



HERBERT
SMITH
FREEHILLS



CELEBRATING 40 YEARS
OF ENGAGING TREASURERS

CORPORATE DEBT AND TREASURY REPORT

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About our research and report

This research comprises a survey of, and follow-up interviews with, finance and treasury professionals of over 75 large UK corporates (primarily FTSE 100, FTSE 250 and equivalents) conducted in February and March 2019.

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. As always, their views added depth to the research findings and their input has been invaluable. Thank you.

Equally, we have enjoyed and appreciated working alongside the ACT in our research this year; their ability to bring the prevailing views of UK corporate treasurers, finance directors and CFOs and a broader economic view to our research is greatly appreciated and significantly added to the data which underpins this report and from which the conclusions are drawn. We look forward to working with the ACT again.

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.

Some of the themes explored in this report are necessarily only addressed in headline terms. During 2019 we will issue short form, practical insights on some of these issues and share views from other treasury professionals. If you would like to receive those please email laura.smith@hsf.com.

Executive summary

Welcome to the results of our annual corporate client research gauging trends in the debt markets in 2019 and beyond.

Key conclusions:

- Corporates are significantly more pessimistic in the short term about the wider economic impact of Brexit than last year but bullish that Brexit will not affect their ability to raise debt in their preferred markets and currencies and in accordance with their own timetables
- Delays to Brexit and implementing Brexit planning are putting strains on supply chains and management teams
- Bank lending is the bedrock of corporate debt capital structures but relationship banking is under greater strain than ever as banks seek to meet internal rates of return by chasing ancillary business
- Drivers for borrowing remain cost focussed although with significantly increased emphasis on terms and conditions to deliver certainty of funding
- IBOR replacement issues will need to become a priority for corporates in 2019 and 2020. A substantial proportion of corporates do not borrow on a fixed interest rate basis. Whilst this explains the wide use of interest rate derivatives, it also illustrates the exposure of corporates to the consequences of the phasing out of IBOR rates. Little progress has been made in settling successor risk free rates in the loan markets and different solutions are emerging across jurisdictions and markets for different debt products
- Alternative and non-bank lending continues to grow in prominence and is at least as important as DCM or private placements as a source of corporate debt for many corporates
- Over two-thirds of increased borrowing this year will be applied towards business investment; corporates are confident in growing their businesses
- The focus on Environmental, Social and Governance (ESG) principles has accelerated dramatically over the last year and is set to influence a number of treasury activities
- Brexit should not distract corporates from their businesses or taking proactive steps to address other economic and regulatory challenges which have emerged

1. Debt raising

Increasing debt

Do you think Brexit will affect your ability to raise debt in your preferred markets or currencies?

74% SAID NO

26% SAID YES

- Corporates remain bullish over their ability to raise debt despite Brexit; Brexit is a "non-event" in relation to the raising of debt
- Fears of 'Brexit' clauses in loan documentation have not materialised
- Unrelated to debt raising, general business related pessimism surrounding Brexit has increased sharply

One respondent noted:

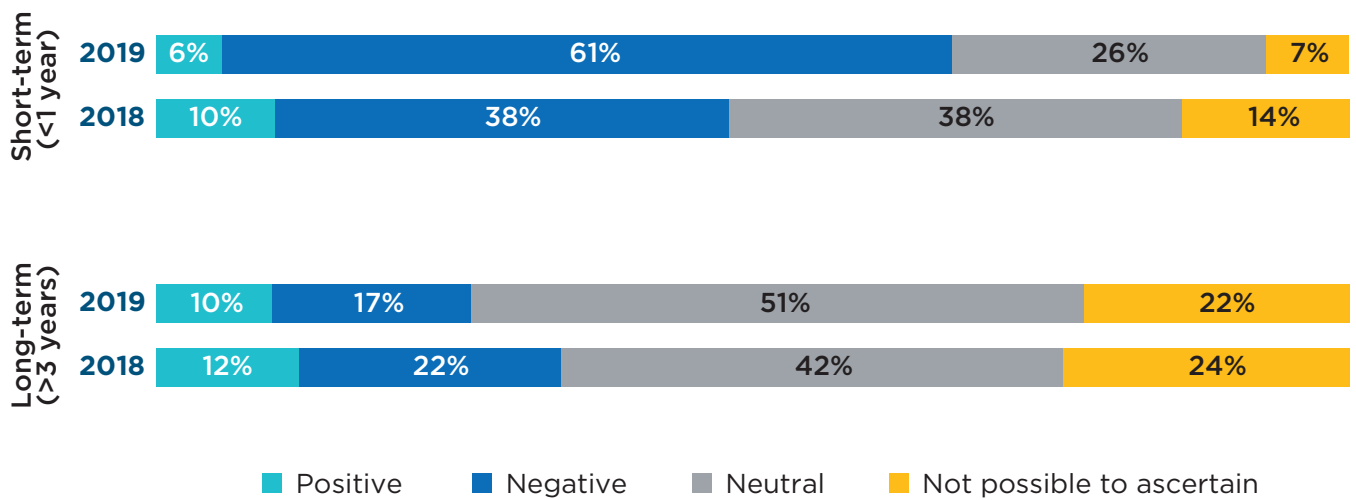
"treasury is not what people are losing sleep over... it's about moving products across borders and managing supply chains."

Whilst our research suggests a strong shift to a more pessimistic short term business outlook as a result of Brexit (which we return to below) this pessimism was not reflected when it came to debt-raising unless Brexit results in a recession.

One respondent described Brexit as a "non-event" in relation to the raising of debt, another noted that "Brexit isn't driving corporate behaviours" when it comes to raising debt and that, for many corporates, the UK and Europe is only part of their portfolio of businesses and Brexit was therefore one of many regional events across the globe. Many noted that there were more substantive factors weighing on debt raising and UK economic health and we comment on these below.

That said, those who had utilised EIB funding did note that Brexit would impact them given the access to long term, cheaper funding that the EIB had previously provided. In addition, some, albeit mixed, anecdotal evidence from respondents suggests that there is increased caution in certain markets with the US private placement market singled out in particular as a market where respondents saw investors behaving more cautiously (potentially due to a general concern over the recessionary risk posed by Brexit).

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



Compared to our research in 2018, our respondents were marginally more confident in relation to the business impact of Brexit over the longer term but considerably more pessimistic about the short term. The longer term view may reflect the work that corporates have undertaken to assess the risk to their businesses of Brexit over that timescale and develop their plans to adapt to it. However, respondents were far more pessimistic about the effect of Brexit on SMEs and how and to what extent they would be able to weather the storm, particularly in the short term.

For larger corporates, the following respondent's comment summarised the view of many:

"we'll be able to ride it out even in a no deal scenario and in the long term we'll get over it".

That said, a fifth of all respondents indicated that the uncertain path of Brexit meant that it was still too difficult to predict the long term implications that it might have and that this uncertainty was likely to continue for years to come even in an agreed deal scenario as the future relationship with the EU was negotiated.

Debt raising: Increasing debt (continued)

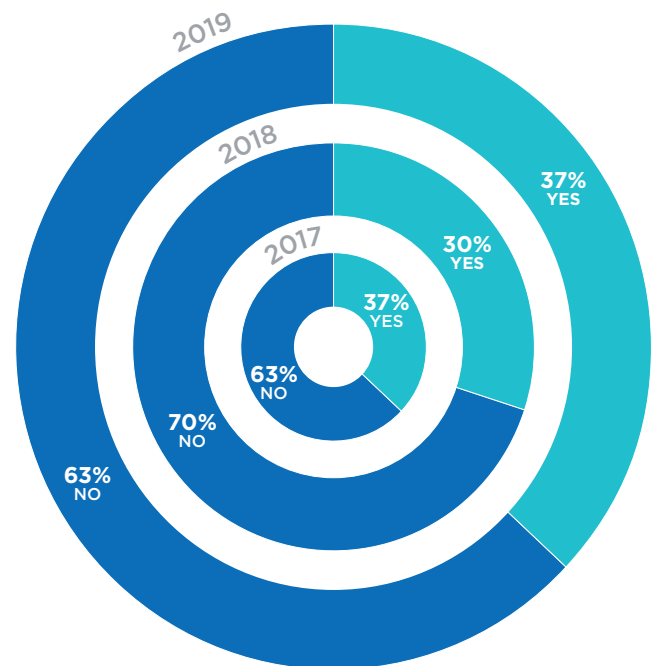
Do you plan to refinance and/or raise new debt this year?

