3.3.1 Towards a Complete Financial Strategy

Unit: Unit 1 – Treasury Strategy

Module: Module 3 – Financial strategy

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Summary: A toolkit to allow the construction of a broad financial strategy, allowing a firm to construct a strategy to allow the firm to deal with the fundamental issue of liquidity risk, arguably the biggest risk of all to a firm.

Keywords: leverage, liquidity, credit rating, spread, margin, life cycle, investment grade, high grade, sub-investment grade, junk, high yield, structured finance, dividend, interest rate risk, translation risk, foreign exchange risk

Contents

1 Introduction 1
2 Leverage or liquidity, which comes first? 1
3 Credit ratings 3
4 Peer group influence 7
4.1 Life cycle influence on financial strategy, product and corporate 8
5 Financial flexibility 9
6 Debt markets 10
7 Lender and bank relationships 13
7.1 Transactional banking v relationship banking 13
7.2 Domestic banks v foreign banks 14
7.3 Large banks v small banks 15
7.4 Commercial banks v investment banks 16
7.5 Regulation 17
7.6 Issues facing those with surplus cash 17
7.7 Other issues 18
8 Structured finance 18
9 Dividend policy 19
9.1 Practical aspects of dividends 21
9.2 Possible approaches to dividend policy 22
10 Documentation 23
10.1 Consistency 23
10.2 Trade off between conditions and cost 23
10.3 Keeping up to date 24
10.4 General 24
11 Corporate structure 25
11.1 Majority owned subsidiaries (> 50%, but < 100%) 26
11.2 Investments without full control i.e. associates / minority interests where less than or exactly 50% of the equity is owned 27
12 Risk management 28
12.1 Interest Rate Risk 28
12.1.1 Financial strategy when cash flow varies with interest rates 28
12.1.2 Financial strategy under high leverage 29
12.2 FX translation exposure 30
12.3 Transaction and other exposures arising from operations 30

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Learning outcomes:

1. Financial strategy comprises many components, with perhaps leverage and liquidity vying for the top spot, although they could be considered two sides of the same coin.
2. Although leverage is probably the most important element of financial strategy, a decision on the amount of leverage cannot be made in isolation.
3. A credit rating target can be a significant driver in any financial strategy.
4. Financial strategy is to a great extent influenced by the peer group, business model, jurisdiction and geographical footprint.
5. Financial flexibility should be a component of strategy.
6. The state and volatility of debt markets must be considered.
7. Banks, as a major component of the debt market landscape, deserve particular attention in any financing strategy.
8. Structured finance appears more often than one might think and a wise treasurer understands its issues.
9. Dividend policy has more influence than might first appear.
10. Documentation and corporate structure must not be overlooked in a complete financial strategy.
11. Risk will follow from a particular financial strategy but equally a financial strategy must accommodate risks arising from the business.

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1 Introduction

The strategy of a business can be summarised as:

- What do we invest in?
- How do we finance it?
- What risks are there and how do we manage them?

The financing decision starts with the amount of leverage that the business should have, and the broad influences on leverage come from many different sources. These range from the theoretical approach in the Capital Asset Pricing Model to the practicalities of Pecking Order Theory, multiples and capital market liquidity, as well as the characteristics of the business itself and its sector.

Other elements of financial strategy form part of this overall aim of how to finance the business. Therefore, it is possible to argue that financial strategy broadly becomes a strategy about liquidity i.e. access to cash, and conversely that liquidity is a key part of the financing strategy. From the risk management perspective, the biggest risk of all for any firm is failing to stay in business and therefore liquidity is crucial to managing that risk. Thus in a sense the entire financial strategy is directed towards maintaining liquidity and minimising the risk of the firm going out of business.

> "Liquidity is a myth. It's never there when you need it." (attributed to Michael Milken)

This reading takes us through many of the elements that might make up a complete financial strategy. Some of these may be considered elements of a treasury strategy, rather than a financial strategy, but the distinction is rather academic, all are directed at the same thing.

An issue that features through all the components of financial strategy is to decide where to start. Leverage is probably the most important component, but that too is influenced by what is possible in practice, and so ultimately, all components must be considered as a whole.

2 Leverage or liquidity, which comes first?

We have argued that leverage is the first decision for financial strategy and that leverage is desirable because of its capacity to improve the return on equity. In this case its influence on liquidity becomes a secondary factor. So, a utility or property company will employ leverage to increase the (risk-weighted) return on equity to a level consistent with general levels in the equity markets. The limits to that leverage are found by exploring restrictions around liquidity, imposed either by the markets or by the borrower's own risk appetite.

It is possible to take an alternative view whereby liquidity is the more important issue and becomes the driver of the capital structure.

Example 1: Water Water Everywhere plc (WWEP) refinancing
WWEP, a utility has borrowed heavily to finance its capital expenditure programme for projects to ensure a continuous supply of water in rural England. It has a range of debt maturities which will need to be refinanced on a regular basis. It must therefore have access to a regular and reliable source of funds and this is only possible if it chooses to be of sufficiently low leverage (i.e. high credit quality) that lenders will always be happy to continue to lend to WWEP.

We can see from this example that the state of the financial markets must therefore be an influence on financial strategy.

Example 2: Liquidity drives the capital structure
Consolidated Cranes Inc has a refinancing requirement of USD 600 million and has expected EBITDA of USD 85 million. Its bankers tell management that deals have recently been transacted successfully as follows:

Senior bank debt (secured on real assets) at	2 x EBITDA
Junior bank debt (2nd charge on secured assets) at	1 x EBITDA
High Yield (heavily subordinated and ranked only above equity) at	3 x EBITDA

This represents total leverage of 6 X EBITDA, so maximum debt funds available are therefore USD 510 million, calculated as follows:

Senior bank debt = 2 x 85 =	USD 170 million
Junior bank debt = 1 x 85 =	USD 85 million
High Yield = 3 x 85 =	USD 255 million
Total = 6 x 85 =	USD 510 million

Consolidated Cranes Inc must therefore adopt a financial strategy around the liquidity available in the markets of $510 million, and must raise USD 90 million in the equity market to meet its overall requirement of USD 600 million.

It must then persuade potential equity investors of its ability to make equity level returns on the USD 90 million, e.g. by demonstrating that growth in the business together with dividend returns will meet those return requirements.

In the case of example 2, the issue of routine continuing refinancing of debt is of less importance than in the case of example 1. That is because in example 2, the financing has been “structured” and renewal all occurs at once, any refinancing is several years away. This concept of structured finance is an important one to understand.

Although either leverage or liquidity may be the priority component, it can further be argued that the liquidity and leverage decision are two sides of the same coin; neither really comes first and each must be decided with the other in mind.

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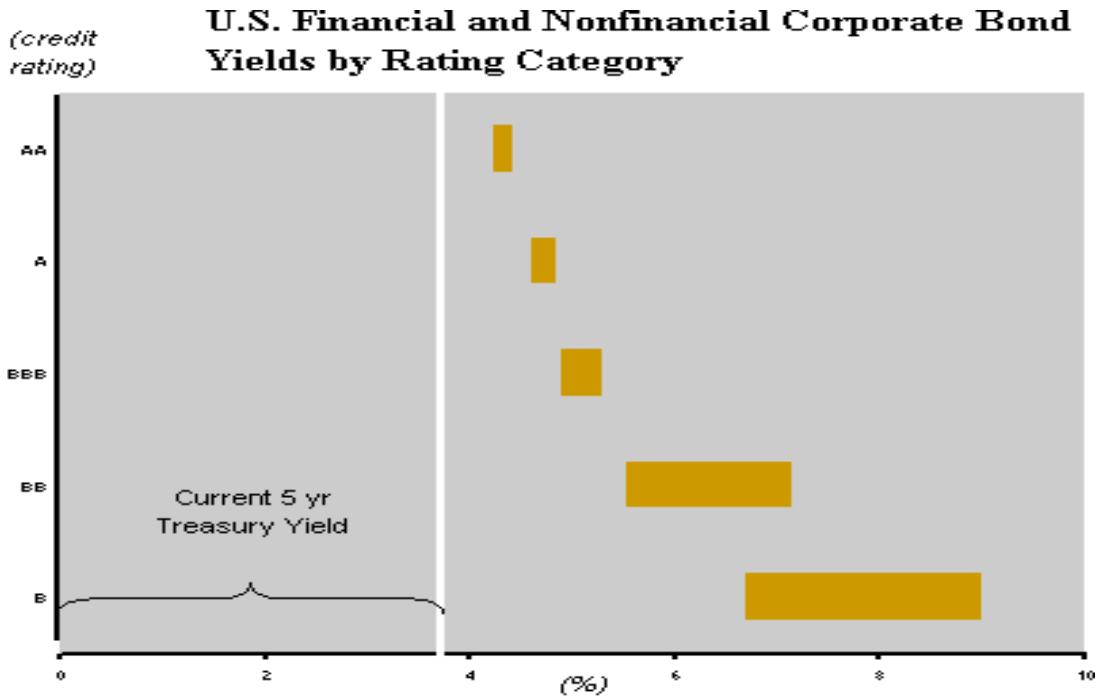
We have made several attempts to make measures of leverage and seen them in action in real firms and we must now turn to measures of liquidity before the two can be married. The liquidity of a company, i.e. its access to cash, is substantially dictated by its credit strength. The most common way to measure this is by way of credit ratings. Larger companies may well have a public rating, but private lenders such as banks and Private Placement investors will derive their own rating for their borrowers.

