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(Translated by Calyon)

Enterprise and finance - **Focus**

## **CASH MANAGEMENT**

### **Is performance again attracting corporates?**

**Very low interest rate levels are spurring companies to review their investment policies. To improve returns, some are turning to structured products or longer maturities. But demand is still strong for products that combine liquidity and simplicity.**

For some weeks now, banks' money market desks have noticed something stirring in cash management: companies are paying attention to returns again! The subprime crisis and Lehman Brothers' collapse sent cash management into two somber years, when corporate treasurers lost all interest in performance in favor of a single watchword: safety. As a result, they concentrated exclusively on extremely short-term, liquid, risk-free investments. However, the persistent decline in rates has made them reconsider this position, or at least question its medium-term relevance. Yes, their investments are safe, but their performance is less and less impressive. "For a few weeks now, we have been seeing stirrings in the corporates market," comments Bruno Laurier, Deputy Head of Corporate Sales, Interest Rate and Currency Derivatives, Europe at Société Générale. "Companies with somewhat longer time horizons are turning to more dynamic products that offer better performance than the current yield curve."

### **New investment needs**

Several phenomena explain why the trend may be changing. During the crisis, some companies improved their cash management, especially through programs to cut costs and optimize working capital. The renewed interest in new ways to manage their investments also coincides with corporates' return in force to the bond market. Corporates' new issue volume has reached a record of over €160 billion for the year to date. "We have typically worked with companies that have structural surpluses – utilities and concession operators, whose activities are largely non-cyclical and little affected by the economy. But now, we are working with a new category of companies, those that have recently issued bonds," confirms Jérôme Barneto, a specialist in structured investments at Natixis. Companies are jumping at opportunities in the market, without necessarily having any need to pay back existing debt. This frees up liquidity, which in turn is invested.

While new needs are coming to the fore, corporates are no less solidly grounded in the safety reflex. Corporate treasurers' first and most basic need remains short-term investment for protection from liquidity risk. On average, investments maturing in three months or less represent between 80% and 95% of what crosses traders' desks. The choice also reflects accounting constraints. "IAS 7 of the IFRS says that in

order for an investment to be considered a cash equivalent – in order, that is, to be able to offset it against a company’s gross debt - its maturity should not exceed three months,” observes Bertrand Lacasse, Global Sales Manager at Calyon. The impact of accounting standards aside, treasurers are trying to avoid any risk of loss and the ensuing publicity that would be negative for the corporate image. “Treasurers prefer to opt for short-term, low-yielding products rather than taking the risk of investing in structured products that could penalize their financial results and, for listed companies, have a negative impact on the stock price,” continues Lacasse. But the range of investments available to corporates is relatively limited.

**Bruno Laurier**, Deputy Head of Corporate Sales, Interest Rate and Currency Derivatives, Europe, Société Générale

**“Inflation-based products should be back in favor with corporates in the next few years.”**



**Commercial paper: credit risk makes a tentative comeback**

Since the crisis began, credit risk has come under even greater scrutiny by corporates, who have upped the level of creditworthiness they require from the issues they invest in. Consequently, up to this point they have turned their backs on commercial paper. Only the best-quality issuers (A1/P1) have remained in constant demand, while other categories of short-term issues have tended to be ignored. “Just recently, we are nonetheless starting to see corporates putting a toe into the water of slightly greater credit risk, with some again considering issuers rated A2/P2,” explains Xavier Boisseau. In general, although yields on commercial paper vary greatly depending on the corporate issuer and its rating, three-month paper on an AAA-rated corporate pays approximately 20 basis points less than Eonia, and that of an issuer rated BBB pays 110 basis points more than Eonia. But for the time being, corporates do not appear ready to invest in securities of lower-quality issuers, despite the higher yields.

**Commercial paper market: average levels of issues versus Eonia swaps (bp)**

<b>Corporates</b>	<b>1 month</b>	<b>2 months</b>	<b>3 months</b>
A-1+/P-1/F-1+	-7.3	-3.7	-0.2
A-1/P-1/F-1	+6.3	+9.8	+13.8
A-2/P-2/F-2	+16.5	+27.5	+37.5
A-3/P-3/F-3	+100	+132.5	+150

Source: AFTB ACI France, June 4<sup>th</sup>, 2009

"Today, there are few investment products that meet both accounting criteria and corporate treasurers' liquidity requirements," acknowledges Laurier. "Corporates invest either in money market funds or in the certificates of deposit, commercial paper and euro medium-term notes (EMTN) that our trading desk offers." In other words, they like simple products. "Even before the crisis, large corporates traditionally did not invest much in structured products," recalls Xavier Boisseau, Head of Sales, Global Markets France at HSBC France. And as for companies that had invested in dynamic money market funds, they stampeded out of these products once they began to be considered toxic in the summer of 2007. This meant that assets under management shrank considerably for some money market funds, whose risk the corporates considered too opaque, in favor of government debt and top-quality funds made up exclusively of AAA-rated securities. While some bankers had never sold a single BTF (fixed-rate short-term discount Treasury bill issued by the French debt agency Agence France Trésor) or OAT (French Treasury bond) to their corporate clients, demand by corporates for this type of debt has rocketed, leading to an explosion in the market for certificates of deposit. "In 2008, many French companies with cash surpluses bought bank CDs for the attractive yields they offered," explains Alain Dellemotte, Head of Corporate Sales, Large Caps France at Natixis. These investment products were favored over funds because of their credit transparency – in terms of rating, CDS levels and capitalization of the issuing banks – and the associated ease of monitoring counterparty risk." CDs therefore became extremely popular with most banks. "Corporate demand for CDs more than doubled in two years," confirms Lacasse. The problem is that yields on CDs have tumbled in the last few months. In late 2008, investors could expect a yield between 20 and 50 basis points higher than Eonia, and even more on three-month maturities. But now, Calyon's three-month CDs pay only around 1%, and Société Générale's only 10 to 20 basis points more than Eonia.



