CLIFFORD CHANCE

Corporate Treasury Financing Series

Issue 1, January 2016

Foreword

We are pleased to introduce our new Treasury Financing series, a monthly bulletin intended to help finance professionals stay on top of market developments and identify the funding opportunities that are right for their businesses. In each edition, we will seek to combine macroeconomic and market updates with specific features on the current financing trends from our market-leading experts.

Financing options are impacted by a myriad of micro- and macroeconomic factors, and through this series we will seek to address some of the key issues affecting the markets. For example, uncertain interest rate moves by central banks, a struggling Eurozone and economic slowdown in China are just some of the destabilising factors affecting a global economy already struggling with the aftermath of the financial crisis and the burden of public debt. In times of political and economic uncertainty, the ability to execute the right funding strategy, with precise timing, will help differentiate those borrowers who are best placed to succeed. Critical to making the right choice will be having a broad understanding of the financing options available, and being able to navigate the complexity of rapidly changing markets.

Corporate Treasury Financing Series

Introduction: Funding Outlook

During the first half of 2015, an increased volume of public statements from some central banks, notably the US Federal Reserve and the Bank of England, had suggested that investors should start to plan for a potential cycle of tightening rates from late 2015 or early 2016. Even prior to the Chinese stock market turmoil in late summer, all indications had been that, absent unexpected shocks, these initial movements would be gradual. When the Federal Reserve finally implemented its first quarter point rise in the benchmark federal funds rate for nearly a decade, in mid-December last year, it was at pains to point out that it was only expecting "*gradual adjustments in the stance of monetary policy*" and argued that "*economic activity will continue to expand at a moderate pace*".

In light of such tentative positioning from the Federal Reserve, and subsequently released Chinese GDP data showing that 2015 recorded the slowest growth in the Chinese economy for 25 years, expectations remain that it will still be some considerable time before central bank rates revert to anything like their historic means. Continued growth concerns affecting the Eurozone, fears over potential ripple effects from the slowdown in China and record low oil prices point towards a benign interest rate path, both for the affected economies and their trading partners.

While economic indicators over the last couple of years have clearly demonstrated that major economies, especially the US and the UK, have made some progress in recovering from the global financial crisis, the burden of public debt remains stubbornly high, with the

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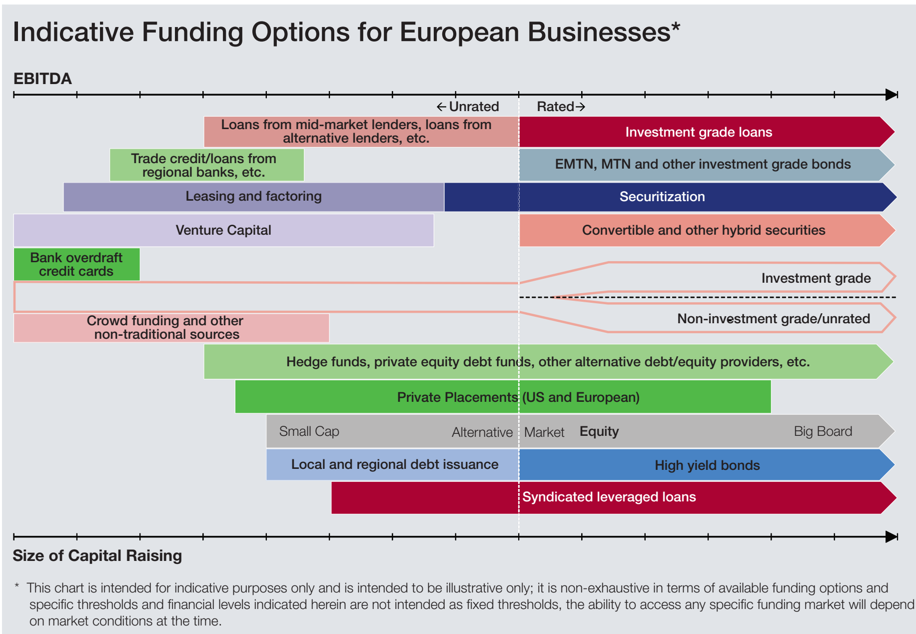

Indicative Funding Options for European Businesses*

* This chart is intended for indicative purposes only and is intended to be illustrative only; it is non-exhaustive in terms of available funding options and specific thresholds and financial levels indicated herein are not intended as fixed thresholds, the ability to access any specific funding market will depend on market conditions at the time.