41% REFINANCE

27% NEW DEBT

32% NEITHER

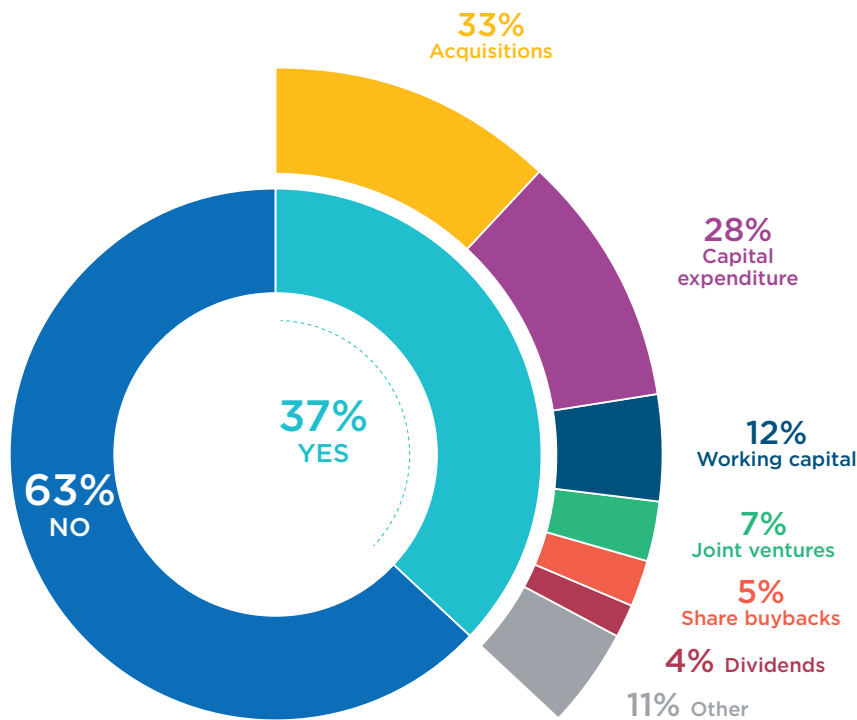
Do you plan to increase your net debt this year (other than as part of usual seasonal adjustments)?



- The high proportion of respondents refinancing or raising debt projected in 2019 was, to many respondents, a sign of confidence in their businesses and the resilience of the debt markets
- Respondents noted some sensitivity around timings to avoid Brexit cliff-edges but Brexit is not dictating overall timing of debt raising
- Anecdotally, the pipeline of corporate debt financing over April/May currently appears lower than in the first few months of 2019. However, some see this as an opportunity with debt pricing potentially falling

- A higher proportion of respondents are increasing debt levels this year compared to 2018 although many questioned why this had bounced back from 2018 levels (when a number of respondents indicated they had refinanced (and had expected others to have done so) in order to reduce Brexit risk)
- There is significant market commentary on rising corporate debt levels. This could be a sign of confidence and resilience resulting in, for example, investment and acquisitions or a sign of stress in corporate debt funding requirements or earnings or investor pressure in relation to dividends. Our research suggests the former

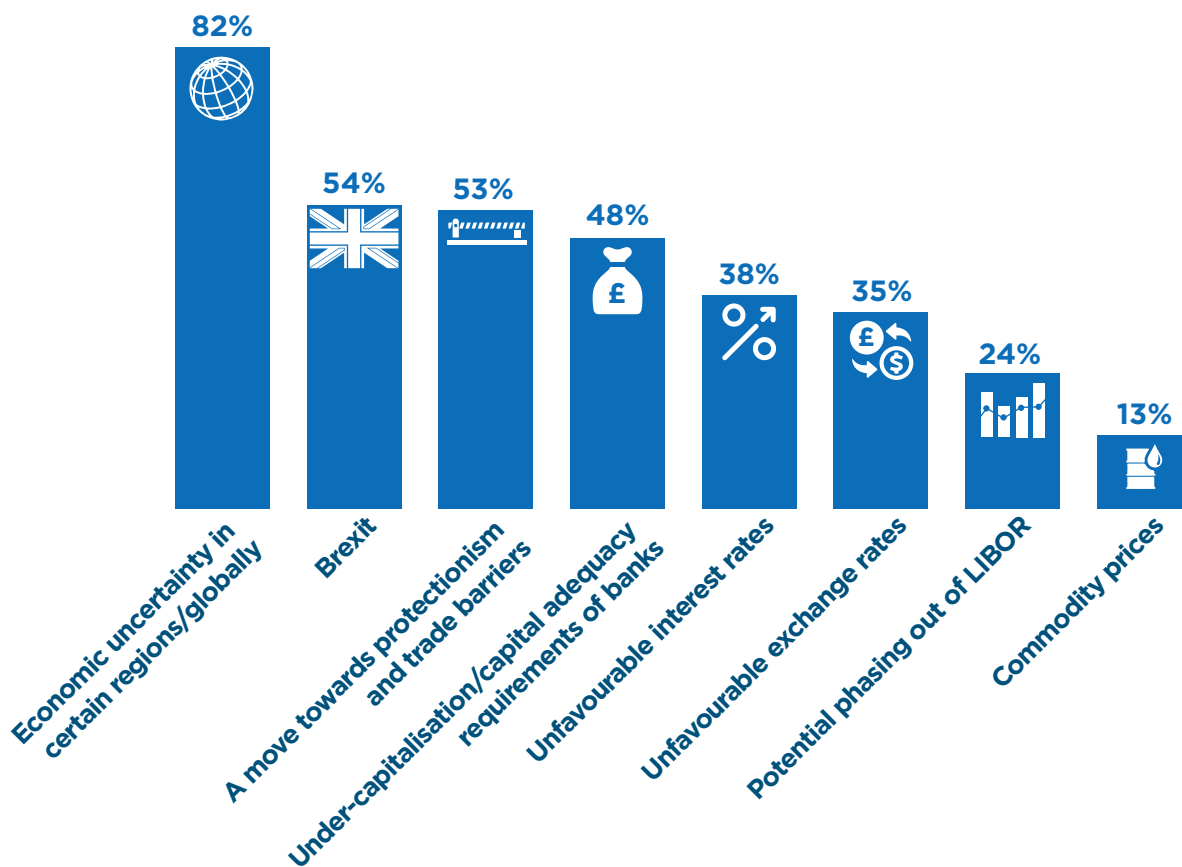
Do you plan to increase your overall debt this year (other than as part of usual seasonal adjustments)?



- Projected year-on-year increase in debt funded acquisitions (a third of all increased debt use (2018: 28%)) alongside higher numbers reporting higher capital expenditure (28% vs 25% in 2018) suggests corporate confidence in business investment with over two-thirds being applied towards business investment
- Anecdotal evidence suggests that the immediate pipeline of acquisition finance opportunities for banks may well be thin, resulting in increased competition to lend (particularly for bridge financing opportunities and related refinancings) which may drive pricing down

Debt raising: Impediments

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



- Macro-economic uncertainty is by far the greatest concern expressed by respondents; its effect could manifest in a number of different ways across different markets and for many, was a proxy for a UK recession
- "Brexit may be relevant locally but the actions of Trump, China and the oil price are much more important"
- Respondents questioned whether these were in fact 'material' impediments currently. The impact of quantitative easing and other central bank policies in creating artificially liquid debt markets may have suppressed the effect of these impediments

"Global economic worries have overtaken Brexit in 2019... The biggest concern is markets drying up"

Macro-economic uncertainty was by far the most heavily flagged potential impediment to debt raising, although no more so than in our research last year (notwithstanding that recessionary concerns and a global slowdown in growth are now far more acute). As in 2018, almost half of respondents flagged that Brexit might become an impediment to debt raising. Our research suggests that Brexit might be more likely to impact on processes, terms and/or pricing rather than dictating the availability of debt itself.

Respondents queried whether economic uncertainty combined with the proposed transition away from LIBOR might result in an increased take-up of fixed rate debt and/or an increased use of interest rate derivatives; we comment on this below.

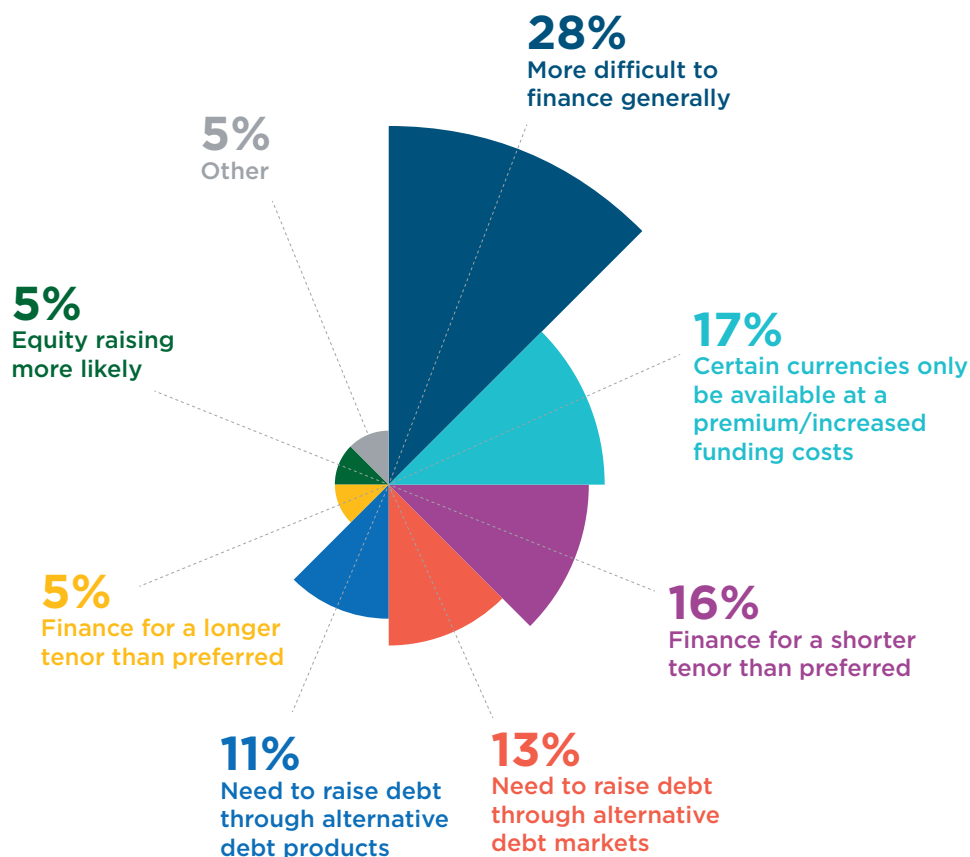
"I think Brexit will have an impact on credit spreads and there might be a liquidity premium to pay, but unless Brexit is going to fundamentally damage your business, I don't see [the debt markets] becoming inaccessible to UK corporates."

