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Agenda

Advancing economics in business

Surviving the credit crunch and beyond

The credit crunch has proved to be a larger problem than initially feared, with corporates entering 2009 facing a higher cost of capital, scarce liquidity and increased refinancing risk. In this environment, companies will need to review their financing strategies, not just to be able to pull through the crisis, but also to be in the position to take advantage of the business opportunities uncovered by the turmoil. Sasha Ryazantsev, Sanjeev Kumar and Andrew Walker of Corporate Financing and Risk Solutions, Royal Bank of Scotland, discuss some of the options

During the last 18 months, the global financial system has seen a dramatic change. The collapse of Bear Sterns, Lehman, Northern Rock and the Icelandic banks; nationalisation of AIG, Fannie Mae and Freddie Mac; sales of Merrill Lynch, Wachovia and WaMu; recapitalisations of Barclays, Goldman, Morgan Stanley, ING, HBOS and RBS; and the break-up of Citigroup is only a short list of events caused by the credit crunch.

Those institutions that have survived are facing new challenges in the wake of the government bail-out programmes across the globe. In this environment, it is important for companies to identify the appropriate financial policy to take them through the recession, on the one hand, and to best position themselves to benefit from potential opportunities that may arise, on the other. This article examines some of the issues faced by companies in meeting these challenges. With a strong flow of new issuance in the credit markets in the first two weeks of 2009, there is evidence that most corporates are accepting the new pricing realities by accessing the available liquidity sources at a cost that would have been considered unacceptable 12 months ago.

Shift of focus from cost to risks and flexibility in financing decisions

In the past, decisions regarding the optimal capital structure were largely driven by the cost and flexibility trade-off between instruments within the debt/equity continuum. Now, with scarce liquidity in most markets, tapping a market that is still open, rather than waiting for the costs to improve, may be a more appropriate strategy. More generally, the emphasis has shifted from cost to liquidity risk, and pre-funding and diversifying funding sources are likely to be the dominant themes in 2009.

Diversification of funding sources

Many corporates, notably outside the USA, have been over-reliant on bank financing as the main source of funding, as opposed to raising finance by issuing securities. There are in general a larger number of rated companies in the USA than in Europe on a relative basis. The European reluctance to issue rated paper can be explained by a number of factors:

– availability of cheap bank funding (until recently);
– access to the Private Placement market (that does not require a public rating) for stronger credits;
– other markets (such as equity-linked) with no requirement for a credit rating;
– a large number of family-owned businesses, especially in France, Germany and Italy, with an aversion to information disclosure to rating agencies and bond investors.

In the past it was possible to attract financing on competitive terms without having to go to the public bond markets, but the picture is different now. First, many issuers have reached the limit of market capacity on an unrated basis. In its recent takeover of Anheuser-Busch, the brewing company InBev initially managed to raise acquisition financing in the bank market, but had to obtain credit ratings in order to enhance its refinancing options. Second, the pricing of equity-linked instruments is driven by a combination of the issuer's credit spreads and the value of the warrant. At a time when credit pricing is volatile, it is often difficult to price an equity-linked instrument, and as such the absence of a public rating may increase the execution risk of the transaction. In this context, issuers might have to reconsider the pros and cons of obtaining a public rating, especially if future flexibility is required for either acquisitions or refinancing of existing liabilities.

With the banks continuing to focus on de-leveraging and de-risking of their balance sheets, there has been a significant compression of the differential between bank debt and bond pricing, with banks demanding a clear and fast path to public market take-out and, in the absence thereof, a pricing that would enable them to hedge the credit risk in the market.

Tapping all markets that are available for issuance

We have seen in the last 18 months that capital markets continually open up and shut and, as such, all issuers should be ready to go to the market whenever a window of opportunity opens.

There has been a fundamental shift and re-pricing of credit from the record lows of the first half of 2007, and this higher-price environment is likely to remain in the near-to-medium term. 2009 has already seen strong new issue activity with issuers accepting new price levels and the market open even for low investment-grade cyclical names, as well as strong sub-investment-grade issuers, as evidenced by the Ba1/BB rated Fresenius SE.