Eurozone in particular suffering from a difficult combination of high levels of debt and a struggling labour market. The increasingly interconnected nature of the global economy also suggests that a slowing Chinese economy will continue to have a significant impact on its trading partners in developed markets.

The likelihood, therefore, is that even if some of the more accommodating monetary policies of the past five years may not be revisited, low interest rates and low overall borrowing costs may well endure for several more years, although liquidity may be affected. For those borrowing over longer time horizons this may create an attractive opportunity to lock in favourable rates, while for those borrowing over the short to medium term there will be a much greater sensitivity to market timing and small variations in credit spreads.

Stealing a March: Innovative Financing Structures

Against this backdrop, achieving targeted and efficient financing structures is paramount, leading to an increase in the innovation and diversity employed in financing. The deleveraging of the banking sector, in the wake of the financial crisis and the regulatory intervention that followed, has also been a driving factor in encouraging corporate borrowers to turn to other forms of financing. As a result, regardless of current turmoil, many non-traditional sources of debt finance are becoming more commonplace:

- **debt funds, alternative asset managers, insurers and pension funds** have stepped into the financing market alongside traditional lending banks;
- **high yield bonds** are now well established outside traditional US markets as a source of liquidity for mid- and large-cap borrowers;
- **CLO 2.0 issuance** has returned both in Europe and the US; and
- **corporate hybrid issuance** has increased exponentially since 2013, and is increasingly seen as an attractive and flexible financing tool.

We expect to see a continuing development of financing structures and products and the trend of convergence over the last couple of years, where features from one market or product "cross-fertilise" into other types of financing, looks set to continue.

This move towards diversification and innovation extends to all levels of the credit hierarchy, with corporate treasurers facing an ever broader range of choices. Evaluating the options, and selecting the optimum funding mix, will represent a key challenge over the coming months. Critical to making the right choice will be having a broad understanding of the financing tools available, and being able to navigate the complexity of rapidly developing markets.

In this series we intend to take an in-depth look at the full spectrum of different funding options, in order to help corporate borrowers make sense of the ever broadening array of innovative and complex tools at their disposal. We will also provide regular updates on the broader macroeconomic and market trends affecting corporate borrowing, which we hope will prove useful as you consider your financing options.

We would very much welcome your thoughts and feedback on the ideas and products featured in this series.

Michael Dakin
Partner, London
T: +44 207006 2856
E: michael.dakin@cliffordchance.com

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Corporate Treasury Update – January 2016

Macroeconomic Outlook

Early 2016 has been dominated by turmoil in Chinese stock markets and the lowest oil prices in more than a decade, as markets in the US and Europe have also reacted negatively to uncertain macroeconomic factors and fears over corporate earnings. Even political rapprochement between the US and Iran, resulting in an easing of sanctions, has been received equivocally by markets balancing the risks of oversupply in global oil markets against the more positive backdrop of reduced tensions.

In the UK, the Monetary Policy Committee noted in its January policy meeting that economic growth had been weaker than expected, with the deterioration in financial markets likely to reduce inflationary pressures in spite of the positive quarterly employment figures published earlier this month.

Reaction to volatility in other asset classes has led to a gentle softening in government bond yields in the US and the UK, with a slender reduction in Eurozone government yields, although corporate issuers have faced wider credit spreads in the wake of market uncertainty.