The perceived threat posed by the under-capitalisation of banks/capital adequacy rules continues to wane (although still noted in 48% of responses (2018: 54%, 2017: 61%)). However, some respondents queried why this remained as statistically significant given periodic stress testing of banks and the actions taken in response.

Many respondents challenged whether these factors were actually impediments to raising debt themselves. A consensus emerged that it was the recessionary impact of these factors rather than these factors themselves which was most likely to affect the raising of debt. In addition, some queried how certain factors could be impediments; for example, persistently low prevailing interest rates for businesses would ensure that debt raising was cheaper than would otherwise be the case. Others however noted that quantitative easing and other central bank policies had created artificially liquid debt markets and that this underpinned the bullish attitude towards debt raising.

Debt raising: Cost of funding

What effect do you think these impediments might have?



- The impact of the impediments may manifest itself in many different ways including credit processes becoming more involved and currency/tenor premiums being applied
- The most likely effect of these impediments is to increase the cost of debt
- In more extreme circumstances the impediments might effectively force debt diversification which may or may not result in more efficient and effective debt capital structures for any given corporate

"Banks' capital costs are rising and they are passing this on. They are ever more hungry for ancillary business to subsidise their relationship lending."

We first reported on the impact of subsidised RCFs and its impact on the bank ancillary business model in our report in 2017 and return to it below.

Ultimately it is unknown how and to what extent these impediments may impact on debt raising and, in many respects, they are likely to do so only indirectly. However, many respondents

believed that the effect of the impediments would be manageable provided that they did not trigger a recession; in those circumstances the effects would be much more pronounced.

In relation to the indirect effect of certain of these factors one respondent queried whether they would result in increased market volatility which would reduce windows of capital markets issuance whilst another queried whether volatility would push them towards different debt markets and products.

It was clear that many believed that these impediments were most likely to result in increased funding costs.

Do you anticipate that your costs of debt funding over the next 12 months will be:

↑ **57%** HIGHER THAN
IN 2018

↓
↑ **35%** ABOUT THE SAME AS
IN 2018

↓ **8%** LOWER THAN
IN 2018

- Year-on-year in our research pricing increases have been predicted
- Anecdotal evidence suggests that for some corporates pricing is generally rising but equally others reported that is not the

case and pricing has remained stable over the last 3-4 years. This does not appear to be tied to relative business performance between financings

"There's never been a more benign interest rate environment and credit spreads continue to fall"

A majority of respondents expect the cost of debt to rise this year (2018 and 2017: 47%) with far fewer expecting the cost of debt to fall. Whether this will be the case will depend upon a variety of factors, not only those impediments identified above but also the total volume of transactions in the markets and whether we will see aggressive pricing for certain financings (for example, bank facilities) remaining a key feature of UK lending.

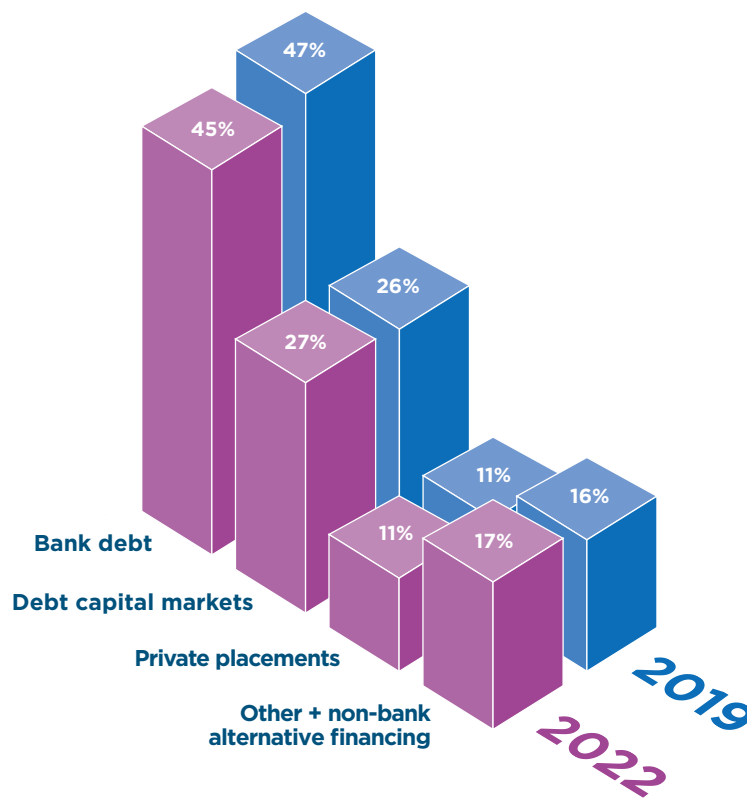
A number of respondents noted that whilst some interest rates had risen (in particular in the US) credit spreads had in certain cases fallen, partially offsetting that rise. Others noted that there was a shortage of new lending opportunities and that debt investors, particularly institutional investors, were chasing opportunities to lend; something that was driving keener debt pricing for borrowers.

Some respondents noted that the increase in UK wage costs fuelled by the tightness in the labour market (which could be exacerbated by Brexit) would create inflationary pressure necessitating the Bank of England to raise interest rates.

2. Capital structure

Debt funding

At the start of 2019 and 2022 approximately what percentage of your total debt funding do you think will be provided by the products described below?



- Respondents were not surprised that the split of funding sources is projected to remain settled over the next three years

- Whilst debt diversification has been a prevalent theme for corporate treasury in recent years there are practical limits to that (driven by a number of factors including the terms and requirements of certain products) and further diversification may be limited

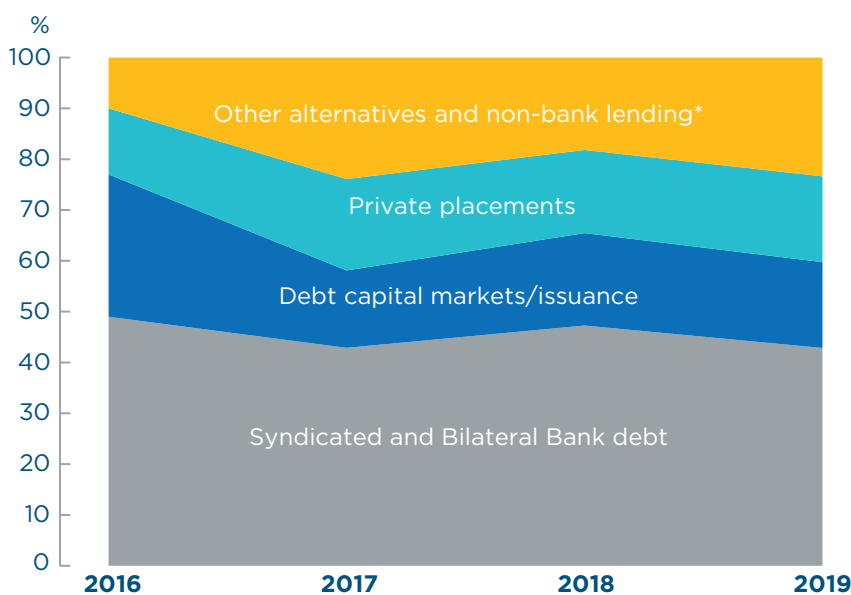
Whilst historically respondents had predicted a more significant shift to debt capital markets products this has not been borne out in our research over the last few years. Indeed, the requirement for a rating, minimum size of bond issue and the business restrictions inherent in maintaining an investment grade credit rating restricts the pool of potential corporate issuers despite it being a very deep pool of liquidity. Instead of that demand shifting to private placements we see an increasing focus on non-bank lending over the next 3 years as noted above although respondents expect this to level off.

However, it does not appear that respondents expect significant further diversification from their current funding sources. The strategy of relying solely on banks as a source of long term debt is a distant memory for many but for smaller corporates remains their only ready access to debt without spending significant management time and cost in developing other creditor relationships.

Looking back to our research in 2016, respondent predictions as to their 2019 funding anticipated a greater reduction in bank debt (to 42%), an increase in private placements (to 21%) and a much lower level of non-bank alternative and other funding (11%). In those respects, alternative forms of lending and non-bank lenders have made significant ground.

Capital structure: Sources of additional debt

If you plan to raise new debt or refinance existing debt in 2019, how will this be achieved?



- Corporates are increasingly seeking, and are well advised to explore, alternative lending arrangements beyond their existing capital structure to provide either current or back-up sources of funding
- Increasing trend of using non-recourse receivables financings as a more cost effective working capital tool than traditional bank lending
- Significant and increasing use of supply chain financing techniques were reported, driving benefits for both suppliers and customers

*includes receivables financing and finance leasing

Whilst bank debt remains the bedrock for corporate debt raising overall, some respondents flagged that they expected that over time this would become more focussed on servicing working capital needs and that permanent debt capital would be provided by other investors. Some saw this as a positive sign and thought that an over-reliance on banks as a source of 'permanent' debt was riskier than previously as banks continued to carefully manage their balance sheets. Conversely, for investment grade corporates some respondents flagged that the depth of the bank and DCM markets meant that there was little need to diversify beyond those markets.

