TREASURERS AND CFOS PERFORM BEYOND CAPITAL RAISING

Best practices in capital markets

The Philippines has come a long way since the Asian financial crisis in 1997-1998. It now has more developed domestic capital markets with a higher level of transparency and a greater capacity among the local financial institutions to underwrite large and long tenor funding requirements, particularly for project finance type of transactions. Playing an active role in enhancing best practices are the treasurers and chief financial officers who are involved not just in capital raising, but in ensuring that their companies have robust risk management systems

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Treasurers and chief financial officers of some of the leading conglomerates and corporates in the Philippines are at the forefront of enhancing the best practices in the country's domestic capital markets and in managing risks in the face of difficult market conditions. Their functions go beyond raising financing for their company operations.

Gabriel Mañalac, senior vice-president and group treasurer of Aboitiz Equity Ventures, says there is now a higher level of transparency in the domestic capital markets and there is a greater capacity among the local financial institutions to underwrite large funding requirements. "We see the deepening of the peso funding market as there has been a shift in borrowing from the US dollar to peso because of the liquidity in the market and the willingness of the banks to lend long-term," he points out. "The local banks now have a deeper understanding of the complexities of project finance."

Mañalac notes that previously, the borrowers were restricted in the tenor by which they could borrow money. But now they could push it to 15 years and some are even asking for 20 years. There is likewise an increasing amount of money being raised at the parent level among the different corporates in the country.

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Opulencia: *Our focus now is to offer the market the right deal structure and to provide alternative investment instruments to our investors*

of borrowers with viable investment projects," Mañalac says. "What is impressive is the understanding of the local banking community of the domestic borrowers such as Aboitiz."

The privatization of power assets by the Power Sector Assets and Liabilities Management Corporation (Psalm) gave the market a big boost in terms of the number of players, which are willing to invest in the Philippines. "We saw a remarkable number of opportunities as Psalm started to privatize its assets," Mañalac adds. "While our neighbouring countries were still talking about the traditional government-supported power sales agreements, we in the Philippines were already privatizing our power assets and looking at the real spot market. We were ahead of the game and in fact, the International Finance Corporation wanted to use the Magat hydropower complex as an example of a successful financing model among the other Asean countries."

Awash with cash

Ysmael Baysa, chief financial officer of Jollibee Foods Corporation, is at the forefront of instilling the best practices in the company by taking a leadership role in formulating its long-term strategic direction.

"I made sure that finance has a voice in our development strategy, which is being handled by a team of senior management," he points out. "It has to be communicated properly because those long-term goals have to be expressed in terms of long-term benefits for the company. These include identifying acquisition targets, which company or companies to buy and actively participating in the negotiations, and which country or countries to invest."

On financing, Jollibee's strategy goes against the conventional wisdom. "We build cash and today 52% of our total balance sheet is financed by equities," Baysa says. "We have a net cash position and we fund our acquisition using cash. This is in contrast with the conventional practice of borrowing money to finance an acquisition because using equity for such an exercise is expensive. While we are willing to borrow, we hardly do that. We even impose a high hurdle rate for our investments."

But investors are happy with the Jollibee strategy. "One of our investors who has been with us for 10 years, says they like what we're doing and they will stay with us as long as we do good," Baysa reveals.

Baysa reiterates, though, that Jollibee is open to other funding avenues such as securitization. The company receives royalties from its franchisees amounting to around three billion pesos a year, which can be securitized and use the proceeds to finance its expansion and acquisitions. "Some financial institutions have discussed with us the idea of securitizing our royalties," he says. "However, we are flush with cash and we do not need more of it at this point in time. I look at cash in a different way. It can be a liability because cash does not generate as much return as we get from our fast food operations."

The company CFO says cash could only give a return of 3% to 4%, while the Jollibee stores generate a return of 18%, which is the reason why it is generating so much cash. "So there is no need for us to securitize those royalties, though we are open to the idea," he adds.

Jollibee is also receptive to foreign borrowings, just like what it did in 2008 when it tapped the renminbi loan market for about US$50 million equivalent to finance its acquisition of Hong Zhuang Yuan in China.

For Baysa, financing is a means to an end; it is not an end by itself. He explains: "Without a good investment and without a good company to buy, we should not raise cash because it will dilute our earnings. Not only that, you will be tempted to use that cash because it is earning less. You may put it into risky investments or you may be under pressure to buy a company that you do not really need to buy. So cash is both a good thing and a bad thing."

Prudence is key

For Ricardo Tan, CFO of property company Vista Land, there are certain practices that are universally adopted by most companies and considered as "best practice" in managing the finances of a company. "You manage your balance sheet – your debt-to-equity ratio, your debt maturity profile, accounts receivable etc… but I don't think you always can have a 'one-shoe-fits-all' approach for all companies. Some practices considered good for one company may not necessarily be optimal for another, and may depend, among other things, on corporate culture, risk appetite, past history etc."

