

# Taking on tight credit markets

*Tight credit markets are creating different challenges for small, large and even public-sector organisations. The Australian Institute of Company Directors and McGrathNicol recently hosted a discussion to assess the state of play of markets and what directors should be doing about them. Zilla Efrat reports.*

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## MODERATOR

WHILE THE DUST OF THE GLOBAL financial crisis (GFC) may be settling, most Australian businesses continue to encounter tight lending conditions and higher financing costs, and will do so for some time.

Internationally, many economies remain fragile. Looking to fund their large budget deficits, governments in Europe and the US will be competing with corporates, including Australian banks, for bond investors.

There are concerns that mature debt about to expire may be replaced with more expensive funding and that banks will increasingly try to offload higher costs onto their customers, continue to ration certain industries and be increasingly discerning about who they lend to. With this in mind, many companies are closely watching their balance sheets and eyeing equity markets to fund future growth.

The Australian Institute of Company Directors and McGrathNicol recently hosted a lunch to discuss the lingering debt market challenges and how boards of directors should respond. An edited extract of what participants had to say follows.

**Alan Deans:** *What challenges are you facing in dealing with current lending conditions and how are they affected by world economic uncertainty?*

**David Vaux:** Clearly, the refinancing of debt is an issue. But as I see it, we are now just returning to what I would regard as the good old-fashioned practice of

having sensible loan-to-value ratios. Before the GFC, the game was to leverage up in a bull market, play hard and hope you got out before the market crashed. You made a lot of money, but it was a dangerous game to be playing. I was fortunate that we sold businesses before the crash and we are now in the process of buying businesses back. Instead of paying EBITDA (earnings before interest, taxes, depreciation and amortization) ratios of 12 times pre-GFC, we are now paying half of that. That to my mind has always been good business and gets back to sensible valuations.

This provides growth opportunities to those who are in cash and there are some great buying opportunities around. The forward PE ratios of Australian stocks are now around 11.5 times. I see this as part of a cycle with winners and losers and I am pretty excited that we are where we are.

I believe what is happening in the PIIGS (Portugal, Ireland, Italy, Greece and Spain) is a distraction. But what is happening in Germany, China and the US is important. I read somewhere that the large companies in the US are now holding about 12 per cent of their assets in cash, which, if the banks are excluded, is worth about \$500 billion. This money is going to be put to good use, buying other businesses and creating efficiencies. US company balance sheets, like those in Australia, are looking pretty good.

If you have a good business, you can still borrow money from the banks. Okay, the margins are a bit higher than what we'd like, but we can still make very good returns despite these higher costs. I believe the banks are now charging what they should have been charging and that pre-GFC, there was a madness going on in the private equity world where you could get debt money at ridiculously cheap prices. The banks seriously mispriced debt. That was due to their greed and their mistake, but fortunately in Australia, that

didn't affect us too much, partly because we were well regulated.

**Chris Last:** We are in the small to medium-sized enterprise (SME) market, but we have not found access to capital restricted. I think we have been privileged in having a good brand and management structure, as well as the clarity on strategy to get the bankers on board. We were also in a relatively low-gear position to start with and had a nice balance sheet with which to go into the conversation. Pricing has gone up a bit, but not to crazy levels. While some small companies may well be paying well over the odds, we don't.

It's also a return to relationships mattering, as opposed to just pitching to secure financing at a point in time. You don't know what storms are going to happen with the next round of quantitative easing, the European fallout or US economy, so relationships do count. If that clarity, understanding and alignment between your banking partner and you is there, you can get capital.

**Ron Nissen:** I am a director of a very small company and the rates from the banks are fine. But the covenants the banks are putting on small businesses are becoming extraordinarily damaging. For example, if you want to do, say, \$500,000 in invoice financing or factoring a month, the banks will say it is no problem. The rates are fine, but they want it covered by \$1 million in bricks and mortar. Now most small businesses have already committed all their bricks and mortar.