One respondent noted the clustering of corporate credits at the BBB/+ level and the broad spectrum of corporate covenants that fell within those ratings. In particular, it was noted that some of the weaker investment grade rated businesses would be significantly more susceptible to macro-economic shocks and that treasurers and CFOs of such companies would be well advised to consider strengthening their capital structures given the likely economic challenges ahead.

In relation to alternative and non-bank lending, a number of respondents referred to the growing role of funds and the credit arms of PE houses in originating and leading on financings (as well

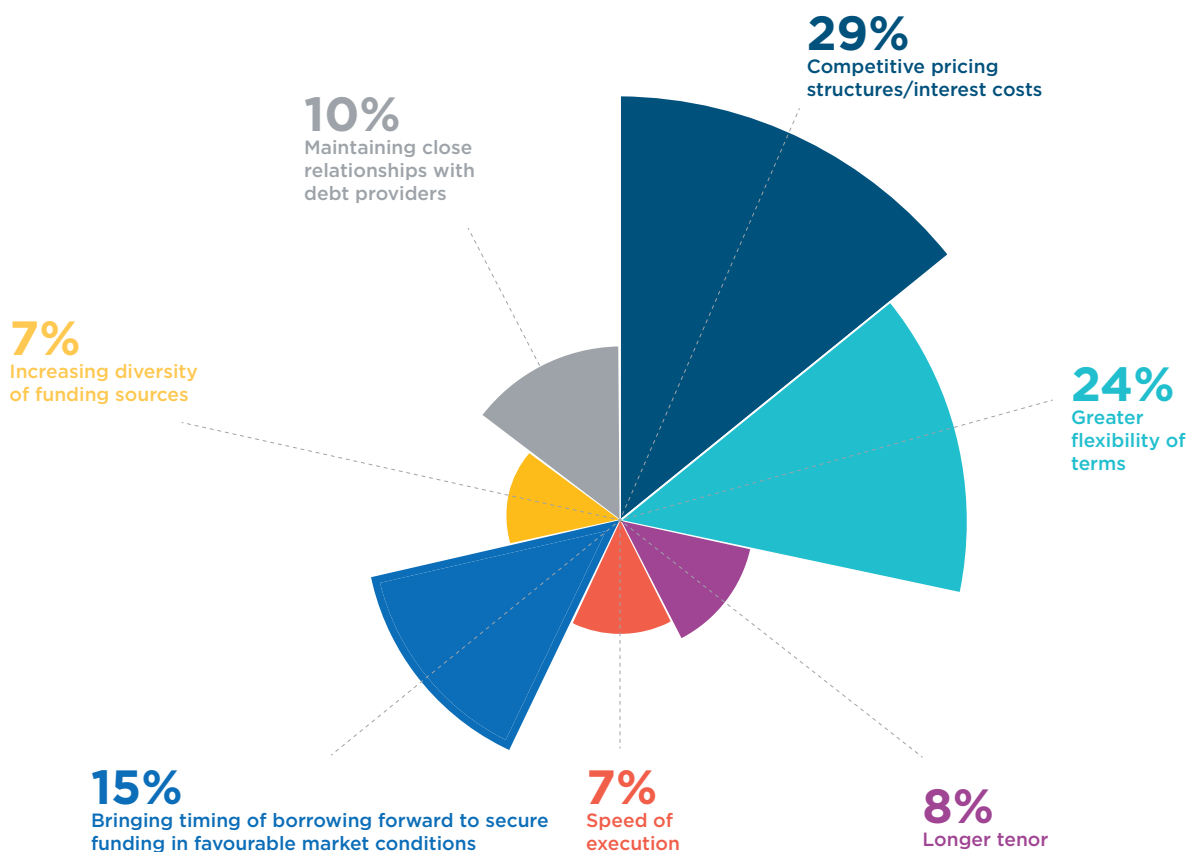
as banks syndicating debt to their 'relationship' institutions that would not compete for coveted ancillary business) and the role of insurers, pension funds and others in buying in to (particularly longer dated) debt instruments. This is typically restricted to non-investment grade financings.

In addition, respondents also pointed to a potentially increased role in leasing and receivables financing (both recourse and 'non-recourse'). Receivables financings were typically used to improve working capital requirements and non-recourse financings in particular appear to be increasingly popular (with recourse receivables arrangements losing some of their historic stigma as a financing of last resort).

Separately, some noted the increased role that supply chain financing played in working capital funding. Many large corporates have established supply chain financing arrangements for their suppliers, providing a source of working capital funding potentially not otherwise available (or only available at higher pricing) for suppliers whilst driving efficiencies in invoice processing and potentially attractive economic arrangements for the corporate establishing those arrangements.

Capital structure: Drivers for borrowing

If you are considering borrowing this year, what are your main drivers for choosing a particular source of funding?



- Cost remains the strongest driver year-on-year
- Focus on relationship banking continues to decline as an increasing number of respondents highlighted stresses in that system, particularly in the context of ancillary business
- Increased focus on operational flexibility for corporates in debt documentation
- Diversification of funding is sometimes the result of pursuing other goals (eg terms/pricing) rather than the key driver itself
- Cultivating new bank relationships and relationships across different debt products on an ongoing basis is key to ensuring that there is sufficient capacity and competition when it comes to raising debt and putting in place other treasury products

"Banks are still funding RCFs and fighting over ancillary wallet, but we are seeing banks getting more aggressive".

"Bank hurdles have increased and they are also under more pressure on margins. They are now prepared to walk away from those who can't get over their hurdles."

The importance of relationship banking in borrowing decisions has declined compared to 2018 (14%) with some respondents noting that relationship lending is under significant pressure. Some noted that conversations with banks around ancillary business had become increasingly strained. Respondents also noted that, in particular over the last 3 years, there had been increasing changes in the composition of bank syndicates as expectations over ancillary business were unable to be met and syndicates were re-set on refinancings as bank appetite to lend to certain corporates oscillated over time.

The view that bank relationships were weakening was typified by the following respondent's statement:

"You need banks when you're growing or in trouble, and you can forget it when you're in trouble"

Conversely a number of respondents noted that they had proactively cut the size of their banking relationships in order to be better able to meet ancillary expectations and foster deeper relationships.

"It is more a case of cutting the size of banking groups as the model still works if banks price this correctly."

Some noted that ancillary income sources had become more constrained over time as corporates opted for vanilla products and certain products had become less attractive for banks to offer due to the associated capital costs or the absence of tax capacity.

A second theme, that of maximising flexibility of terms, was repeatedly raised by respondents both in relation to this question and others. The reasons for this varied; for example some cited the focus on products with limited covenants such as investment grade DCM issuance. Others noted the re-growth of covenant lite transactions (and variants thereof) and a desire to maximise flexibility of terms to enable corporates to take advantage of opportunities eg acquisitions without being constrained by creditor consents. Finally, some focused on the ability to build in further buffers to better insulate the business from the effects of a financial downturn eg by increasing headroom in financial covenants or further qualifying events of default.