Vista Land raised funds in the US dollar bond market in October 2010 initially with US$100 million, which it re-opened six months later with another US$75 million. "I was often asked why we did it because borrowing in US dollars was more expensive and we felt we needed to hedge the foreign exchange risk. Well, we believed that there was a window of opportunity which we wanted to take advantage of and introduce the "Vista Land" name to the international fixed income community. We also wanted to diversify our sources of funding and create a benchmark for the company which would hopefully allow us to reduce our financing costs in future international bond issuances. In addition, as most of the corporates here have

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Tan: *While borrowing in foreign currency was a bit more expensive and you need to hedge, we have our own reasons for doing that*

Dispo: *While local companies can access the offshore markets, because they are doing business here, they also have to look at the domestic capital markets*

learned by now - you borrow when the money is available because things can change pretty quickly."

Having borrowed in the US dollar bond market, Tan was urged by many not to hedge because of the expectations of the peso appreciation against the dollar and so they were bound to make money anyway. But having experienced the Asian financial crisis in 1997-1998, they've learned some tough lessons and decided to take the peso speculation out of the equation by hedging the company's dollar borrowings.

This year, Vista Land tapped the domestic capital markets with a 4.8 billion peso (US$115 million) unsecured note issue. "There is a lot of liquidity in the domestic market and it's a lot cheaper to raise money domestically today."

"With regard to risk management, there are events that one cannot anticipate. The best one can do is understand the risks that are out there and constantly monitor events. You also should acknowledge that you may underestimate the impact to your company of unlikely events you cannot foresee. The so-called 'Black Swans' have been coming with some regularity over the last few years – the 1997 Asian crisis, 9-11, the subprime crisis, the tsunami in Japan and now the problems in Europe. "Often you are caught between being too paranoid and trying to provide a hedge for everything - and doing nothing. You just need to manage your risks, understand what the risks are, and communicate what you are doing to the market."

"I think one has to make a distinction between 'taking a view'"or more bluntly 'making a bet', and 'hedging a position'. There have been well-known cases locally where executives took a decision, for example, to lock-in prices of raw materials amid a rising market. This may be considered a hedge because in an effort to preserve margins, at some point you cannot simply hope that prices will stop rising. However, the market views (wrongly, I think) you as a genius if prices continue to rise well beyond your locked-in price, and as a failure if prices fall below that price. In fact, all you have done is use common sense and prudent financial management. You try to create some certainty (in this case in your raw materials' cost) in a period of general uncertainty. This is different from taking a view that the peso will continue to appreciate and you therefore borrow in foreign currency to take advantage of future foreign exchange gains. As some have learned during the 1997 Asian crisis, you are effectively taking an open-ended risk. This may sound ridiculous but theoretically your potential losses are unlimited," Tan remarks.

Cash management lessons

The development of the domestic capital markets is likewise beneficial to Phinma, which exited some of its major businesses such as cement and steel, in the wake of the Asian financial crisis. According to Phinma senior vice-president and treasurer Pythagoras Brion Jr, the company ended up with a lot of cash following their asset disposals – a good portion of which was in US dollar.

At that time, Phinma wanted to re-invest the money, but it was not possible to do so overnight for such a big amount. Brion narrates: "We were looking at a five-year horizon and so it took quite sometime for us to re-invest the money. At the same time that we were faced with that challenge, there were political and economic volatility in the market, which made it even more challenging."

There were not much investment vehicles then that the local fund managers could offer to Phinma. So what the company did was to tap the foreign banks and along the way learned from them. "We were on our own. We have to study the financial market and develop skills to read the market as investors and not as traders," Brion recalls.

Today, Brion says he's happy that the country boasts of a more developed local fund management industry even as he sees more room for improvement.

Another challenge that Phinma faced was how to handle its cash management. As the company expanded its remaining businesses, it was generating a lot of cash and as the magnitude and the pace of its cash flow increased, it has to improve its cash management system.

When Phinma still had its cement business, Brion notes it was operating on six cash management desks, not an efficient approach. What the company did was to streamline its bank relationships and centralize its cash management system. In doing so, it managed to cut its cash float by two-thirds.

Brion points out that while the foreign banks have a more developed cash management system, Phinma decided to stick with the local banks because of their wider network. These are the banks that provided good support to Phinma even during the difficult times.

Another challenge that confronted Phinma was dealing with large-scale business expansion. It has huge investment in the power sector and was building its own plants. However, it failed to win bids when the government privatized its power assets. As such, it has a large funding requirement. "We were not in the market for many years, so we did not know how the market would price us and what kinds of covenants they would impose on us," Brion recalls. "So we decided to bring in the banks early and work with them to understand their concerns about our credit, what their pricing considerations were, even as we were finalizing our feasibility study on the project. We were fortunate enough the banks that we've selected were flexible in understanding our project and they were with us every step of the way, enabling us to improve the financing package."

For its property subsidiary, which is also growing, Phinma does not have a problem raising financing. Brion adds it was cheaper to raise money for its projects and since the nature of its housing business offers certain predictability in terms of turnover, it helped them raised a 1.5 billion peso corporate note issue in 2011.

