Liability Management – The Basics

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When I work with companies to optimize their capital structure, it is not unusual to find opportunities for efficiency by making adjustments to their stock of existing financings. It can be useful for management to periodically evaluate the terms and conditions of its existing debt as compared to market conditions for new financing. They may not necessarily reflect current market conditions or the company's credit profile, and it may be worth reviewing the possibility of refinancing. This of course must be part of management's ongoing strategic planning, and in particular within the oversight of its capital structure.

The cost of borrowing money is similar to the price of any other good or service, at least conceptually. Banks use complicated models with many variables to determine pricing levels for each borrower. These variables change constantly, which can lead to significant fluctuations over time in theoretical credit margins. Additionally, each lender's funding cost is unique, based on its deposit base as well as its own access to liquidity in the market. Each bank will perform its own credit analysis of the borrower to determine credit margins, and will also consider its appetite to increase or decrease exposure to certain market segments and geographies. All of this can lead to significant differences in pricing among lenders. Often, there is some room for negotiation, given competitive forces and cross-selling opportunities for the lender, as well as management's negotiating ability.

Therefore, opportunities to achieve lower financing costs can originate from movements in global markets. Management has no control over the movements themselves, but can formulate strategies to access the market at the right time and with the most efficient transaction in terms of design and structure. Other opportunities can derive from improvements in the borrower's credit quality, capital structure optimization or exercising tighter management of banking relationships.

On the other hand, pricing is not the only driver of liability management. It is not uncommon to see companies raise money in anticipation of future needs, such as entities looking to grow inorganically. Management can be in a better negotiating position for an acquisition when its treasury is cash-rich or transaction-related financing is already in place. Another recurrent driver is the desire to change the credit structure of previous transactions, for instance modifying security packages or covenants, which may have been determined at a different stage in the company's development. It is also common for companies with certain characteristics to substitute bank financing with bond placements, which can offer advantages in terms of pricing, tenor and freeing up credit lines, but at the same time subtracting some of the flexibility that comes with bank borrowings.

While liability management transactions can significantly improve overall conditions for the borrower, upfront transactions costs should be considered. These can be relevant, especially when replacing funding from one market with another. Banks usually collect fees for new financings as well as for modifications, and there may be legal and other expenses involved in the transaction.

Under certain circumstances, it is possible to modify existing financings as opposed to replacing them with new ones. Modifications can be made with respect to tenor, structure, security and even pricing. Usually, the modified loan will reflect terms and conditions similar to a new financing, but approvals and documentation are quicker to execute and transaction costs are lower given that the parties already have a long-standing credit relationship. Bankers are often willing to improve credit conditions when warranted, principally due to potential substitution by another lender. However, any modifications to credit conditions must consider the overall relationship between borrower and lender, since other loans and services can be affected, and so the conversation can be delicate.

Conditions for new financings will never match exactly those of previous transactions, given the enormous number of constantly moving elements that influence negotiations between companies and their lenders. Proactively monitoring the market and benchmarking existing liabilities against available funding alternatives in search of opportunities to refinance is part of management's ongoing responsibility to optimize its capital structure.

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