PAIB Forum: Treasury Management – Financing Business in a Volatile Economic Climate

The chair of the Institute's professional accountants in business (PAIB) leadership panel, Chew Fook Aun, together with a panel of prominent bankers - Peter Chan of ANZ, Phil Lipton of HSBC and Mike Wood of Citic Ka Wah Bank - shared their experience and insights on the above topic at a forum on 15 March 2010 at the Hong Kong Club. The forum was chaired by the PAIB leadership panel member Susanna Chiu.

The following were among the points covered by the speakers:

Financing options and considerations

- When financing a business effectively in volatile market conditions, the management should consider internal factors (e.g. amount and timing of required funds, legal and tax implications, etc.), external factors (e.g. market sentiment in fund raising, credit rating of the company (although this is not an essential element for good quality companies in Hong Kong), interest rate and outlook, etc.) and work on the company's cash flow forecast.
- Common financing methods include equity financing (e.g. issuance of new shares/preference shares, internally generated funds, etc.) and debt financing (e.g. issuance of bond/commercial papers, bank financing, etc.). Each has its own pros and cons.
- Advantages of bank financing: tax deductible for loan interest; flexible loan structure; it can be revolving and help diversify sources of funding which is useful when other sources of refinancing debt, such as capital markets, may dry up. However, there is the maturity date to consider and bank loans get paid back before equity.
- Reference should be made to other recent successful cases, in particular on the terms and structure of the deal. It is important to know the market and have good relations with a network of banks to be able to negotiate a favorable rate. Timing can also be important. For bank loans it may be advantageous to formulate and work out a financing plan early in the year when banks may have targets to meet.
- Bank financing may be in the form of bilateral, syndicated or "club" (i.e., a limited number of participating banks) loans. Self-arranging club loans is a possibility for larger companies that have built up a good relationship with bankers over a period.

Factors considered by banks when deciding on loans

- Factors banks look for when assessing risk include ability to repay, sustainability of the business, earnings and returns on capital, industry risks, capital/asset base and gearing, management (experience and strategy), cash flow, liquidity, liability profile (e.g., short/longer-term maturities).
- Banks will try to understand the nature and structure of the industry and the competitive position of the borrower. The business risk is generally reflected in profitability measures such as margins and returns on capital compared with the peer group. Banks also try to understand financial risk through

measures such as debt/EBITDA and debt capital. This enables the lender to produce an overall risk profile of the borrower. Cash flow and asset coverage metrics are used.

- Building relationships remains a key issue.

Developments in the loan market

- Hong Kong was the third largest market in the region for syndicated loans (after Japan and Australia) up to 2006 and terms were favourable for borrowers. Pricing for the top-tier blue chips fell to as low as 30 basis points above HIBOR and for mid-cap companies to below 100 basis points. Later in 2007, the financial crisis started to emerge, but initially Asia seemed to have decoupled. Deals were still being written but credit was drying up. The market went into a deep freeze for six months at the end of 2008, with loan volumes bottoming out in 2009. Despite the downturn, the banks were not saddled with a significant volume of defaults and bad loans in Asia. Nevertheless, there was a subsequent re-pricing of risk and the pricing of loans jumped significantly. The Link Reit was one of the first deals when the market began to pick up (priced at HIBOR + 1.75%) in early 2009.
- There has been a big improvement in 2010 so far, although the pricing for mid-caps, having spiked at over +3% in 2009, is coming down more slowly. Local and other Asian banks are becoming more active, while European and US banks are now less active in the syndicated loan market. This year the tenor of loan facilities is expected to increase to five years and beyond. Pricing is coming down, although it is not as low as the levels achieved in 2007.

Real estate financing

- Types of real estate financing: acquisition financing, where the development is completed, is easier to deal with than development financing. As regards the latter, land acquisition may be financed up to 50% and construction costs up to 100%. Working capital financing is available to the top developers.
- Key factors considered by the banks include management expertise, track records, on-going relationship, asset location and quality, cashflow position, security package, loan tenor, recourse to sponsor (and sponsor's financial background), loan-to-value ratio, liquidity environment, etc. Generally speaking there is a higher risk premium for Mainland deals given the evolving economic and regulatory environment there.
- The extent of security requirements will depend on the borrower. Common requirements include first priority legal charge over the property asset; share mortgage/debenture over the project company and immediate holding company; assignment of sales and/or rental; full guarantee/completion and cost overrun guarantee by sponsor.
- Customary loan covenants include construction cost disbursement against certified architect/surveyor certificate, loan-to-value ratio, debt service ratio, periodic construction progress report, cash-trap on asset cashflow, approval on minimum sale price; for deals in China, completion of the four certificates (land use right certificate, planning permit, construction permit, work commencement permit). Restrictions now apply on onshore foreign currency lending.

- Market situation: housing supply in Hong Kong during 2010 is still expected to be low. In the Mainland's main urban areas, the year-on-year increase in Q4 2009 was highest in Shanghai (86.9%), Shenzhen (65.7%) and Beijing (63%), but the available inventory of new homes sharply decreased in most major cities in 2009 compared with 2008.

A key conclusion of the forum was that PAIBs should develop and maintain good relationships with their banks. It is then more likely that their banks will fund them regardless of the market situation.