Small businesses are also dealing with big companies and those debtors' days are going out. They are being squeezed. The politics in Australia focus on rates to home owners because they are the voters. But the small businesses struggling to get good commercial arrangements from their bankers are not really of great interest at the political level.

**Peter Anderson:** Theoretically, banks around the world have always focused on risk, but in the mid-2000s that went out the window. The biggest change now is a reversion to where banking should have been – a greater focus on risk. As a result, there is different pricing for different sectors within the economy and for different products. Invoice factoring is a good example because it is one of the highest-risk products and the banks have experienced many problems in recovering invoice-financing exposures. The banks have now re-risk graded that type of facility based on experience and invoice financing is generally a lot harder to get and more expensive.

Similarly, across different parts of the economy there are areas where it is very hard to get funding at the moment. All the banks admit they have more exposure to commercial real estate than they would like. If you are in another part of the market, funding may be available, albeit a bit more expensive than it was a few years ago. I think that is how it's going to be over the next few years. Each business is going to be assessed on its risk profile, looking at everything from its capital structure down to its operations and cash generation, as well as the macro-industry it is in. It will take a while for the market to get used to that.

**Chris Witt:** There is some consolidation happening on balance sheets. To give an example, one of the companies on whose board I sit is growing at 40 per cent per year compound. It is fundamentally in a leadership position and has all the things it can have in terms of credit and equity risk. It is going national, expanding and building a plant in Melbourne. The banks said, sure, they would lend it X amount of money to go with its equity and debt – at 19 per cent. But the company had to put the same amount of money on deposit with the bank at five per cent.

**John Walker:** Pricing is starting to become sufficiently available for companies that have an equity buffer. But there are many companies, particularly small businesses, that don't yet have that equity buffer. They are going to have to access equity markets to get their capital, not debt markets. The banks are really just a symptom of that issue. They are in business not to lose money.

**Vaux:** There is also an emerging mezzanine debt market. A lot of it is in real estate refinancing where the banks are reducing their ratios. There are a lot of people focusing on that market at present and a lot of syndication opportunities.

**Erin Flaherty:** I am involved in one of the largest infrastructure public-private partnership (PPP) projects in Australia. It has about \$1.9 billion in debt guaranteed by New York monoline insurers. The monoline insurance industry consisted of a group of insurers that only had one line of insurance, which was to guarantee debt. They would charge a premium for guaranteeing debt based on an entity's ratings. Without this guarantee, an infrastructure project like ours would probably have been rated BBB. By arranging monoline insurance, we were able to obtain a AAA credit rating and consequently cheaper financing. But as a result of the GFC, these insurers have been decimated. It was fancy financial engineering and ultimately has proved unsustainable.

Many large state government capital projects, such as new hospitals, trains, roads, desalination plants, were financed in a similar fashion – off the Government's balance sheet and cheap.

We operate as a PPP. One of the challenges here for public infrastructure is that once you introduce the private sector, you introduce the profit motive as no one is going to commit to such large projects without a commercial return. This is a problem facing the Very Fast Train

(VFT). Perhaps major infrastructure projects should stay with the Government. I believe we need to bring back into government a frontier mentality – that we are building things to last for all Australians which, by their very size, need to be undertaken by the states and/or Federal governments.

It may cost billions of dollars but it's for the future. There may need to be an increase in tax or a special levy raised. But what has happened over the past couple of years is that because of short-termism and because governments don't want to be seen as "the baddies" by raising taxes, these types of projects have been offered to the private sector. You then get into sophisticated financial arrangements that are challenging for all concerned.

**Nissen:** The advantage of the PPP structure is that you get the commercial view of big projects. Let me ask, what sort of commercial rating would we give the National Broadband Network bond? Would it get funded?

**Flaherty:** The other issue with these big infrastructure projects is that there is a very high expectation on the part of the public that the Government will bail them out because they are like the banks, too big to fail.