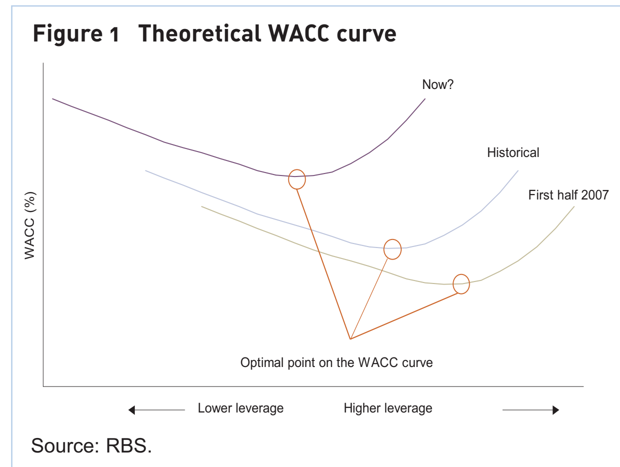
The equity markets have bounced off from the lows of the fourth quarter of 2008, but remain challenging, as evidenced by a number of cancelled or delayed IPOs and the discounts seen in rights issues. For companies with an ongoing share buyback programme, putting share buybacks on hold is a source of additional liquidity. In fact, there is evidence that this is already happening as share buyback activity has virtually ground to a halt since October, despite record lows of equity market valuations that, in theory, would represent good buying opportunities (examples include GlaxoSmithKline and Phillips). Many companies with particular liquidity concerns are also revisiting dividend policies.

Application of Modigliani and Miller propositions to the current environment

Typically, decisions on the optimal capital structure have been driven by the cost of capital derived from the capital asset pricing model (CAPM). This typical approach in a Modigliani and Miller setting would indicate that the optimal capital structure is one that maximises cheap, tax-deductible debt until such point that the probability-weighted costs of financial distress associated with higher leverage begin to outweigh the benefits thereof.

This optimal point was traditionally positioned at the lower end of the investment-grade range, but, up until the beginning of the credit crunch, arguably shifted towards the high BB range. As a result, the relationship between risk, cost and flexibility in the first half of 2007 was significantly different from historical levels, with the focus clearly on cost since refinancing risk was deemed

Figure 1 Theoretical WACC curve



Source: RBS.

to be low and flexibility of issuing both debt and equity appeared to be high.

Now, however, cost, while still important, is secondary to the ability to refinance in order to reduce the risk of financial distress and secure the flexibility of doing deals in the future. While limited liquidity and increased volatility make weighted average cost of capital (WACC) calculations difficult, it may be argued that the optimal WACC curve has shifted again, now to strong investment-grade levels, from the levels seen in early 2007 (see Figure 1 above).

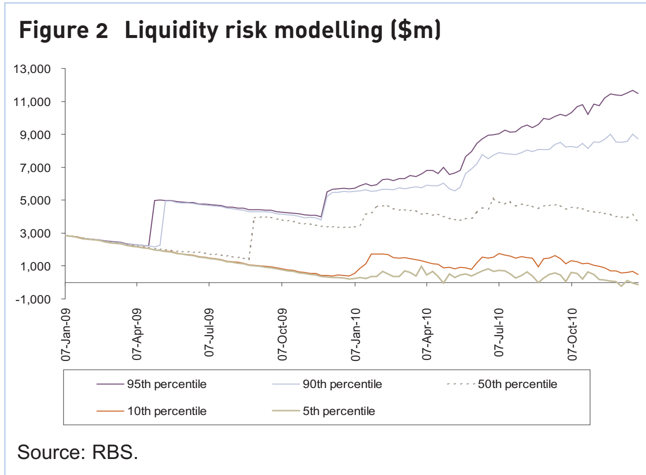
It is also important to note that using the CAPM to identify the cost of equity may not be the most appropriate approach in the current market circumstances, and we would favour a market-based approach, whereby the discount rate is deduced from the consensus equity cash flows and today's share price. Typically, this yields a much higher cost of equity than that implied by the CAPM.

Modelling future net cash flows as a test for funding liquidity risk

The current environment has led corporates to pay much more attention to their liquidity condition. The management of liquidity risk is challenging given its interrelationship with many other risks, both market- and business-related.