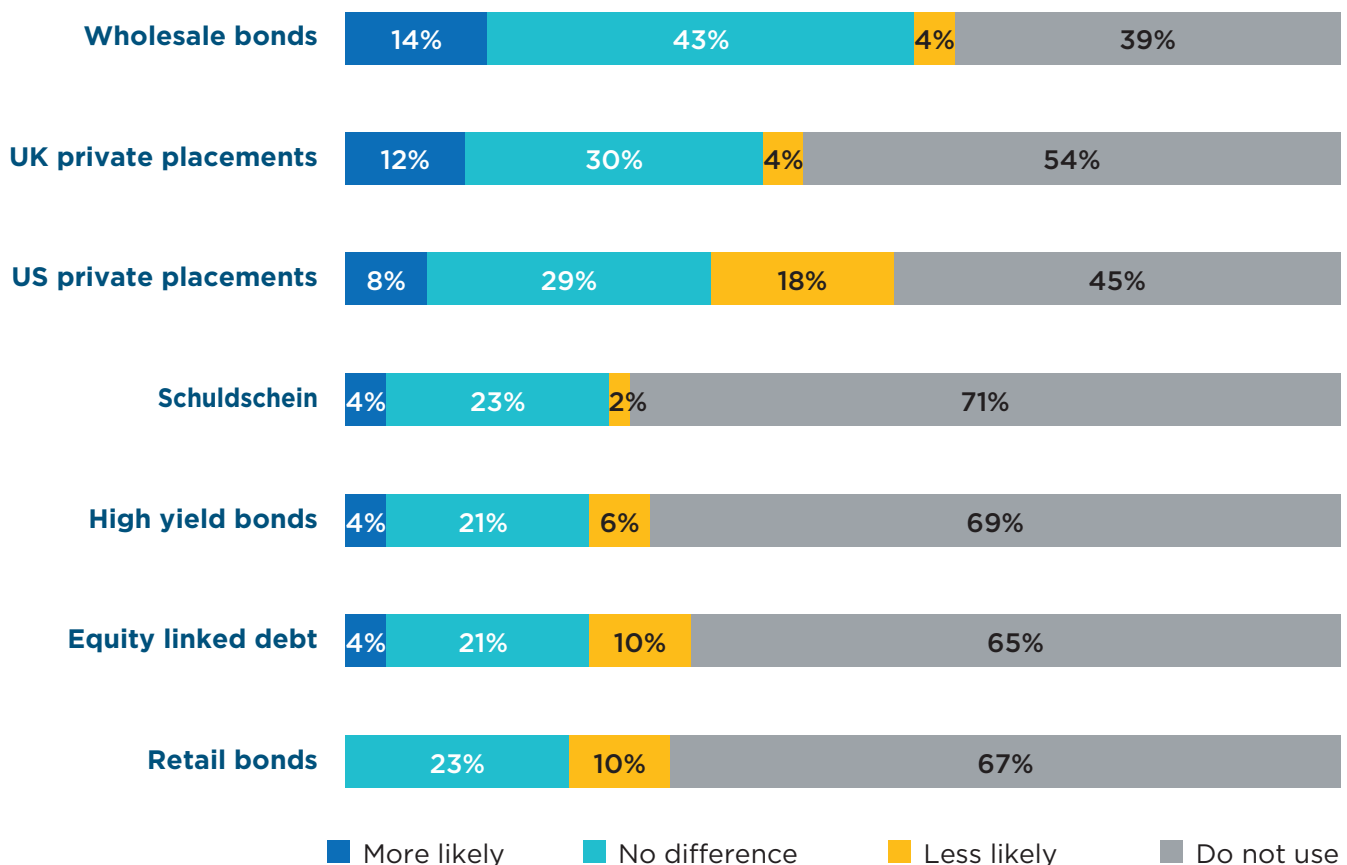
IFRS 16: Planning and implementation

Where it applies, IFRS 16 requires that operating leases be brought on balance sheet for accounting periods ending on or after 1 January 2019. The effect is that lessees will appear to have more assets but also more debt. Corporates have previously addressed this by adopting frozen GAAP language and retaining the pre IFRS 16 treatment of operating leases in their bank facility agreements but not all debt financings customarily use frozen GAAP; for example US private placements typically use floating GAAP.

However, even where frozen GAAP is used this may not provide a permanent solution as treasurers will need to reconcile pre- and post-IFRS 16 figures for covenant compliance purposes and the challenge will be for borrowers to agree with lenders the required flexibility for permissions baskets, ratios and related definitions in their bank financings as well as to solve the issue more generally for their floating GAAP financings.

Capital structure: Fixed rate debt

Compared to 2018, are you more or less likely to consider the following fixed rate debt products?



- A number of respondents noted that, given the certainty provided, the current premium for fixed rate products over equivalent floating rate products represented good value
- Whilst there is a modest uptick in wholesale bonds, overall respondents were less likely to seek fixed rate products than in 2018. This may reflect the prevailing interest rate environment

- A large proportion of respondents do not use fixed rate debt products, suggesting that there may be an opportunity to raise that type of debt (for example, if the uncertainty around replacement IBOR rates continues)

Bonds

Only the wholesale bond market was picked by respondents as a more likely source of debt raising this year. However, the requirement for an investment grade credit rating and a very large minimum issuance size of (unless privately placed or a tap issue) means that that market is necessarily limited to larger, often listed or equivalent corporates.

Regular issuers typically put EMTN programmes in place so that they can take advantage of potentially attractive but sometimes narrow market windows, particularly in times of market volatility. They can also make use of their EMTN framework to do "private placements" with relatively little effort at the time of trade (assuming they keep their programme up to date over the course of the year).

For investment grade issuers, the terms and conditions of bonds are relatively covenant free – a capital markets form of negative pledge, a form of change of control protection (a put at par, or a coupon step-up should a change of control occur and trigger a ratings downgrade) and market standard events of default. This is in contrast to the bank loan and private placement market where, customarily, a broader range of financial and business facing covenants are required. The need for a credit rating and the public nature of the market tend to be factors that concern treasurers but for those who use the public bond markets it provides a deep pool of liquidity.

A number of respondents noted that retail bonds had fallen out of favour some time ago and that this would be likely to continue barring a systemic change in the way in which those bonds were perceived, marketed and priced.

Private placements

Whether or not wholesale bonds are available, a likely source for debt diversification has been the private placement market, and, in particular, the USPP market. Interestingly, whilst a distinct UK private placement market has struggled to develop in recent years in a manner akin to the USPP market (and some of the reasons for this were set out in our 2016 report) a 'private placement' has become an umbrella term for a number of different lending products and counterparties.

The private placement markets generally offer greater flexibility both in terms (including variety of tenors and issue sizes which can range from the tens of millions upwards) and acceptable credits (whilst for the traditional USPP market, a proxy investment grade credit rating is certainly desired, this is not the case for certain other investors who invest in privately placed debt issuances) compared to conventional DCM. However, the requirement for covenants and the fact that the deepest, most competitive funding tranches tend to be denominated in US dollars thereby necessitating swapping dollars to other operating currencies if required for business reasons (or accepting the costs and risk if currency swaps embedded in USPPs are terminated due to early repayment of the notes). Private placements tend to be used by DCM issuers where they offer a pricing arbitrage opportunity.

Quotes are direct quotes from respondents

Schuldschein

Aside from those private placement markets the schuldschein market remains open although anecdotally it appears that the product meets fierce competition in the UK from the tried and tested USPP and increasingly UKPP markets. The oft-cited ease of execution and maintenance of schuldschein has in some cases not been borne out, particularly so for the listed note variant (*Namensschuldverschreibung*) where dealings through clearing services, the need for a notary and the waiting times for certain objection procedures to lapse can contribute significantly to timescales and costs. In addition, in certain transactions USPP investors have sought to import those terms into schuldschein issuance which has complicated and delayed both the process and documentation and treasurers should be alive to the risk of this in discussing opportunities with potential investors.

"schuldschein comes and goes but doesn't seem to stick".

HYB and TLB

Some respondents commented that, for many, high yield bonds weren't well understood and that this had resulted in a natural reluctance to proactively engage with that market.

Aside from other options, "covenant-lite" and/or "covenant-loose" term loan Bs ("TLBs"), have been popular in the leveraged/acquisition finance market and for corporates who might not have an investment grade credit rating or equivalent, as have high yield bonds. When considering TLBs versus high yield bonds in terms of key features and practical implications, TLBs are typically subject to floating rates whereas high yield bonds are predominantly fixed rate instruments. As the group of lenders participating in TLBs are institutional investors instead of traditional banks, the investor base tends to provide a deeper market and liquidity than traditional bank loans.

TLBs are typically more flexible in terms of documentation compared to high yield transactions. TLBs do not require an offering memorandum (and hence no 10b-5 due diligence and opinion are needed). As a result the documentation for a TLB can save the borrowers and sponsors time and legal costs over high yield bonds.

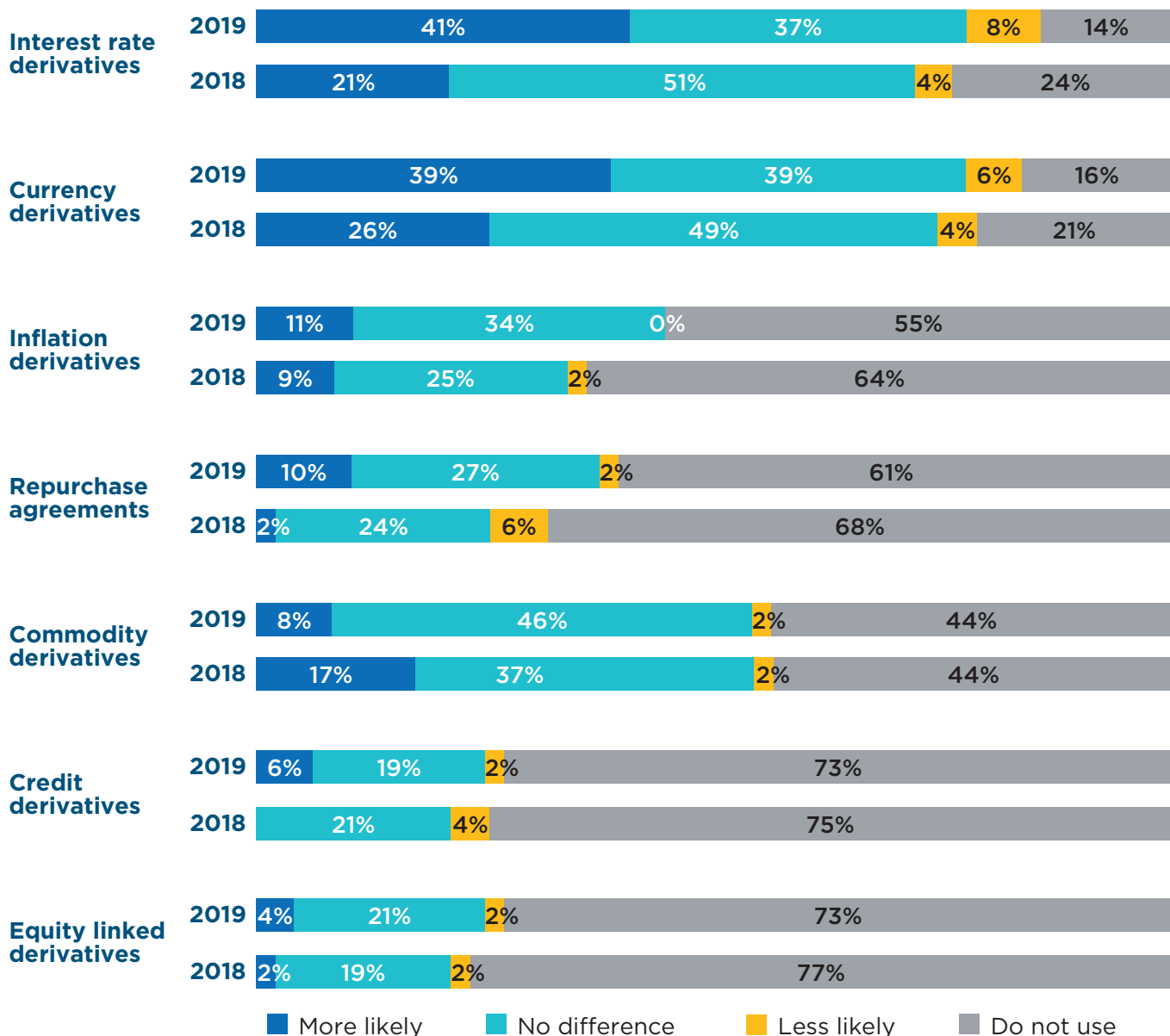
EIB funding

A point raised in interviews was the role which the EIB had served in providing long-term cheap financing for corporates and projects and whether that debt would now be refinanced in the bond or private placement markets (at potentially much higher cost). Some flagged that the increased difficulty in obtaining EIB funding since the serving of the Article 50 letter had meant that that process was in any event underway and that the documentation process with the EIB had been challenging in any event.