**Walker:** Commonwealth Bank (CBA) is raising \$500 million presumably due to pricing partially relevant to the government guarantee. Now what is going to happen to the pricing when the government guarantee goes? And, what about supply?

**Anderson:** Westpac raised a chunk of debt earlier in the year and it managed to get it away. It was uncertain at the time that it would. CBA has managed to do the next round. Westpac saw a market out there but expected it to have a limit, although it didn't know exactly where that was. It is not expecting to be able to source all of its wholesale funding from offshore. So there is still some cash out there looking for a home in that

corporate market, but if you look at government stimulus packages around the globe over the last two and a half years, they all have to be funded. They are all competing for private funding and there is no alternative but for bond funding for banks and other corporates to get more expensive.

**Walker:** But none of that is a solution. That is just moving the leverage from one spot to another.

**Anderson:** I agree. I think that all the US has done is to shift the debt from the banking system and some of the private stuff to government. That's happening now in Europe. Deleveraging has started to happen slowly, but it probably still has five years to go or more. Deleveraging is necessary because our excesses were extreme globally, particularly in the US.

**Deans:** *What is happening with insolvencies and who is feeling the pain?*

**Anderson:** We have reached a period of calm. We have dealt with most of the very large matters, such as Babcock & Brown, Centro (although it's continuing), Allco and ABC Learning. Those had structural issues and their funding mixes were flawed. They had short-term finance against long-term obligations. The credit shutter was rolled down and all of a sudden there was nowhere for them to go for funding. What we haven't yet had is a whole lot of demand-driven distress.

Australia has weathered the last couple of years pretty well and as we sit here today, I think all the banks would say they are pretty comfortable with where their portfolios sit.

I'm not yet convinced we aren't going to have another little surge of distress in the mid-market area. However, I do have sympathy for the banks. They are an easy target and if you look at what's happening in many other countries, we are very fortunate that our banks withstood the GFC. The reality is that you can't ask your banks to be more aware of risk and more

prudent and then want them to lend money to everyone at very cheap rates. Their response is natural. It is difficult for us because it is a change from the last couple of years, but really it's a change back to what I think is a sensible risk-focused process as opposed to an unfair one.

**Vaux:** Do you think the US practice, Chapter 11, would help keep more businesses alive?

**Anderson:** I think the alleged benefits of Chapter 11 are a furphy. The way the banks in Australia have done it in the last three or four years, compared with what happened in 1990, is massively different. If the banks think there is any chance of survival, they are prepared to support businesses. The banks have supported companies behind the scenes confidentially for very long periods. Most of my work is working with the banks to try to find a solution. In Australia, generally they only get to formal receivership and the insolvency stage when there really is no hope left, no matter what you do.

In the US, certain airlines have been in Chapter 11 for two years and more. It inhibits competition and prolongs inefficiency and bad operators. These airlines were the worst performers in the industry. They went into Chapter 11. They shed all their creditors. They operated for two years under bankruptcy protection until they were in a position of ascendancy and then came out of Chapter 11 and were all of a sudden industry leaders. Meanwhile, the other airlines, operating under normal competition rules and having to pay all their creditors and their bankers, suddenly slip back to three or four in the line. I don't think that's fixing the industry. I think that's artificially propping up the bad businesses.

**Flaherty:** But doesn't that help the directors? The statistics show that in small companies, directors call insolvency too early and in larger companies,



they call it too late. If you have a Chapter 11 situation, at least you can give the directors a bit of time to make the decisions.

**Anderson:** We have the voluntarily administration regime here. The insolvent trading rules of Australia are a very separate discussion. Those rules are too prohibitive and I think they are unhelpful.

As an industry we have been talking this through with various parties and changes are being looked at. Chapter 11 may give some protections to the directors, but it has a number of downsides.

In Australia, we can deal with the director issue without having to introduce Chapter 11. The reality is that if you are in a workout with your bank, it will be putting your debt on hold and trying to work with you to find a way through.

