HERBERT
SMITH
FREEHILLS

ANNUAL CORPORATE DEBT FINANCE AND TREASURY REPORT 2018

ISSUE 5

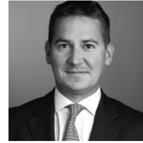
APRIL 2018

Key contacts

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

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

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



Robert Moore
Partner, Corporate/M&A
T +44 20 7466 2918
robert.moore@hsf.com

Elliot Beard
Senior Associate, Corporate Debt Finance
T +44 20 7466 2815
elliot.beard@hsf.com

Isaac Zailer
Partner, Tax
T +44 20 7466 2464
isaac.zailer@hsf.com

The contents of this publication, current at the date of publication set out in this document, are for reference purposes only. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

Herbert Smith Freehills LLP and its affiliated and subsidiary businesses and firms and Herbert Smith Freehills, an Australian Partnership, are separate member firms of the international legal practice known as Herbert Smith Freehills.

© Herbert Smith Freehills LLP 2018

Executive summary

Welcome to the results of our annual corporate client research gauging trends in the debt markets in 2018 and beyond.

Key conclusions include:

- Business confidence remains robust. Across all areas of investment at least 80% of respondents projected the same or higher levels of investment than in 2017.
- Noting that this research was undertaken prior to the breakthrough on the potential transition arrangements, respondents overwhelmingly reported that Brexit was not affecting their spending plans.
- Bank lending remains the cornerstone for corporate debt raising with increasing focus by corporates on their bank relationships.
- Corporates are likely to maintain or increase cash reserves in 2018.
- Compared to 2017, respondents were marginally more pessimistic about the downside risks of Brexit although this is projected to reduce over time. There was significantly greater concern about the negative business impact of a 'hard' Brexit.
- The end state is too uncertain for corporates to meaningfully finalise/implement Brexit contingency plans.
- Brexit is not affecting the availability of treasury products or the terms on which they are available.

About our annual corporate debt research

This research comprises a survey of, and follow-up interviews with, finance and treasury professionals of 60 large UK corporates (primarily FTSE 100, FTSE 250 and equivalents) conducted in February and March 2018.

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

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

1. Expenditure
Expectations for 2018

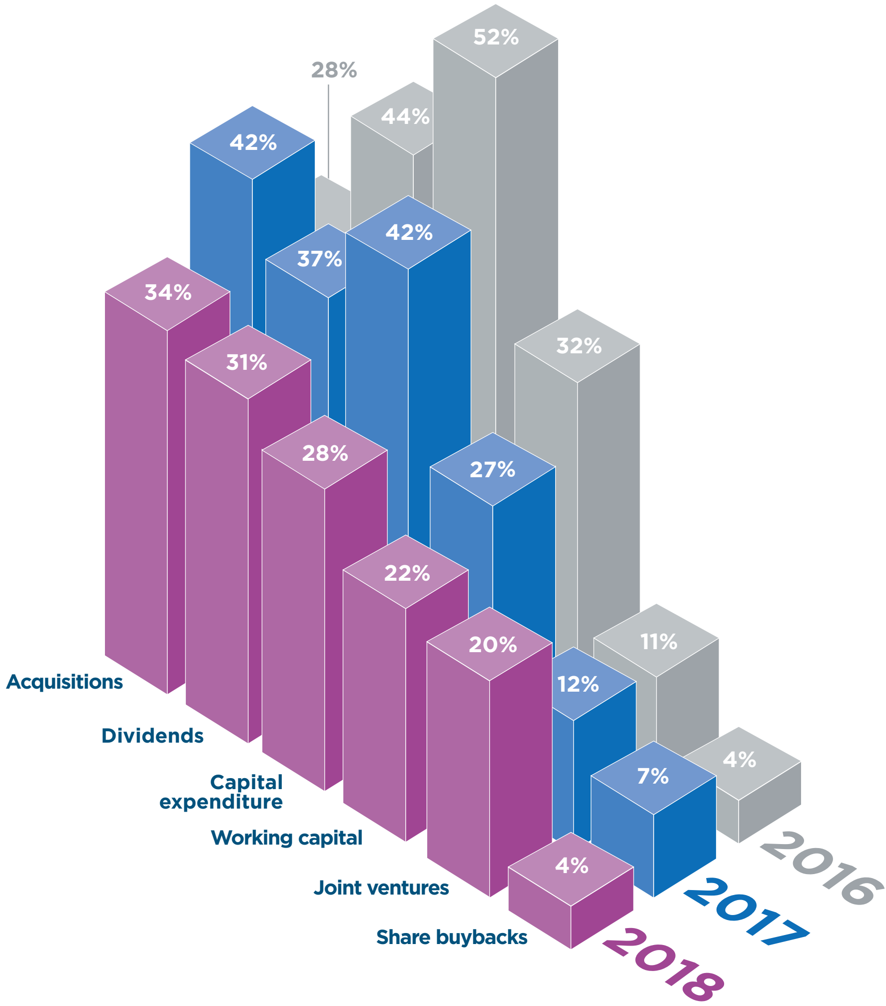
Looking ahead, how do you anticipate that your expenditure on the following will compare to last year?

Overall there is an expected softening of **increased** expenditure across all categories (other than joint ventures). However, as represented opposite, a significant proportion of respondents still reported year on year growth in expenditure compared to last year.

Across all categories, those maintaining the same level of expenditure as last year exceeded 45% which, when aggregated with those increasing their expenditure, represented the overwhelming majority of the respondents. As one treasurer noted:

> "This indicates strong business confidence for many and a 'steady as you go' business attitude for the majority of the remainder".

Of the areas reporting falling levels of expenditure compared to 2017, capital expenditure (20% of respondents) and working capital (16% of respondents) were by far the most significant. It may well be that, in relation to capital expenditure for example, this reflects for that minority the end of a protracted period of substantial investment. Aside from those two areas, the results were overwhelmingly in favour of maintaining or increasing year on year expenditure. In relation to acquisitions, 90% reported either similar or higher spending than 2017, matching expected global M&A trends for 2018 driven by high cash reserves, continued low borrowing costs and strong underlying economic fundamentals.



Those replying “higher”

Expenditure: Brexit

Has the prospect of Brexit changed your spending plans?

Noting that these results were obtained prior to the recent in principle break-through on the potential Brexit transition arrangements, one treasurer commented:

> "it's a confidence vote in the powers that be"

with another questioning whether, from a business perspective Brexit might be a "Y2K" like event ie a significant amount of concern leading up to leaving the EU which did not materialise in practice. A common theme emerged of those:

> "at the sharp end of business not really registering changes in business spending as a result of Brexit".

The results may, in part, be driven by responses of global corporates for whom Brexit is relevant but not materially so in the global marketplace.

Another took a practical view:

> "we need to keep investing in our business. That's what our competitors are doing and that's what our shareholders and stakeholders expect".

To the extent that expenditure was projected to be lower on account of Brexit this arose in relation to capital expenditure and acquisitions but very low proportions of respondents noted this. In interviews some respondents were however, more cautious about this potentially upbeat response. One referred to Brexit steering groups "scratching their heads" as to what to do and another asked:

> "how do you prepare for changes in the regulatory landscape when you don't know what those changes will look like?"

On that basis some opined that it was too early to change spending plans. A number of others mooted that business had faith that a smooth Brexit would ultimately be delivered meaning that, for now at least, investment plans should not change.