3 Credit ratings

A credit rating is a measure of the likelihood of a default in repaying a security (or bank loan or creditor etc) combined with the likelihood of recovery on such a default, in other words a measure of credit risk. This has led, over time, for ratings to become a measure of two things with regard to borrowing:

- The cost of debt
- The availability of debt

Exhibit 1: The cost of debt by rating



All OAS (option-adjusted spreads) are calculated off the reference five-year Treasury yield. 'AAA' rated entities are not shown owing to small sample size. Range width in each rating category represents the minimum and maximum points of corporate bond yields in the period Jan 31, 2004 – Jan 31 – 2005.

Source: Standard & Poor's Global Fixed Income Research

In Exhibit 1 we see that the cost of debt is heavily influenced by the credit rating. This is broadly true whatever the state of the markets - 'normal' and 'abnormal' markets affect the absolute cost of borrowing, but not the relative levels. Also, the cost is more predictable the

stronger the grade. High Yield issues (BB and B in the chart) tend to trade more like equities, i.e. their pricing is more uncertain; this is partly because High Yield debt has more of the characteristics of equity, being closer to it in capital structures and approaching it in risk terms.

However, and almost more importantly, the credit markets, bank, bond and private placement markets, have come to adopt ratings as benchmarks, indicating both different levels of liquidity and different terms and conditions applying to the debt. This is broadly because institutions have limits on the amount that can be invested with any one name or level of credit risk, with some institutions specifically prevented from investing in sub-investment grade paper. Broadly speaking AAA borrowers will have little difficulty accessing debt, whereas BBB borrowers may find limits to tranche size and be subject to liquidity squeezes. There is then an enormous jump down into sub-investment grade or speculative territory (High Yield), where the ups and downs of the market become severe and the markets often close completely or severely restrict loan size. Therefore, a sub-investment grade borrower cannot guarantee liquidity through borrowing, whereas a single A or AA borrower probably can, at least in *normal* times.

Private Placements use a proprietary form of ratings to which the same principles broadly apply.

A similar effect occurs in the short term debt markets, particularly the US and Euro Commercial paper markets, which are governed by short term ratings. A-1 borrowers have access to substantially more amounts of liquidity than A-2 or A-3 borrowers.

This distinction extends beyond bond markets into bank markets, where documentation and access to uncommitted facilities such as daylight (settlement) limits and derivative lines, are all broadly linked to credit risk (i.e. the rating).

It will come as no surprise, therefore, that the targeting of a credit rating can become a central plank in a financial strategy because it will give some certainty of access to finance. Essentially, after taking into account the underlying business risk, the credit rating is based on financial analysis. So, as before, targeting a credit rating is broadly equivalent to targeting leverage.

Exhibit 2 shows the key ratios used by Standard & Poor’s, and we can recognise many of them as measures of leverage.

Exhibit 2: Key ratios used in the credit rating process[1]

Ratio	Formula
Operating income before D&A to revenues	(Operating income before D&A) ÷ revenues
EBIT interest coverage	EBIT ÷ interest
EBITDA interest coverage	EBITDA ÷ interest
FFO interest coverage	(FFO plus interest paid minus operating lease adjustment to depreciation) ÷ interest*
Return on capital	EBIT ÷ (average beginning of year and end of year capital)
FFO to debt	FFO ÷ debt
FOCF to debt	FOCF ÷ debt
Discretionary cash flow to debt	Discretionary cash flow ÷ debt
Net cash flow to capital expenditures	Net cash flow ÷ capital expenditures
Debt to EBITDA	Debt ÷ EBITDA
Debt to debt plus equity	Debt ÷ (debt plus equity)

Notes:

D	Depreciation
A	Amortisation
FFO	Funds Flow from Operations
FOCF	Free Operating Cash Flows
Discretionary cash flow	Cash flow from operations minus capital expenditures minus dividends paid
Net cash flow	FFO minus dividends

*The numerator reflects FFO before interest paid; the denominator reflects interest expense.

For a detailed description of these terms, see the S&P website.

Read Chapter 3, pp 77 - 82 from Applied Corporate Finance, by Aswath Damodaran, 4th edition, for an overview of the ratings process.

Rating agencies have been reluctant to publish target ratios for each rating level in an attempt to dissuade corporates from targeting these ratios without considering other aspects of credit risk. Their disclosure has therefore changed over the years, but in Exhibit 3 we see a recent publication which combines business risk with financial risk, i.e. leverage. Notably we see the importance of debt multiples (as opposed to classic balance sheet gearing) to evaluate leverage, but we also see the interaction of leverage with business risk. Of course,

[1] Source (no longer available): Standard & Poor's website (registration required) http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245319405405

in most firms which target a credit rating, the business risk profile is broadly fixed and so the targeting does come down to ratio management. Such firms will then model leverage ratios and follow the rating agencies' (or bank's) own adjustments and modelling techniques, which the agencies are usually happy to share.

Exhibit 3a: Business risk and financial risk[2]

Business And Financial Risk Profile Matrix

Business Risk Profile	--Financial Risk Profile--					
	Minimal	**Modest**	**Intermediate**	**Significant**	**Aggressive**	**Highly Leveraged**
Excellent	AAA	AA	A	A-	BBB	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	--	BBB-	BB+	BB	BB-	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	CCC+

Exhibit 3b: Financial risk from measures of leverage

Financial Risk Indicative Ratios (Corporates)

	FFO/Debt (%)	**Debt/EBITDA (x)**	**Debt/Capital (%)**
Minimal	greater than 60	less than 1.5	less than 25
Modest	45-60	1.5-2	25-35
Intermediate	30-45	2-3	35-45
Significant	20-30	3-4	45-50
Aggressive	12-20	4-5	50-60
Highly Leveraged	less than 12	greater than 5	greater than 60

[2] Source (no longer available in this form): Standard & Poor's website (registration required) http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245319314383

The targeting of a rating is much more about *access* to finance and liquidity than it is about the *cost* of finance. The cost of finance will vary according to underlying interest rates and market attitudes to credit much more than the effect of a few notches or changes to a credit rating.

Another element of financial strategy concerning ratings is whether to adopt them in contracts with third parties. Possible uses might include the setting of a margin on bank debt according to a rating or the extension of credit to trading counterparties. However, care should be taken with such steps as the use of ratings triggers has been known to accelerate the failure of a firm, because as a rating falls and a counterparty seeks less credit exposure, the availability of credit from elsewhere will also fall. This applies to trade credit as well.

Example 3: Rating triggers
Sentron Inc, a single A rated firm operating in the oil sector, issued capital market debt with a covenant that the bonds would be repaid if the firm fell below investment grade. The firm was eventually rated below investment grade but at that time no other lenders were prepared to advance credit because of a temporary shortage of 'junk' investment appetite and also arguably because downgrades can scare off any lender. The firm failed and in the resulting insolvency the existing bond investors received back less than par value.

