhausted means is another subject in itself.

There is a wide range of different sources of financing available to companies. In 20-plus years in treasury, I've considered or designed implementation plans for term or bridging loans; convertible, rated, unrated, Formosa or Schuldschein bonds; private placements, commercial paper; and even equity when necessary. Each solution provides its own pros and cons, and is appropriate in different situations. A key consideration for financial and company flexibility in comparing these solutions is that bank loans provide more flexibility than bonds, i) to repay early, and ii) to amend restrictive covenants.

A committed revolving credit facility (RCF) is like a committed overdraft and can be treated on most occasions the same as cash on hand – as long as you have a reasonably weak material adverse change clause within the terms. They are incredibly flexible and, depending on your business's risk profile, RCFs have consistently been cheap for a long period now.

Financing for acquisitions

One strategy to maximise flexibility for acquisition financing is to assume that, absent a major market catastrophe, the capital markets in some form will be available (possibly via a short-term bridging loan). For that strategy to hold, it is sensible to ensure you maximise the number of alternative capital market options, and have resources available (ie cash on hand or RCF) to cover working capital swings and downside scenarios.

An alternative to this strategy is to pre-fund acquisitions with an arrangement that allows the financing to be recalled should the acquisition not happen for whatever reason. However, a company might require certainty of financing prior to announcing the acquisition, when the need for confidentiality prevails. In either case, the cost of carrying this debt is likely to hit the company's earnings line.

Credit ratings

You don't need a credit rating to ensure flexibility for significant financing exists. It can add to financial flexibility, however, by providing access to markets where a rating is needed, but to the possible detriment of business flexibility. Considerable management and treasury team time is required to maintain a rating, and managing to a rating or a rating range can handcuff the company. It's not always easy for rating agencies to fully understand your company, and so building a history and rapport is very important.

Unrated or convertible bond issuance can be available, but these markets have been known to unexpectedly and suddenly shut. Therefore, within your toolkit, the base assumption might be that these markets are closed.

Financing locations

It's not just what type of financing you need to

consider; it's also what market you're going to access for that financing. Debt can be issued in many markets around the world. Investors looking for a home for their cash exist in Europe, America, Asia and Australasia and, if you're a global company, it's prudent to ensure you have the necessary documentation in place to access many of these markets. The problem of currency can be solved (maybe at a cost). Documentation is pretty standard, and if you put a medium-term notes programme in place, you can access a number of markets with one set of documents.

Repayment tenors

Reliable cash forecasting is a very important input when assessing appropriate borrowing tenors. Ideally, you'd have access to financing that allows the flexibility to fit the company's cash flows. Different markets typically offer a limited choice of tenors. The US bond market, for instance, is very inflexible when it comes to tenors. The European market is more flexible and can be used to fill in gaps in a debt portfolio. The sterling market has a fairly long-term horizon, dominated by investors looking for assets to duration-match their long-term liabilities.

Having access to each of these markets would provide maximum flexibility when it comes to tenor of funding. If flexibility of tenors is important to the company and a choice of market is necessary, the European bond market might be considered as a potential primary source of financing.

Short-term financing

As well as long-term 'core' financing, it's important to consider efficient use of short-term opportunities to enhance financial flexibility. For instance, uncommitted money market loans and overdrafts are important tools if you have reliable banks in your banking group to provide them.

You should ensure regular engagement with your relationship banks so that they understand the company and you know what their strengths and capabilities are. Providing them with opportunities to show their worth is important to maintaining a strong and mutually beneficial relationship.

For a smaller company without access to many financing pools, tools still exist in the effective use of working capital. Cash is the most obvious form of financial flexibility. You should ensure idle cash is being used efficiently and utilise cash-pooling arrangements. It's also possible to accelerate cash receipts by selling receivables (the receivables don't have to include only bad payers).

Build the foundations

If you do not have the requisite skill set immediately available within a team, you can build it via ACT courses and qualifications. The MCT qualification certainly provides an invaluable foundation of knowledge. Alternatively, assess options to enhance your financial flexibility regularly with your external advisers.

The more robust a financing toolkit is, the greater financing flexibility will be afforded to the company. It's important to prepare yourself for both good and bad surprises.

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The views expressed are his own