

Corporate Treasury Management

Foreign Exchange and Interest Rate Risk Report of BG Group

Executive Summary

- Identification of major foreign exchange and interest rate risk affecting BG Group reveals that the Group is exposed to translation and transaction risk to the US dollar. Economic risk relating to the US dollar also poses a threat to the company. Interest rate risk is containable.
- BG Group utilises forward contracts, interest rate swaps, cross-currency interest rate swaps, forward rate agreements and currency swaps. Internal hedging methods include matching receivables and payable, centralised treasury function and switching of currency base.
- Transaction and economic risk are identified as major threats to the Group. Interest rate risk should not be hedge due to currency economic landscape. Only big single transaction items are to be hedged.
- Financial and non-financial information to be included in the ratings book to acquire good credit ratings from independent credit rating agencies

Working Paper



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1. Executive Summary

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2. Identify and Rank Foreign Exchange and Interest Rate Risk

2.1 Translation Exposure to the US Dollar¹

BG Group deals mainly in oil and gas of which natural gas constitutes 71% of the Group's business (BG Group, Annual Report, 2008). BG group has an exposure to the US Dollar mainly because the trading in the international markets of oil and gas are mainly in US Dollar while the Group reports its earnings in British pound Sterling. Justification of this translation risk can be seen in 2008 when EPS grew 74% compared with 2007 due to exceptionally high commodity prices which BG Group receives as revenues in US dollars. At constant US\$/UK£ exchange rates and commodity prices, EPS only grew 28%.

Furthermore, BG Group's annual report 2008 shows that a significant majority of the Group's business activities are conducted in US dollars and that the Group is holding substantial US Dollar-denominated assets that are subjected to translation risk. BG Group's 2009 estimates shows that a 10 cent strengthening (or weakening) in the US Dollar against the pound Sterling would increase (or decrease) operating profit by approximately £250 to 300 million.

¹ Please refer to Appendix 1: Table 1 & Figure 2

Also to be noted are the huge capital investments in the Americas amounting to £3,243m. Should these investments be denominated in currencies other than the Pound sterling, there is a high probability that translation exposure would be present when the Group consolidates its financial statement at the end of the financial period. Effects of translation risk are normally seen in the income statement and balance sheet.

2.2 Basic Transaction Exposure to the US Dollar²

BG Group's main revenues and costs are denominated in US Dollars. However, due to the different locations in which the company operates, BG Group may incur costs in different currencies other than the US Dollars. This may cost a mismatch between the revenues earned and the cost incurred during business operations. The annual report shows that the Group operates in mainly nine core countries, namely, Australia, Brazil, Egypt, India, Kazakhstan, Trinidad and Tobago, Tunisia, the UK and the USA.

Due to the large scale of operations in Brazil and Australia, the Group is also heavily exposed to cost incurred in Brazilian Real and Australian Dollars. The presence of long-term gas contracts are a prime example of transaction exposure to the US Dollar. If the Group locks in the price of gas in US dollars for a contract expiring 1 year later, any fluctuations in interest rates of the Brazilian real (cost of production) would mean that there would be a danger of the Brazilian Real strengthening against the US Dollar and squeezing the Group's profit margin.

Other causes of transaction risk to the US Dollar include long-term gas contracts that must be honoured at future dates. Although being able to lock-in a certain amount of profits by using long-term gas contracts, there is an opportunity costs involved as prices of the commodities or the value of the US Dollar may increase. An example of this would be Kashima, a Japanese oil refinery that imports crude oil, refines it, and sells the refined oil in the Japanese market (Bekaert & Hodrick, 2009).

2.3 Economic Exposure (other currencies against the US dollar)³

Economic exposure to BG Group is also substantial due to the location of the Group's operations. With 37% of the Group's employees based in the Americas and a further 36% based in Africa, the Middle East and Asia, we can assume that these geographical areas hold

² Please refer to Appendix 1: Table 1 & Figure 9

³ Please refer to Appendix 1: Table 1

the main portion of the Group's costs. BG Group would have to pay employees in their respective domestic currencies while receiving US Dollars in return for its revenue.

Organisations like Gazprom and Royal Dutch Shell on the other hand, operate in different geographical regions compared to BG Group. This means that the costs of operations of Gazprom for example, are mainly denominated in the Russian ruble instead of in BG Group's Brazilian real. The mismatch between the two currencies would mean that if the Russia ruble depreciates against the US Dollar while the Brazilian real appreciates against the US Dollar, Gazprom would gain a cost advantage as its operating cost would have gone down relative to BG Group.

This gives Gazprom room to manoeuvre in terms of profitability and volume of sales. Should Gazprom seek to gain higher sales, it can lower its US Dollar price to gain a cost advantage of BG Group. On the other hand, if Gazprom wants to increase profitability, it can maintain its US Dollar price and sell oil and gas knowing that its cost is decreasing due to the weakening Russian ruble. Either way, Gazprom would be able to benefit should there be a long-term depreciation of the Russian ruble against the US Dollar.

2.4 Interest Rate Exposure to Floating Interest Rates⁴

The Group's gearing ratio and debt to equity ratio is around 7% and this clearly shows that the Group is exposed to interest rate risk. Net borrowings which is the net off figure of cash and cash equivalents with finance leases, currency and interest rate derivative financial instruments and short-term and long-term borrowings is £972m. Long-term borrowings are £1,897m compared to short-term borrowing which is only £ 281m.

A further look into the annual report reveals that the US Dollar is the main currency in which the company's borrowing is comprised of. Borrowings in Sterling were £528m compared to £1,151m of borrowings in US Dollar. There were also borrowings in Brazilian reais of £397m. The total amount of financial assets excluding short-term debtors in floating US Dollars was £1,074m compared to financial assets in Sterling that amounted to £212m.