If a firm adopts a policy to target a rating, it must choose where on the spectrum it will target. This choice is mainly about how frequently the firm needs to refinance or to raise new money for investment as well as the targeting of a return on equity. Many utilities and larger firms such as oil majors tend to target a rating around the single A range or better. This is because they are frequent and heavy users of capital markets. Banks, continuously in need of capital, have to be of the highest grade and have tended to settle around AA (note that a AAA rating (where many banks once sat) is increasingly rare and tends to be limited to entities benefitting from the guarantee of an AAA-rated sovereign). Today, however, banks often struggle to reach single A credit ratings, let alone AA. Industrial companies seem happier to target a rating around BBB because targeting anything stronger is too restrictive on their capital structure and would diminish the return on equity too much.

4 Peer group influence

Most commercial management teams are aware of who their competition is and how strengths and weaknesses are distributed in the market, and they have a plan as to how to manage them. For example, supermarkets in the UK spend a long time analysing the price of products in their competitors and indeed go so far as to advertise (favourable) differences as selling points. A particular supermarket may aim to be at a certain percentage of price for a basket of goods compared to a major competitor.

Treasurers do not often venture into peer group territory but it is arguable that they should at least understand the financial strategy of their peer group and of competitors. Both equity and debt investors will compare members of a peer group, and competition occurs not just in products but in raising finance as well. A firm should seek to attract capital more cheaply than its competitors. As with many competitive forces, a common outcome is that peers tend

to herd together as no one participant feels as though they should be too far out of line in case such a policy proves wrong. There are always exceptions to this rule and a common one is that one or more firms in a sector are financed by Private Equity. This can have a major influence on the sector.

Example 4: Peer group influence on ratings targeting
Bell plc, a large oil major with interests throughout the oil supply chain, also engages in speculative exploration projects and requires large amounts of capital to do this. It is accepted that there is limited demand in the market for debt issued by oil companies and Bell will therefore compete with other oil majors not only in the exploration and extraction and refinery of oil but also in the capital markets. It therefore targets a rating slightly higher than its peers.

Example 5: Competition in finance
Extronica SA manufactures rolling stock for rail operators around the world. A project typically takes one year from bid to acceptance and a further four to five years until delivery, often with a service contract after that. Extronica is sub-investment grade and the high cost and difficulty of procuring bid and performance bonds restricts the number of contracts it can bid for. In addition, its customers are concerned that Extronica might fail in the middle of a contract, in which case the customer's business might be disrupted.

Accordingly, Extronica is at a large disadvantage compared to its investment grade competitors.

4.1 Life cycle influence on financial strategy, product and corporate

Read Chapter 7, pages 294 – 300 and pages 328 - 329 from Applied Corporate Finance, by Aswath Damodaran, 4th edition; "Financing Behaviour" looks at the distinction between internal and external financing and the factors which affect how firms draw on each source. Damodaran concentrates on the corporate life cycle but the principles can also be applied to product / market life cycles.

Exhibit 4: Product / market life cycle

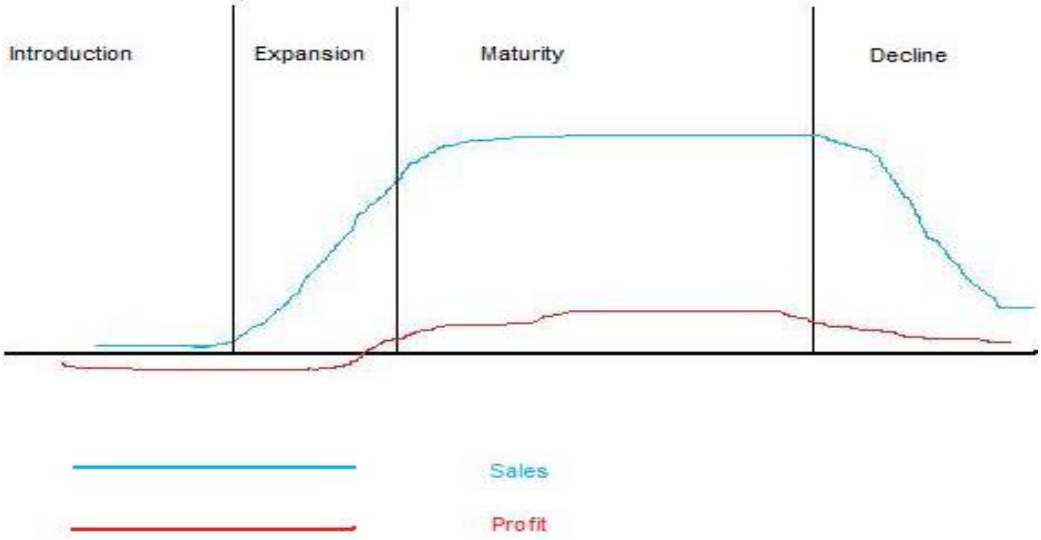


Exhibit 4 covers the sales and profit characteristics of the life cycle of a typical product. Using profits as a proxy for cashflows, only in the maturity phase is the firm a creditworthy borrower. During the *introduction* and *expansion* phases, the product is new and therefore risky. Sales could just as likely to fall as to grow. In the *decline* phase profits and cash generation are falling, limiting the firm's ability to service and repay debt.

Example 6: Product life cycle
Shockia SA makes mobile handsets. Each model is expected to have a life of around two years before a competitor is expected to produce a phone with better technology, at which point sales of the existing model will decline. Shockia plans its financings around this profile. For each launch there is no certainty that sales will grow, however lenders obtain comfort from the portfolio effect as Shockia has several different products at different stages of development at any given time. And to remain bankable, Shockia must maintain a stream of products coming through the business. The cash from mature products supports new products coming to maturity and the decline of older ones.

Some products such as food have a perpetual life cycle. However, in this case the tendency is for them to become commoditised, where the general economics and business model around them is understood. In such cases competition has usually reduced profitability to relatively low levels. Where a product has become commoditised, the cash flows are at least more certain, allowing a different approach to financing, where assured cash flows can support an assured level of debt.

5 Financial flexibility

We have seen in the readings in Damodaran that financial flexibility is one factor in deciding financial strategy. With higher leverage comes less financial flexibility. Although the borrowing of money does not automatically cede control, there are two fundamental ways in which flexibility is lost when money is borrowed. The first is that a lender will impose controls in the form of covenants. A lender seeks to ensure that a borrower remains in the same credit condition as when the loan was first made and this is achieved with covenants, both financial and non-financial. The second revolves around the increase in financial risk when leverage is increased. When leverage is particularly high, total enterprise risk is also high. In such a case corporate activity such as an acquisition or other large investment is more difficult to accommodate without financial risk becoming excessive.

Financial flexibility is likely to be required in the following scenarios:

Scenario	Comment
Ability to make acquisitions	Some industries go through periods of consolidation where smaller businesses are combined into larger businesses.
Ability to make large investments	A new factory or investment in product development may be necessary in some businesses.
Ability to withstand shocks	Clearly a lower leveraged firm can last longer than a competitor in a stressful situation. It is arguable that stressful situations (Black Swans perhaps) are more common now than in the past.
Expansion into new markets	Expansion into a new market can be both expensive and risky.
Expansion of sales generally	Expansion normally requires investment, either in fixed assets or working capital or both. Credit products such as bank guarantees or letters of credit may be required. Even submitting quotations may increase business risk.
Working capital	On a similar them, expansion can mean higher working capital and inflation or increased pricing, perhaps in commodity markets, can cause working capital toi rise.
Derivative collateral	Margining requires ample capital todeal withy price changes if margining is used, either to avoid the need for facilities, or to avoid credit risk on the counter party.
Contraction	Withdrawal from a particular market may also require investment and cash expended in the short term may be excessive in relation to losses that might be occurring.
Sensitivity to Creditworthiness	Some customers and suppliers also consider the credit risk of their counterparties, both on financial grounds and on the grounds of sustainability as a trading partner. Customers in long term contracts or where service and support is required are particularly susceptible.

It is also worth noting that too much flexibility might be a bad thing. Managers might be too willing to make mistakes, too keen to spend what money they have, thereby increasing both business risk and financial risk at the same time.

6 Debt markets

If a firm is to borrow (i.e. obtain leverage) then it must find lenders. So a major part of financial strategy is to work out which debt markets to access. In the same way that the liquidity decision affects the leverage decision, the ability of debt markets to meet desired leverage requirements must also be taken into account. Detailed descriptions of capital markets are in another reading, but broad considerations for *larger* firms are considered here.

