TREASURY TRENDS

March 2018 | www.bancorptreasury.com | www.barringtontreasury.com

Issue 417

Demystifying the Debt Funding Decision

There are a number of different debt funding options for businesses, each coming with their own characteristics and therefore advantages and disadvantages.

Broadly, these can be categorised as follows:

- Bank funding
- Debt capital markets ("DCM")
- Structured finance

Bank funding can be secured or unsecured, is typically senior ranking (although does not have to be) and can be provided under different structures (e.g. bilateral or syndicated).

Bank funding is typically provided for up to 3-5 year terms, at floating interest rates (although facilities can be term, at a fixed rate). Facilities can use standard bank documentation (which is generally lender friendly) or bespoke documentation (which will cost the borrower legal fees, but may provide more advantageous terms). Bespoke documentation is often used by larger corporates or institutional borrowers.

DCM options include commercial paper, domestic bonds or medium term notes, which can be secured or unsecured, senior or subordinated, targeting retail or wholesale investors, as well as foreign options (e.g. US Private Placement funding) and longer term or hybrid instruments (equity type elements). DCM sources can provide an entity with increased funding diversity and tenor, as well as fixed interest rates for the implemented volume and timeframe. Some types (such as commercial paper) require a credit rating, while many will have different hedging considerations for treasurers compared to typical bank facilities (e.g. foreign currency or fixed interest rate characteristics).

Structured finance instruments include receivables financing, asset backed financing, sale and leaseback and securitisation structures, amongst others. These are usually more complex than other options, and may come at a higher cost, but can offer increased flexibility to borrowers. This may allow them to access funds that might not otherwise be available, or transfer risk to another party.

Size matters

An analysis of the debt composition of listed companies generates some interesting insights. As you would expect, companies with lower overall debt volumes are normally 100% bank funded.

As a company's debt requirements increase, sources of funding invariably become more diversified through the addition of non-bank funding sources. For the entities with the most debt, bank funding may comprise less than half of the debt facilities as shown in the chart below.

This demonstrates the impact of size as a factor for an organisation's funding mix. We find that there are several

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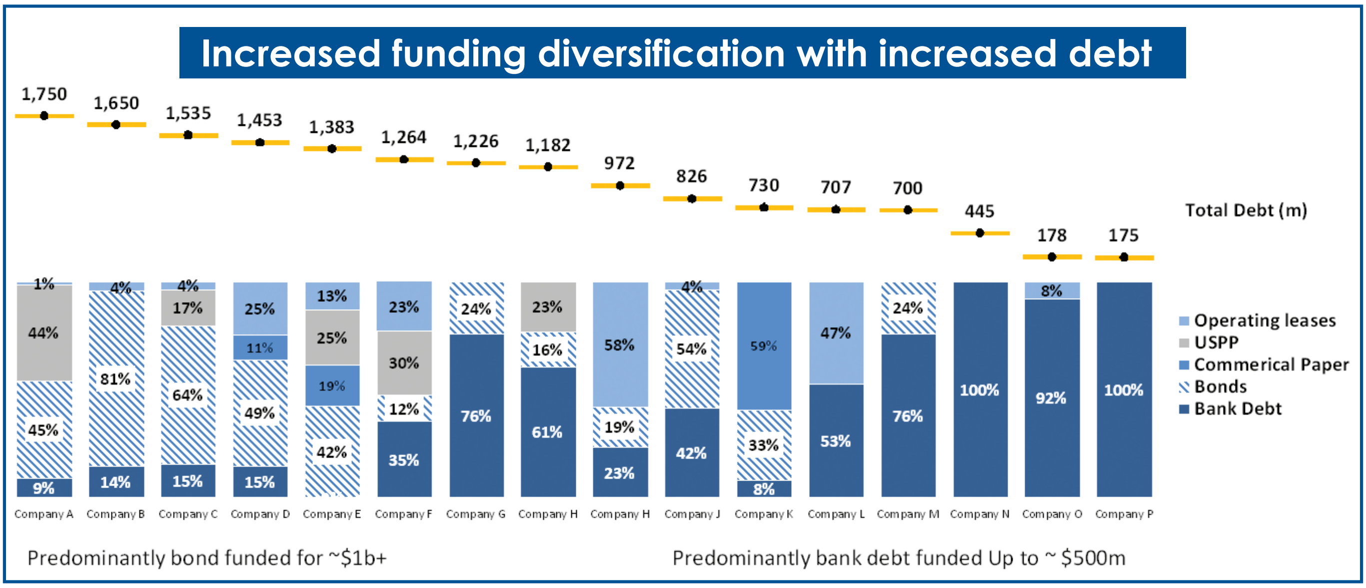

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aspects to this. Banks have loan or counterparty concentration limits — these vary depending on the credit quality of the borrower and may flex over time in line with broader market lending appetite. For example, if a company has $20 million of debt, a major trading bank is not likely to seek to have this amount split amongst other banking partners. Conversely, a single bank is generally unlikely to provide more than $150-200 million to any one borrower.

As the debt volume increases, so does a bank's desire to share the volume. This may initially be by way of bilateral or syndicated facility arrangements. This allows an individual bank to not hold more than its desired maximum debt exposure to an individual entity. As debt levels increase even further, broader banking groups, or consideration of alternative funding methods becomes necessary.

Several of these alternative funding options have practical minimum volume requirements. This may be due to investor size requirements, or simply because the cost of implementing such instruments is not economic below a certain size. For example, many institutional bond investors require an issue to be at least $100 million in order to meet bond index minimum requirements.

What has become more noticeable over the past year is divergent appetite from banks for different sectors and individual credits, coinciding with a broad lift in bank funding margins. This has seen companies consider alternative funding options, particularly those corporates at the larger end of town.

Capital structure and leverage

The impact of capital structure and leverage can be seen in the availability of different funding options for an entity. For many companies, bank funding will often present as the lowest cost option (although some bond markets are cheaper at present), particularly for shorter term commitments. However, banks will typically only lend to certain levels of leverage. For companies seeking higher indebtedness, alternative funding options may be more readily available. Higher leverage can also increase the attractiveness of some off balance sheet structured finance options, such as certain receivables financing or sale and leaseback arrangements. These can be used to reduce headline leverage, or unlock additional funding capacity that might not be otherwise available due to bank covenants or other constraints.

Whilst changes to accounting standards may alter the attractiveness of these options (e.g. IFRS 16, which will bring most operating leases onto the balance sheet), they can still deliver other benefits such as risk transfer.

Thinking outside the box

Given the fickle nature of bank lending appetite, being open to alternative financing methods may provide a business with a solution that best meets its needs. Diversification can also help ensure the continuity of financing when things turn bad. At such times focus often swings sharply from 'cost of funds' to 'security of funding.'

The team at Bancorp/Barrington have significant experience in analysing, designing and implementing a wide range of bespoke debt funding options. In the past three years alone, we have advised more than 100 clients on close to $10 billion of debt funding in Australia and New Zealand.

For those with significant borrowing requirements and regular debt maturities, the development of a broad funding plan can help steer strategic direction and ensure a holistic and forward looking approach to funding.

If you would like some advice as to the realistic funding options for your business, assistance in ensuring you are receiving market terms and appropriate pricing for the quality of your credit, or help in identifying and implementing a simple or creative funding solution, feel free to contact us to see how we can assist.

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