3. Derivatives

2019 forecast

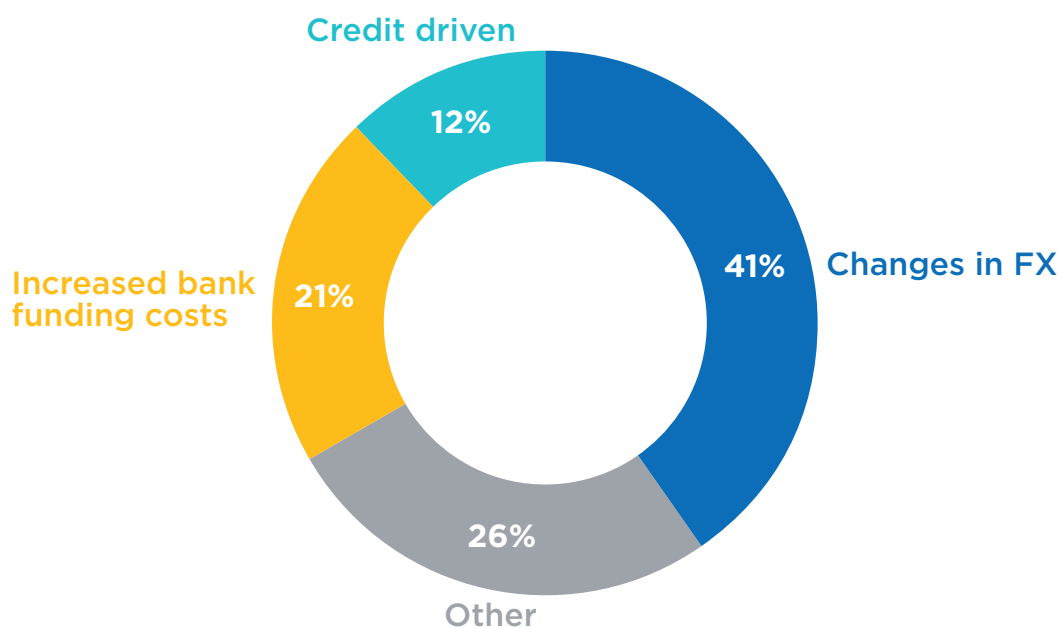
Compared to 2018, do you anticipate that you are likely to enter into more or less of the following treasury products in 2019?



- As expected, a significant majority of respondents use FX and/or interest rate derivatives, with 2019 projected to see significant increased interest in those derivatives
- FX derivatives look set for continued focus due to the persistence of the macro-economic challenges highlighted above

- The capital cost for banks associated with certain derivatives may impact on their supply
- Interest rate derivatives remain heavily used by corporates with recent changes in accounting standards and expected changes in interest rates driving growth

If more likely, please specify the reason(s) for the increase.



"We are being driven to use more derivatives by our balance sheet, particularly changes in accounting standards. Under IFRS16, certain liabilities come on to your balance sheet. Where these liabilities are denominated in foreign currencies, especially dollar denominated, this will create massive P&L variations and there is a concern to minimise this".

The results of the survey indicate a marked change in the planned use of derivatives compared to 2018, particularly in interest rate and FX derivatives, but also, to a lesser extent, in less traditional asset classes such as inflation derivatives and repurchase agreements (repos). Some respondents questioned whether a consensus was emerging that we are moving towards a higher interest rate and FX risk environment despite various central bank pronouncements to the contrary.

The drivers behind the planned increased use of FX derivatives (a 13% increase from 2018) could in part be explained by short term factors such as Brexit, but also by the wider macro-economic trends noted elsewhere in the report, such as economic slowdown in China and US trade policy, leading to greater volatility in FX markets. Similarly, the increased use of interest rate derivatives (a 20% increase from last year) might be driven by continued

expectations of central bank interest rate policy leading to interest rate rises in the medium term, particularly in the US, notwithstanding that the risk of this seems to have receded recently.

Overall, the increased usage of interest rate and FX derivatives in 2019 demonstrates that a significant range of corporates continue to see these products as important tools to manage volatility in their businesses driven by wider macro-economic trends.

Also noteworthy is the fact that corporates are increasingly (though in smaller numbers) looking to non-vanilla products in this area. The rise in inflation derivatives is likely to be driven by recent volatility in the inflation indices over the last 2 – 3 years. It also reflects an evolving market for the product, as some banks have been forced to exit or downscale by high capital charges whilst others have consolidated, which has led to simplification and a drive towards less capital intensive products. Similarly, a marked increase in the use of repos by corporates (an 8% increase from 2018) indicates that the appetite for the higher yield that this product provides in comparison to other traditional cash investments (such as deposits or money market funds) remains strong. It also demonstrates increasing bank appetite for short term funding from non-traditional sources, which has led banks and clearing systems to offer a more standardised and less administratively burdensome product range for the corporate sector.

4. LIBOR transition

Transition planning

Have any of your relationship banks contacted you about the upcoming transition away from LIBOR and other IBOR Rates?

55% SAID YES

45% SAID NO

Have you begun contingency planning for the upcoming transition away from LIBOR and other IBOR Rates?

37% SAID YES

63% SAID NO

LIBOR underpins over US\$350 trillion of transactions globally*

- LIBOR is being phased out. Little progress towards finding a solution has been made despite repeated regulator insistence that IBOR rates will be phased out in 2021
- At this stage banks have not resolved how this will impact on their own business, let alone that of their customers
- A one size fits all solution is unlikely to work and across different markets and jurisdictions. Potential solutions are moving at different paces and in potentially in different directions creating the risk of market fragmentation
- The inadequacies of "fallback" procedures in loans and other treasury products (ultimately exposing corporates to banks' own funding costs) will be an issue for corporates to focus on in the near term

"Banks haven't figured out what the IBOR transition means for them let alone their customers. Very few banks out there voluntarily raise IBOR transition with us".

UK and other global regulators have repeatedly stated that IBORs must be phased out from 2021, to be replaced by alternative risk-free rates (RFRs) such as SONIA for the UK and SOFR in the US. Much uncertainty in this area remains, but it is clear that the cessation of IBORs is likely to have an economic impact on debt and other treasury products which reference IBORs, as the new RFRs will operate on a different basis to the IBORs which they replace. This is likely to lead to changes in product valuations, as well as anticipated funding costs. This upcoming change has already led to renewed scrutiny and focus on the terms in documents which provide for fallbacks to the IBOR if it ceases to be published, some of which have required significant enhancement.

Some respondents were surprised that those who have begun contingency planning (37%) was so high.

* Source: J.P.Morgan Asset Management | Market Bulletin | The LIBOR spike | May 2018

Quotes are direct quotes from respondents

"I think the LIBOR issue is interesting. Regulators have spotted that banks are doing very little about LIBOR and have started to apply pressure. We are not that exposed to LIBOR and we have a plan in place as to how we would mitigate against changes, but the big question is how we will replace it... However whatever index banks change to, I think they will make money from it. "

Our analysis indicates a variety of potential issues in this area. No single rate has yet been located to replace IBORs, and so a one-size-fits all replacement is unlikely. Different products are moving at different speeds to locate suitable alternatives to IBORs, leading to the risk of fragmentation between linked treasury products (such as interest rate swaps hedging a floating rate loan). Similarly, different jurisdictions are embracing different approaches to replacing IBORs, creating a risk of different outcomes on similar products driven by currency or region. Most notably, the levels of market awareness and readiness for the change in the corporate sector remains varied.

The results of the survey support this analysis. Nearly half of respondents have not yet been contacted by relationship banks on this important subject, and two-thirds have not begun contingency planning despite less than 18 months remaining until IBORs are expected to cease publication. Some respondents noted that the significance of this issue should be on a par with Brexit, and some have taken considerable steps in readiness, such as renegotiating debt profiles, considering alternative interest rate benchmarks and reviewing all in-scope contracts, transfer pricing and intra-group lending issues to determine potential exposures. However, for many, the solution is some way off.

"LIBOR changes are under reported and will become a prominent issue in 2019. This is potentially as much work as Brexit was in 2017 and 2018."