Market	Considerations
Investment grade bond market (High Grade, BBB and higher)	Generally open for new issues. Liquidity increases as the rating improves. Name is generally crucial to success, especially on a first offering although this might be arguably diminishing as a factor. Issuers can only access ('tap') the market at certain times.
Sub investment grade bond market (High Yield)	Not always open. Liquidity is limited and very weak for CCC issuers. Can only tap infrequently.
Bank market	Generally open but since 2008 there has been a trend away from bank finance. For those with a strong rating, the bank market is not the natural place to borrow – the bond market is preferred. BBB is probably the sweet spot for bank funding. It can be difficult for sub-investment grade borrowers to access bank debt as their primary source of funding, although possible on a secured basis. In fact in the mid 2010s, the sub investment grade bank market is very liquid. Banks are the only source for facilities such as overdrafts; revolving facilities; trade finance and derivative lines - although some competition is appearing in FX; and cash management products.
Private Placement (PP)	The market is generally open with good liquidity, including small tranche sizes. Private placement is often a first step away from bank finance for many borrowers but probably best for mid-market size firms. Covenants can be tight and amendments difficult. PP is a major market in the US (accessible to both domestic and overseas issuers), but there are only fledgling markets in Europe.
Euro Medium Term Notes ("EMTN")	Usually open as for Investment Grade bond markets. Generally used on an 'as and when' basis, so less a primary source of liquidity than a useful supplement. Effectively a part of the investment grade bond markets but with smaller tranche size and often shorter term maturity. Increasingly available to smaller, issuers with weaker credit.
Commercial Paper	Generally open for the highest investment grade borrowers but issues are short term maturity and can need bank support via back up (standby) lines.

Any financial strategy therefore has to take these considerations into account, bearing in mind that borrowing conditions are often subject to fashion and can change rapidly. Thus a financial strategy may need to change just as quickly.

Typical approaches to the choice of debt markets, primarily for normally financed companies, allied of course to choices in leverage or rating strategy, can be summarised under three alternatives.

Approach	Comment
Limit to one market	Limiting borrowing to one market increases dependence on that market in case it suffers from illiquidity or overcapacity in a particular name or sector. However many companies adopt this approach – often limiting borrowing to the bank market.
Phased approach to one market	This approach limits borrowing to one market (e.g. banks), but splits the funding so only part of the total matures at any one time. This reduces the risk that there is insufficient capacity to borrow or re-borrow the full requirement at one time.
Phased approach to multiple markets	This approach uses a variety of markets and sets maturity limits by market, amount and borrowing term. This reduces the risk that failure of multiple markets will threaten liquidity, and is the ideal approach.

A further factor in terms of debt markets is that of debt maturity. We have seen that ideally the term of debt should be chosen to ensure that maturities do not crowd together, thereby increasing refinancing risk. But with a blank canvas (and it is worth standing back from time to time to review the position), the term of each debt needs to be considered.

Generally, bank debt can be repaid with relatively short notice and sometimes without penalty and it is normal to elect for as long a facility as possible, unless the facility is for a particular short term need. In any case, except in particular sectors (e.g. where longer term debt can be secured against long life assets) bank finance is naturally of shorter maturity. Most committed bank lending is in the 3 to 7 year bracket (although increasingly shorter term) and only sectors such as infrastructure, housing and similar fields can access longer term bank lending.

Private placement borrowing is very expensive to repay early but it is generally long term as the insurance company lenders prefer to have longer term assets. There are ‘sweet spots’ which borrowers generally have to accept.

Bonds are not intended to be repaid before their maturity, so firms with no definite long term requirements tend to issue bonds for relatively short periods. Utilities, whose business model is always to have debt, will go for much longer maturities. There are ‘sweet spots’ in the bond markets such as 5, 7, 10 and 20 years and sometimes longer which borrowers generally accept. Only the most well known and creditworthy names can borrow for the longer maturities of say 20 years and above.

Note that bonds are often issued with call features, allowing the borrower an option to redeem (‘call’) the bonds at a pre-agreed cost and on pre-agreed dates. Exercising this option can be quite expensive - normally a percentage of the face value of the issue – however it does give the issuer some flexibility and an upper limit on the cost of repaying the bond early. There are other techniques for redeeming bonds, such as buying them in the secondary market or making a tender offer.

Borrowing gets more expensive as maturity increases, to reflect the increased risk of borrower default, inflation and illiquidity risk (i.e. the investor requires a higher return for tying his money up for longer). Careful thought needs to be given to taking on long term financing, with its greater difficulty and expense to repay, if the debt maturity is a long way beyond the planning horizon of the borrower.

7 Lender and bank relationships

If a leverage strategy is chosen, then no matter how small the leverage might be, there must be lenders to fund that leverage. Such lenders then become investors in the business with an interest in it performing according to expectations, and their interests must be taken into account. Borrowers compete with each other for available capital, and/or for favourable interest rates, and so relationships with lenders need to be fostered.

Customer / supplier relationships are a common theme in modern business management, with some under particular spotlight. In the financial space, counterparties need each other to remain healthy, and each should benefit from the other growing (but not necessarily changing) its core business.

If a lending relationship is to be long lasting, then the general principles of any supplier / customer relationship should apply.

These might include:

- The aims of each party are clear
- Pricing is transparent
- Each expects the other to earn a profit commensurate with the risk
- Each is honest and respects that surprises are not good for relationships

The relationship between corporate and bank can extend into all the banks who service that particular sector. Bankers talk to each other, especially during episodes like syndications and a borrower's reputation with one lender will be carried onto others. This reputation can also get carried back to peer group members of the sector.

The sectoral issue is also important because banks often target certain sectors or have to enforce limits by sector.

Concentrating on banks (where there is more choice than in other debt markets), some of the issues to consider include:

7.1 Transactional banking v relationship banking

This traditional split is a first approach to banking relationships.

Transactional banking implies:

- One-off deals

- Go to the cheapest supplier (subject to capability)
- Price or terms is most important

So whenever a corporate has a transaction, such as a cash management implementation or a bond issue, it goes to a group of banks who are known to have expertise in the relevant area and request that each submits a proposal for the transaction, setting out price and capability. The corporate selects the best bank for the role, with price and service the deciding factor.

Relationship banking implies:

- A continuing stream of transactions
- Maintaining a panel of banks who know the borrower and who between them can deliver most of the borrower's needs
- Business is given only to banks on the panel (with whom each competes)
- Banks are morally obliged to support the borrower
- An extension to all bank products
- Loans may be loss leaders but allow banks into the inner circle
- The concept of 'ancillary business', from which each bank earns a return which enables the overall relationship to meet the bank's risk-adjusted return on capital (RAROC).

The moral dimension impacts the borrower's concerns about sourcing liquidity in all scenarios. In times of stress or when the borrower wants to a do a large deal, it needs to know that liquidity is there. The borrower hopes that its relationship banks will be there for it and promising business is one way to do this.

Thus under a relationship banking policy, whenever a corporate has a transaction, such as a cash management implementation or a bond issue, it goes only to the group of relationship banks, perhaps concentrating on those who might have expertise in the relevant area. Banks will be expected to compete between themselves within the limited group. The corporate selects the best bank for the role from the group.

Note that some corporates adopt a halfway house. For example, a corporate may take a transactional approach when selecting the bank to lead its syndicated borrowings, but a relationship approach for its ancillary business which is given only to syndicate banks or to the leading participants in the syndication.

7.2 Domestic banks v foreign banks

This split is about which banks to use for a variety of different products. In multinational groups this dimension becomes more complicated because for any one location the same bank might be domestic or foreign depending on which view you take. For example, a European multinational with operations in the United States will view a US domestic bank as foreign when it operates in Europe but domestic in the US.

Some features of domestic and foreign banks are set out below.

Domestic	Foreign
The use of a domestic bank confers some obligation on the bank to support the borrower's businesses in that territory	A foreign bank can bring substantial amounts of capital and expertise into a region
A domestic bank is unlikely to leave its core territory, which is a risk if a corporation uses a foreign bank – the foreign bank may withdraw to its home country.	A foreign bank is likely to be able to support international trade at both (or all) ends
A domestic bank will understand local rules and peculiarities of the market, in its territory especially with regard to exchange controls and regulations	A foreign bank is likely to be able to support international cash management processes
A domestic bank is likely to have more influence with authorities in its home territory	

Arguably some banks no longer have a nationality. Consider HSBC which is headquartered in London, but with roots both in the UK, China & Hong Kong.