Besides that, the Group's annual reports also show that the group is exposed to refinancing risk as some of the interest bearing assets and liabilities are maturing in one to five years time. This may negatively affect BG Group because the current credit crunch may result in financial institutions only lending for a higher amount of interest rates.

Please refer to the risk map in Appendix 2

⁴ Please refer to Appendix 1: Table 2, 3 & 5

3. Evaluation of Hedging Techniques

The three risks that will greatly affect the performance of BG Group include 1) transaction risk to US Dollars from long-term contracts, 2) economic risk relating to US Dollars and 3) interest rate risk on floating foreign denominated borrowings.

3.1 Internal Hedging Techniques

3.1.1 Matching receivables and payable

The matching of receipts and payments in the same currency would allow the Group to insulate itself from foreign exchange risk. This is because the fluctuations in the value of currencies would not have an impact on the Group because receivables are used to pay receivables in the same currency.

For example, BG Group's operation in Malaysia would be insulated should the company match the cost of operations in Malaysian ringgits by paying them with Malaysian ringgit gained from selling their products in Malaysia. Fluctuations in other currencies, for example, the US Dollar, would be inconsequential because the company would not have to pay operating cost in Malaysian ringgit with US dollars.

However, the matching of payables and receivables are only able to succeed to a certain degree. This is because BG Group has operations in more than one country. The Group would have to borrow in US dollars in order to match revenues US dollars. This would explain why the borrowing of the group in floating rate US dollar debts is relatively high. To provide better insulation towards risk in other countries, the Group can try to obtain revenue in domestic currencies to pay operating cost in foreign countries, for example, revenues and payables in Brazilian reais. This technique ignores economic risk.

3.1.2 Centralised and decentralised treasury function

BG Group with its centralised treasury function is able to utilise multilateral netting to as a form of internal hedging against foreign exchange exposures. Multilateral netting is commonly found in enterprise-wide risk management (EWRM) where subsidiaries of the parent company would report the forecasted receipts and payments in foreign currencies and the estimated current exposures to these foreign currencies.

The central treasury would then calculate the net exposure of the company towards each currency after taking into account internal hedging and use external hedging to hedge

residual exposures. This technique is applicable to BG Group because 1) the group is a large multinational corporation, and 2) the Group has operations and exposures in nine core countries.

However, multilateral netting requires the Group's subsidiaries to have a standardised budget reporting periods and also a clear understanding of taxations and exchange controls in respective countries. Besides that, it is also important that the savings gained through the implementation of the EWRM information system is enough to offset the cost involved in setting it up.

The advantages of EWRM includes being able to reduce the cost of capital by managing the volatility of earnings. This is done through external hedging of dangerous exposures towards foreign exchange and interest rate risk. Besides that, ERM also helps organisations to exploit natural hedges (through internal hedging) and maximise the portfolio effect as stated in the capital asset pricing model.

3.1.3 Switching of base currency

Switching of base currency is a long-term strategy that involves changing the key operations of a company to another location. This hedging technique involves high cost as the company would have to inject huge sums of capital investment into new geographical regions. However, this technique is perhaps the only way to effectively manage economic risk.

According to Alan Shapiro (2005), Toyota had to change its cost base by shifting its manufacturing operations to the United States due to the rising value of the Japanese yen against the US dollar. This was done to ensure that other manufacturers that were located in other countries would not obtain a cost advantage against Japanese manufacturers in the United States.

BG Group has implemented this strategy through the proliferation of their operations in Australia, Brazil and the United States. By having operations in these geographical regions, the Group can ensure that competitors operating in the same region would not gain a cost advantage due to long-run changes in exchange rates.

3.2 External Hedging

3.2.1 Forward exchange contracts⁵

The annual report of BG Group indicates that the Group uses forward exchange contracts to hedge foreign exchange risk. This is done by locking in the exchange rates on spot for delivery in the future. By doing so, the Group would be insulated from any fluctuations in the foreign exchange markets from the time the contract is signed until the time the material products are delivered. This technique is effective in managing transaction risk exposures to foreign currencies.

For example, if the Group has a US\$ 1m worth of exposures due to a contract to supply gas to the United States and seeks to hedge this risk, the Group can go into a forward contract to lock in the exchange rates of the US dollar versus the Pound sterling. The group can sell a forward contract at the current date to a bank stating for delivery at a future date. By doing this, the amount of that the bank owes you would be determine today.

Another way that would be appropriate in managing transaction exposure is to use a futures contract instead of a forward contract. According to Bekaert and Hodrick (2009), futures are different than forwards in the sense that they are exchange traded, standardised, fixed maturities, lower in credit risk and contains margins to be adhered to. However, futures do not contain the flexibility to tailor the amounts and maturities of the contract.

Since BG Group is involved in the wholesale of natural gas, it is assumed that their customers are normally large distribution companies with a good credit rating. Should this be true, forward contracts are more practical since the Group is able to tailor the requirements of their contracts and lock in future profit margins at the current date. (See table)

3.2.2 Currency swaps⁶

According to Bekaert and Hodrick (2009), one of the first currency swaps occurred in 1981 when the World Bank and IBM decided the use it to manage the composition of their foreign exchange debts. The World Bank had a significant outstanding debt denominated in US dollars, Deutsche marks and Swiss Francs. IBM on the other hand, had debts denominated in Deutsche marks and Swiss francs. Both the World Bank and IBM entered into a currency swap because, the World Bank wanted to balance its US dollar debts with its

⁵ Please refer to Appendix 3: Table 7 & 9

⁶ Please refer to Appendix 3 Table 8

debts in Deutsche marks and Swiss francs, while IBM wanted Deutsche marks and Swiss francs for fear of the dollar depreciating.