Market Update

China	
China Manufacturing Data	Concerns were raised following poor data – the Caixin China Manufacturing PMI index dropped to 48.2 from 48.6, falling further below the 50 level which demarks growth from contraction.
China Instability	PRC equity markets have seen significant volatility, with first market suspensions and then early closures under new safety measures introduced by government. More recently, however, markets have levelled although observers remain concerned over the market outlook, including an extension of the short selling ban.
China Trade Surplus Increases	Notwithstanding the reduced manufacturing output, the PRC trade surplus expanded with a surplus of $60b in December resulting in a full year surplus of $594.5b. The trade surplus helped to offset capital outflows which took pressure off the yuan, leading some to economists to conclude that the economy is stabilising.
Rating Agencies	
S&P Reports Corporate Credit Conditions Weaken	S&P reported that corporate credit have deteriorated at the fastest pace since 2009; it indicated: ■ Average corporate rating fell half a notch from BB+ to BB ■ 3x greater risk of downgrade vs. upgrade (17% of companies on “negative” watch vs. 6% on a “positive” watch, the widest gap since the global financial crisis began) ■ Key areas of risk remain in oil and gas, metals and mining ■ China slowdown and Fed “lift-off” are key issues for investors
Moody’s Reports Defaults and Liquidity Steady, but Creative Financing on Offer	In Moody’s recent European High Yield report, the rating agency noted its key predictions for 2016: ■ Corporate credit ratings to be stable – across both IG and HY ■ Default rates stay near 3% in Europe (c.f. 2015 y/e @ 3.4%) ■ Many European HY credits have sufficient liquidity for 2016 ■ Those seeking liquidity will need to be more creative in financings – e.g. seeking factoring and reverse factoring
Federal Reserve	
US Fed – “lift off”, but not all at once?	Following market upheaval, many market commentators have become more neutral on their view of the next Fed rate hike coming in March and many are now deferring the next expected hike to June. Open Markets Committee meetings: Jan 26/27, Mar 15/16*, Apr 26/27, Jun 14/15*, Jul 26/27, Sept 20/21*, Nov 1/2 and Dec 13/14* (*meeting with Summary of Economic Projections and chair press conference)
Investment Grade	
Debt Capital Markets	Although market uncertainty has acted as a brake on corporate bond issuance in 2016 to date, the record USD 46bn bond issue by AB InBev to fund its acquisition of SAB Miller was a stand-out transaction. Reaction to volatility in other asset classes has also led to a gentle softening in government bond yields in the US and the UK, with a slender reduction in Eurozone government yields notwithstanding destabilising factors, including the imposition of substantial losses on Novo Banco bondholders by the Portuguese Central Bank. Declining government bond yields have been partly offset by increases in credit spreads as investors react to volatile market conditions.

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Investment Grade	
Corporate Hybrids	Corporate hybrids enjoyed an extremely successful 2015, as investor demands for yield continued to support the market. Issuance was more subdued in the later part of the year, on fears over rising rates and short-term uncertainties resulting from S&P's decision to remove equity credit from a number of outstanding hybrids in late autumn (see *Featured Product – Corporate Hybrid Bonds*). It remains to be seen whether receding fears of further rate rises will help renew demand as 2016 develops.
High Yield	
Global High Yield Markets Quiet	Out like a lamb and in like a lamb! with a quiet finish to 2015 and a quiet start to 2016. Each market has had an inaugural issue, pipeline remains reserved, although optimism remains: ■ Asia: PRC's Evergrande Real Estate opened the market by pricing $700 million of high bonds in two tranches. With a slowing Chinese RE market and a wall of refinancing, 2016 will likely see issuers selectively utilise international and domestic markets to refinance and restructure their debt. ■ Europe: Atalian tapped its existing bonds for €125m at 104.75, a premium from the pre-deal price of 107.5. This was the sixth year running that a tap or cross-over credit opened the market ■ US: Deal volume for the first two weeks of 2016 stands at $800m on two transactions, or less than one tenth of dollar volume for the first two weeks of 2015. Energy continues to weigh heavy on the high yield market.
High Yield Funds See Significant Outflows	HY Funds in the US and Europe saw significant outflows to end 2015 as markets adjust to Fed "lift-off": ■ Europe: reported a €404m outflow in December, capping off its longest losing streak of the year, but, notwithstanding the negative trend, recorded a total of €9b of inflows for 2015 (compared to €4.15b and €8.94b in 2014 and 2013, respectively) ■ US: the market ended the year with a $114m outflow to result in a full year outflow of $7.1b, split evenly between mutual funds and exchange traded funds Observers are keenly watching the 2016 funds flow numbers as a barometer of the year to come.
Derivatives	
Clearing of OTC Derivatives	2016 will see the introduction of some key market reforms for OTC derivatives. The mandatory clearing of certain liquid classes of OTC derivatives through clearing houses (also known as central counterparties, or CCPs) is likely to be phased in from summer 2016 for groups which trade significant amounts of OTC derivatives for non-hedging purposes. Corporates should understand the application of the new rules to group pension funds, which may be subject to stricter regulation. If caught, corporates will need to put in place complex clearing arrangements, resulting in increased and daily margin calls.
Equity Financing	
Equity Financing	Against a backdrop of extreme volatility in the equity markets, there is a concern that raising equity capital is becoming more challenging. However, while some transactions are being deferred, others appear to be powering ahead and, as things stand, outlook for the first half of 2016 remains positive. [The demerger and IPO of Clydesdale out of National Australia Bank is scheduled to close in February and is expected to be one of the largest deals in the European market this year.] Elsewhere, EM equity activity remains muted, with Middle East activity an exception as activity remains steady. Corporates using their equity in listed companies as collateral to raise financing at preferential rates.
Equity-Linked Financing	The market for equity-linked bonds performed strongly in 2015, with issuers achieving very cost-effective issuance spreads relative to traditional corporate bonds. Of particular note were so-called "equity-neutral" convertible bonds, which allow issuers to issue cash-settled convertible bonds without taking any risk of having to issue equity in order to fund conversion. The embedded option is hedged through the purchase of call options in the market, which provide the cash settlement amount to be delivered to the converting bondholder.

