CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE?
A CORPORATE PERSPECTIVE

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Ladies and Gentlemen,

You have been given an outline of capital markets by Rob Douglass. Rob has focused on these markets from the point of view of a manager.

I think it would be of use to examine these markets from a corporate or borrowers' perspective. Let me assure you that the perspective of borrower and manager are not necessarily the same and that on many occasions, we borrowers, put our managers through the hoops to achieve a particular objective. Unfortunately the reverse also applies.

Recent Developments in Approach to Capital Markets

In recent years two important factors have arisen which have resulted in changes to the way in which corporates approach capital markets with particular emphasis on offshore markets.

The first is the securitisation of the market. Historically investors have tended to lend their funds to banks and other financial institutions. These institutions, after evaluating credit risk and adding a suitable profit margin, then on lend to corporate and other borrowers.

This situation has changed. Investors have become more sophisticated and are prepared to do their own credit analysis. If satisfied with the credit, the investor is prepared to buy securities (bonds, notes, debentures etc.) direct from corporates providing the pricing is correct. In doing so the investor by-passes the banking system, and as a consequence, achieves a better return on his investment.

A further factor influencing the investor is that he no longer automatically perceives the banks as being better credits than the corporates. Given the wide range of problems affecting banks today, including the massive level of non-performing loans to South American, Asian and Eastern European countries, and petroleum and agricultural financings in the US and other places, investors often see the corporate as a better risk.

These are the main factors which have caused an incredibly rapid growth in the offshore securities markets. Corporates of the desired credit quality are able to access the securities market at better rates than they could obtain from their banks.

The second major factor influencing a corporate's approach to borrowings is peculiarly Australian. You may recall that in May 1983, the law relating to withholding tax was amended to remove the withholding tax exemption which was available to Australian entities borrowing offshore.

This change in law forced borrowers to examine more closely other exemptions included in the legislation and to rethink their overseas borrowing strategies. It became clear that those borrowers who could access the offshore securities markets in their own name (or with bank support) would be in a position to continue to borrow on a withholding tax free basis.

This could be achieved by the issue of securities on a widely offered basis. As long as the Commissioner of Taxation is satisfied with the breadth of offering of a particular issue of securities, and certain tests regarding the end use of the funds are met, he will allow interest payments to be made on a withholding tax free basis.

Obviously borrowings from banks would not meet a widely offered basis test and quality borrowers were forced to access the overseas capital markets directly. The combination of securitisation and changes in withholding tax laws seems to have resulted in Australia becoming the largest per capita seller of "widely offered" securities in the world markets.

Considerations

When considering borrowing in international capital markets there are two main considerations which the borrower must take into account.

First, despite the development of Euro A$ markets in recent times, the borrower is generally going to be exposed to foreign exchange risks. In theory, the borrower will either repay more or less than the A$ equivalent of what he originally borrowed. Unfortunately he is likely to suffer a loss as the A$ has traditionally weakened against other currencies and is likely to continue to do so.

The borrower needs to take a conscious decision regarding this risk. There are possibly three alternatives. First, he may accept the risk and do nothing. Many government and semi-government authorities have taken this position over the years, generally, to the disadvantage of us taxpayers. Some corporates have also gambled. You will have read that News Corporation reported large foreign exchange losses when they guessed incorrectly a couple of years ago.

Secondly, the borrower may hedge his risk through a number of foreign exchange markets. The end result of such a hedge will be an A$ liability at a cost similar to the equivalent cost of borrowing in Australia. This may still be attractive to the borrower, either because he is able to achieve a lower cost than domestically or because he is not able to borrow domestically in a similar form.

The products available to hedge the liability vary depending upon the maturity from forward sales of currency to long dated currency swaps. A third alternative is that a hedge already exists. It is available to those borrowers fortunate enough to have overseas assets denominated in the same currency as their borrowings. This gives a natural hedge in that any movement in the value of the asset is automatically offset by an opposite movement in the value of the liability.

BHP is in this fortunate position. Approximately 25% of our assets are denominated in $US. This basis makes us very comfortable with $US borrowings and has, in fact, led us in recent years to concentrate entirely on $US. We are further protected by substantial $US revenues. Nearly 50% of all our sales revenues are either denominated in or based on $US. Many Australian borrowers have substantial sales revenues denominated in other currencies and are able to hedge their borrowings against this revenue flow.

The second major consideration for the borrower is whether he wishes to borrow on the basis of fixed interest rates or floating interest rates. Fixed interest rate borrowings have a constant interest rate throughout the life of the loan. It should be noted though that, for a number of reasons, the availability in recent years in Australia of fixed interest loans to corporates has been virtually nil. Interest rates on floating rate loans are set periodically through the life of the loan according to a pre-determined formula. Of importance to the borrower is the fact that floating rates are subject to greater volatility than fixed rates. It was only four or five years ago that $US floating rates were over 20%, whereas today, they are below 7%. In the same time fixed rates have ranged between 8% and 16%.