Currency swaps allows BG Group to change the currency of denomination of its debts and thus help in managing the composition of debts in a particular set of currencies. This allows BG Group to manage its exposure to transaction as well as translation risk. Currency swaps have a low credit risk and is a relatively cheaper way to manage foreign exchange risk. The downside of a currency swap is that they cannot be terminated in the sense that BG Group must pay the promised amount to the other party of the swap contract.

Problems may arise if BG Group expects a receivable in US dollars from a third party to fulfil its swap obligation but then realises that the counterparty defaulted. This would result in the Group having to go to the spot market to obtain US dollars at spot exchange rates and would defeat the purpose of hedging using a currency swap.

3.2.3 Interest rate swaps/Cross-currency interest rate swaps

Interest rate swaps enables the Group to manage the composition of the maturity of its debt profile. Many companies have revenues that are high during booms and low during recessions. If a corporation borrows at fixed interest rates during boom times, this would increase the likelihood of default should a recession occur as low revenues would be matched with high interest payments.

Some companies would then resort to borrowing short-term so to match revenues with floating interest rate payments. However, the danger of borrowing short-term loans is that lenders may refuse to renew loan agreements at the maturity of existing loan facilities. BG Group can utilise interest rate swaps to change the maturity of its debt profile by swapping either fixed interest rate loans with floating interest rate loans or vice versa.

Interest rate swaps can also be used to manage foreign exchange risk. Cross currency interest rate swaps can be use to swap foreign exchange interest rate payments to hedge against foreign exchange risk. BG Group uses foreign exchange swaps to change the composition of its debt denominated in foreign currencies. This is done by swapping the interest and principal amount of a debt for example, in Brazilian reais into a debt in US dollars. By doing so, the Group can match its revenue in US dollars with its operating cost that is now also in US dollars.

3.2.4 Forward rate agreements

Forward rate agreements are similar to forward currency contracts in the sense that they lock the future level of interest rates. Any movements in interest rates in the future would then result in one party having to pay cash compensation to the other party of the forward rate agreement. The advantages of a forward rate agreement is that it can create certainty as specific interest rates in are locked in on spot. Furthermore, forward exchange rates are tailored according to the needs of the company as they are not standardised.

However, forward rate agreements will result in the company losing any chance of being able to benefit from favourable movements in interest rate movements. Besides that, forward rate agreements are not traded on exchanges and therefore contain more risk of a counterparty defaulting. As with forwards, a counterparty that defaults in a forward rate agreement would probably cause the Group to suffer a huge loss on the contract.

4. Hedging Decisions

4.1 Hedging Philosophies and Industry Analysis

The three hedging philosophies are 1) **to hedge nothing**, 2) **to hedge everything** and 3) **to hedge selectively**. BG Group should hedge selectively by hedging only large contracts that have the potential to cause huge losses. The rationale is that BG Group with its operations in many different geographical regions is able to lower its risk by internal hedging. Besides that, it would be counterproductive to hedge everything as this would incur a high cost to the Group. Hedging selectively is extremely important for BG Group should it seek to purchase costly heavy equipment in other countries. These transactions are large one off transactions which make them exceedingly risky.

It is likely that the oil and gas industry would remain highly volatile in the coming years. Oil prices has been an unstoppable juggernaut since the early days of 2002 (back then, oil prices was merely at the US\$20 level). Since the emerging economies of China and India took off, the price of oil has spiraled up to almost an alarming 600% and reaching a record high of US\$147.27 on July 11 (Tee Lin Say, 2008) before subsiding. Volatile oil and gas prices call for more vigilance in hedging activities. The goal of the group is try and lock in low cost and high gas prices to ensure profit margins are high.

The US dollar on the other hand has been very volatile after the implosion of the sub-prime mortgage crisis in 2007. The US dollar has a very close correlation to oil and gas prices

because both commodities are traded in US dollars in the international commodities market. The US dollar normally has an inverse relationship with oil and gas prices because if the US dollar falls, oil and gas producers would try to raise their pump prices to maintain their purchasing power. Evidence of this can be seen when oil and gas prices increase due to the weakness in the US dollar on 15 June 2009 (Financial Times).

4.2 Hedging Transaction Exposures to the US dollar⁷

Modigliani and Miller (1958) argued that hedging is irrelevant unless hedging activities can lower a company's taxes, affect its investment decisions or can be done cheaper than the original transaction that was hedge. Furthermore, hedging will not change the investor's perception of the firm's systematic risk and hence will not have an impact on the company's risk profile and the compensation needed when raising capital.

The duo also argued that individual investors can also hedge and change the composition of their portfolios themselves regardless of the firm's hedging preferences. Since some of these investors are holding shares in the company for specific exposures, a firm's hedging activities would actually damage the individual investor's portfolio of assets. Although individual investors may not be able to hedge as effectively as bigger corporations, large mutual fund investment companies would not have an issue in commanding the same terms as big corporations.

The second popular argument against hedging is that hedging is costly and would not be in the interest of shareholders. The argument is that selling a currency for example, at a forward discount would not be good for the company since spot rates are actually higher. This argument is not correct because the forward discount takes into account the differences in interest rates that must be discounted in order to obtain the forward value. A more accurate cost of hedging would be the bid-ask spread causes the cost of forward hedging to increase with the maturity of the contract.

Another popular theory against hedging is the capital asset pricing model (CAPM). The CAPM states that the returns on a financial asset increase with risk and if a company holds a fully diversified portfolio of financial assets, the only exposure left would be systematic risk. Hedging foreign exchange risk which is considered as systematic risk would not be possible as the cost of hedging would outweigh the benefits of hedging while hedging

⁷ Please refer to Appendix 3: Table 10

unsystematic foreign exchange risk is unnecessary if the company has a diversified portfolio of assets.

The zero sum theory supports the conclusion above by stating that in the long-run, all unhedged foreign exchange gains will net out and hence if a company has an infinite life expectancy, hedging is unnecessary. Furthermore, some companies have only a small portion of their operations overseas hence would feel that hedging foreign exchange risk would not be beneficial to their company.