Economic Data Outlook:	
Federal Open Market Committee meeting	26/27 January
Bank of England MPC meeting	5 February
Bureau of Labour Statistics data published	5 February
Bank of England quarterly inflation report published	12 February
ECB Governing Council Monetary Policy meeting	10 March

Contributors

Marc Benzler, Frankfurt
Gary Brooks, New York
Michael Dakin, London
Paul Deakins, London
Iain Hunter, London
Andrew Kelly, Hong Kong
Christopher Roe, London
Will Winterton, London

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Featured Product – Corporate Hybrid Bonds

Simon Sinclair
Partner, London
T: +44 207006 2977
E: simon.sinclair@cliffordchance.com

Paul Deakins
Senior Associate, London
T: +44 207006 2099
E: paul.deakins@cliffordchance.com

Relevance/Suitability

As their name suggests, corporate hybrid bonds are capital markets instruments that blend a mixture of debt and equity-like characteristics, and form a deeply subordinated layer of debt financing within a company's overall capital structure. These instruments combine favourable tax and accounting treatment with subordination features and deferral mechanisms that can support the credit ratings of debt instruments higher up the capital structure.

Corporate Hybrid Issuer Checklist

- ☑ Rated entity
- ☑ Need to optimise leverage
- ☑ EUR 300-500mn + issue size
- ☑ Long-term funding requirements
- ☑ Ability to deduct interest payments

Pros

1. Support standalone rating
2. Covenant light
3. Possible equity accounting
4. Tax deductible coupon
5. Significant investor demand

Cons

1. High coupon
2. Non-call periods
3. Refinancing risk
4. Vulnerable to rising interest rates

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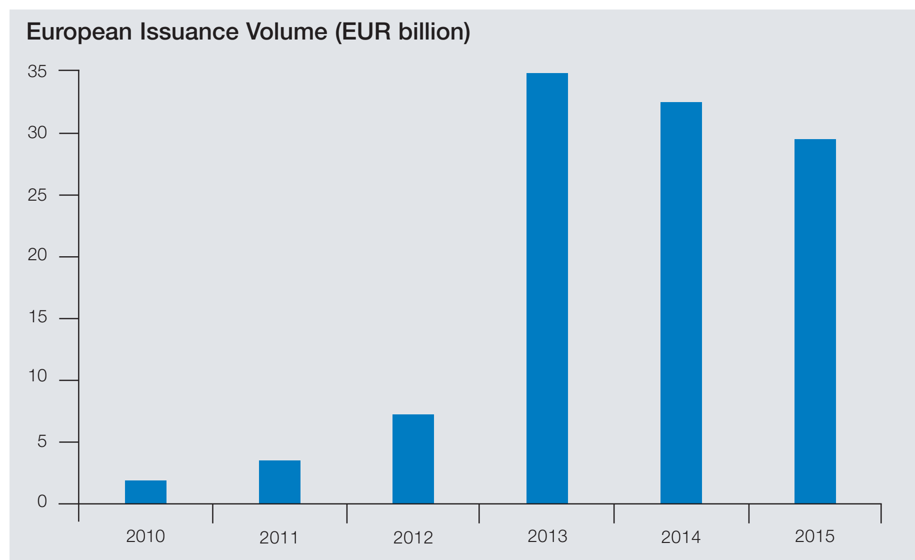
History/Overview



European hybrid issuance has expanded significantly since 2013,[1] with estimated issuance having increased five-fold to EUR 25-30 billion per annum in 2013 and 2014, a trend which has continued during 2015. Issuance has also diversified away from traditional sectoral concentrations around utilities and telecoms, with transport, automotives, media and pharmaceuticals among those benefiting from investor demand for higher-yielding assets.

Historically, corporate hybrid bonds were used as a "defensive" form of financing, providing support for the senior debt rating while maintaining favourable tax treatment and thereby achieving an efficient capital structure. Increasingly, however, corporate hybrids have also been used to finance, or part finance, acquisitions in conjunction with more conventional forms of debt and equity financing, and have proved particularly popular in relatively highly leveraged sectors such as telecoms.