**Xavier Boisseau**, Head of Sales, Global Markets France, HSBC France

"In structured products, corporates especially look for underlyings that they know well, such as currencies and interest rates."

### **Investing longer-term**

These plunging yields are leading some companies to review their investment strategies. Those with longer time horizons are responding by lengthening the maturities of their investments. "Given these very low interest rates, certain large corporates are going further out on the yield curve while investing in high-rated issuers. They are thus capturing higher yields thanks to the slope of the curve – the spread between two- and ten-year yields being now nearly 200 basis points," explains Barneto. But to meet the very skittish, conservative requirements of finance departments, treasurers must keep the exits open in case the company needs to find

a way out of an investment. “When corporates decide to invest for a time horizon longer than three months, they also want to be able to manage their liquidity risk,” explains Boisseau. “That is why we increasingly offer them ‘puttables’, products that offer the right to put options which are exercisable every three months” (see box).

**Alain Dellemotte**, Head of Corporate Sales, Large Caps France, Natixis

“Since the start of the year, we have noticed renewed interest from some corporates in more structured products, provided that invested capital is guaranteed at maturity.”



Other corporates agree to invest in slightly more complex products in order to increase their expected returns, but only on certain conditions. “Since the start of the year, we have noticed renewed interest from some corporates in more structured products, provided that invested capital is guaranteed at maturity,” notes Dellemotte. These more complex products are attractive because of their low opportunity cost – i.e., the risk relative to the expected return. Now that Eonia has slipped under the 1% threshold, companies can readily accept the possibility of a zero return if an option strategy fails, if in exchange they can expect a return of up to 3% or 4%, as is currently the case. By combining the credit risk of a bond and the performance of an underlying – interest rate, currency, equity index, commodity, etc. – structured Euro Medium Term Notes (EMTNs) can provide a better return than a traditional product whose return reflects money market yields. “We create structured products that enable finance departments to invest in the performance of an underlying, with invested capital guaranteed at maturity. This lets them improve their return on surplus cash with a very advantageous risk/return profile,” confirms Barneto. “Products may also be structured to symmetrically offset the revenue variations of a company with a natural exposure to changes in currencies or commodity prices.” For example, if a company whose revenues increase when the euro goes up has cash to invest, it can choose a product that enables it to receive a more sizeable coupon if the euro drops to make up for the resulting revenue shortfall. Corporates can also improve their investment performance through traditional options, such as range accrual notes. This product offers a yield of between 0 and 5%, for example, depending on the range in which three-month Euribor is trading at each maturity. The narrower the Euribor range, the higher the yield. “In general, corporates especially look for underlyings that they know well, such as currencies and interest rates,” explains Boisseau.



**Bertrand Lacasse**, Global Sales Manager, Calyon

“Puttable bonds are a good fit for corporates’ current requirements as they seek liquidity.”

## **The comeback of inflation-indexed products**

Although short-term, very liquid products continue to win favor, initial signs of an increased appetite for risk in corporates are causing banks to think carefully. "Starting in the second half, we hope to go back to promoting certain longer-term products," explains Laurier. "Medium-term inflation risks are high, and we would particularly like to offer our clients inflation-indexed investments that would enable their cash to keep its value in the event of price rises." For example, we could envisage a five-year investment that plays on a rise in inflation, offering a fixed 6% coupon for the first two years, and 120% of European inflation in the later years. "This type of product has been around for a long time, but only recently have certain companies started to show an interest in it," says Laurier. "With the very heavy financing needs of governments all over the world, inflation-based products should again hold interest for corporates in coming years." In fact, only one thing is certain now: it will take some time before corporates again accept the notion of risk and make performance their top investment criterion.

### **Growing interest in puttables**

Fixed-income products known as 'puttables' are bonds that generally mature within two to three years and come with a put option that investors can exercise at certain predetermined periods, normally every three months. For this reason, they are treated as short-term products, because they enable the investor to maintain the cash-equivalent nature of the investment while offering a higher return, thanks to their step-up coupons, which increase gradually if the investor decides not to exercise his option. "A puttable bond issued as part of a Calyon EMTN returns approximately 140 basis points more than three-month Euribor after a year and a half, an attractive coupon for a risk-free investment," enthuses Calyon's Lacasse. This type of product is a good fit with corporates' current requirements as they seek liquidity to confront the crisis and seize any potential opportunities for acquisitions at deep discounts.

Moreover, both investors and issuers appear to have something to gain. "The puttable product is worthwhile for the subscriber as well as the issuer," explains Dellemotte. "The subscriber receives a better return on his investment than on traditional certificates of deposit, thanks to the step-up coupons, on the condition that he does not exercise his put. The issuer builds the investor's loyalty and locks up longer-term financing with good terms."

*By Angèle Pellicier*