Base on the arguments above, BG Group should hedge selectively contracts or transactions in the US dollar that is considered to be large and one off. This is because the Group has large scale operations in Australia, Brazil, Egypt, Kazakhstan and the United Kingdom that represents exposures to foreign exchange currencies other than the US dollar. The Group reduces this exposure with an internal hedging strategy by borrowing or swapping foreign denominated debts into US dollars.

This is primarily the main reason why the Group should not hedge its exposure to US denominated debt as this exposure is already a hedge against the mismatch of revenues in US dollars against cost that are in other currencies. However, there are certain benefits to hedging that need to be considered. According to Bekaert and Hodrick (2009), hedging can increase the value of a firm by reducing its expected future income taxes.

Clifford Smith and René Stulz (1985) also argued that hedging can increase the value of a firm by reducing the expected costs of financial distress. The cost of financial distress is losses in the value of a firm because of the likelihood of a bankruptcy in the future. Hedging reduces the probability of financial distress because it seeks to make earnings less volatile in the long-run. A model by Froot, Scharfstein and Stein (1993) also stated that less volatile earnings enable companies to better exercise investment opportunities and growth options.

4.3 Hedging Economic Exposure relating to the US dollar⁸

Among all the foreign exchange risk, economic risk is the hardest to identify and also the hardest to hedge. Identifying economic risk requires analysts to make a long-term forecast of exchange rate movements while taking into account relative inflation rates. Identifying economic risk also involves knowing the cost base of competitors and also any hedging done

⁸ Please refer to Appendix 3: Table 10

by competitors. There are namely two theories concerning whether to hedge economic exposure.

The theory is the purchasing power parity that states that the exchange rates between two currencies will adjust to reflect changes in the price levels of the two countries (Frederic Mishkin, 2007). If the purchasing power parity holds perfectly in the short-run, it would mean that there is no foreign exchange exposure as price levels would adjust to cancel them out. Even with time lags, price levels would adjust accordingly in the long-run to offset any movements in exchange rates.

However, according to Frederic Mishkin (2007), the purchasing power parity assumes that two countries are producing identical goods, low transportation cost and trade barriers and no restrictions in the flow of capital. This is usually not the case in reality as there are restrictions to the international flow of funds by capital controls and trade barriers. Frederic Mishkin (2005) continues by saying that the purchasing power parity theory is a poor predictor in the short-run.

The second theory concerning economic exposure is the market efficiency theory. According to Frederic Mishkin (2005), current prices in a financial market will be set so that the optimal forecast of a security's return using all available information equals the security's equilibrium return. In other words, in an efficient market, a security's price would fully reflect all available information. Since gains and losses in the long-run would average out, the market efficiency theory implies that there is nothing to be gained from hedging. This is a serious over-generalisation by assuming that if markets are frequently efficient, they are always efficient.

BG Group faces threats from economic exposure but has managed to lessen the impacts through the diversification of markets and countries of manufacture. Furthermore, the Group uses cross-currency interest rate swaps to match US dollar revenues with US dollar costs. Furthermore, long-term gas contracts would also ensure that the Group is able to lock in profit margins for a longer term with hopes that foreign exchange movements would move according to the purchasing power parity condition.

4.4 Hedging Recommendations

BG Group should not hedge its main interest rate exposure to US dollar borrowings. Although the Group uses cross-currency interest rate swaps, this is done to change the

composition of the Group's borrowings in foreign denominated debt. It would be counter-productive to hedge interest rate risk again after the Group has already done so for foreign exchange risk exposures.

Furthermore, due to the inverse relationship between the US dollar and gas prices, if the US dollar depreciates and the interest rates on US debt increases because of the Fisher effect (Frederic Mishkin, 2007), this would mean that BG Group can increase gas prices to offset any loss in purchasing power. To add to this, economic data shows that although the Central Bank's base lending rates are low (in the US and the UK), the credit crunch has caused banks to cease lending activities.

A credit crunch would most likely mean that banks are unwilling to lend to corporations unless at a high interest rate. Should BG Group lock in interest rates now, the Group would not be able to take advantage of favourable interest rate movements in the near future. Economic activity is likely to rebound within either this year or next year. Oil and gas prices may rise while interest rates for corporations may decrease as credit situation ease.

5. Credit ratings

It is important for BG Group to obtain high credit ratings in order to lower its cost of capital. Bonds with default risk always have a positive risk premium, and an increase in its default risk will raise the risk premium (Frederic Mishkin, 2007). However, if BG Group is able to obtain a higher credit rating for its bonds, this would mean that BG Group will need to pay a lower risk premium. Furthermore, credit ratings from big credit rating agencies like Moody's and Standard and Poor's are recognised internationally. This would mean that good credit ratings would decrease the cost of debt internationally on foreign denominated borrowings.

5.1 Ratings Book (Information Required, please refer to Appendix: 6)

5.1.1 Financial Information

BG Group should ensure that its yearly annual report is in line with the reporting and disclosure requirements of international accounting standards. This includes information with high accounting and earnings quality. This can be done by being conservative in recording profits and stating of cost. Revenue should only be recognised when received while costs are

acknowledged when they are known with certainty. Conservative earning policies with good earnings quality are likely to obtain a higher rating.

Methods in which consolidation of balance sheet and income statement should also be clearly stated so as to provide rating agencies with a better understanding of how translation risk would impact the company. Assets like property, goodwill and intangible items should be either undervalued or recorded with a fair value. Depreciation and taxation methods should also be noted down and discontinued operations should be clearly defined. This is to foster transparency and avoid making the financial statements misleading.

