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Corporate Treasury Update

February 2016

Corporate Treasury Update – February 2016

Macroeconomic Outlook

The volatile market conditions that marked the start to 2016 were a sobering backdrop to Federal Reserve chair Jannet Yellen's semi-annual monetary policy report to congress. As the chair noted: "*Financial conditions in the United States have recently become less supportive of growth, with declines in broad measures of equity prices, higher borrowing rates for riskier borrowers, and a further appreciation of the dollar*". This was reflected in the minutes of the Federal Open Market Committee's January meeting, released a week later, which focussed on the threats posed by financial market uncertainty and slowing growth in key trading partners such as China, Canada and Mexico.

In the UK, the announcement by David Cameron that the UK would hold its long-awaited referendum on EU membership on 23rd June, an issue that has divided opinions among senior members of the Conservative party, led to a marked depreciation in sterling. At the same time the Eurozone has been facing different challenges, as the purchasing managers' index fell to its lowest level in more than a year, and a sharp sell-off in additional tier 1 securities issued by Eurozone banks led some commentators to speculate that a sustained wariness around the asset class may have wider implications for the real economy.

Global Updates	
Davos 2016 – The Elephant in the room	The end of January saw the World Economic Forum in Davos; themed as "The 4th Industrial Revolution" it looked at the social, political and business opportunities/challenges of the rapid emergence of the next wave of technological developments. Clifford Chance attendees reported that while there was focus in the formal sessions/theme, inevitably current events dominate much of the "fringe" discussions.
Oil Prices – A deal, but no change	Despite Saudi Arabia and Russia agreeing to reduce oil production, with the acquiesce of Iran, there has remained significant volatility and no meaningful upward movement in oil prices with a KSA officials confirming what many traders suspect that the deal is in name only and will not be reflected in practice and market views sees the historically low oil prices continuing for the foreseeable future. Notwithstanding this, an announcement that the Venezuelans will meet with the Saudis, Russians and Qataris has resulted in markets reconsidering the possibility of reduced production.
Iran – Welcome back	With the lifting of certain, but not all, sanctions again Iran under the Joint Comprehensive Plan of Action (JCPOA), increasing number of business are looking to invest in (and finance their investments in) Iran. While the road ahead is not year entirely clear, Clifford Chance has drafted a briefing that provides initial guideposts and points to consider in the respect of the extent of the sanctions relief now in place, the sanctions that remain and the compliance challenges for those pursuing opportunities offered by these developments. *http://www.cliffordchance.com/briefings/2016/01/iran_sanctions_implementationdaywhatyo.html*
US Elections	
Super Tuesday – The show won't end for a while, but it is building towards a crescendo	The election cycle in the US is well underway (primaries and caucuses have been held in IO, NH, SC and NV) with no expectation that the "fun" will end any time soon as mixed and in some cases surprising results continue to spur (some of) the candidates on. There will, however, we will see a major crescendo on Tuesday March 1 ("Super Tuesday") with 11 primaries – AL, AK, AR, GA, MA, MN, OK, TN, TX, VT and VA – and 8 further states voting in the following week.
Brexit	
Markets expected to remain quiet until after vote	With the Brexit vote scheduled for 23 June, market commentators believe that capital markets generally will be quiet until the uncertainty around the vote is resolved. Impact has been felt across markets (see below) and Sterling denominated issuances are expected to be particularly adversely affected until the outcome is known.
Loans	
Limited overall flow of new money, but increase in private lending	A quiet start to 2016 for new deal activity with fewer refis and recaps and not the hoped for M&A deal flow, but the European market remains liquid. Banks continue to dominate, but the last 12 months has seen an uptick in lending by non-bank and unitranche lending in European small/mid-cap deals (going beyond the more usual UK, German and French markets).
Pricing and negotiating pressure is up for loans (and other debt products)	Lenders are making a greater distinction between credits which is reflected in pricing and documentary terms. This is particularly true for European leveraged term loan B financings. The more aggressive cov-lite financings for less popular credits have seen push back from lenders on terms such as the ability to incur incremental debt and to make restricted payments and a number of deals having their pricing flexed upwards in order to successfully syndicate.