This is a critical issue for corporates. For example, if IBOR rates are not available and the standard fallbacks do not provide a reference 'base rate' for interest calculations then borrowers may find that the applicable rate is the banks' cost of funds (and corporates are entering into long term loan arrangements (eg 5 years+) accepting these risks). Whilst this might drive the more transparent pricing for bank loans which some respondents said they would welcome (as noted elsewhere in this report) this also directly exposes borrowers to the credit strength of their banks (and market perceptions of that bank driving its wholesale pricing). There is also uncertainty as to whether this would be a viable long-term solution to the disappearance of IBORs. It also potentially creates issues for banks in forcing them to determine their actual cost of funding at a particular time (and if this becomes the market default banks would need to constantly report their cost of funding).

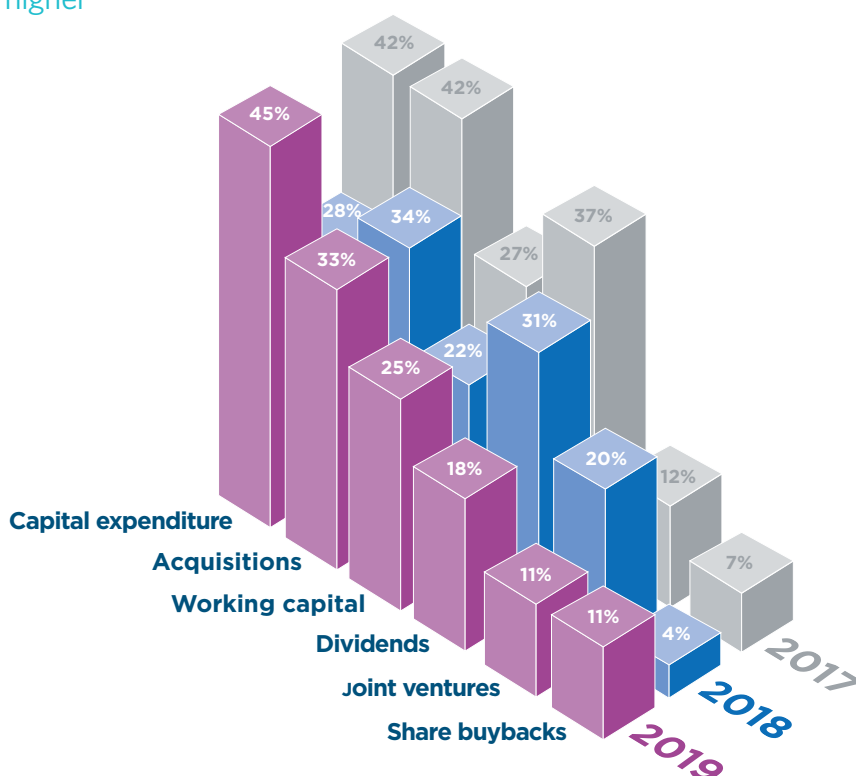
IBORs have also permeated beyond treasury products into other business areas, such as accounting, commercial contracts and leases. The regulatory determination to phase out IBORs remains firm, although the precise timeframe and form it will eventually take is currently uncertain. Corporates are therefore advised to continue to focus on this issue and commence contingency planning across all affected areas and products.

5. Expenditure

Expectations for 2019

Looking ahead, how do you anticipate that your expenditure on the following will compare to 2018?

Those replying “higher”



- Respondents offered various reasons for the bounce in capital expenditure but no consensus emerged

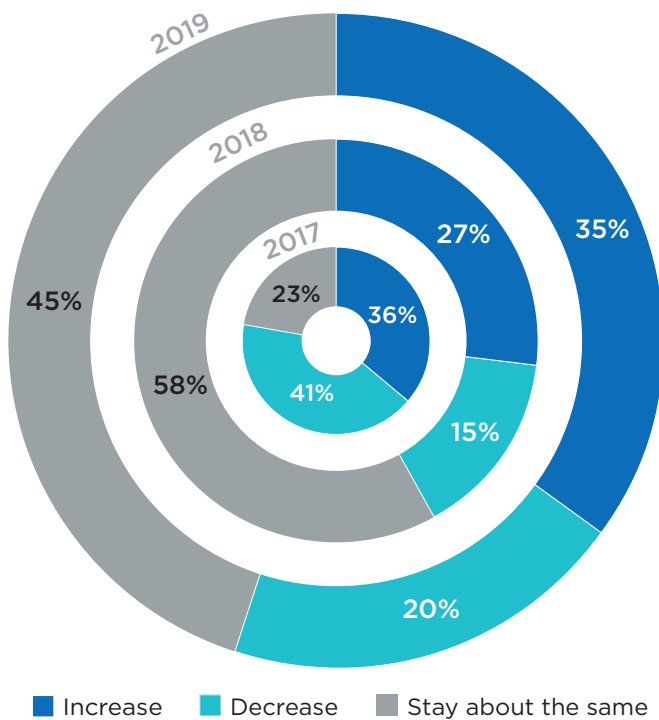
- The trend of lower spending on dividends continues and that has been a feature since our 2016 report. Some noted the role of the Pensions Regulator and pension trustees in seeking to ensure consistent funding for shareholders and pension schemes

Respondents noted the strong increase in higher capital expenditure anticipated this year and queried whether that was as a result of the lower increased capital expenditure predicted in 2018. Some noted that the deferral of capital expenditure in the UK in the current economic environment would not be surprising and the deferral of investment by corporates in the UK has been well documented in the media. There are a number of possible explanations for the increase (including potentially the expectation of investment following clarity on the Brexit position, overseas

investment and the difficulty in further deferring investment) and respondents offered differing views for this.

A number noted the relatively bullish approach to acquisitions and queried whether the year on year fall in increasing dividends suggested that cash was being retained to fund acquisitions and better manage increases in leverage or whether it reflected the slowing growth in corporate earnings.

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



- As in 2018, respondents broadly anticipate holding similar or larger cash deposits than last year
- Respondents provided various reasons for this including anticipated acquisition funding and providing a greater working capital buffer

Counterparty behaviour - Are you experiencing more cautious credit behaviours from your trade suppliers or customers in the way that they transact with you?

77% SAID NO

23% SAID YES

- Many noted in interview the low number of respondents experiencing more cautious credit behaviors and that this reflects collective confidence in the economy
- This does to an extent ignore the potential effect of the macro-economic factors described above which respondents noted could have a material economic impact. In addition, this also seems to ignore central bank concerns raised around corporate leverage. That said, commercial realities may prevent a different approach being taken
- Corporates are well advised to ensure that processes to assess counterparty risk and exposures are adequate

Overwhelmingly respondents indicated that they were not seeing more cautious credit behaviours from counterparties. A number of respondents commented that this was to be expected in an environment where there was confidence in the economy (when competitive pressures might preclude any other course of action). However, this ignores statements from both the Federal Reserve and the Bank of England around the potential implications to the US and UK economies of the growing fragility of large numbers of companies due to their increasing leverage which might result in more severe and constrained economic downturns (see for example the statements made by BoE's Financial Policy Committee last Autumn).

As such this is an area that deserves ongoing attention to ensure that credit exposures are appropriately managed and that processes to monitor counterparty risk are adequate.

6. Brexit Planning

How prepared are you for Brexit?

96% OF BUSINESSES IMPACTED
BY BREXIT

68% OF BUSINESSES
SOMEWHAT PREPARED

19% OF BUSINESSES
FULLY PREPARED

- The uncertainty of how Brexit will be implemented (if at all) prevents most corporates from addressing its most obvious consequences
- Whatever Brexit-related actions that could be undertaken by corporates have been taken
- For the small minority who are able to fully plan for Brexit this is likely a product of their particular businesses rather than the ability to predict all Brexit outcomes

"everything's solvable, it's just painful"

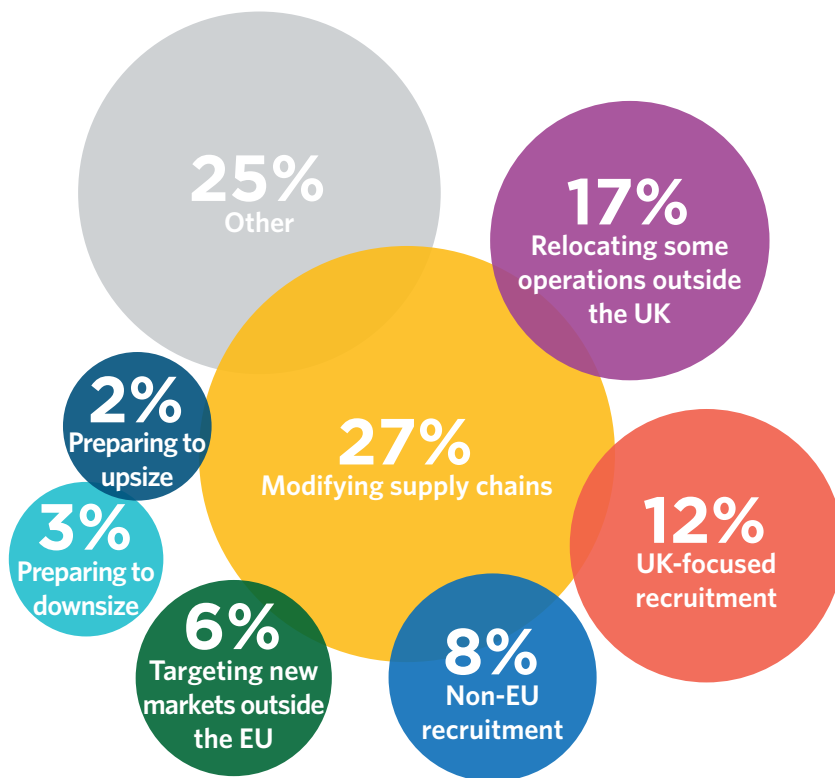
"how do you prepare for the unknown"

Some respondents were surprised that companies could be fully prepared for Brexit given the prevailing uncertainty and the significant number of diverse issues which it could raise (for example, outside of the treasury, the uncertain legal status of European workers, and the Brexit 'push' factor resulting in many mainland Europeans leaving the UK). However, it was also clearly the case that some corporates, due to the nature of their businesses, had much more limited exposure to Brexit than others.