Off-balance sheet activities must be clearly noted down and explanations of derivatives should be explained in the footnotes. The capital structure of the company should also be clearly reported and gearing ratios clearly shown in the rating book. Other information includes information concerning the liquidity of assets like government and corporate bonds. The ability to generate cash must also be stressed in the cash flow statement.

BG Group should also include a sensitivity and volatility analysis in the rating book. This is to bring to light BG Group's exposure to interest rate and foreign exchange movements. Hedging activities should also be included and their effects taken into account. Relationships between energy prices and the US dollar must also be stated clearly so as to foster understanding in the industry.

The main aim at providing financial information is to prove to creditors that BG Group is able to remain a profitable business and service its debt. Hence, the company's track record of earnings growth and also business performance is important. Sustainable earning power should also be included so as to give credit rating agencies the assurance that BG Group would be able to service its debt obligations.

5.1.2 Non-financial Information

Non-financial information is equally important as credit rating agencies would consider them crucial in examining the sustainability of business activities. Industry risk is one of the main factors to consider. In the case of BG Group, natural gas and oil are necessities that must be utilised in every country. This means that BG Group is able to transfer any increase of cost to consumers and thus has a low price elasticity of demand.

Oil and gas companies also enjoy high barriers to entry due to the high initial outlay needed to purchase expertise and equipment. In terms of market position, there are not many players in the industry and therefore the rivalry in industry is deemed to be low. Geographical regions in which the company operate would also be of interest to credit rating agencies to assess the Group's foreign exchange exposures. Capital investments and also major R&D outlays would also be relevant in a ratings book to show the future direction of the company.

Another important aspect of the company is to state its ownership and shareholder information. To be precise, the structure of ownership and the stakeholders are important items to be included. Notes concerning the management of the company like the Group's corporate goals and outlook, attitudes to risk, experience and background should also be included. Another important item is the performance of the company as compared to peers and competitors in the industry.

The level of protectionism in each country should also be taken into account. Operations in countries like Russia are particularly risky because of their poor historical records. International competition from other corporations should also be included. In the case of BG Group, Gazprom, British Petroleum and Royal Dutch Shell would be its main competitors.

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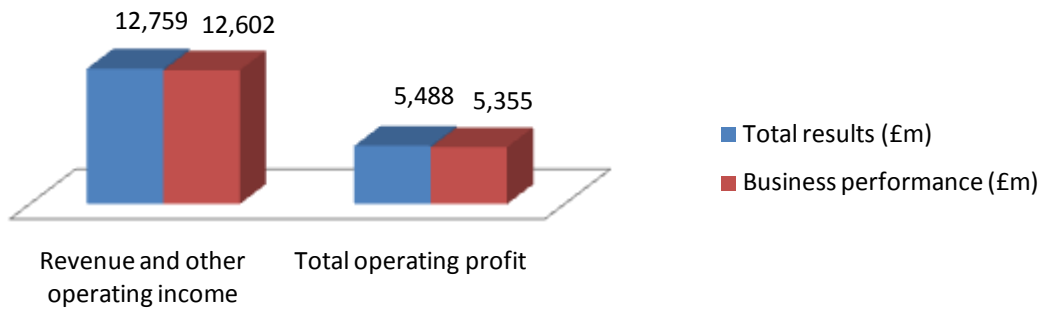
Appendix 1: Company Data

Table 1: Key Highlights

Points	Details	
BG Group	<ul style="list-style-type: none"> • Has a highly cash-generative business • Low level of gearing • Committed lines of credit • Natural gas accounts for 71% of the group's production 	
Natural gas	<ul style="list-style-type: none"> • More important to BG Group's earnings than oil • Gas prices have an explicit linkage to oil prices because of inter-fuel competition • UK saw gas prices increase (prices in US was in decline) • Gas prices decline less severe than oil • It is likely that energy prices will continue to grow 	
US dollar	<ul style="list-style-type: none"> • Dominates the revenues and costs of BG Group's business • Accounts reported in pound Sterling 	
Core operations	<ol style="list-style-type: none"> 1. Australia 2. Brazil 3. Egypt 4. India 5. Kazakhstan 	<ol style="list-style-type: none"> 6. Trinidad and Tobago 7. Tunisia 8. United Kingdom 9. United States
Commodity prices	<ul style="list-style-type: none"> • A US\$ 1.00 rise (or fall) in the Brent oil price would increase (or decrease) operating profit in the Group's E&P business in 2009 by around £55 million • Hedging methods include long-term gas contracts, sharing of price risk with gas suppliers, futures contract, forward based contracts and swap contracts • The Group only hedges certain (mostly none) gas and oil revenues 	
Foreign exchange risk	<ul style="list-style-type: none"> • Exposure to translation risk because income statement and balance sheet are reported in pound Sterling but majority of business activities are in US dollars • On consolidation, assets and liabilities denominated in foreign currencies are translated into pound Sterling at closing rates of exchange • Trading results of overseas subsidiary undertakings, jointly controlled entities and associates are translated into pound Sterling at average rates of exchange • Holds substantial US dollar denominated assets • A 10 cent strengthening (or weakening) in the US Dollar against the pound Sterling would increase (or decrease) operating profit by approximately £250 to 300 million • The Group borrows in or swaps majority of its borrowings into US dollars • The Group does not hedge US denominated transactions (only specific transactions) • Other exposures included the Brazilian real and the Australian dollar 	
Interest rate risk	<ul style="list-style-type: none"> • Financing costs may be significantly affected by interest rate volatility • Group's interest rate management policy requires that borrowings are substantially in floating rate • The Group limits the amount of borrowings that mature within any specific period 	
Financial instruments	<ul style="list-style-type: none"> • Interest rate derivatives to manage composition of fixed and floating rate debt • Currency derivatives to hedge certain foreign currency cash flows and to adjust the currency composition of its assets and liabilities • Treasury operations include the use of interest rate swaps, foreign currency swaps, cross currency interest rate swaps, forward rate agreements and forward exchange contracts 	
Competitors	<ul style="list-style-type: none"> • Many new countries are looking to develop LNG import capacity, including, Canada, Chile, the Netherlands, Singapore and Thailand 	

Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

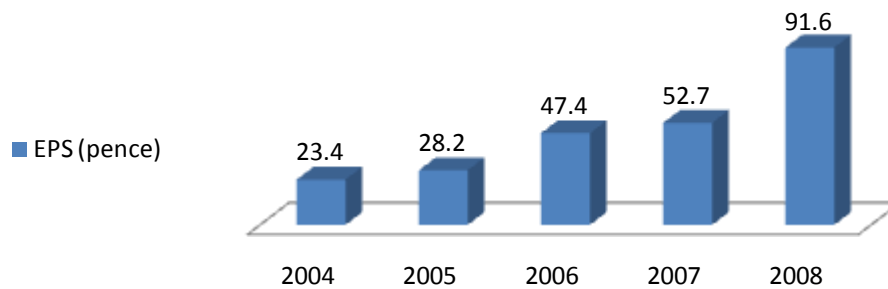
Figure 1: Performance Highlights



Business performance excludes disposals, certain re-measurements and impairments as exclusion of these items provides readers with a clear and consistent presentation for underlying operating performance.

Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

Figure 2: EPS (pence)

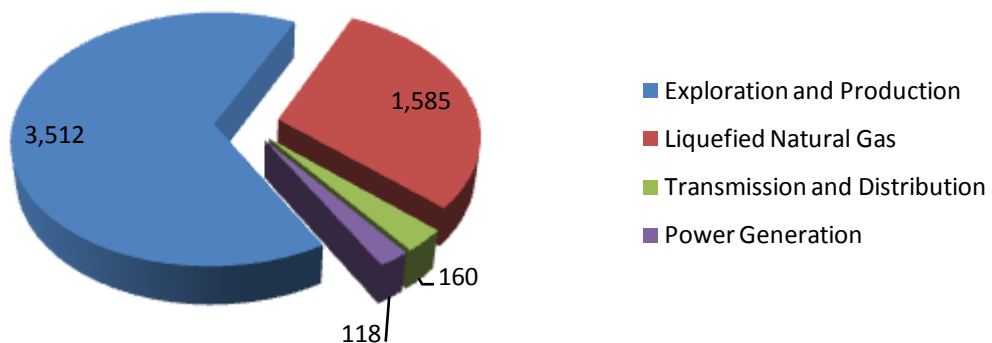


In 2008, EPS grew by 74% compared with 2007. This performance reflected strong growth including outstanding results from the LNG business and the contribution of exceptionally high commodity prices during the year.

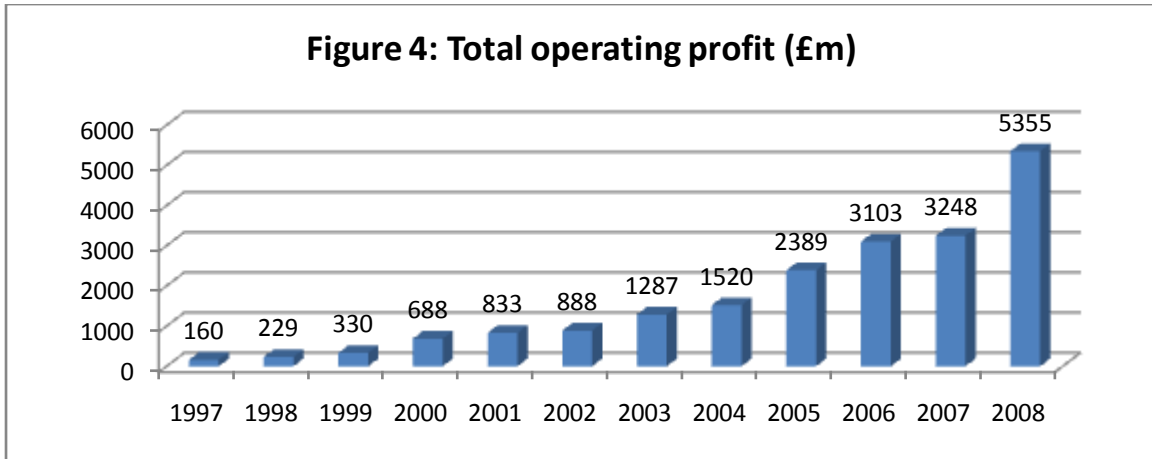
At constant US\$/UK£ exchange rates and E&P commodity prices, EPS grew by 28%

Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

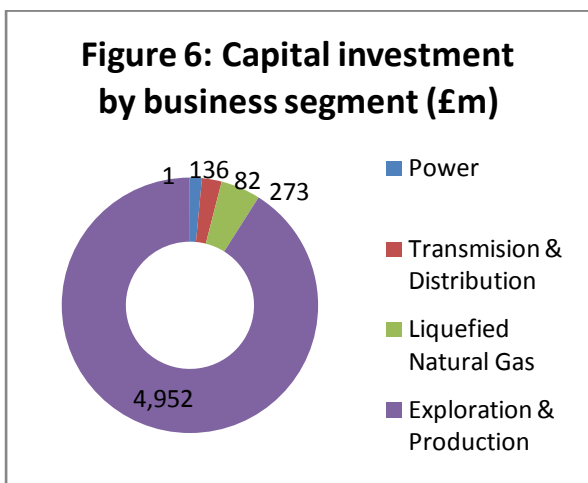
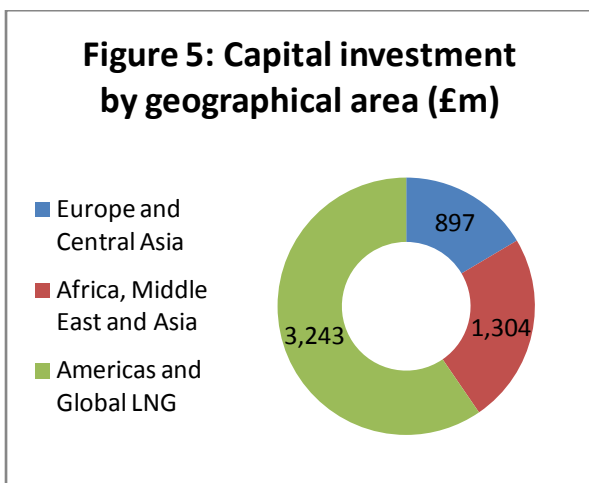
Figure 3: Business Operations (£m)