7.3 Large banks v small banks

Banks can also be classified as big or small. Sometimes a borrower may prefer to bank with a small bank, and sometimes it may have no choice – for instance if a subsidiary has a particular local need which can be met only by a small local bank.

Large banks	Small banks
Large banks are usually able to offer more services, especially the so-called Universal Banks which offer commercial banking services and investment banking services. Most also offer retail and private banking services as well, so they can meet the need of firms and their employees.	Small banks can usually move very fast.
Large banks are able to devote more resources to the customer	One customer can be very important for a small bank, leading to better support.
Large banks are able to provide larger facilities	Arguably a customer is proportionally more important to a small bank than a large one, and can attract better service levels.
Large banks can operate world-wide	Small banks may specialise in a particular niche market, which may be unprofitable (and therefore not served) by a large bank.

7.4 Commercial banks v investment banks

With the widespread adoption of the universal bank, so that almost every bank claims to be able to offer most services, this distinction is perhaps of less importance but in fact many pure investment banks are weak in some areas. In addition, as countries enact legislation such as Dodd-Frank and in response to Basle III, the Vickers report, the Liikanen Report and the Volcker Rule, universal banks may well split back into commercial and investment banking entities. We may have already seen the years when banks were very big one-stop shops (supermarkets) where everything could be bought from them. In the future banks may be smaller and more specialised. This, of course has implications for the relationship banking model which broadly assumes that all banks within the 'inner circle' can broadly supply all services required and there is sufficient competition between them.

Commercial banks	Investment banks
Usually have the largest balance sheets, enabling them to lend and hold debt	Have weak balance sheets and are usually reluctant to lend. If lending does occur, it is likely that the bank will sell down a participation very quickly
Have the most sophisticated IT offerings	Have wide industry connections
	All facilities, e.g. derivative and settlement lines, likely to be smaller than from commercial banks
	Often tied in as financial advisors (M&A, strategic, broker, etc)
Tend towards relationships	Tend to be transactional

Example 9: Investment bank offering commercial facilities

Allied Inc's treasurer discussed a significant transaction with the company's investment bank financial advisers, Manley Soldman, which involved a large foreign exchange exposure which required serious attention. Manley Soldman advised a proprietary solution from its own trading desks.

When fully researched by the treasurer, it turned out that Manley Soldman could not offer sufficient credit in terms of mark-to-market and settlement risk for the transaction without collateral. However, placing collateral would breach the negative pledge clause in Allied's other loan agreements. The treasurer used a solution from its commercial bank relationships.

One thing worthy of note is that no corporate can function without banks as they are needed for:

- Cash management, including holding bank accounts, overdrafts and settlement limits
- Card acquiring services
- Letters of credit
- Guarantees

- Trade finance products
- Derivatives
- Bond issuance (as underwriter or seller of bonds)
- Private placement (as arranger, although in some cases negotiations are direct with the lenders)
- Providing committed facilities – i.e. where there is a contractual obligation to lend
- Together with short term borrowings and deposits (which arguably can be sourced elsewhere)

It is worth spending time to understand when banks act as principles and provide facilities directly or when they act to find individual counterparties with an equal and opposite financial need to the firm. Direct lending by a bank, letters of credit and OTC derivatives involve the bank as principal and the banks intermediate in markets. Bond issuance and private placement is where banks act more as agents and the banking sector is disintermediated (but note that in bond issuance banks may be initial buyers or underwriters of an issue).

Most of these require some form of credit exposure on behalf of the bank. Therefore, no corporate can escape the need for a strategy for its relationship with banks.

7.5 Regulation

Regulation has tightened significantly since the financial crisis of 2008 and it is widely accepted that the cost of bank credit will rise significantly compared to earlier periods. Of course we have, in the mid 2010s, witnessed a contraction in margins but most commentators believe that this is likely temporary.

Lenders are generally subject to regulation. Banks globally are subject to the Basel Regulations[3] together with any domestic regulations which might apply in the jurisdictions in which they operate. US banks, and indeed other financial institutions likely to be lenders, are now subject to the Dodd Frank Act as well as (eventually) probably having to comply with Basel III. In Europe, insurers are subject to the Solvency II Regulations.

The lessons for corporate financial strategy are complex but essentially revolve around knowing your supplier and the constraints under which they operate. Regulations also operate in slightly different ways according to whether a corporate is a borrower or a depositor or indeed has exposure to a bank following price movements in a derivative trade.

7.6 Issues facing those with surplus cash

Until 2007 few treasurers (except those in larger and very cash rich firms) spent much time on assessing the credit risk of their banks, associated products such as money market funds, or other deposit takers in the financial sector such as insurance companies, except perhaps in very simple ways. However, the credit exposure can be significant. It extends not only to deposits, but also to in-the-money derivatives, to the cash circulating within a company's bank accounts and cash transmission, and to the ability of such institutions to meet demands for lending under revolving credit facilities as well as continuing to provide cash management facilities and issue letters of credit and bank guarantees. At one stage in the credit crisis there was a risk of collapse in world trade because banks were unwilling to

[3] The Basel Accord is mandatory regulation for the G20 countries. Basel III is set to supersede Basel II in the current decade.

trust letters of credit from other banks, interbank lending and risk taking being crucial in the whole financial supply chain.

Common new approaches to establishing credit risk limits include the use of credit ratings and credit default swap (CDS) and equity pricing. The latter are more responsive to current events although herd behaviour, fashion and fluctuations in supply and demand can skew prices.

It is almost inevitable that the limit applied by a corporate to a bank will be smaller than might be applied by the bank to the corporate. While this arises due to differences in the size of capital, it can affect relationships and must be managed. The same principles of transparency should apply in this area as elsewhere and the corporate should not be shy of telling the bank their limit.

7.7 Other issues

Personal relationships are often the crux of the issue in corporate treasury, with treasurers often following individuals as they move between banks, rather than the banks themselves and vice versa. Banks also often follow individuals as they move firms.

Treasurers often have to be self reliant and need someone they can trust, but must beware of placing too much reliance on an individual. A change in policy at the bank or at the corporate can destroy relationships and often the relationship may be dictated not by the treasurer but by performance in another area, such as the cash management function. In addition, memories are long and whole relationships can be affected by an issue in one area.

8 Structured finance

Structured finance is often not so much a component of a financial strategy as a complete financial strategy. This is because structured finance is generally used to facilitate a major corporate transaction such as:

- A major refinancing following a credit threatening situation (e.g. loss of investment grade rating)
- Management buy in (“MBI”)
- Management buy out (“MBO”)
- Initial Public Offering (“IPO”)
- De-listing
- A private equity transaction (if different from MBI or MBO, e.g. public to private)
- Special dividend or capital repayment
- A significant acquisition
- Project finance
- Infrastructure financing and public projects
- A large property transactions (e.g. Opco / Propco structures – see Example 10 below)

In structured finance the typical large corporate approach of having several different sources of finance with different maturities (all to achieve diversity and reduce refinancing risk) is typically lost to one major negotiation of debt, with the likely repayment of all existing borrowings.
In this case, the strategy is to make the financing work and then to run the project, as the finance is likely to have been put in place either to last for several years or to be fully repaid over the life of the project.

Example 10: Opco / Propco financing
Allfarthing plc runs a range of pubs and hotels and has historically owned the freeholds of its properties. It sells all the freehold properties into one legal entity (the Propco) which is financed predominantly by debt finance in a structured transaction. Propco then leases the properties back to Allfarthing plc (the Opco) which is left with the trading operations. This structure maximises debt capacity on the back of the credit strength of the freehold properties.

Typical features of structured finance include:

- High leverage
- Security over all assets including the shares of subsidiaries, know-how and patents etc.
- Debt in several different layers, e.g.
    - Senior bank debt
    - Subordinated bank debt
    - Bond market debt, almost certainly subordinated to the senior bank debt
- A relatively long financing period
- Relatively high cost debt finance

While structured finance has no general impact on more normally financed firms, it is worth bearing in mind that situations demanding structured finance can arise quickly. A treasurer who understands his corporate structure, nature and value of assets and the location of those assets or their records, will be in a strong position.