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High Yield Bonds	
High Yield Markets Quiet	Global High Yield markets remain moribund with the lowest activity levels seen in recent memory with few deals being launched and some significant deals withdrawn from the market. Presently there are no signs of the deal flow increasing (and European deal flow in particular is expected to be impacted by Brexit), but pressure in the pipeline is growing.
High Yield Funds See Significant Outflows	Reflecting weak market sentiment, high yield fund flows remain volatile. Following a €1.3 billion outflow in January, Europe experienced further outflows of €1.1 billion in the first half of February. The US, however, bucked the trend and saw a $66 million inflow after two weeks with a cumulative outflow of $1.1 billion. Funds flow don't auger well for future primary issuance and the buyside clearly has the upper hand at the moment.
Coercive Exchange Offers	The US and European High Yield markets have experienced a variety of "coercive" exchange offers designed, to varying degrees to provide noteholders with a Faustian choice to exchange or be trumped by new senior debt. This is a topic that will be discussed in detail at the Clifford Chance sponsored *European Opportunities Forum* to be held in New York on 2 March (http://mergermarketgroup.com/conf/dw-european-opportunities/).
Investment Grade Bonds	
Debt capital markets	Better credits can sell bonds and February saw some rebound in debt issuance following a difficult January in which only $416bn of debt was sold; the lowest total since the equivalent period in 2002 according to Thomson Reuters. February saw a number of investment grade issuers return to the market, including Apple, IBM and Toyota. There was also a rare bright spot in long-dated sterling, as the Universities of Cardiff and Leeds both priced debut transactions at record low yields for the sector.
Derivatives	
Clearing of OTC Derivatives	The first wave of mandatory margining for uncleared OTC derivatives transactions comes into effect in September of this year, and while the mandatory margining rules are not intended to apply to most corporate users it is worth bearing in mind that they will in due course impact investors like pension funds, and will have an impact on their available liquidity as they will be required to allocate assets to satisfying margin requirements. See below the feature article: *Corporate users of derivatives voice concerns over EU derivatives rules*
Equity Financing	
Global Equities	Equities remain on a roller-coaster ride with significant fluctuations across nearly all markets as reacted to global financial instability and a variety of bad to mixed news and in part reflecting short positions being taken against commodity and bank names, among others.
IPO and primary issuances	The recent sale of Brakes, the London-based food supplier, by Bain Capital to US food distribution company Sysco resulted in the withdrawal of Brake's potential IPO. This again demonstrates that sellers are prepared to run dual-track M&A/IPO processes so as to give themselves maximum flexibility in seeking the best possible exit sale terms.
Islamic Finance	
Islamic Finance	Global Islamic finance assets climbed to $1.814 trillion in 2015 and the value of assets in the Islamic finance sector is expected to increase by 80 percent over the next five years, reaching $3.24 trillion by 2020. The majority of Islamic finance assets are held by Malaysia ($415 billion), Saudi Arabia ($413 billion), Iran ($345 billion) and UAE ($161 billion). S&P expects global sukuk issuance in 2016 to reach $50 to $55 billion, compared with $63.5 billion in 2015 and $116.4 billion in 2014. Sukuk is expected to play a role in financing key infrastructure developments and projects in Africa and the GCC. Sovereign sukuk account for the majority of all sukuk issuances, followed by issuances by financial institutions and power & utilities companies. Q1 2016 is off to a cautiously optimistic start with the Government of Sharjah issuing US$500 million sukuk.

Economic Data Outlook:	
Federal Open Market Committee meeting	15/16 March
Bank of England MPC meeting	17 March
ECB Governing Council Monetary Policy meeting	10 March

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Corporate users of derivatives voice concerns over EU derivatives rules

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The European Market Infrastructures Regulation ("EMIR") entered into force in summer 2012. It represents the key part of the EU's response to the G-20's post-financial crisis commitment to reform the OTC derivatives markets and brought thousands of non-financial corporates into the complex world of financial regulation. In the context of the European Commission's mandatory review of EMIR, a number of individual corporates and trade associations have voiced concerns about the burden which EMIR places on corporate users of derivatives and have called for reform.

"We have serious concerns that corporates using derivatives for hedging purposes today are unnecessarily and disproportionately burdened by [EMIR] requirements."

"…the dual-sided reporting regime and the requirement to report intragroup transactions place disproportionate, costly and unnecessary burdens on end users…"

Coalition for Derivatives End-Users' Letter to European Commissioner Lord Hill, January 2016

The key areas of controversy

Reporting – EMIR requires that all EU users of derivatives report details of their transactions to an approved "trade repository" (e.g. DTCC or UnaVista). If a corporate trades a derivative with a dealer, both the corporate *and* the dealer must report to a trade repository. This "dual-sided" reporting regime has been accused of unnecessarily adding to the administrative burden of end-user corporates when a "single-sided" regime (under which only the dealer would report) would achieve the regulatory objective and would match the approach adopted in the US.

Intragroup derivatives – many corporate groups trade derivatives through a central treasury hub and then back-out the benefit of those derivatives to the group entities where the underlying risk lies via intragroup transactions. Generally, under EMIR intragroup transactions get treated like derivatives traded outside the group (although EMIR provides limited and complex exemptions from some of the more onerous obligations). Arguing that these transactions redistribute instead of increase risk, corporates have argued for broader exemptions to apply to intragroup transactions, including an complete exemption from the reporting requirement.

Narrow the clearing obligation – most corporates will escape the EMIR clearing obligation (the requirement to clear derivatives through an approved clearing house). However, groups which are heavy users of derivatives for non-hedging purposes (e.g. if there is significant commodity trading in the group) will be subject to the clearing obligation in respect of all of their derivatives, irrespective of whether they are hedging or speculative. Larger corporates have noted the drain that clearing (which requires daily collateral posting) places on corporate treasury reserves and liquidity and the detrimental consequences of this for their core businesses. They have called for a narrowing of the clearing obligation.

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Redefining the definition of systemically important – EMIR seeks to identify corporate groups which are systemically important to the derivatives market and impose a heavier regulatory burden on those groups. Currently, EMIR looks at the gross notional amount of derivatives used in a group in determining such systemic importance, but allows companies to exempt hedging transactions for this purpose. Regulators have suggested that this exemption is not working as intended and propose abolishing the hedging exemption. End-users have responded with concern, fearing that this will bring non-systemically important groups within the scope of the clearing and mandatory collateral obligations and place inappropriate burdens on the corporate treasuries of such groups.

The immediate challenge

As the debate rumbles on in the background, corporate treasuries must nonetheless comply with their immediate obligations under EMIR. The next 12 months will see mandatory collateralisation of uncleared derivatives for the first time, and the beginning of the phase-in of the EMIR clearing obligation. Whilst this will primarily impact group pension funds and groups containing commodity trading, corporate treasuries generally (even those using derivatives for hedging purposes only) are likely to see the costs of the increased regulatory burden for their dealer counterparties flowing through into increased pricing for their own trading through 2016 and 2017.

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