A practical test for liquidity risk is to quantify net cash flows at future points in time with different confidence levels (see Figure 2 below). The analysis starts with the current cash balance, and simulates how the liquidity position would change on a week-by-week basis. In order to incorporate uncertainty of cash flows from operations, risk modellers study distinctive features of the industry and company. Cash flows from investing are taken from the business projection base case. Cash flows from financing are simulated, taking into account probabilities of market openness.

Figure 2 Liquidity risk modelling ($m)



Source: RBS.

The simulation generates many possible outcomes for the corporate cash balance over the analysis horizon. The results allow the company to assess its liquidity risk and potential cash-flow gaps.

Change in the approach to executing corporate actions

Asset valuations have come down significantly, in terms of both absolute values and price/earnings (P/E) ratios, making assets more accessible for potential buyers. On the other hand, buyers have to be more careful to close the deal as there are significant challenges: establishing the true value of the asset in an environment of earnings uncertainty and foreign exchange volatility; access to liquidity of the credit markets; hidden costs; and pension deficits. It would therefore pay to be well prepared and pre-arrange access to funding in order to best benefit from lower valuations.

Relatively low valuations of assets

The equity markets posted significant negative returns of between –33% and –65% in the period between July 2007 and December 2008 (see Figure 3). At the same time, the fall in projected earnings has not been as severe, leading to a downward trend in forward-looking P/E ratios (see Figure 4).

While there might be bargains to be had in the current market environment, the rising cost of capital may imply that even at these valuations a deal is still not creating value. Also, while the P/E ratios may have fallen below the long-term average levels, any further adjustment may happen through downward revision of earnings rather than price appreciation as the world economy slips into a recession or a period of stagnation.

Forced sellers

A phenomenon of current capital markets is the existence of a number of distressed sellers that could present buying opportunities for those corporates that are prepared to take them. These 'fire sales' have been driven by a number of factors.

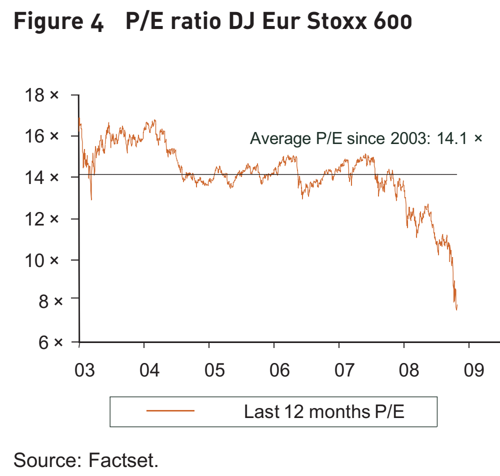
- **Distressed sellers of assets**. Corporates as well as financial institutions have a focus on streamlining their portfolios and seeking liquidity, and are therefore natural sellers of any non-core assets they may have on their balance sheet. General Electric put its Appliances division up for sale in 2008 before withdrawing it due to low valuation achieved at the time. It would now appear that it is willing to take a lower price for the asset in order to obtain a liquidity injection.

- **Owners of assets hitting limits of their borrowing capacity**. The falls of the equity markets have led to some corporates and individuals facing margin calls on stakes held in public companies.[1] If the asset owners fail to find cash to put up the margin, the bank liquidates the pledged shares (putting further pressure on the share price). Some of the recent examples of forced sales of assets bought on margin include Oleg

Figure 3 Global stock markets (Jan–Oct 2008)

Source: Bloomberg.

Figure 4 P/E ratio DJ Eur Stoxx 600



Source: Factset.

Deripaska's holdings in Hochtief and Magna; Aubrey McClendon's stake in Chesapeake Energy; and Sumner Redstone's stakes in Viacom and CBS. The most recent corporate example includes the sale of Advanced Medical to Abbott Laboratories for $1.4 billion after the former's debt-financed acquisition strategy led to an over-leveraged position and a sharp erosion of its share price.

– **Regulatory-driven disposals**. While not directly related to the credit crunch, those companies with a requirement to sell assets—for example, BAA in relation to Gatwick, Stansted and Edinburgh Airports—may have to accept a lower price than would otherwise be achievable had they the option of waiting for a market improvement.