**Walker:** To me in Australia, the debt market has vastly benefited by the equity raisings we had in the market in those two years from September 2007. A huge amount of money was put back into businesses. They changed from debt to equity.

**Witt:** But that was all in the top 200. Because of tight credit markets, there has been very uneven access to capital, both debt

and equity. I'd say the solution is mezzanine markets, high equity debt, hybrid equity facilities and converting facilities. This is almost mimicking the private equity instruments used in the US. I think the legal structure we have here doesn't always allow that to be an easily done activity. For example, some of the protective preconditions of some convertible notes are to have the right to replace the CEO, or the right to revamp boards. To give effectiveness to this, you must have multiple agreements. I guess what I am saying is we have a bit of a clunky system to allow us to adapt as rapidly as we need to in the market.

**Nissen:** There is a fundamental risk of having too much freedom, like in the US. The people who were originating the loans were packaging them up and selling them off before the ink was even dry. Nobody was bearing risk or feeling any responsibility. The important thing is to ensure the original supplier of the finance maintains a significant amount of that risk, so that risk gets adequately priced.

**Walker:** There has been a move away from relationship banking to transactional banking.

**Last:** At the SME end, you don't really have much of an opportunity to have more than one person who understands your needs because there aren't many alternative providers. There is just the one person and in many ways, it is about how you get that one person to understand what is going on and what your real risk is as opposed to what they perceive it as.

**Vaux:** It is extremely difficult to raise equity for small businesses. I wonder whether this is something the ASX should be looking at – that second board of listings where compliance costs are less.

**Nissen:** I work with a company that wants to raise \$1.6 million in equity. If I look at its cashflow, P&L and balance sheet, it should just be going to the bank and borrowing it. But the conditions from the bank are so onerous that it is going to have to do it with equity, and unfortunately the owners are going to take a tremendous haircut. I think the valuations people will be prepared to put it at are going to be significantly less than what the company thinks it is worth.

**Walker:** We are post-GFC and in the middle of massive uncertainty and the reality is that money that was cheap as chips before now, all of a sudden, has a different

value. I agree about being able to articulate to your bank a strategy and business plan and to make sure it covers all the risky bits. Often you just need to slightly reorganise the information and put different words around it. It is about finding the way to present the information in a way they can understand.

**Last:** And, it's not just to your relationship person. When everything is going well you deal with the relationship person, but when push comes to shove, it's the credit department. So it's important to ask your relationship person how you can help the credit committee understand you better.

**Anderson:** You are right. There is a broader audience and you need to make your material meet or match their decision needs. It doesn't mean you are always going to get as much as you want but, gee, you can improve your chances dramatically.

**Deans:** *What requirements do providers of mezzanine finance have?*

**Vaux:** I will give you an example of a property in Chittering, an outer suburb of Perth, where the developer ran out of money. The project was three-quarters complete and needed to raise some money to be completed. They asked us for mezzanine equity priced at 15 per cent. Plus we took 20 per cent of the profits out of the project and it should have a 12-month period. So we should be able to get about a 30 per cent return on our money.

**Walker:** See! That's the sort of price this risk should command.

**Deans:** *Is there lots of money available in that market or is it a fairly niche market?*

**Vaux:** There is a fair bit of money around, but it tends to be just syndicates put together by word of mouth really. You know, friends of friends.

**Anderson:** That's usually smart money and very discerning money. In terms of property, the banks are working on so much property around the country it's not funny. There are many property deals that would love that sort of injection

and they are just not going to get it because people who do have the funding have a lot of choices. So there is definitely opportunity there, but you would not say it's going to fill the finance gap.