9 Dividend policy

This section concerns dividends on ordinary shares (or common stock) paid by companies quoted on public markets. Dividends paid by privately owned companies, such as family or private equity owned companies, or subsidiaries of groups are subject to different criteria, although a crossover can occur where there are large shareholdings and the proportion of stock actively traded is small.

Because dividends are essentially voluntary, and broadly decided by management, equity investors look for a dividend policy. There are enormous variations in dividend policies. Lloyds TSB Bank in the UK, prior to the credit crunch, paid roughly double the sector average over many years. In contrast, Warren Buffet's Berkshire Hathaway Inc. has not paid a cash dividend since 1967.

Dividend policy can be viewed as both a financing decision and a distribution decision. Retained profits are a readily available source of finance with zero issue costs or procedures when compared with issuing new equity or new debt. High payout ratios imply more frequent recourse to external funding whereas lower dividends mean it is even more imperative that retained profits are profitably invested to produce earnings growth and hence capital gains for investors.

The major issues within dividend policy are:

- Does dividend policy affect company value?
- How do companies decide on their dividend policy?
- What would be the effect of a cut in dividend?
- In what form do shareholders prefer their returns?

For students with a particular interest in this field, we recommend reading Chapters 10 (Dividend Policy) and 11 (A Cash Flow Approach to Analyzing Dividend Policy) in Applied Corporate Finance, by Aswath Damodaran, 4th edition. Chapter 10 looks at dividend policy generally, in particular considering 3 schools of thought: the irrelevance school; the dividends are bad school – only applicable if dividends and capital gains are taxed differently; and the dividends are good school – investor preference, signalling, etc. In Chapter 11 Damodaran considers other forms of distribution such as share buybacks.

As long as the company has opportunities to invest in sufficiently profitable projects, dividend policy becomes a realistic choice about the level of distribution. If a company contains or reduces its dividends compared to previous levels and reinvests the funds in the business, the value of the company will probably fall initially. However, if the funds are reinvested in projects that earn a return higher than the investors' required return, the value of the company will eventually rise above the value under the previous dividend policy. We tend to see high retentions and low dividends for young, fast-growing businesses.

It is now well established both in theory and in practice that, if a company does not have any investment projects on which it can earn the investors' required rate of return, it should pay out all of its earnings and any unwanted cash in dividends. This will allow the investors to reinvest their capital more profitably elsewhere. We see this happening through higher dividend payouts and/or special dividends or share buybacks by companies in declining industries.

Signalling theory is a major aspect of dividend policy. It says that dividends and dividend policy indicate information which the management of a company hold and which they wish to communicate to their shareholders. This may seem odd when there are plenty of opportunities for investor communications, but because a dividend reduction is often seen as calamitous, the theory does carry weight, as it is a real commitment by management to distribute cash.

Example 11: Dividends as signals
Microsoft, which has a history of high growth and has paid no dividends, announces that it will start paying dividends next quarter.

The dividend may signal that Microsoft's project choice is becoming less attractive, and this will have negative consequences for future growth and project returns. In addition, shareholders in Microsoft are likely to be oriented to capital gains and may not like the dividends for tax reasons. The share price is likely to fall on the news.

A very high dividend may be viewed by the market as a sign that the management have information that shows that future earnings and dividend prospects are very good, and that a similar level of dividend payout will be maintained in the future. Similar sentiments would be attached to a progressive dividend policy, i.e. a rising dividend.

The psychology surrounding dividend cuts is more difficult, however, and a company is likely to delay such a decision in the hope that matters may improve despite current indicators. The theory of the crowd helps here. In 2008 and 2009 many companies slashed dividends in the face of recessionary forces. No doubt gaining confidence from seeing their peers cut dividends, many are likely to have been relieved to get off the treadmill of an ever rising dividend.

9.1 Practical aspects of dividends

There are a number of practical issues that influence the real-world decisions of companies in relation to their dividends.

Distributable reserves

In most regimes dividends on ordinary shares can be paid out only from after-tax distributable earnings, generally referred to as retained earnings. The paying company's retained earnings must therefore be positive at the time the dividend is paid (and afterwards) and, for many multinationals, the practicalities of remitting dividends from subsidiaries (which themselves must have sufficient distributable reserves) up to the parent company to create sufficient retained earnings to accommodate the dividend from the parent can be challenging.

Note that many companies have a variety of capital reserves in addition to retained earnings, all of which combine to what we generally refer to as "equity". The most common capital reserves are share capital, a share premium reserve and often capital reserves arising as a result of revaluations, acquisitions or capital reorganisations. These capital reserves are not easily distributable as their purpose is to act as a protection buffer for those dealing with the company. In the UK for instance, court approval is required before capital reserves can be distributed.

Cash flows and growth

A company with large reported profits does not necessarily have sufficient cash to pay dividends. It might need its cash to fund high levels of capital expenditure, or to fund working capital to expand the business.

Thus growth industries tend to have low payout ratios as earnings are retained for future expansion, whilst stagnant industries tend to have high payout ratios on average. This has echoes from the issues around company life cycle.

Gearing and capital structure

Retained earnings build up a company's equity and so have an effect on the level of balance sheet gearing. Dividends mean an outflow of funds and the possibility of the need to re-finance the company at some point with either debt or equity.

Therefore, the leverage policy and dividends go hand in hand. Remember that leverage may not be defined simply in terms of debt and equity but also in terms of interest cover, multiples of earnings, cash flow or EBITDA.

Evidence tends to show that when the economy is booming, companies have high dividend payouts, but gearing is often not raised. Either the company is generating sufficient cash to fund the dividend, or if it needs extra finance the company may favour rights issues.

Equally, clinging to high payouts in the face of falling cash flows can exacerbate fundraising issues, as unaffordable dividends eventually require the raising of additional equity. It can seem like a merry-go-round of cash.

9.2 Possible approaches to dividend policy

Companies have several different alternatives that seem to be available in setting dividends.

Dividend cover

This is a key measure of affordability and a possible basis for a policy. It is calculated as after-tax earnings per share divided by dividend per share. A dividend cover of 1.5x or 2.0x may be acceptable for a company that has stable earnings and cash flows and is in a mature industry. On the other hand, a company that has highly variable earnings and cash flows and is in a risky sector might be expected to have a dividend cover in excess of 5x. Note that dividend cover conventions vary considerably in different markets.

Stabilisation

The Lintner theoretical model says that the dividend depends partly on current earnings and partly on the dividend for the previous year, which in turn depends on that year's earnings and the dividend in the year before that. It has been confirmed by research that dividends are a function of a weighted average of past and current earnings and this accords with the observable practice of maintaining a stable, smoothed dividend over time. This means that dividends will not automatically increase in line with earnings, but instead will be a lower proportion of earnings in good years and a higher proportion of earnings in bad years. Investors, therefore, can be reasonably confident about the cash element of their return. The policy, for example, might be for dividends to grow at the long term rate of profit growth subject to maintaining adequate dividend cover.

Pay out a fixed proportion of earnings

A policy that is adopted by some companies is for dividends to be for instance one-half of profits after tax, which often results in large fluctuations from year to year. This effectively relies on Modigliani and Miller's dividend irrelevance theory, but requires clear communication with investors if dividend rises and falls are not to be misconstrued.

Pay a sustainable dividend

Firms tend to forecast their financial position a few years into the future. This gives some idea of the funding requirements for investment projects and thus the medium term outlook for free cash flow (after funding projects). The firm can then aim to pay a sustainable regular dividend without the need to raise additional equity, providing some certainty to investors and sending a consistent signal.

By avoiding raising the regular maintainable dividend beyond its normal growth rate, the company does not send an erroneous signal that it has moved to a new sustainable base level for future growth. If however, the change in cash flows is representative of a new sustainable rate, the company can be moved gradually to a new maintainable regular dividend – while managers explain clearly to shareholders the reasons for the change.