In considering whether to borrow on a fixed rate basis, a borrower will if possible take into account a number of factors. These will include the absolute level of interest rates and whether it is a rate which he feels comfortable paying for the life of the loan. Borrowers are less likely to borrow at fixed rates at times when interest rates are historically high. It is here that the interaction of the term of the loan and the interest rate become important. When interest rates are historically high, the borrower will tend to finance himself on a shorter term basis with the objective of refinancing at lower rates in the near future.

It is important for the corporate borrower to maintain a prudent balance between floating rate debt and fixed rate debt. Unlike banks, the corporate is unprotected on the asset side and needs to limit his exposure to the volatility of floating rates. We try to keep the mix roughly in balance with a slight leaning towards fixed rates in times of low fixed rates and a slight leaning towards floating rates in times of medium to high fixed rates.

It should be recognised that despite a desire to access a particular market for what are perceived as very good reasons by the borrower, that market may not be receptive to that borrower at that time for any one of many reasons.

However it is now possible to achieve the desired end result despite these problems.

One of the capital markets products which has developed rapidly in recent years is the interest rate swap. Elliott Jones is going to discuss this subject in detail later. Suffice to say that the interest rate swap allows the corporate to change the balance of his debt portfolio without necessarily changing the source of his funding, or in other words to synthetically create his desired form of debt independent of the original source of funds.

Indeed, without any change in liability to lenders, a borrower may substantially change his mix between fixed rate and floating rate exposures to take advantage of changes in the interest rate picture.

BHP Experience

Enough of the factors which a corporate must consider when arranging new finance. Let us look at a small number of facilities which have been arranged by BHP in recent years.

First, as an example of the way things have changed, I will discuss a facility arranged in 1982 with a group of Australian and international banks.

Under this facility the banks have agreed to provide US dollars on request (up to an agreed limit). Borrowings can be repaid and redrawn with appropriate notice. Interest is payable on a floating rate basis. Because the facility was arranged prior to changes in the withholding tax laws, interest payments are made to the banks free of deduction of withholding tax.

We can contrast this with a US$700 million Euronote facility which was arranged in November 1985. In many ways the facilities are similar. The major difference is that funds (in normal circumstances) are obtained by the issue of short-term notes direct to the investors on a widely offered basis (although the facility is underwritten by banks and the funds guaranteed to BHP at certain rates despite problems which may exist in the market).

This difference is an obvious example of the two changes in the market from an Australian point of view. First, the banks are bypassed as a supplier of funds. Cost of funds under the 1985 Euronote facility are significantly lower than the 1982 bank facility as a result. Secondly, the Euronote programme qualifies for a withholding tax exemption.

Both facilities are, however, good examples of methods of borrowing funds for short terms on a floating rate basis. They provide an invaluable source of funds at short notice and give a borrower the capacity to make significant investments without needing to worry about finance at that time. Generally, drawings under these facilities will be replaced with long-term borrowings or internally generated cash so that they become available for further use.

We should also look at a fixed rate US$ borrowing. At the end of 1985, fixed rates in the US$ market were at the lowest levels for some years. More importantly, rates were at a level which we were happy to pay for a medium to long term.

Consequently, we arranged a US$150 million Eurobond issue for a term of seven years at 10% interest.

It was intended that this borrowing would be used to repay short-term borrowings utilised at that time. However, our acquisition splurge of late last year saw the proceeds utilised in the Mt. Newman acquisition.

I have spent some time looking at corporate borrowings; that is borrowings where the lenders have access to all assets of the borrower in the case of default by the borrower.

To wrap up this brief discussion, let's have a look at a project financing made in the capital markets. In this context, I see a project financing as being one where lenders have recourse only to the assets to which the financing relates rather than the total assets of the borrower.

Historically, financings of this kind have been made by banks following detailed evaluation of the credit risk. When the Queensland coal mines of Utah were acquired from GE we intended fully to access banks for the necessary project financing.

However, while preliminary negotiations were under way the withholding tax changes I have mentioned previously were announced. An alternative which provided cost effective withholding tax free funds was required.

Straight access to the capital markets was not feasible. Investors could not be expected to evaluate a project credit. In reality the only group capable of evaluating the credit and taking the risk was the international banks.

This they did. Once they had been satisfied we were able to access a number of markets supported by the banks; that is the banks guaranteed the various issues (for an appropriate fee). The credit risk for the lender became the various banks.

This structure has since become quite common in financing Australian projects. The recent refinancing of Woodside comes to mind.

I have attempted to briefly look at capital markets from a corporate point of view. I hope you will be able to put these non-legal comments into context with the comments of the other members of this panel.