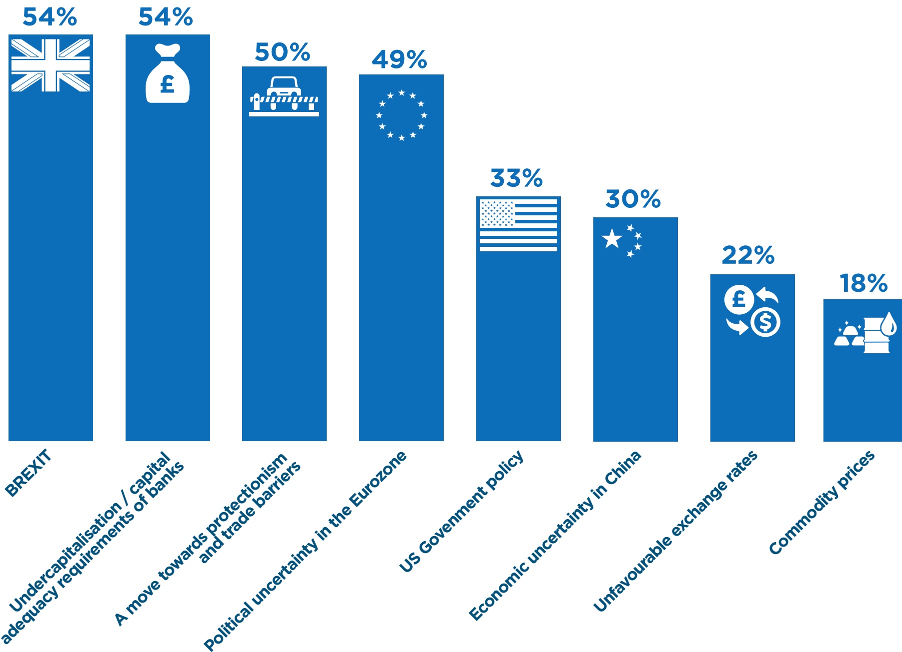
2. Debt raising

Impediments

What do you consider to be the major impediments to corporates raising debt over the next three years?

In comparison to the confidence around Brexit illustrated by the previous responses, more than half of respondents thought that Brexit may be an impediment to raising debt (marginally up on our results last year).

A number of respondents anticipated that this was more likely a threat to companies further down the credit spectrum or for SMEs rather than themselves.



Debt raising: Impediments

As with our research last year, concerns around undercapitalisation of banks remained a focus for respondents, although significantly fewer reported this to be a concern compared to last year. In talking to respondents, it seems that this factor is not limited to just undercapitalisation with respondents flagging concerns around broader changes in the regulatory environment and how that will impact on banks. This echoed views expressed by respondents in our research last year. As one treasurer put it this year:

> "Regulatory change for banks is more of a concern. The golden days of bank lending are going. Revolving credit facilities will become more difficult."

Another noted:

> "the subsidised RCF will have to change".

Another treasurer commented:

> "Banks are dropping out of refinancings and capital adequacy requirements are being used to justify this. Companies don't have enough ancillary business to feed all of the banks all of the time".

As one respondent stated:

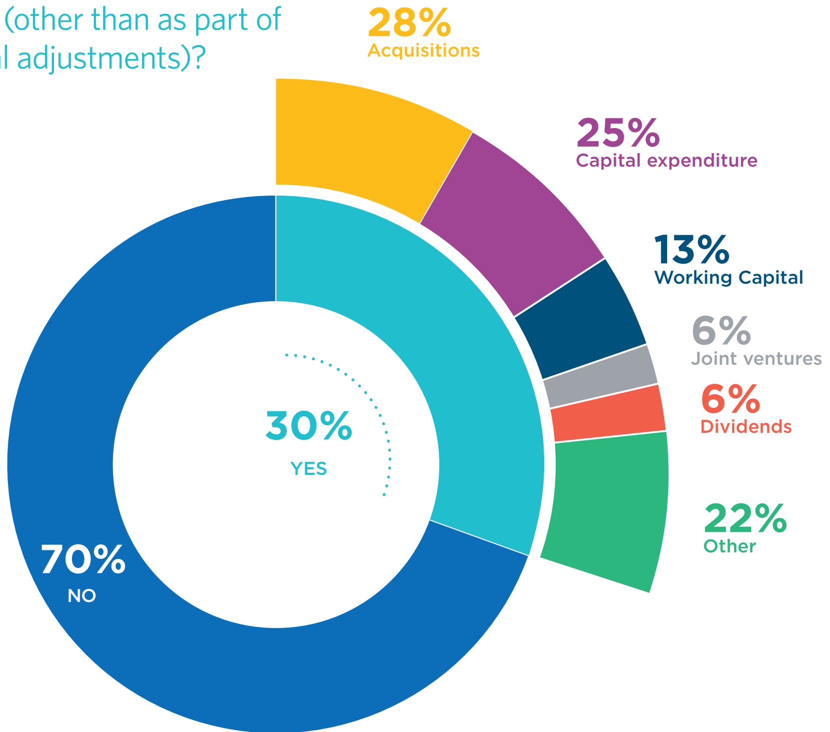
> "a concern is that banks are being much more aggressive in trying to get clients to meet their return targets, even when some products are uneconomic. I think we will see more participations in RCFs sold on. This is not always good".

Some respondents observed that EU related concerns seem to be underplayed in the findings particularly given the potential impact of Brexit on EU headquartered banks and that the larger systemic issues which have been well reported over recent years at national levels within the EU had not been addressed.

Finally, the proportion of respondents expressing concerns around US government policy has abated significantly compared to the levels which we reported last year.

Debt raising: Increasing debt

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

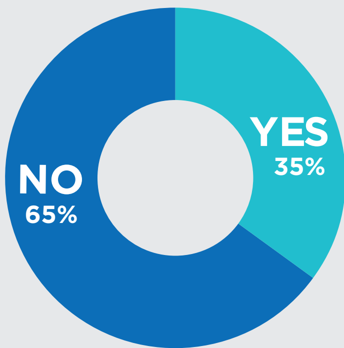


Only 30% of respondents planned to increase their overall debt this year compared to 37% in 2017 and nearly 50% in 2016. Given the acquisition and investment plans of many respondents, this suggests that some of that higher expenditure will be funded from retained earnings or, as is an increasing trend currently, through the use of equity. One respondent noted that the recent history of strong corporate earnings - in some instances, flattered by the fall in the value of sterling - made further debt raising less necessary.

The percentage of respondents using debt funding for acquisitions and capital expenditure is lower than last year (42% and 35% respectively in 2017) with debt funding being increasingly used to fund dividends and joint venture investments as well as for other miscellaneous purposes.

Debt raising: Refinancing

Do you plan to refinance any of your debt this year?



At 35%, the number of respondents seeking to refinance their debt this year is down significantly from last year (47% and, in 2016, 41%). This may reflect the cyclicality of refinancings and, as treasurers seek to smooth their debt maturity profiles (and given the diversified debt capital sources of most corporates) this number may stabilise over time.

The debt markets remain benign, particularly for investment grade corporates, with significant debt raising possible across products and markets, and in the immediate term, there does not appear to be anything which would significantly disrupt that.