Key Considerations

The hallmark of these instruments is the ability to combine favourable tax and accounting treatment with loss absorbency features that can support the credit ratings of liabilities ranking higher up in the capital structure. They are often structured with perpetual maturities in order to achieve equity accounting treatment under IFRS, while maintaining sufficient "debt-like" characteristics to achieve coupon deductibility under applicable tax regimes.

Their other key benefit is the way that they are treated by rating agencies, usually being recognised as a combination of debt and equity for the purposes of the key financial ratios that support the relevant ratings methodologies. The majority of European corporate hybrids issued to date have been structured to achieve "intermediate" or "Basket C" treatment (based on the S&P's and Moody's scales), which allows them to be treated as 50% debt and 50% equity for these purposes. By improving the debt to equity ratios used by the agencies, these instruments therefore provide support for the long-term unsecured credit rating of an issuer's senior debt.

Key to the structuring of these instruments is balancing the competing requirements of perpetual or long-dated maturities and discretionary coupons on the one hand (in order to satisfy equity accounting requirements and rating agency requirements for permanence and loss-absorbency), with investor demands and tax requirements on the other.

Timing and Logistics

Corporate hybrid securities have the additional advantage of being treated as debt for the purposes of the Prospectus Directive and associated European listing regimes. Transactions can therefore be executed in as little as four to six weeks by well-organised issuers.

Recent Trends

Recent offerings have shown a tendency towards larger deal sizes and dual tranche offerings, with different call dates and different currencies, in order to take advantage of strong investor demand. There has, however, been some uncertainty in the market during the final quarter of 2015, as a result of S&P's decision in late October to remove equity credit from just over USD 23bn in principal amount of outstanding bonds which contained a call feature tied to a loss of investment grade status. Most affected issuers have, however, been able to implement relatively simple amendments to their outstanding hybrids in order to restore the equity treatment.

Conclusion

While these instruments may be vulnerable to pricing pressure once interest rates begin to revert to more normal long-term levels, it would seem that, in the short to medium term, their popularity with investors and issuers is likely to remain strong.

1 *Graph derived from Bloomberg data*

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CLIFFORD
CHANCE

Worldwide contact information
35* offices in 25 countries

Abu Dhabi
Clifford Chance
9th Floor, Al Sila Tower
Abu Dhabi Global Market
Square
PO Box 26492
Abu Dhabi
United Arab Emirates
T +971 2 613 2300
F +971 2 613 2400

Amsterdam
Clifford Chance
Droogbak 1A
1013 GE Amsterdam
PO Box 251
1000 AG Amsterdam
The Netherlands
T +31 20 7119 000
F +31 20 7119 999

Bangkok
Clifford Chance
Sindhorn Building Tower 3
21st Floor
130-132 Wireless Road
Pathumwan
Bangkok 10330
Thailand
T +66 2 401 8800
F +66 2 401 8801

Barcelona
Clifford Chance
Av. Diagonal 682
08034 Barcelona
Spain
T +34 93 344 22 00
F +34 93 344 22 22

Beijing
Clifford Chance
33/F, China World Office
Building 1
No. 1 Jianguomenwai Dajie
Beijing 100004
China
T +86 10 6505 9018
F +86 10 6505 9028

Brussels
Clifford Chance
Avenue Louise 65
Box 2, 1050 Brussels
T +32 2 533 5911
F +32 2 533 5959

Bucharest
Clifford Chance Badea
Excelsior Center
28-30 Academiei Street
12th Floor, Sector 1,
Bucharest, 010016
Romania
T +40 21 66 66 100
F +40 21 66 66 111

Casablanca
Clifford Chance
169 boulevard Hassan 1er
20000 Casablanca
Morroco
T +212 520 132 080
F +212 520 132 079

Doha
Clifford Chance
Suite B
30th floor
Tornado Tower
Al Funduq Street
West Bay
P.O. Box 32110
Doha, Qatar
T +974 4 491 7040
F +974 4 491 7050

Dubai
Clifford Chance
Level 15
Burj Daman
Dubai International Financial
Centre
P.O. Box 9380
Dubai, United Arab Emirates
T +971 4 503 2600
F +971 4 503 2800

Düsseldorf
Clifford Chance
Königsallee 59
40215 Düsseldorf
Germany
T +49 211 43 55-0
F +49 211 43 55-5600