**Deans:** *What should boards be doing now to ensure they are abreast of what is going on in their companies?*

**Flaherty:** We have taken the view that it's very important that our directors know the company's commitments, what the debt covenants are and although I hate this term, the granularity of it all. We sort of hit them over the head with the detail. It can't just be lost in the board papers and it can't be skated over. We have specific strategy sessions where we go through the debt documents and say this is where we are. The directors have all found this very helpful.

**Last:** At the smaller board level, regular basic reporting is critical. When does the debt mature? Where might we fall foul? What is our debt/equity funding strategy? Part of it comes down to asking what our balance sheet looks like over the medium term, because debt could be harder to find. What do we need to do about our dividend payout ratios? What do we need to do about our dividend reinvestment plans? Do we turn them on? Do we turn them off? Also, what is our longer-term game plan for cash demands, acquisitions and capex? So it's almost the basics of four or five things being with the board frequently so that it is aware and understands what is happening.

**Flaherty:** Often the finance committee is aware of all that and not the wider board. It is important that the wider board knows as much as the fincom does.

**Last:** And, also what are the alternatives? If you have one bank lined up as preferred, is anyone lining up a second one should you need it because you want to grow or just create some competitive tension?

**Witt:** Right now, there isn't a lot of slack in the system. If you came into a tight spot, you are going to have a crisis very rapidly and the lead time for raising equity or getting debt satisfied will have run out. So I would tell people, give yourself a lot more of a cushion.

**Flaherty:** I think you have to start early too. What happens is people procrastinate and don't have a sense of urgency. It is so important to know what the problem is and then to do something about it.

**Walker:** Gone are the days when the equity market didn't really care if it was current or non-current debt. Now the equity market is absolutely focused on what portion of your interest-bearing debt comes due in the next 12 months and is asking how you are going to refinance it and whether you are able to turn that into a long-term debt.

**Vaux:** What I think is going to be a really interesting problem for boards is the disclosure to the market as they get closer to their refinancing dateline. What are you expected to do? Are you expected to give a running commentary about how things are going? You have approached five banks. You've had three knock-backs and you hope to God the next one is going to come in for you. It's going to be very difficult

**Anderson:** If you are a second-tier or small company, and you're not absolutely sure about your ability to finance forward, you just have to carry a bigger portion of equity on your balance sheet, even if that makes a hole in your earnings or means being a bit more conservative about expansion projects. With the level of uncertainty, you probably have to treat cash as being a bit precious and as your insurance policy. If you can tap the public markets for equity, maybe go and get some now.

**Nissen:** If you are in that mid-tier or smaller market place, you are going to have to look at equity rather than debt markets and you

will have to be very careful in terms of your analysis of why you want more funding at the moment. If you have expansion plans, is this the right time to be doing it?

**Vaux:** There are also plenty of new private equity players looking around. But there are also companies such as BHP – it will have \$30 million of cashflow coming out in the next three years.

**Last:** Over the last couple of years it has been satisfactory for boards to have a conservative approach to cash on balance sheets or low debt and people are expecting everyone to say: Okay, well don't do anything big – sit back. We will not criticise you for having a lazy balance sheet. Now I think the pressure from the institutions and analysts could well be to get on with it. We are out of the GFC. Let's turn on the tap. They will encourage boards to step out. I would probably say to boards to take care over that. Just think whether it is really the right time, because we don't know what's going to happen.

**Anderson:** BHP can hand back billions of dollars and will be fine, but in the second-tier space, you may not be able to get it back. It is easy to give away and it might be harder to get it back. So you probably have a different decision to make.

**Walker:** At least until the debt market starts lending more. It's a hard thing to ask the equity market to put in more money when the debt market, which gets first take when things go bad, isn't prepared to put in more.

**Deans:** *Let me ask you to look into your crystal balls. How do you see things evolving over the next year or two?*

**Walker:** I don't see the debt supply increasing materially any time soon. I think the trading banks in Australia will focus on increasing their margins as much as they politically can to enhance their P&Ls. So there will be an emphasis on equity to leverage and fund

growth. My sense is that price will go up in the debt markets. It has been a year of shifting private debt to public debt and then realising the problem hasn't gone away. So we either have to get enhanced values for our assets, better cash flows from our businesses or we are not going to get any more new capital.