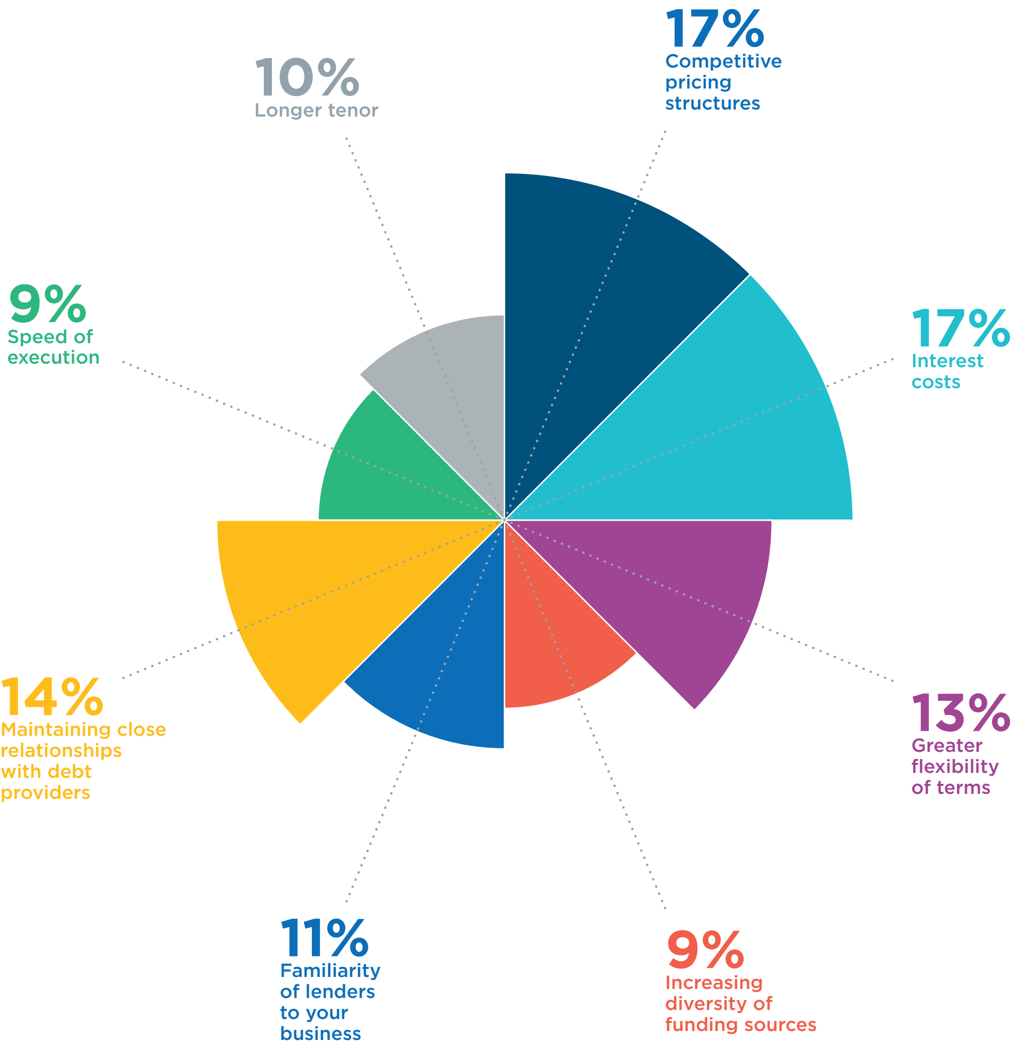
Debt raising: Drivers for borrowing

Brexit aside, if you are considering borrowing this year, what are your main drivers?

The key drivers for borrowing have become less delineated compared to last year, although the cost of debt, across its two categories, remains the key driver (although approximately 15% weaker than our results in 2016 and 2017).

Looking at the results of our research in 2016 and 2017, there is a continuing shift of emphasis towards maintaining relationships with debt providers and the familiarity of lenders to a corporate's business; in essence, a slight weakening focus on cost and a greater emphasis on relationship.

One respondent queried whether this shift is a sign that, with the potential headwinds corporates may face in the medium term, they are focusing on those lenders (typically banks) who know them best and with whom they have the longest and deepest relationships.


17%
Competitive pricing structures
10%
Longer tenor
9%
Speed of execution
17%
Interest costs
14%
Maintaining close relationships with debt providers
13%
Greater flexibility of terms
11%
Familiarity of lenders to your business
9%
Increasing diversity of funding sources

Debt raising: Cost of funding

Compared to 2017 what do you anticipate your costs of debt funding will be over the next 12 months?

47% HIGHER

37% ABOUT THE SAME

16% LOWER

These results are almost identical to last year (in 2017, 47% predicted higher, 40% the same and 13% lower).

For blue-chip corporates, access to funding at costs which remain near historic lows remains a prevailing theme and is consistent with our findings last year. Slightly further down the credit scale, and as noted earlier, the subsidised RCF bank lending model is under strain with lenders sometimes unable to meet internal rate of return hurdles with the ancillary business available to them. In those transactions, which are increasingly seeing bank syndicate changes on a refinancing, pricing is rising compared to last year. The position may also differ across debt products. One respondent noted that whilst bank pricing may be rising slightly they were able to raise debt in the private placement markets at 2016 pricing levels.

The pricing trend was explained by one treasurer as follows:

> "on the one hand people are expecting turbulence, the end of quantitative easing in Europe and US interest rates inching up, while on the other there is the possibility of interest rate cuts if the UK economy slows".

Another factor driving up pricing may be the recent ending of the Term Funding Scheme whereby almost interest-free loans were made to banks to facilitate greater lending to corporates.

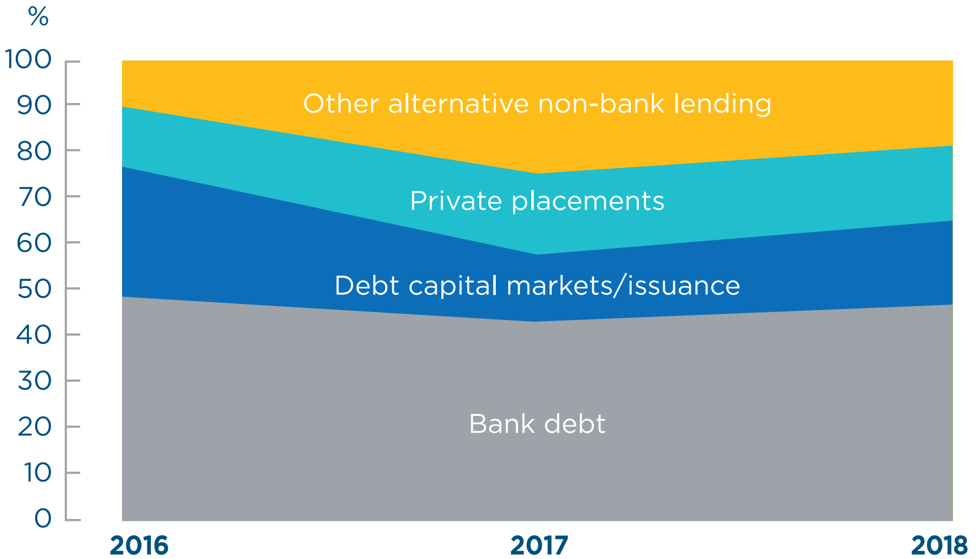
Outside of this research anecdotal evidence points generally to the rising cost of debt with a number of respondents noting that interest rate rises which have been:

> "threatened since 2009 now seem much more real".