Frankfurt
Clifford Chance
Mainzer Landstraße 46
60325 Frankfurt am Main
Germany
T +49 69 71 99-01
F +49 69 71 99-4000

Hong Kong
Clifford Chance
27th Floor
Jardine House
One Connaught Place
Hong Kong
T +852 2825 8888
F +852 2825 8800

Istanbul
Clifford Chance
Kanyon Ofis Binasi Kat. 10
Büyükdere Cad. No. 185
34394 Levent, Istanbul
Turkey
T +90 212 339 0000
F +90 212 339 0099

Jakarta**
Linda Widyati & Partners
DBS Bank Tower
Ciputra World One 28th Floor
Jl. Prof. Dr. Satrio Kav 3-5
Jakarta 12940
T +62 21 2988 8300
F +62 21 2988 8310

London
Clifford Chance
10 Upper Bank Street
London
E14 5JJ
United Kingdom
T +44 20 7006 1000
F +44 20 7006 5555

Luxembourg
Clifford Chance
10 boulevard G.D. Charlotte
B.P. 1147
L-1011 Luxembourg
T +352 48 50 50 1
F +352 48 13 85

Madrid
Clifford Chance
Paseo de la Castellana 110
28046 Madrid
Spain
T +34 91 590 75 00
F +34 91 590 75 75

Milan
Clifford Chance
Piazzetta M. Bossi, 3
20121 Milan
Italy
T +39 02 806 341
F +39 02 806 34200

Moscow
Clifford Chance
Ul. Gasheka 6
125047 Moscow
Russia
T +7 495 258 5050
F +7 495 258 5051

Munich
Clifford Chance
Theresienstraße 4-6
80333 Munich
Germany
T +49 89 216 32-0
F +49 89 216 32-8600

New York
Clifford Chance
31 West 52nd Street
New York
NY 10019-6131
USA
T +1 212 878 8000
F +1 212 878 8375

Paris
Clifford Chance
1 Rue d'Astorg
CS 60058
75377 Paris Cedex 08
France
T +33 1 44 05 52 52
F +33 1 44 05 52 00

Perth
Clifford Chance
Level 7
190 St Georges Terrace
Perth WA 6000
Australia
T +618 9262 5555
F +618 9262 5522

Prague
Clifford Chance
Jungamannova Plaza
Jungamannova 24
110 00 Prague 1
Czech Republic
T +420 222 555 222
F +420 222 555 000

Riyadh
Clifford Chance
Building 15, The Business
Gate
King Khalid International
Airport Road
Cordoba District, Riyadh, KSA.
P.O.Box: 3515, Riyadh 11481,
Kingdom of Saudi Arabia
T +966 11 481 9700
F +966 11 481 9701

Rome
Clifford Chance
Via Di Villa Sacchetti, 11
00197 Rome
Italy
T +39 06 422 911
F +39 06 422 91200

São Paulo
Clifford Chance
Rua Funchal 418 15ºandar
04551-060 São Paulo-SP
Brazil
T +55 11 3019 6000
F +55 11 3019 6001

Seoul
Clifford Chance
21st Floor, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
T +82 2 6353 8100
F +82 2 6353 8101

Shanghai
Clifford Chance
40th Floor, Bund Centre
222 Yan An East Road
Shanghai 200002
China
T +86 21 2320 7288
F +86 21 2320 7256

Singapore
Clifford Chance
Marina Bay Financial Centre
25th Floor, Tower 3
12 Marina Boulevard
Singapore 018982
T +65 6410 2200
F +65 6410 2288

Sydney
Clifford Chance
Level 16, No. 1 O'Connell
Street
Sydney NSW 2000
Australia
T +612 8922 8000
F +612 8922 8088

Tokyo
Clifford Chance
Akasaka Tameike Tower
7th Floor
2-17-7, Akasaka
Minato-ku
Tokyo 107-0052
Japan
T +81 3 5561 6600
F +81 3 5561 6699

Warsaw
Clifford Chance
Norway House
ul.Lwowska 19
00-660 Warsaw
Poland
T +48 22 627 11 77
F +48 22 627 14 66

Washington, D.C.
Clifford Chance
2001 K Street NW
Washington, DC 20006 – 1001
USA
T +1 202 912 5000
F +1 202 912 6000

*Clifford Chance's offices include a second office in London at 4 Coleman Street, London EC2R 5JJ. **Linda Widyati and Partners in association with Clifford Chance. Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

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