In certain sectors like mining, profits may grow to take up the slack. In Australia, we are this fortunate little island that is buffered to a certain extent from the reality of where we are at. But it's a perception rather than a reality. We get our capital in global markets. The banks realise that. They are going out and raising capital and trying to get as much margin as they can from the risk they are prepared to take at present.

My sense is that unless the deleveraging of about 20 to 25 per cent around the world happens – either through time, repayment of the debt or expansion of the values that debt markets are lending on – we should not rely on debt finance being more than what we've got now.

**Nissen:** We raised the point that it's very market sector-specific and very company size-sensitive in terms of what is going to happen. Some lack of confidence in the world economy over the next year or so is likely. I don't think it is going to go back to a GFC scenario, but people will continue to be very negative about how quickly the world economy can come out of this.

I agree that debt markets will stay difficult. I don't think the rates will be significantly out of whack with what they are today, particularly in Australia. They are going to continue to creep up, but will be manageable for most companies.

But in the sector where I work, the SME space, companies are going to have to get very tight in how they run their businesses. If there is any slack left in the business that they can remove, they are going to have to do it. They are going to have to focus on building

those relationships with their bankers or shareholders so that they do have some protection for the future. I would be cautious about any grandiose plans for expansion.

**Flaherty:** I am cautious too. While pricing continues to come in, in the bond market, I don't think it will go anywhere to the pre-GFC spreads. It's just going to be very slow and hopefully steady, depending on what happens in Europe. I think there is a lot of volatility there.

There are still a whole lot of structural issues that have to be sorted out in the US – the housing market and unemployment. There may even be a change in the US Government, which could have an effect on our debt and capital markets.

In the infrastructure space, there is a whole rethink going on about the best models and ways of delivery. I'm sure the PPP model will be further refined.

**Anderson:** I think the US, Europe and UK are going to be flat for at least five years. We won't be immune from that. That means businesses need to manage their cash with great care and proceed with caution. But much will depend on which sector of the market you are in.

You shouldn't underestimate the effect of our dollar on the market. If you are in exports, tourism or a similar industry, it will be very tough while the dollar is where it is, particularly with everyone else in the world hurting as much as they are.

**Witt:** In the past, investment expansion plans were probably not held to as much scrutiny as they should have been. I would caution boards to look very closely at these and in particular, at sensitivities. The question I'd be asking is: What can go wrong and how badly? What are my options? I think we will see equity values under pressure. So if you really want to have access to equity, you need to be flexible, realistic

and considering hybrid-type instruments that have debt and equity characteristics.

**Vaux:** I think there are very good buying opportunities. I would not underestimate the potential for a turnaround in the US. Areas such as housing affordability are improving and low mortgage rates do have a significant effect on the ability of the US consumer to go back out there and spend money. So I would not be surprised to see the US significantly turn around.

But as always, you have to bear in mind what the next catastrophic event is that may happen. I don't know, but obviously North Korea/South Korea is a potential trouble spot. That is the only one I can see on the horizon. Some of the problems among the smaller European countries will be slightly unsettling, but I don't think it's enough to significantly destabilise world economies. I also see no reason why China's managed growth rate of around eight per cent won't continue.

**Last:** Prices may go up a bit more, but not that much. The most important issue is that long-term lending lines are unlikely to be there. You have got to get used to being more short term. Boards can no longer go through that cycle of saying: Oh no, it's been nearly five years. We better brush up on those banking relationships. It's now going to have to be every couple of years.

Investing time in understanding relationships and the business model will pay dividends, especially if you have the opportunity for growth. Run scenarios often – what can go wrong and how might that upset the plan? I don't know if it will be Europe or US or where, but something might come that you can't see now. Plan for that! ☐