Of those who reported higher costs, 68% attributed this to increased bank funding costs (2017, 38%), 25% to increased margins (ie credit driven) (2017, 46%) 25% to other reasons (which is the same as 2017 and respondents again noted this was likely due to increases in UK/US interest rates), with 8% citing increased FX costs (2017, 17%). In some cases respondents selected more than one factor. Whether those selecting the bank funding costs option relates to the likely incremental costs resulting from regulatory change is unclear (and it seems too early to factor in, for example, the costs incurred by banks in having to create separate capital pools for the UK and EU as a result of Brexit and the inefficiencies that will arise as a result).

3. Capital structure
Sources of additional debt

If you plan to increase your overall debt or refinance any of your debt in 2018, how will this be achieved?



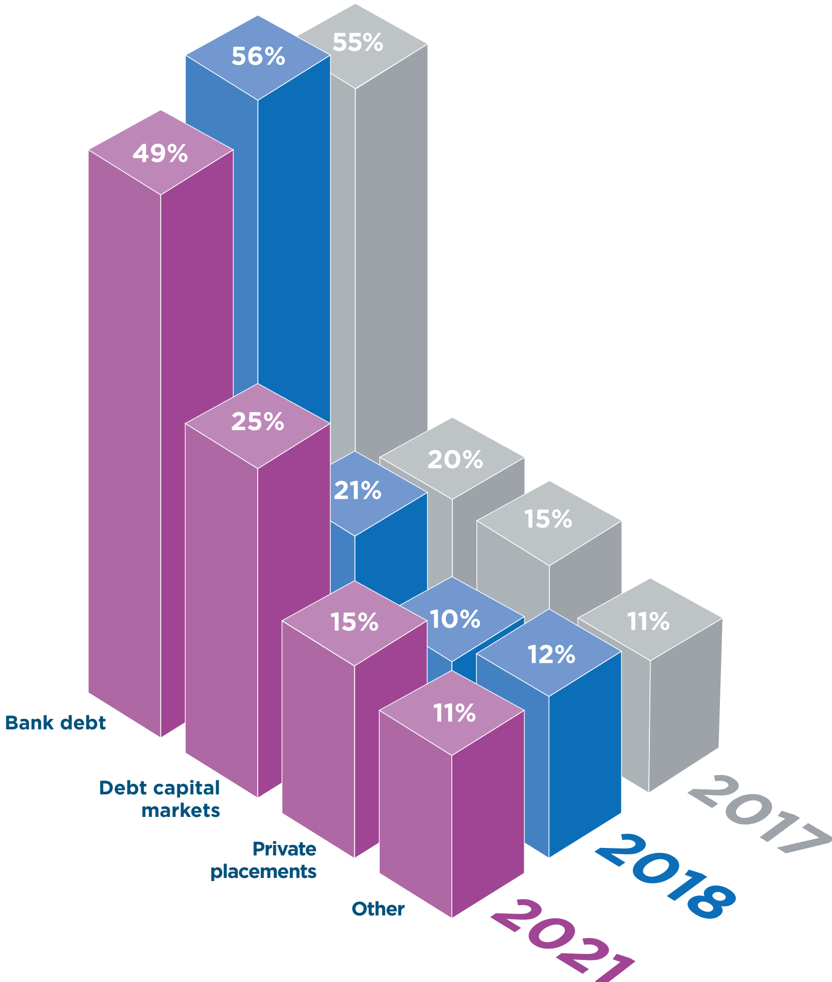
For the majority of respondents, year on year additional debt raising will be achieved through the bank loan markets. Some respondents queried whether this was in part driven by the need for shorter term funding for which the bank market is arguably most suitable - which might be especially the case for net cash generating businesses. In broad terms the percentages of respondents utilising the DCM and private placement markets has remained constant year on year, whilst the heightened interest in alternative non-bank lending reported in 2017 has partially receded though remains more popular than in 2016.

In relation to alternative non-bank lending, respondents noted in particular the widespread use of both recourse and non-recourse receivables financing arrangements (whether arranged by the supplier or the customer (the latter often described as 'supply-chain financing'). However, in the light of recent corporate collapses the continued appetite of banks to make available those facilities was questioned by some respondents.

Those approaching the debt capital markets for increased borrowing remain below 2016 levels and whilst some reasoning for this is offered in our commentary relating to fixed rate debt section (page 16-17), some respondents noted that, for them, there had continued to be certain arbitrage gains in pursuing, for example, a USPP vs a DCM issue. That said this does run counter to wider market commentary around increasing use of DCM to meet incremental funding needs.

Capital structure: Debt funding

At the start of 2017, 2018 and 2021 approximately what percentage of your total debt funding do you think will be provided by the products described opposite?



Bank debt remains, and is projected to remain, the cornerstone for corporate debt raising. One respondent explained that the bank market had proved so flexible and efficient in terms of the cost and process of raising debt that it had dissuaded corporates from raising debt via other means:

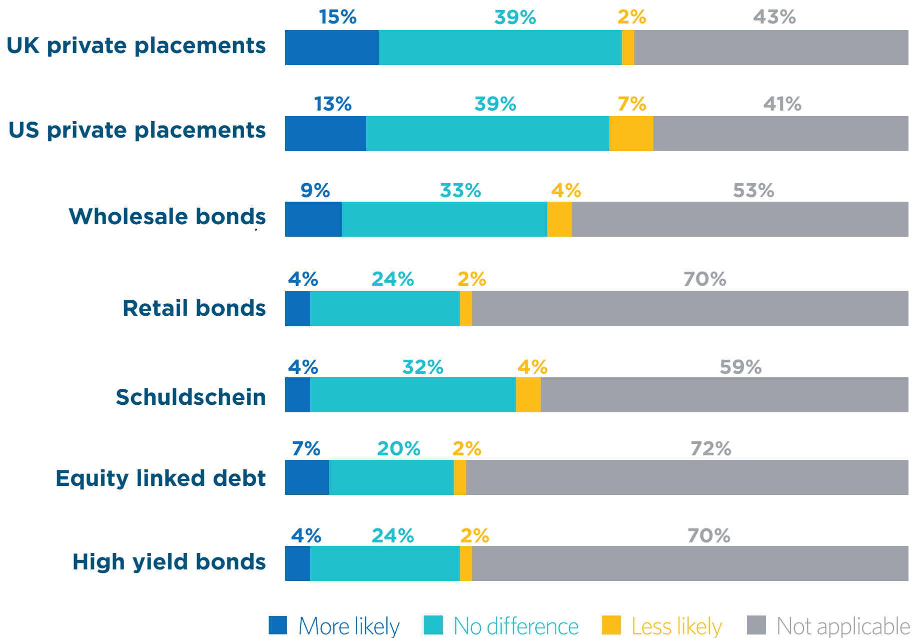
> "Banks have continued to offer very cheap and easy funding – it's like a drug, we can't get off it!".

Over the last four years respondents to our research have projected a future shift to the debt capital markets but across the last three years the percentage which DCM actually contributes to the total corporate borrowing of respondents has not materially changed. This year, the three year projected increase in raising debt in the debt capital markets is more modest (25% compared to an expectation of 29% (in 2020 projected in our 2017 research) and 26% (in 2019 projected in our 2016 research). Some respondents noted that rather than there being significantly greater numbers of companies approaching the debt capital markets in the future diversification might take the form of existing DCM issuers issuing debt in other debt capital markets eg to the US and Maple markets.