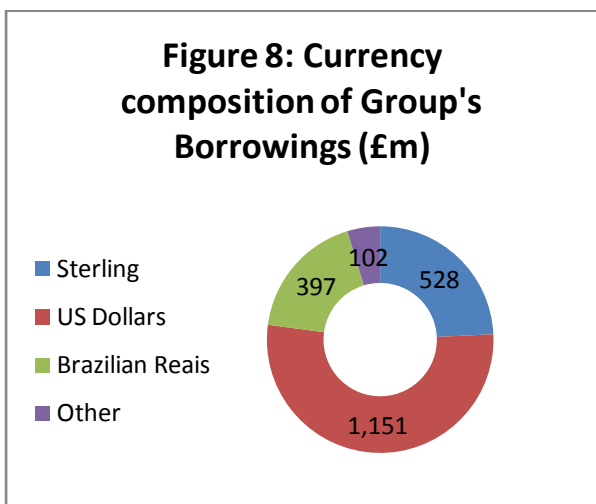
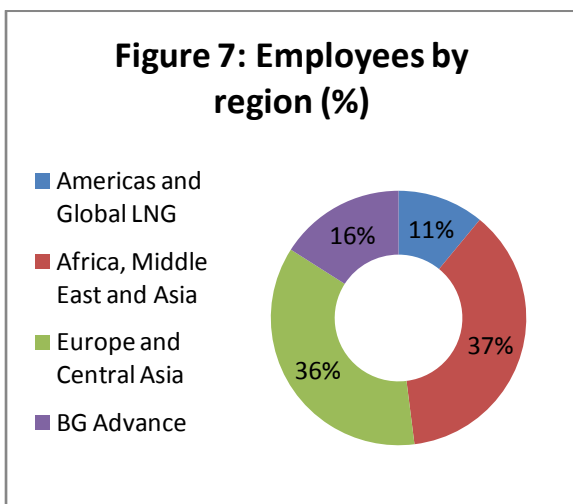
Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas



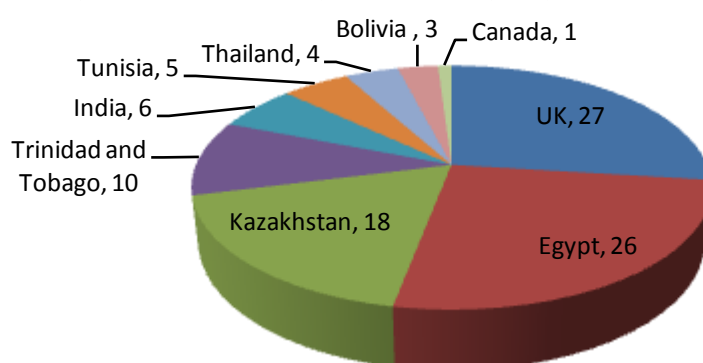
Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas



Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas



Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

Figure 9: BG Group - Oil and gas production 2007 (%)

Source: BG Group, 2008, Data Book, A Portfolio of Opportunities

Table 2: Financial Derivatives

	2008	
	Assets £m	Liabilities £m
Interest rate derivatives	19	-
Currency exchange rate derivatives	988	(744)
Cross-currency interest rate derivatives	7	(97)
Long-term UK gas contracts	-	(242)
Other commodity derivatives	1459	(898)

Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

Table 3: Currency and interest rate profile of financial assets

	2008		
	Fixed rate financial assets £m	Floating rate financial assets £m	Non-interest bearing assets £m
Currency:			
Sterling	73	212	208
US Dollars	45	1074	45
Other	-	357	15
Total	118	1643	268

Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

Table 4: Gearing

	2008	2007	2006	2005	2004
Net (borrowings)/funds	£m (972)	25	(103)	(30)	(1186)
Gearing Ratio	% 7.1	(0.3)	1.6	0.4	20.6
Debt/equity Ratio	% 7.7	(0.3)	1.6	0.5	25.9

Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

Table 5: Sensitivity Analysis

	Market Measurement		Business Performance		Equity	
	2008	2007	2008	2007	2008	2007
UK interest rates	+150 basis points	+100 basis points	2	9	10	8
US interest rates	+100 basis points	+100 basis points	(3)	(4)	(9)	(8)
US\$/UK£ exchange rates	+20 cents	+20 cents	(25)	(12)	(58)	(16)
UK gas prices	+15pence/therm	+10 pence/therm	(3)	-	(133)	(89)
US gas prices	+1US\$/mmbtu	+1 US\$/mmbtu	(11)	10	167	51