Acquisition tactics alone are no longer the key to a successful closing

In the pre-credit crunch era, the mergers and acquisition (M&A) teams of corporates and investment banks would have focused on such aspects as the tactics of the approach for a target, likely competition, and regulatory issues. Availability of financing was often taken for granted. Now, however, we have seen some deals fall through purely due to problems with financing the transaction.

Such issues as existing debt at the target, likely movements in foreign exchange and commodity prices, as well as pension liabilities have also become more important in ensuring a successful M&A execution. The presence of a change-of-control clause in the target's debt might increase the funding requirement to a level beyond (the much decreased) market appetite. FX and commodity price movements may significantly affect bid prices, and these could be especially important when doing deals in emerging markets, while obtaining financing in the major currencies. The real cost of pensions, on the other hand, could turn out to be significantly higher as the funds' assets underperform, whereas the cost of liability may be underestimated if the AA spreads, which have widened significantly, are used for discounting purposes.

Being well prepared is paramount

As a result of such challenging financial markets, those issuers that are well prepared are likely to benefit and come out stronger in the long run as a result. Being prepared could be divided into the following.

– **Engage in the financing discussion in conjunction with the M&A dialogue**. In order to ensure that a financing package is obtainable for the deal, it is important to start financing discussions at the same time as the M&A ones. The key factors to be evaluated include the currency in which the funding needs to be raised, the mechanics of a debt pushdown from the bidding company to the target, composition of share or asset pledges, equity or quasi equity raisings, and timing.

– **Pre-fund the acquisition in the public markets as and when they open, in order to preserve the bank market liquidity available to the acquirer**. The bank markets are currently going through some challenging times and many issuers are finding it difficult to raise even shorter-term bridge facilities. Therefore, reducing the amount to be raised in the bank markets could be crucial to the success of a transaction. Vale's $11.5 billion rights issue in July 2008 is an example of a corporate pre-funding potential transaction.

– **Managing/preserving/optimising an existing credit rating, or obtaining one if not rated**. A rating process typically takes 10–12 weeks and requires senior management involvement. Running the rating process simultaneously with an acquisition would put additional pressure on management time. Moreover, rating agency attitudes are changing. This may include a shorter de-leveraging time post-acquisition, a more conservative view towards to the execution risk of disposals, and an increased liquidity cushion requirement. It is important to stay abreast of these so as not to be caught out during the transaction process.

– **Make disposals in advance of the transaction**. It may be difficult to execute disposals at this time; however, they may still prove to be an important source of liquidity. For example, minority stakes in listed entities could be one such source.

– **Obtain certainty of funds even in jurisdictions where this is not strictly required**. The availability of a certainty of funds commitment from lenders is required in some jurisdictions such as the UK, but not in others such as the USA. We do believe, however, that in the current market environment the availability of a funding commitment could be the distinguishing factor that would differentiate the bidder from the pack.

Conclusions

In the post-credit-crunch world, corporates will have to readjust to the new market realities characterised by constrained liquidity of debt and equity markets, changed market risk positions, and increased regulatory pressure and restrictions on leverage.

These markets represent opportunities for stronger corporates to acquire weaker peers. However, being prepared for corporate actions is paramount in order to

optimise the results. This involves pre-funding both debt and equity, managing market risks more carefully, and obtaining credit ratings and making disposals, if necessary. It is a time when companies can distinguish themselves from the competition, and optimal handling of financing and risk positions will be one of the distinguishing factors.

The recent market events have also highlighted that determining a corporate strategy for financing and risk management must be based on a deep understanding of markets as a whole. Performance of the credit markets has affected equity and commodities. The volatility of FX rates has led to pressures on corporates' balance sheets, and the unravelling of the banks' business models is affecting the real economy via equity, debt and currency markets. This demonstrates the true extent of globalisation and integration between the financial system and the real economy, and a thorough understanding of these linkages will be crucial for all corporate CFOs and boards.

Sasha Ryazantsev, Sanjeev Kumar and Andrew Walker

[1] When investors buy securities on credit, their brokers typically ask them to maintain a minimum margin between their cash deposit and the market value of the securities held. If this margin is breached, the broker asks the investor to deposit more cash or additional securities into their account. This is referred to as a margin call.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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