Projected use of the private placement markets remains broadly similar to that reported last year and the overall trend this year suggests that there will be marginally more diversification of debt sources than in place today. In none of our research surveys however have we seen a strong trend towards a more US DCM driven debt capital structure, which is consistent with trends in our surveys to date but perhaps contrary to wider market commentary more generally.

Capital structure: Fixed rate debt

Compared to last year, are you more or less likely to consider the following fixed rate debt products?



US and UK private placements remain the mainstay for corporates looking to raise fixed interest rate debt; their flexibility in size of issue and the absence of a rating requirement making them particularly attractive to a wide range of corporates and more accessible for some than the wholesale bond markets. The proportion of those reporting that these instruments would not be applicable to them remains broadly consistent with our research last year.

One respondent noted that regulatory changes were afoot which benefitted USPP investors and that, as a result:

> "the PP markets are getting wider and diversifying away from their conventional corporate clients. Universities for example are using it because of the innovative nature of that market."

Other respondents noted that regulatory changes encouraged PP investors to consider investing lower down the credit curve and that features such as deferred drawing enabled corporates to lock-in funding well in advance of the funding event thereby driving certainty in the annual debt funding calendar.

Some respondents noted that the Schuldschein market had not developed in the way they had expected a few years ago. Concerns emerged as to the relative cost compared to the US private placement market, the issuance route being less well trodden compared to USPPs (though with shorter documentation) and stories of somewhat unwieldy consent processes. One respondent said of the Schuldschein market:

> "it makes the USPP market look like a doddle."

Respondents noted that the UKPP market appears to continue to grapple with the limitations and challenges raised in our earlier reports (which can be accessed via links at the end of this report). Very little was said by respondents in relation to retail bonds, echoing the sentiments expressed last year, whereas equity-linked and high-yield issues were, for the corporate (as opposed to leveraged) community, truly the exception rather than the norm.

Capital structure: Cash levels

How do you anticipate the levels of cash that you currently hold will change over the coming year?

27% INCREASE

58% ABOUT THE SAME

15% DECREASE

In interviews, treasurers and FDs universally agreed with these findings. Compared to last year, far fewer respondents were considering reducing their cash levels (15% in 2018, 41% in 2017) with far greater maintaining cash levels (58% in 2018, 23% in 2017). One treasurer said:

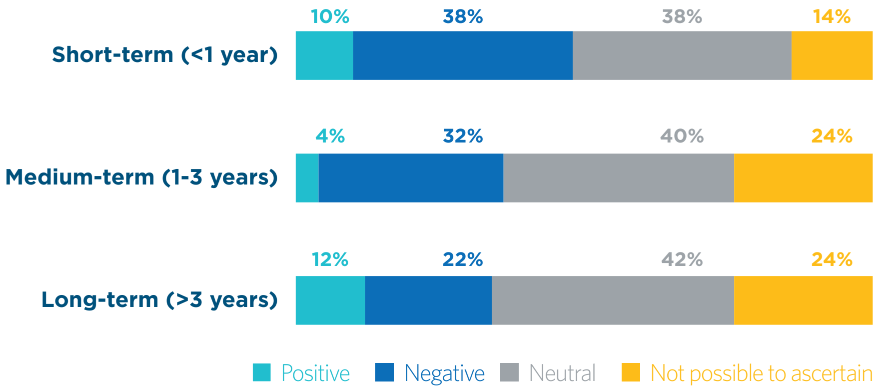
> "the last thing you want to do as you enter into a period of uncertainty is to be light on committed facilities and cash......it's better than going cap in hand to your lenders".

As noted earlier, concern around bank capitalisation was flagged as the joint most material impediment to raising debt, although there was little by way of feedback that this translated into a bank solvency concern. This may be reflective of the observations made by respondents and noted above around bank appetite to roll-over on refinancings where ancillary business expectations had not been met. Other respondents explained this as corporates holding on to cash on a short term basis to fund capital expenditure and acquisitions, themes also noted above.

4. Brexit

General

Do you think Brexit will have a neutral, positive or negative impact on your business?



A number of respondents explained the short term negative responses as driven (at this stage) by uncertainty and the risk of, at least temporarily, a 'hard' Brexit. That said, whilst this year there were slightly fewer reporting that the short term effects of Brexit would be negative than in 2017, the number reporting Brexit as a positive impact on their business was also less than last year. Overall the respondents were marginally less optimistic about Brexit than last year.

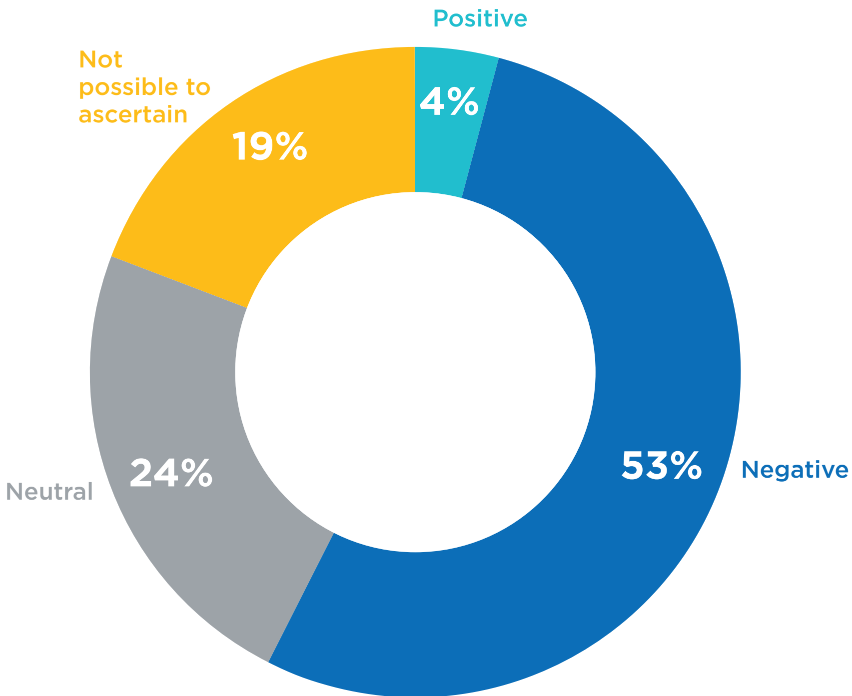
In light of the prevailing circumstances at the time of the research, this may not be surprising although a number of respondents commented that few large international corporates would see obvious net positive trends for their businesses as a result of Brexit. Others were surprised that the results were not more negative given the lack of progress towards achieving a smooth Brexit at the time of the research. It is also not surprising, given the current lack of clarity over the end state, that a substantial number of respondents were unable to predict the medium to long term consequences of Brexit for their businesses.

Over time, respondents believed that the negative effects of Brexit would reduce (along with higher proportion noting a neutral effect); many respondents queried whether this was in fact the expectation that trade arrangements (and treaties with the EU and elsewhere) would be substantially progressed over that time period.

Overall though, on average more than half of respondents thought that Brexit would be positive or neutral for their businesses.

Brexit: Hard Brexit

If there is a 'hard' Brexit (ie reverting to WTO trade rules) do you expect that the impact on your business will be?