"What a waste of money and resource in order to plan for an avoidable no-deal Brexit".

All respondents noted the significant management time and cost that had been expended in Brexit planning and were concerned about the lag effect this would have on their businesses and the negative impact that this has had on their people.

What steps have you undertaken to prepare for Brexit?



"Delay is a worse outcome than no deal in many respects. It means more uncertainty, more stockpiling and therefore potentially unnecessary production and over-supply".

- Supply chains, relocating operations and recruitment are key issues for corporates
- Stockpiling, stockpiling, stockpiling

- Additional operational and regulatory issues emerging from Brexit implementation plans are resulting in additional operational and legal issues and incremental costs

Respondents had already adapted supply chains in order to address potential Brexit risks including by changing trading entities for sales into the EU (for example to Luxembourg or Dutch subsidiaries) in order to take advantage of EU-third country and intra-EU trading arrangements. However, respondents noted that in doing so other issues had emerged, for example new regulatory and licensing requirements as well as addressing potential tax implications all of which had resulted in large amounts being expended in dealing with Brexit both in terms of management time and cost.

Some noted that a number of potential options were not actually open to them in practice. For example, for some, relocating operations simply wasn't practical absent clarity on the UK's future relationship with the EU. Others flagged the need to plan for currency volatility, address pan-European cash pooling arrangements, modify cross-border intra-group lending arrangements and accelerate cross-border dividends prior to any exit. The issues raised for treasurers to deal with are numerous.

One of the consistent themes in interviews (and reflected regularly in the media) is that of corporates stockpiling raw materials and other assets. Some commented that a short delay to Brexit would exacerbate the stresses already imposed on supply chains by stockpiling as further stockpiling might well be required prior to the next deadline if no Brexit deal had been agreed by that time. Some noted that warehousing space was now extremely limited thereby precluding further stockpiling as a way of dealing with short-term disruption.

"It's surprising and depressing, it will impact on our earnings and economy"

commented one respondent in relation to those seeking to relocate operations offshore whilst another noted that targeting new markets ought to have been something that corporates were doing in any event and that this might now be harder if the UK had very limited trade deals agreed with other countries.

Quotes are direct quotes from respondents

Brexit: Impact: respondents' views

Respondents were asked: The biggest consequence of Brexit for our business will be ...



Recessionary fears

- The negative impact on UK GDP will be bad for UK budgets and bad for business
- Lack of new business opportunity in the short term
- Effect on growth in the UK and on sterling
- Lower economic growth than would otherwise be the case
- The impact on the macro-economic environment, consumer confidence and the knock-on impact on volumes
- Negative consumer sentiment in the UK
- It will weaken our overseas competitor in the UK



Funding and capital

- The loss of EIB funding
- Funding for our new projects
- An environment where capital spending is reduced
- The risk that Britain drops down the list of priority countries for business investment
- Macro-economic uncertainty in our UK markets and lack of investment in the UK
- Adverse movement in foreign exchange rates
- Increased reporting requests to internal and external stakeholders



Uncertainty and business disruption

- Business uncertainty generally
- Prolonged and short-term uncertainty
- Economic uncertainty leading to procrastination by UK businesses
- Price and risk uncertainty and volatility
- Short term disruption to supply chains
- Disruption to international trade
- Lack of business and consumer confidence
- Relocation of some operations offshore



Inefficiency and cost

- The inefficiency that results from differing UK and EU regulations
- Increased regulatory burden and costs for doing business in Europe
- The red tape that follows due to uncertainty
- Increased administration and operational complexity
- Inability to have free trade with our neighbouring European countries
- Ensuring we comply with relevant legislation in both the UK and Europe
- Administrative issues around taxes
- Encouraging sourcing from outside EU



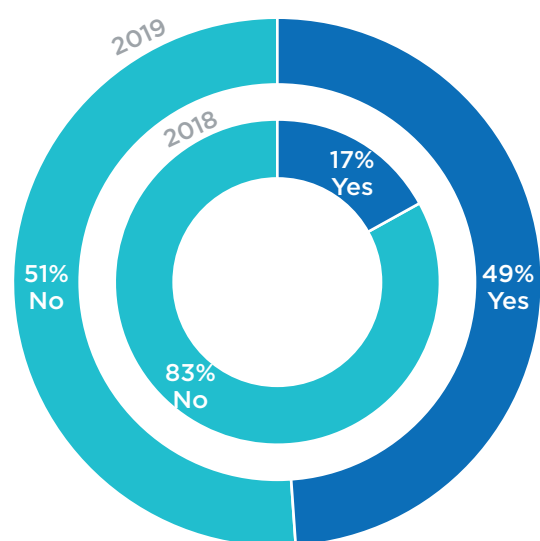
Employees and recruitment

- Recruitment will be more difficult and more expensive
- Negative impact on labour supply until a coherent immigration policy emerges
- Reduced access to EU workers who represent 25% of construction workforce in London
- Concern over retention and recruitment of staff in London (as rely heavily on EU staff)
- Short term labour issues
- Impact on income for UK employees with expected inflation increases
- A progressive reduction in the protective policies of the EU



7. Environmental, Social and Governance ("ESG"*) factors

Investors and corporates are increasingly focusing on ESG. Is ESG a factor for you when formulating your debt funding strategy?



- Many respondents reported on the "game-changing" interest in ESG principles and predicted that interest in it, and its influence in debt financing, would continue to grow.
- Utilising ESG principles in debt financings in order to reduce overall cost is an accelerating trend.
- Adoption of ESG targets in debt documents can result in cost reductions though many cautioned that the time and cost of implementing and maintaining that could well exceed the benefit.

The prominence of ESG factors is clear with the proportion of respondents saying that ESG factors played a part in their debt funding strategy increasing from 17% in 2018 to 49% in 2019. In particular, 29% of respondents said that they were reporting on ESG issues to lenders and other stakeholders and the same percentage considered ESG credentials when selecting which financial institutions to transact with.

In the loan markets, in December 2018, the Loan Market Association and others jointly issued a set of "Green Loan Principles". These principles are broadly aimed at facilitating and supporting environmentally sustainable economic activity by setting out key principles for green loan products and a framework under which corporates could gain access to better terms if they applied the proceeds of such loans only towards eligible "Green Projects".

In March 2019, the same industry bodies jointly issued a set of 'Sustainability Linked Loan Principles'. These principles have broader application and envisage borrowers and lenders agreeing to sustainability performance targets (SPTs) for borrowers and linking the loan terms to the borrowers' performance against these targets. For example, a borrower which achieves its SPTs may benefit from a reduced margin on its loan. Importantly, these principles envisage such loans being made available for general corporate purposes rather than just for particular green projects (as is the case with green bonds and green loans). This means that a potentially wider pool of borrowers may be able to take advantage of such loans.

Whilst the principle is noble, many respondents questioned whether the economic benefit and reputational risk of pursuing it (if not met) were justified. For example, the economic benefit of ESG compliance triggering margin reductions may well not offset the cost of agreeing, measuring and reporting on SPTs (which could include negotiating and agreeing SPTs with creditors, creating internal systems to document performance against SPTs, obtaining third party opinions as to the appropriateness of SPTs, developing internal expertise to verify applicable methodologies and/or agreeing any terms for external review of performance against SPTs by auditors and/or independent ratings agencies).

As one corporate treasurer commented:

"ESG compliant loans are more baggage than they're worth given the minimal margin reduction they provide".

We predict that 2019 in the bond market will see an increased focus on sustainable bonds broadly across the market but whether this is embraced by UK corporate bond issuers remains to be seen. The ICMA has in place its Green Bond Principles and Social Bond Principles (together with Sustainability Bond Guidelines) which issuers of sustainable bonds may choose to voluntarily follow and comply with. In addition, ratings agencies are increasingly focusing on sustainability.

* Environmental, social and governance ("ESG") factors are a set of criteria which corporates, their creditors and other stakeholders are increasingly taking into account when making credit decisions. ESG factors cover issues such as climate change, raw material use and pollution (environmental), human rights, employment rights and equality (social) and transparency, audit and executive pay (governance).

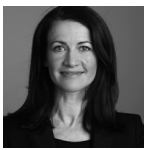
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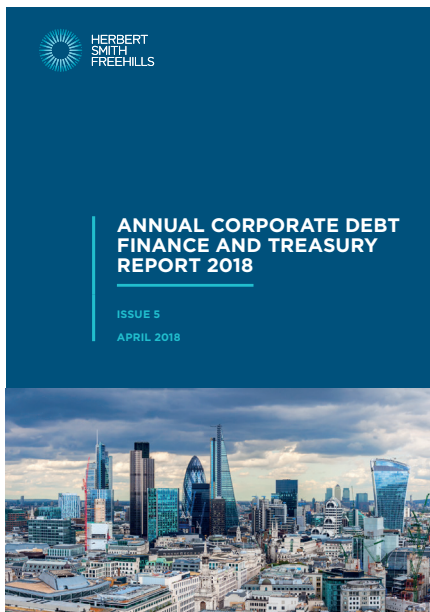
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