Market innovator

A leading participant in the development of the domestic capital markets is Ayala Corporation, which has a flair for innovation as it shifted its fund raising activity from overseas into the peso market. Its previous reliance on foreign borrowings was driven by the fact that the local banking market was not liquid for a conglomerate such as Ayala, which has several subsidiaries that are commingled into one single borrower's limit (SBL). "In view of this reality, we needed to borrow overseas, tapping all manner of funding avenues such as floating rate notes, fixed rate notes, as well as convertible and exchangeable bonds. You name it, we've probably done it."

The Asian financial crisis in 1997-1998 proved to be a wake-up call. Many corporates were then keeping open position since the foreign exchange market was not moving. "Philippine investors could just sell forward and on every maturity, you could realize a healthy profit. We were fortunate that while the currency depreciation in the wake of the crisis increased our funding cost, the yield on the assets where our foreign currency loans were invested were significantly many times over. Ayala's successful foray into the foreign exchange market opened the eyes of many corporates as our issues bridged the funding gap resulting from the significant lack of quality hedging products."

Ayala started tapping the domestic capital markets in 2004, but it soon realized that the bank credit lines were used up very quickly in view of the SBL that impacts on conglomerates such as Ayala. At the same time, the peso bond market was then very shallow and predominantly short-term in nature (i.e., three to five years) with the largest issue size that could be raised was just about one billion pesos.

Opulencia recalls, "These were the reasons why we had to innovate (and still do); otherwise, we would be vulnerable to volatilities in the local marketplace. While it was more doable to raise funds in the dollar market in significant sizes of US$100 million or US$200 million, the reverse was true in the peso market. Given overall market conditions and our own sense of market timing and behaviour, we leveraged on Ayala's top-notch reputation for corporate governance as well as Ayala treasury's proven track record in structuring innovative debt offerings that also serve to maximize shareholder value, putting Ayala firmly in the radar of the serious global investor."

The first peso transaction that Ayala launched in 2004 was a seven billion peso corporate note, which was upsized from the initial target of five billion pesos and represented the largest such deal in the market at that point in time. "That was, I believe, the beginning of the development of the peso capital market and many best practices emanated from that deal."

In launching the transaction, Ayala worked with several underwriters – the only corporate to do so – since it was not a common market practice as the underwriters usually grouped themselves into two or three when arranging a deal.

In another transaction, Ayala was able to price a deal below the level that was achieved by the sovereign, demonstrating the strength of its credit while using product features to optimize its borrowing cost. Opulencia quickly retorts, "It is not the sole objective of Ayala to achieve the tightest spread on a deal. True to its 175-year history of providing fair and reasonable value, Ayala always demands of its underwriters to provide fair terms for the benefit of the investors who continue to regard Ayala throughout the years as a preferred issuer".

"Our focus now is to offer to the market the right deal structure and to provide alternative investment instruments to our investors," continues Opulencia. "Since our successful sortie in the domestic capital market in 2004, Ayala's policy remains to establish a long term relationship with retail investors in pricing its transactions. From a level of 30% retail in our 2004 deal, we were able to significantly raise retail to 91% participation in our 10-year, 10 billion peso deal in May 2011. This particular debt paper, which boasts of a significant rise in retail investors taking up the paper, featured multiple puts on the fifth and eighth years. In the 15-year debt paper launched in April 2012, 70% of the entire transaction was taken up by retail. Definitely, the retail investor is key to our funding strategy."

In 2006, Ayala launched the first local currency hybrid capital transaction in Asia – a funding instrument that has gained popularity now especially among the Singapore dollar investors. In conclusion, Opulencia says, "Our deals are examples of how we design products that address the needs of a particular market segment (made up of retail investors.) While our retail investors still generally prefer tenors of five years and seven years, we have tested this short-term horizon such that our retail investors are willing to go longer into 10 years and even 15 years with the right product appropriate for their needs, enhanced by their confidence on the issuer's integrity and track record in the capital market."

Risk management takes front seat

Apart from imparting and following the best practices in the domestic capital markets, the treasurers and CFOs are likewise putting emphasis on risk management. Aboitiz, according to Mañalac, is in the process of developing an overall risk management system – which he describes as challenging – for the conglomerate as a whole. "Risk management is very important; it is there to help you set parameters on how much risk you are willing to take," he emphasizes.

In terms of hedging, Mañalac says Aboitiz does derivatives, but they do not top-up when there is a mark-to-market call. "We do it specifically to hedge a position – to lock in the cost and revenues and that's it," he adds.

"For Vista Land, we like to keep our approach to risk management simple. Basically the simpler the better – understand the rationale for your taking a position and be aware of the downside risk. There are so many ways, for instance, to hedge your foreign exchange position. In our case, we put our dollars in a bank account, negotiate a certain rate and borrow against it. The negative carry is part of the cost of hedging," the company CFO opines.

Brion agrees with both Tan and Mañalac on the need for a robust risk management. "There are a number of business risks that need to be taken care of," he says. "A simple rule is to be cautious of the risks, understand them and keep things simple. We need to be prudent when it comes to hedging." A