Whilst the likelihood of a 'hard' Brexit vacillates from day to day, a substantially greater number of respondents thought that a hard Brexit would have a negative impact on their businesses. One respondent remarked:

> "This reflects the fact that the full impact is unknown. The most negative impact will likely be on those with purely domestic businesses.....international companies with limited UK exposure are shielded to some extent and this could even be attractive from a currency perspective."

Others noted that a 'hard' Brexit might well occur but that, if it did, it was likely to be an interim measure and that whilst many had thought the effect would be negative it was not possible to ascertain how negative it might be (and it is worth noting that, at this stage, 20% of respondents were unable to ascertain what the impact would be).

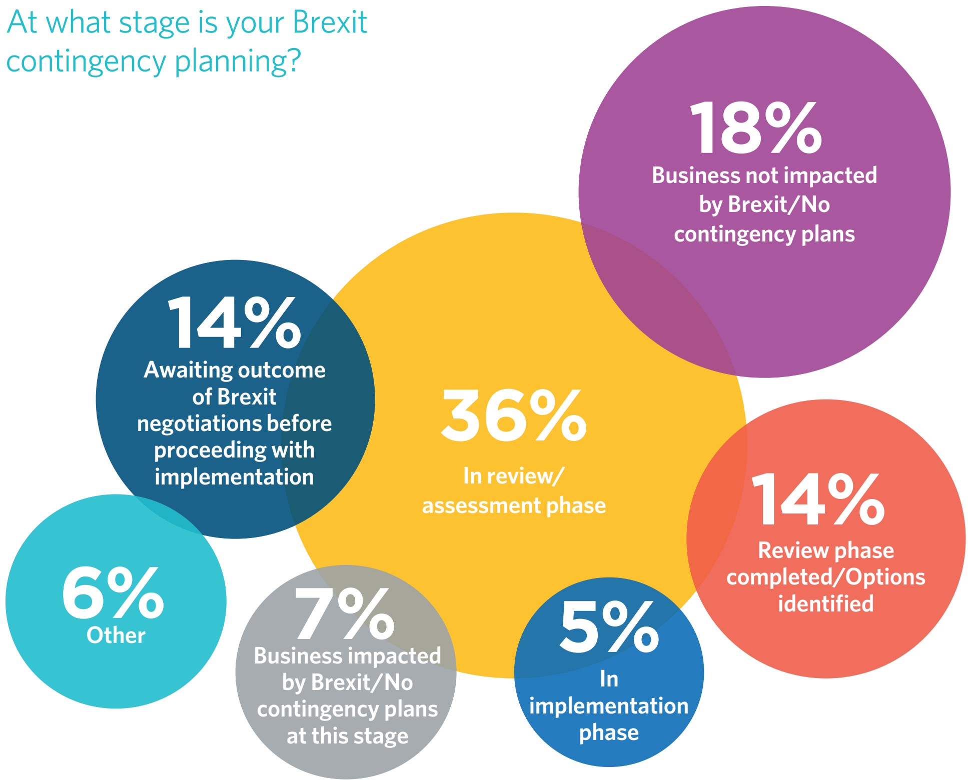
There is some inconsistency between the medium term business optimism generally (whether or not Brexit occurs) and the impact of Brexit. In interviews many respondents flagged this and the overarching view was that, regardless of the political statements to date, many were discounting the likelihood of a 'hard' Brexit occurring (noting that the EU would also not want that given the potentially very negative effects for certain EU member states).

As one respondent put it:

> "If hard Brexit happens, it is inconceivable that it would not be fixed in the short-term. There would be a political impetus to fix it."

Brexit:
Contingency planning

At what stage is your Brexit contingency planning?



"Businesses need not delay investment decisions, or rush through contingency plans based on guesses about the future deal."

STATEMENT IN BRUSSELS BY DAVID DAVIS, SECRETARY OF STATE FOR EXITING THE EUROPEAN UNION, 19 MARCH 2018

Compared to financial institutions, corporates are some way off in either having identified options and making plans or implementing those plans. The overall message though was encapsulated by the following respondents:

> "I'm surprised by those already in implementation phase. How can they be for something that's still unknown?" and "it's simply impossible to plan at this stage".

Some respondents noted that the review/assessment phase would, for many, last a number of months until much greater clarity on the 'end state' had been provided. At this stage, potentially only a 'hard' Brexit could be planned for.

Others noted that the cost and time of addressing some of the potential downsides of Brexit eg moving manufacturing facilities or assembly lines were simply too great to be undertaken in time (even assuming that the transition period is ultimately implemented) or indeed at all (eg if there wasn't the pool of skilled labour required elsewhere or the cost was prohibitive).

A consistent concern raised related to the secondary impact for corporates ie not a direct downturn in their business but, for example, more difficult access to debt capital (eg to historically cheap EIB funding as well as greater marshalling of capital by commercial banks), Brexit triggering a general UK downturn which then impacted on that corporate's business eg due to lower discretionary spending or inflation and the impact upon pension deficits and:

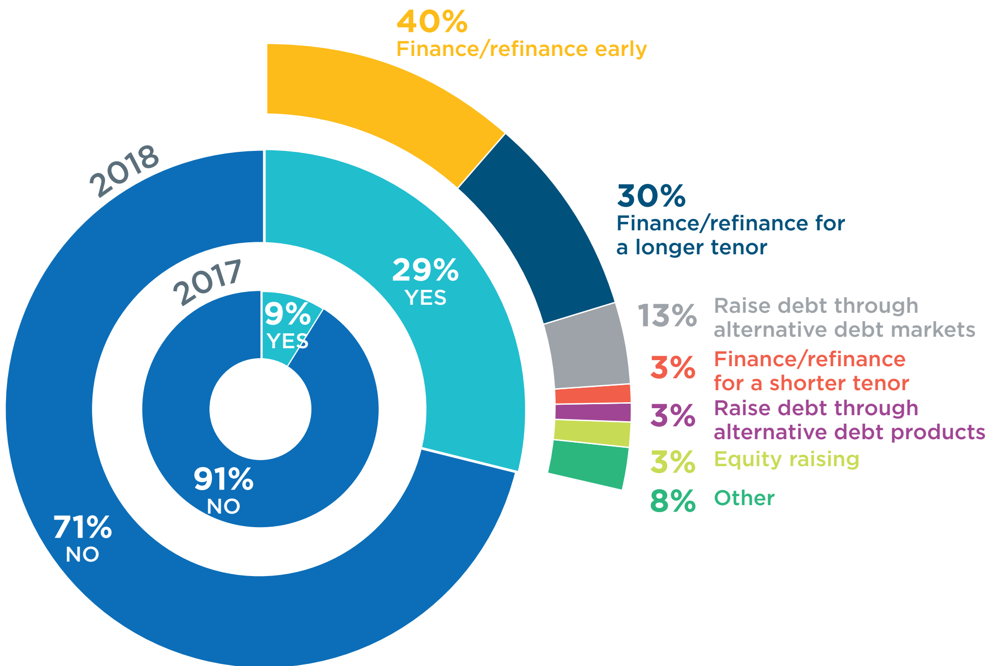
> "the negative macro-economic impact for the UK leading to weaker growth and pressure on government finances".