10 Documentation

It may seem strange to include documentation as a plank of financial policy, but it will probably come as no surprise that when Lehman filed for bankruptcy in the US, administration in the UK, and similar procedures elsewhere, the state of the documentation was a key issue in trying to resolve matters. On the part of the bank, it was very difficult to find all the relevant documents, ISDA documents in particular, to establish the rights of each individual counterparty. On the part of the counterparties, many were surprised at the terms set out in their own documentation and did not fully understand the procedure in the case of insolvency of either party. Insolvency lawyers were kept busy for years trying to unravel the mess. Nobody had expected the situation which arose and very few had devoted sufficient time to documentation.

While consideration of counterparty insolvency is one issue, and too technical for this reading, there are issues arising from this and other areas which should form part of an approach to documentation in terms of the relationship with financial providers.

10.1 Consistency

There are clear merits in having consistent documentation:

- Understood by management in the firm
- Cheaper to negotiate (as lawyers are less involved)
- A common front to all lenders and other financial suppliers

It will be almost impossible to have completely consistent documents unless all relationships with financial providers are done on syndicated terms. Cash management arrangements and many facilities, e.g. derivatives, will almost always be bilateral, so differences are bound to arise. Being on top of these is key.

10.2 Trade off between conditions and cost

Occasionally there is an opportunity to obtain a lower cost for tighter terms, usually with regard to the setting of levels of financial covenants. Thus a higher interest cover covenant may shave a few basis points off the margin. Some borrowers have been offered several different alternatives during negotiations. This is merely the manifestation of the risk / reward trade off.

However, talking about risk / reward at a late stage in negotiations can seem strange and such an approach can only be really effective if carried out early on in the process, generally at the outset when negotiating the term sheet, i.e. the indicative commercial terms for the agreement. Even then, the business model is fixed and the mindset of management can be simply to obtain the funds to put the business plan into operation. Any change to a business plan, for example, might be completely unacceptable. Managing a business to exact covenants is probably more of an art than a science and this should be borne in mind.

10.3 Keeping up to date

While fairly obvious, it is not easy to keep documents up to date. ISDA documents and bank account / dealing mandates are probably the ones where things are most likely to fall behind.

10.4 General

There is not much choice in documentation. The market and credit rating band generally dictate what kind of document is put in front of the treasurer to negotiate. It is up to the treasurer to ensure that the firm can actually operate under the terms of the loan agreement. The majority of the negotiation will centre around covenants, especially 'carve-outs' and 'baskets' to prevent covenants from being too restrictive. The level of financial covenants will also be a key consideration.

Example 12: Carve outs

Move You Sir plc is a real estate agency with operations around the world, financed largely by debt. MYS plc is essentially sub-investment grade and its lenders required that all the assets of MYS plc and its subsidiaries are secured in support of the debt. However, one subsidiary (Move You Madam Inc) is owned only to the extent of 60% of its equity, with the balance being quoted. Giving security from this subsidiary would disadvantage local shareholders compared to MYS plc shareholders. Accordingly, MYM Inc is "carved out" of the requirement to give security. MYS plc may be required to pledge its shares (the 60%) in Move You Madam Inc instead.

Example 13: Baskets

Airserve Inc is an airline service company, with subsidiaries in many countries located near major airports. Financed by bank debt on sub-investment grade terms, the buying and selling of local franchises is a common occurrence for Airserve. It has agreed with its lenders that should any such disposals be made, then the proceeds must be used to repay bank debt permanently. However, it wishes to retain some disposal proceeds to be ploughed back into the purchase of franchises. It agrees a "basket" of USD 50 million per annum of disposals that do not need to be used to repay bank debt.

Example 14: Subsidiary covenants

Lundy Pty Ltd manufactures paper products in locations around the world close to the forest

natural resources it needs for raw materials.

It wishes to expand in Russia and finds a low cost form of finance from an export credit agency in Russia (ECAR) to help fund its factory, but without recourse to the parent. A requirement of ECAR is that financing should be in Euros to the local subsidiary, and ECAR requires financial covenants based on the Russian subsidiary's results.

Lundy agrees to this and signs up for covenants based in Euros and with fairly aggressive tightening in the first two years.
The rouble falls in the foreign exchange markets, increasing the relative value of the subsidiary's Euro debt and threatening the covenants described in Euros. Assuming that Lundy wants the subsidiary to continue operating, then to prevent a default, either Lundy will have to fund the subsidiary's repayment of the debt (via an inter-company loan) or Lundy will have to renegotiate the terms of the debt, most likely at higher interest rates. Note that the lack of recourse means that Lundy isn't *obliged* to refinance the loan – it could walk away.

11 Corporate structure

This topic may come as a surprise as a component of financial strategy because most structures are fixed. A treasurer coming into an organisation has to accept the status quo and in many cases most subsidiaries will be wholly owned. This is in many ways a luxury for a treasurer. When a subsidiary is owned 100%, the treasurer (and the tax planner) has more or less complete control over the capital structure and can also include the subsidiary in all the "group" types of arrangements such as zero balancing, pooling, netting, insurance and so on. The only impediment to this is where exchange controls might prohibit this, but at least the treasurer is in control.

However, there are often reasons why some subsidiaries are not 100% owned and/or why some investments are made where there is not full control, i.e. the shareholding is below 50%.

The drivers of structural decisions are usually based around:

- Returns
- Risk
- Scarcity of finance
- Repatriation of cash / debt repayment
- Tax
- Management incentivisation
- Availability of partner investors
- Protecting commercial interests

No accounting distinctions are drawn in the following analysis.

11.1 Majority owned subsidiaries (> 50%, but < 100%)

Typical reasons for this model include:

- Shareholdings left over from an acquisition where the previous owner wanted to retain an equity stake in the business
- Local management is to be incentivised
- Local agent insists on an equity stake or requires incentivisation to work in the interests of the majority owners.
- Exchange control reasons
- To reduce risk

Depending on the size of the stake, this has implications for treasury management.

Any “group” type arrangements are usually cost saving for the subsidiary and so subsidise the minority holder unless properly charged for. This is most extreme in the case of lending to (or guaranteeing the debts of) the subsidiary, where the majority holder is often expected to “take the lead” and lend, usually because of its perceived deep pockets.

Intercompany pricing of goods, as well as treasury services, is also an important consideration. This also applies to the issue of trade credit.

Dividends may cause issues, because it might not suit one or other of the parties to have cash distributions, although the minority party would in reality probably be unable to prevent a distribution unless there was a separate shareholder’s agreement or the minority was being treated unfairly.

Accounts are consolidated, meaning that performance in these subsidiaries will count towards covenant behaviour and especially cash flow based covenants in the holding company, even though any cash generation may not easily be remitted to the parent.

Often the company will carry the corporate name and there may be some moral obligation to bail it out under any circumstance.

There may also be tax considerations. For example, in the UK, tax relief is permitted between companies subject to UK corporation tax that are in the same 75% group - where companies have a common ultimate parent and at least 75% of the shares in each company (other than the ultimate parent) are owned by other companies in the group.

These often sound disadvantageous to treasury management, but can be part of a successful financial strategy if properly incentivised local management increase shareholder value.

11.2 Investments without full control i.e. associates / minority interests where less than or exactly 50% of the equity is owned

Such arrangements are used for:

- Highly speculative investments
- Maintenance of a stake following a disposal e.g. a management buy out, either to retain upside or as a form of financing
- Where two or more firms need to come together as a consortium or joint venture to provide expertise and each wants to retain an equity interest (for its upside)
- Project Finance

Project Finance is also typically associated with highly geared structures, where the finance and financial risk required would overwhelm most normally financed firms.

Features of this type of arrangement include:

- Limited access to / recourse to parent company capital
- Limited moral obligation to fund expansion or losses
- Does not usually carry parental name or reputation or guarantee
- Limits risk to the investing companies
- The associate will not participate in common "group" activities such as netting and cash management

Where the shareholdings are 50/50 these are sometimes referred to as 'deadlock' companies.

Much emphasis is put on the customer / supplier relationship in modern corporate finance. The fashion is for customers and suppliers to become closer and one way of achieving this is for one to take a stake in the other, leading to the issues seen above.

Example 15: Rolls Royce
Rolls Royce manufactures aero engines to exacting high standards following development which can be extremely expensive. Accordingly lead time is high and product lives are long. To reduce the risk in development it enters into arrangements with its suppliers to ensure that they will also benefit from a long term investment in their own parts supply. These arrangements amount to a form of profit share, mimicking equity ownership.