Those planning to relocate operations outside of the UK gave examples of European, but also of US, Middle Eastern, Indian and Far Eastern, jurisdictions. Brexit may trigger a more fundamental operational business review to ensure that corporates are best placed over the longer term rather than simply reacting to Brexit itself.

Of the low levels who had identified options or were in the implementation phase, the options identified were too varied to illustrate any meaningful trends.

Brexit: Capital structure

Has Brexit changed your thinking around your preferred capital structure or the timing of any financing/refinancing?



As responses to the previous question demonstrated, general business operational matters may be difficult to identify and implement at this stage but, arguably, corporates have greater control in relation to locking-in their committed funding early to avoid any potential turbulence arising from Brexit.

In relation to early refinancing, some noted that this was prudent (particularly for 2019 and 2020 maturities) but as one treasurer noted (expressing the view of a number of respondents):

> "markets are particularly liquid at the moment so this trend is not just about or specific to Brexit. Longer tenors are attractive too [because of flatter yield curves] so companies want to take advantage of that too."

Another respondent noted that to refinance early was:

> "a natural response to any uncertainty.......although there are no concerns about the strength of financial institutions as a result of Brexit".

As noted in our research last year, queries were raised by respondents as to whether European banks would be less visible in the UK markets post Brexit (for example due to loss of passporting or capital constraints and the financing of EU businesses were UK banks not be able to do so in the same way as currently). Aside from those regulatory concerns flagged above, respondents noted that the loan markets remained very strong with few reasons to believe that an early refinancing was necessary.

Brexit: Treasury products and terms

Have financial institutions that you transact with indicated that they will no longer be able to provide certain products to you following Brexit?

98%

SAID NO

Almost universally respondents had not encountered these types of issues. A number of respondents noted that this might be more of an issue for EU domiciled corporates – for example EU-based treasurers with London-based relationships and the ability of the European operations of banks (assuming no passporting) to service those relationships from their European offices (allied with questions over the ability to recruit enough employees locally with sufficient experience across the product ranges to cover their clients' needs).

Have financial institutions that you transact with indicated that features or terms of certain treasury products will change following Brexit?

94%

SAID NO

Aside from requested amendments to ISDA documentation (stay provisions, bail-in language and permitted transfers) which have yet to gain general market traction and which are often driven by the circumstances of individual banks, the only responses here related to Brexit-related termination provisions which were being requested by the EIB in relation to its loan documentation. For the wider debt markets, respondents reported no issues.

5. Regulatory

Ring-fencing

Are banks raising regulatory ring-fencing as a hurdle in their continued lending to and other business with you?

The number of respondents who reported that regulatory ring-fencing was being raised as a hurdle to lending almost halved compared to that reported in our research last year. For the vast majority of respondents this was an administrative issue:

> "lots of correspondence but no real action needed"

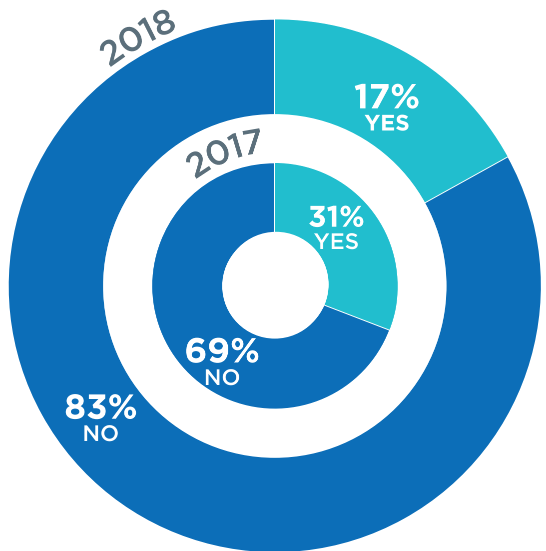
although:

> "some [counterparties] send a few pages and some send a tome".

A few respondents noted more significant issues (eg a syndicate member couldn't achieve the otherwise agreed pricing on a financing so had to withdraw, another bank had withdrawn a product) but these were the small minority.

The lack of standardised processes across all banks led to some respondents noting that, on an industry-wide basis, the process could have been better managed at a regulatory level whilst others acknowledged that:

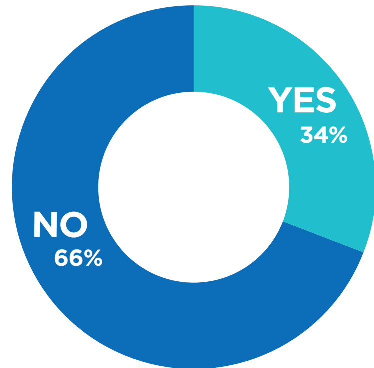
> "the banks have handled it well".



Concerns expressed last year about the non-ring-fenced bank being likely to have a lower credit rating than the ring-fenced bank and thereby potentially limiting the business that could be undertaken with the non-ring-fenced bank from a treasury policy counterparty risk perspective appeared not to have materialised as a future risk yet.

Regulatory: Tax

Taxation rules in a number of key jurisdictions are changing or are expected to change shortly (for example in relation to the deductibility of interest). Will this change the way that you structure your balance sheet?



Those who planned to change the manner in which debt is raised across their corporate groups as a result of tax changes flagged that there would be increased matching of debt raising to revenue generating companies. This would particularly be the case where deductibility of interest costs became an issue. Some of this would be achieved through third party borrowing, some by intra-group lending and others via group cash-pooling arrangements. Care will be needed to ensure that restrictions in debt financings (for example on incurring financial indebtedness) are adhered to.

Others reported that, given the sensitivity of tax matters and the public relations impact of adverse news in this area, it would be critical to comply with both the letter and the spirit of applicable tax legislation. Another said:

> "aggressive tax planning is definitely out"

but that minimising the instances where tax in one jurisdiction did not lead to relief in another would be fair to pursue.

The changing global tax environment is not a new story. Steps for curbing some practices attributed in particular to global groups - designed in broad terms to shift profits from high tax paying jurisdictions to low tax jurisdictions - have been the focus of the OECD-sponsored Base Erosion and Profit Shifting (**"BEPS"**) project for several years now.

Many jurisdictions have, even before the BEPS project completion over 18 months ago, began to implement new domestic tax legislation which restricts heavily the ability to lower the tax base in the jurisdiction where revenue or value are generated. This process has picked up in pace since the BEPS project recommendations were made public.

Separately, the EU is working to introduce its own set of tax measures designed to combat similar practices, and the EU Commission has been pursuing a number of high profile multinationals for unpaid tax, on the basis of alleged violations of the state aid rules.

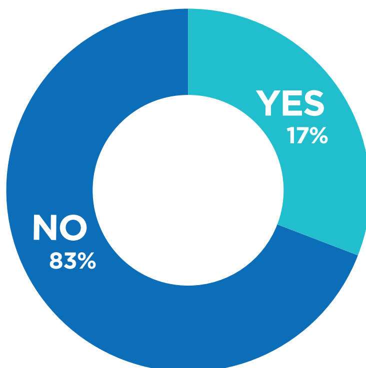
Although not covered in this report in detail, the new tax legislation spawned by the above focus on multinationals impacts on financing structures in a number of ways, including by imposing tighter restrictions on tax relief for finance costs, reversing the tax benefits associated with some hybrid debt structures, and making access to double tax treaties (and hence favourable withholding tax rates) limited to bona fide set ups. If not already in hand, borrowers and lenders would be well advised to review the impact of the new rules on their debt structures.

Regulatory: Environmental, Social and Governance ("ESG") factors

Certain investors are increasingly focussing on ESG factors. Is ESG a factor for you when formulating your debt funding strategy?

Even for the small minority which reported that ESG was a factor in formulating their debt funding strategy, its role was, at least at this stage, relatively limited. Those pursuing green financings (such as green bonds) were extremely limited (20% of those who said yes, so 3.4% of the total); the overall cost of funding (together with the additional upfront and ongoing work necessitated by a green bond) pushed treasurers to more conventional products. Whilst there is some impetus from parts of the investment community to invest in green financings, the liquidity in other markets is such that interest in borrowing in these 'green' markets remains muted. Over 60% of those who responded yes used ESG as part of their decision making processes or reported on ESG issues to lenders and other shareholders. One treasurer commented that:

> "The ESG agenda is becoming more and more important and we need to be ready for those conversations – it's being taken more seriously by the investment community".

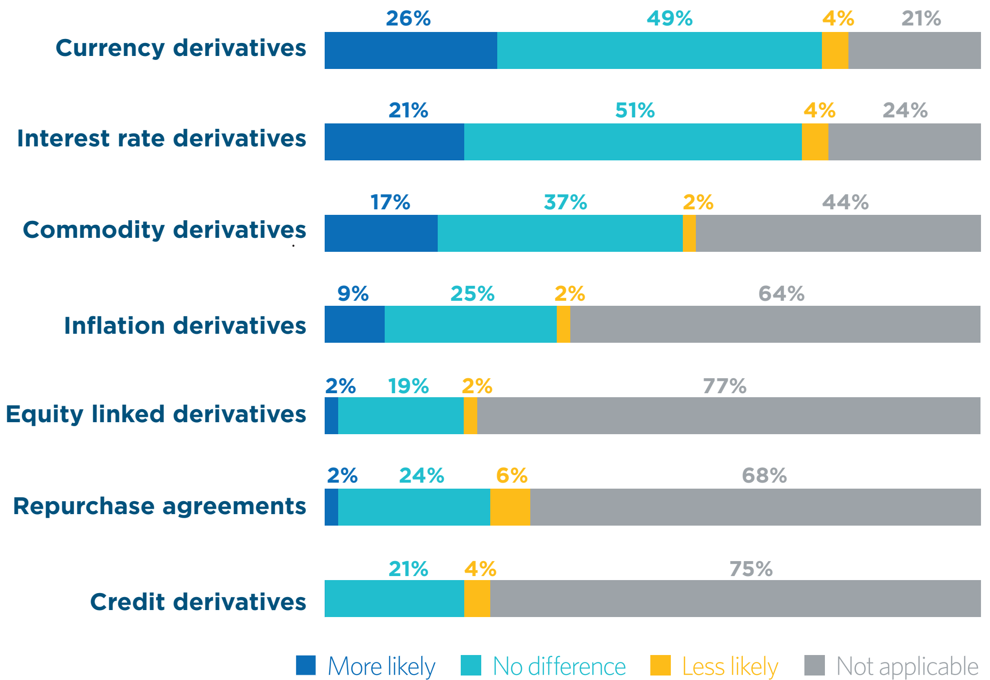


As such, for now it seems, the primary impact of ESG is around investor reporting rather than green debt issuance. As one respondent put it:

> "This is an important issue but doesn't detract from the fact that I'll use a product if it is the right fit at the right price...I'll use it because its cheaper; not because it's greener."

6. Derivatives
2018 forecast

Do you anticipate that you are likely to enter into more or less of the following treasury products in 2018?



Derivatives 2018 forecast

Compared to 2017, considerably fewer respondents reported anticipating greater use of currency, interest rate and commodity derivatives (in 2017, 41%, 29% and 23% respectively). This may well link into the fact that respondents have reported less Brexit related concerns, which have been a feature in the prior year when considering these products. However, taking into account those 2017 projections and the anticipated increases this year, year on year, there is considerably greater focus on the use of these products. Whilst it is true to say that, as businesses grow, there will be a natural growth in the use of these instruments one respondent noted:

> "In times of greater volatility, corporates turn to these products"

whilst noting in relation to the continued muted interest in equity linked derivatives, repurchase agreements and credit derivatives:

> "these more exotic types are irrelevant to most of us – it's a niche market".

Another respondent flagged that, currently, FX volatility was relatively low and this made FX options (particularly US$-£ currency options) cheap and that the purchase of options as a hedge against FX risk was, for them, a prudent step given the uncertainty ahead. More broadly, given the direction of interest rates in the UK and the US it is perhaps not surprising that there is the desire to hedge against interest rate rises now. As one respondent noted:

> "We think interest rates will finally rise this year as QE slows down."

Given the broad satisfaction with institutional bank lending and lack of desire to change cash levels, as reported above, it is not surprising that repurchase agreements have not yet found traction within this audience.

Other publications of interest

If you are interested in reading last year's research please email laura.smith@hsf.com.

Please do also get in touch with feedback should you have any regarding this year's report or if you would like to discuss any of the issues raised in it. Contact details are in the executive summary of this report.

For more on our corporate debt finance practice, please visit https://hsf.com/our-expertise/services/corporate-debt-finance-and-treasury

For advice and information on putting your Brexit plans into action, please visit hsf.com/delivering-brexit

For M&A services please visit www.herbertsmithfreehills.com/our-expertise/services/mergers-acquisitions

HERBERTSMITHFREEHILLS.COM

BANGKOK
Herbert Smith Freehills (Thailand) Ltd

BEIJING
Herbert Smith Freehills LLP
Beijing Representative Office (UK)

BELFAST
Herbert Smith Freehills LLP

BERLIN
Herbert Smith Freehills Germany LLP

BRISBANE
Herbert Smith Freehills

BRUSSELS
Herbert Smith Freehills LLP

DUBAI
Herbert Smith Freehills LLP

DÜSSELDORF
Herbert Smith Freehills Germany LLP

FRANKFURT
Herbert Smith Freehills Germany LLP

HONG KONG
Herbert Smith Freehills

JAKARTA
Hiswara Bunjamin and Tandjung
Herbert Smith Freehills LLP associated firm

JOHANNESBURG
Herbert Smith Freehills South Africa LLP

KUALA LUMPUR
Herbert Smith Freehills LLP
LLP0010119-FGN

LONDON
Herbert Smith Freehills LLP

MADRID
Herbert Smith Freehills Spain LLP

MELBOURNE
Herbert Smith Freehills

MILAN
Studio Legale Associato in association
with Herbert Smith Freehills LLP

MOSCOW
Herbert Smith Freehills CIS LLP

NEW YORK
Herbert Smith Freehills New York LLP

PARIS
Herbert Smith Freehills Paris LLP

PERTH
Herbert Smith Freehills

RIYADH
The Law Office of Nasser Al-Hamdan
Herbert Smith Freehills LLP associated firm

SEOUL
Herbert Smith Freehills LLP
Foreign Legal Consultant Office

SHANGHAI
Herbert Smith Freehills LLP
Shanghai Representative Office (UK)

SINGAPORE
Herbert Smith Freehills LLP

SYDNEY
Herbert Smith Freehills

TOKYO
Herbert Smith Freehills

© Herbert Smith Freehills LLP 2018 2981B /130418