Example 16: Commercial pressures
Unicorn Ltd supplies fuel tanks to a car manufacturer, Beema GmbH, within the UK. Beema is a challenging customer for Unicorn, who is concerned at the risk of deterioration in this major relationship. In addition, Unicorn wants to expand its production of fuel tanks to new customers and markets. Unicorn enters into a 50/50 ('deadlocked') joint venture with Cartex GmbH, a key supplier of fuel tanks to Beema in Germany. Through the JV Unicorn gains access to Cartex' fuel tank technology and design input in return for contributing production

expertise both to the JV and to Cartex' overall business. Furthermore, because of the JV structure, Beema can't put pressure on the commercial UK fuel tank relationship without putting pressure on Cartex – a relationship that is very important to Beema.

So the JV enables both Unicorn and Cartex to access new markets, and it enables Unicorn to protect itself somewhat from undue pressure from a more powerful customer.

12 Risk management

It could be argued that financial risk management follows from financial strategy. We deal with risk separately in Module 4 and usually only consider financial risk after the commercial decisions have been made. However, we have seen that many aspects of financial strategy are circular. Leverage can't really be considered without thinking about financial risk – at least in broad terms. Similarly, financial risk cannot be separated from financial strategy. Therefore, in this section we will briefly consider how some of the 'classic' financial risks interact with financial strategy and leverage.

12.1 Interest Rate Risk

Two major aspects of interest rate risk should be considered in the context of financial strategy:

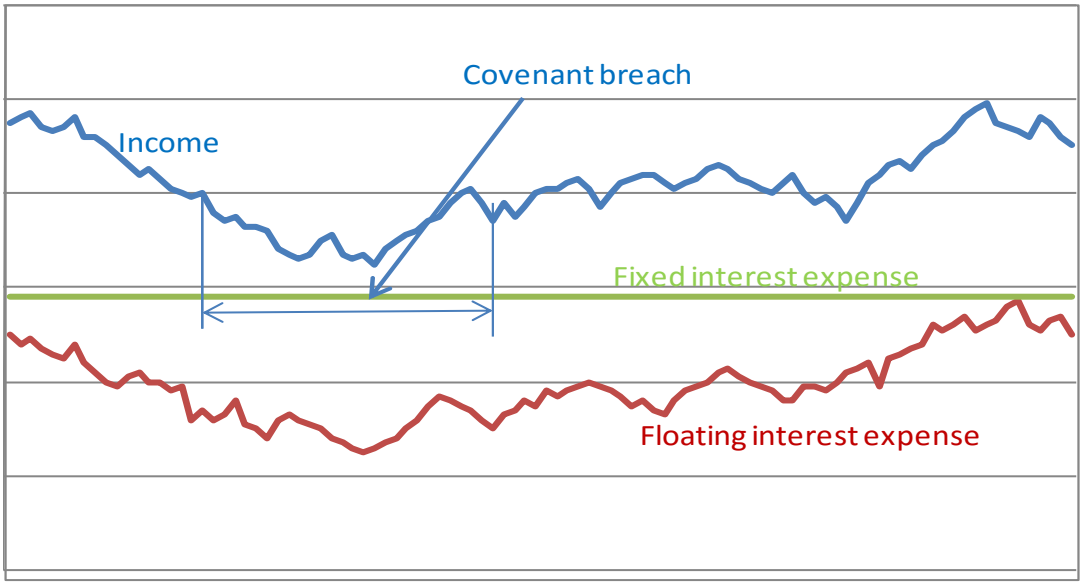
- How does the business model and cash flow change according to the level of interest rates or real interest rates?
- Does a movement in the level of interest rates threaten the business model if debt forms a major part of the capital structure?

12.1.1 Financial strategy when cash flow varies with interest rates

If the business prospers with high interest rates, or when business activity is high, then financial strategy should point to using a higher proportion of floating rate finance. Exhibit 5 shows a business whose earnings are roughly aligned with interest rates. A fixed interest expense is inherently risky for this firm because it does not protect financial covenants such as interest cover, or indeed any other credit ratios. A floating rate interest rate profile is likely to better protect the credit ratios.

Examples of businesses which are interest rate sensitive might include owners of commercial property, or businesses which can pass on inflation or take advantage of growing markets – but which have to respond when inflation falls or the market shrinks. Rising interest rates are associated with high inflation or growth.

Exhibit 5: Interest rate risk for a business with high earnings volatility



In Exhibit 5, the income of this firm is related to interest rates, so that there is a broad stasis between them, leaving interest cover fairly constant. Any fixing, as shown, is likely to cause a covenant breach, despite our broad cultural understanding that fixing interest rates actually reduces risk.

Example 17: Business levels follow interest rates
Clothing Connoisseurs Ltd operates in the mid-range clothing market and aims at all ages up to middle age. It finds that it sells more and is more profitable when the economy booms, at which point the authorities are in the process of raising interest rates. Its earnings are correlated with interest rates.

Financed heavily by debt, it decides that its interest cover covenant can be significantly protected by financing totally with floating interest rates.

If the level of business falls when interest rates rise, then the natural financial strategy would be to carry excess cash, although this would be rare and so very low gearing is more probable. Construction companies typically fall into this category although this has not been the case during the financial crisis.

12.1.2 Financial strategy under high leverage

Firms with high leverage are naturally more susceptible to interest rate risk than others. Some firms are naturally funded by higher levels of debt, mostly those with high asset values such as transport, infrastructure or property assets. Because returns from those business models are relatively low, gearing is necessary to achieve equity returns comparable with those obtainable elsewhere in the market. The other obvious high leverage situations are private equity or structured finance situations.

It is normal in these cases to fix interest rates to quite a large extent, at least initially, to reduce the total risk in the business model, there being sufficient financial risk already. This

approach is driven partly by a desire to reduce the effect of interest rate shocks – which can happen faster than one can change the business model; and partly by an (implicit) assumption that there is sufficient profitability to absorb the fixed interest cost despite a downturn in the business.

Example 18: Property company heavily financed by debt
Southminster Estates plc owns and rents out high quality residential / office and light industrial premises in the south of England. Financed mostly by debt, its rents are generally fixed for the term of each lease, rising only with inflation. It is therefore heavily exposed to rising interest rates within a lease term (were it to use floating rate debt). Southminster therefore tends to adopt a high level of fixing in its debt portfolio.

The approach taken to interest rates will affect the decision on which market to approach and what other facilities are likely to be required. Because bank finance is generally floating rate and bond finance generally fixed rate, any switch of interest rate profile from this natural position will require the use of derivatives, which will themselves require capital, either in the form of bank facilities or in cash to post as collateral, if required.

12.2 FX translation exposure
Foreign exchange translation risk has an influence on financial strategy because some of the responses to it require debt in a variety of currencies, which may or may not coincide with the natural ability of the firm to raise debt in those currencies. If that is the case, some synthetic approach might be needed, such as utilising currency swaps which will themselves require capital, again either in the form of bank facilities or in cash to post as collateral.

12.3 Transaction and other exposures arising from operations
The business model may imply the need for the use of products to protect against commodity or foreign exchange exposures.

Example 19: Defence company with capital projects
ZFW plc sells defence equipment, from aircraft and ships to uniforms and food containers. It competes with other manufacturers around the world and puts in tenders, priced according to current market conditions. The tenders from manufacturers tend to be in different currencies. At any one time it is therefore at risk as its tenders may become uncompetitive as foreign exchange rates move and/or become loss making. While the portfolio effect across markets may help to reduce this risk, ZFW's cost base is mainly Sterling and the company is exposed to a strengthening in Sterling. It therefore needs the ability to both absorb this risk and to be able to use derivative products to protect against it.

Example 20: Rolls Royce long term FX
Rolls Royce, selling aircraft engines, has a very long term order book and to protect against foreign exchange risk, uses long term foreign exchange forwards and other instruments. It therefore needs facilities with banks to enter into these derivatives.

The list of examples can be easily extended but the implication from this is that if the business model has a fundamental underlying riskiness arising from the need to quote or

carry risk in price lists or elsewhere, then it must have sufficient capital both to be able to carry the risk and to allow the use of derivatives to manage the risk in some way.