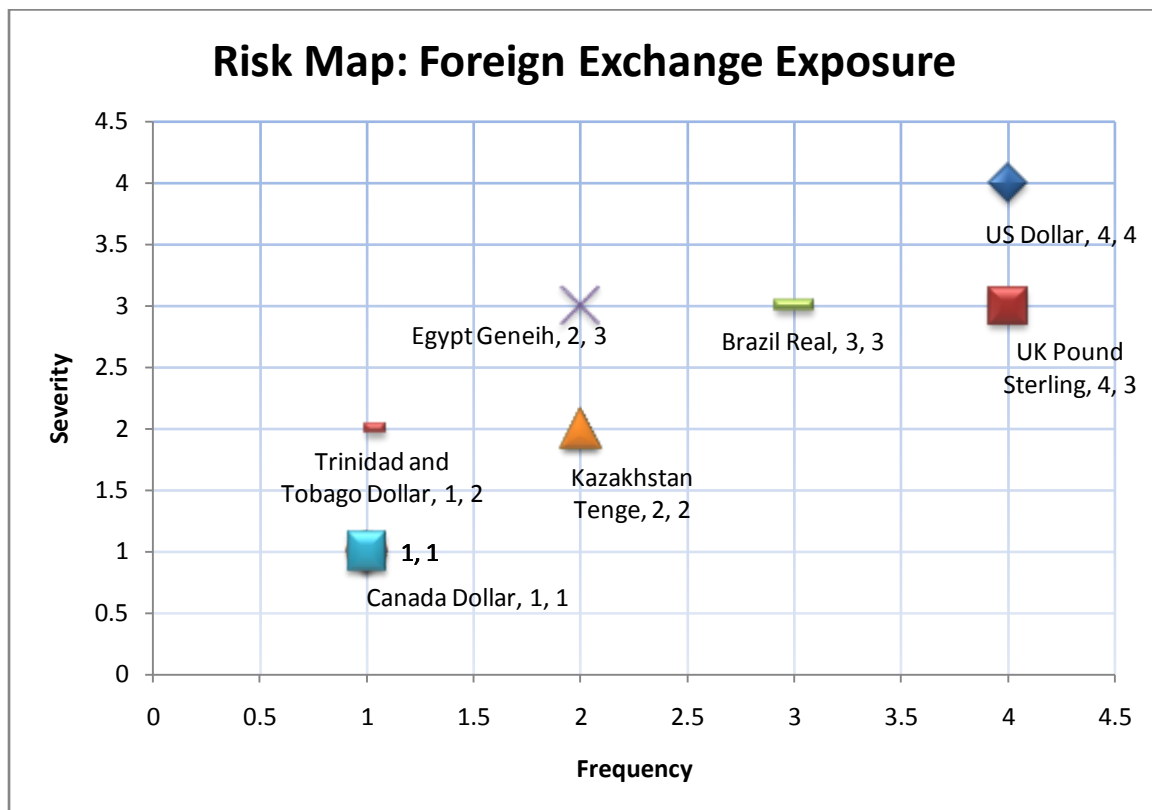
Source: BG Group, 2008, Annual Report and Account, A World Leader in Natural Gas

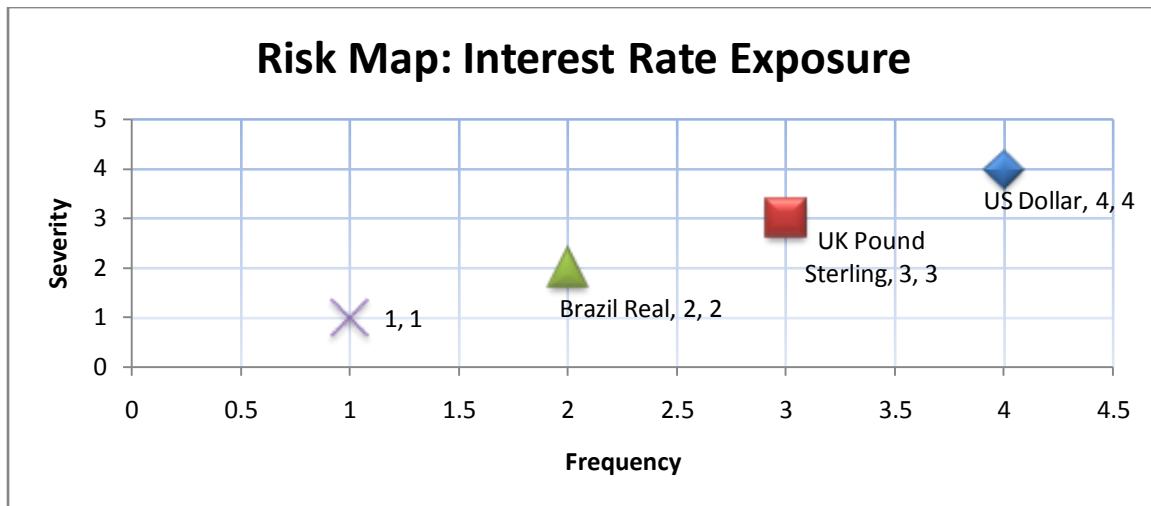
Appendix 2: List of Foreign Exchange and Interest Rate Risk

Table 6: BG Group's risk exposure

Exposures	Details	Severity	Frequency
Foreign Exchange:	Production of Oil and Gas:		
US Dollar	LNG importer into US (55% of imports)	4	4
UK Pound Sterling	59.2 mmboe	3	4
Kazakhstan Tenge	39.6 mmboe	2	2
Egypt Geneih	56.6 mmboe	3	2
India Rupee	13.7 mmboe	1	1
Tunisia Dinar	11.9 mmboe	1	1
Thailand Baht	9.9 mmboe	1	1
Trinidad and Tobago Dollar	23.0 mmboe	2	1
Brazil Real	Largest distribution of gas (Comgas)	3	3
Bolivia Boliviano	5.5 mmboe	1	1
Canada Dollar	0.9 mmboe	1	1
Australia Dollar	Alliance with Queensland Gas Co	2	2
Interest Rate:	£m		
Sterling	528	3	3
US Dollars	1,151	4	4
Brazilian Reais	397	2	2
Other	102	1	1

Source: BG Group, 2008, Data Book, A Portfolio of Opportunities

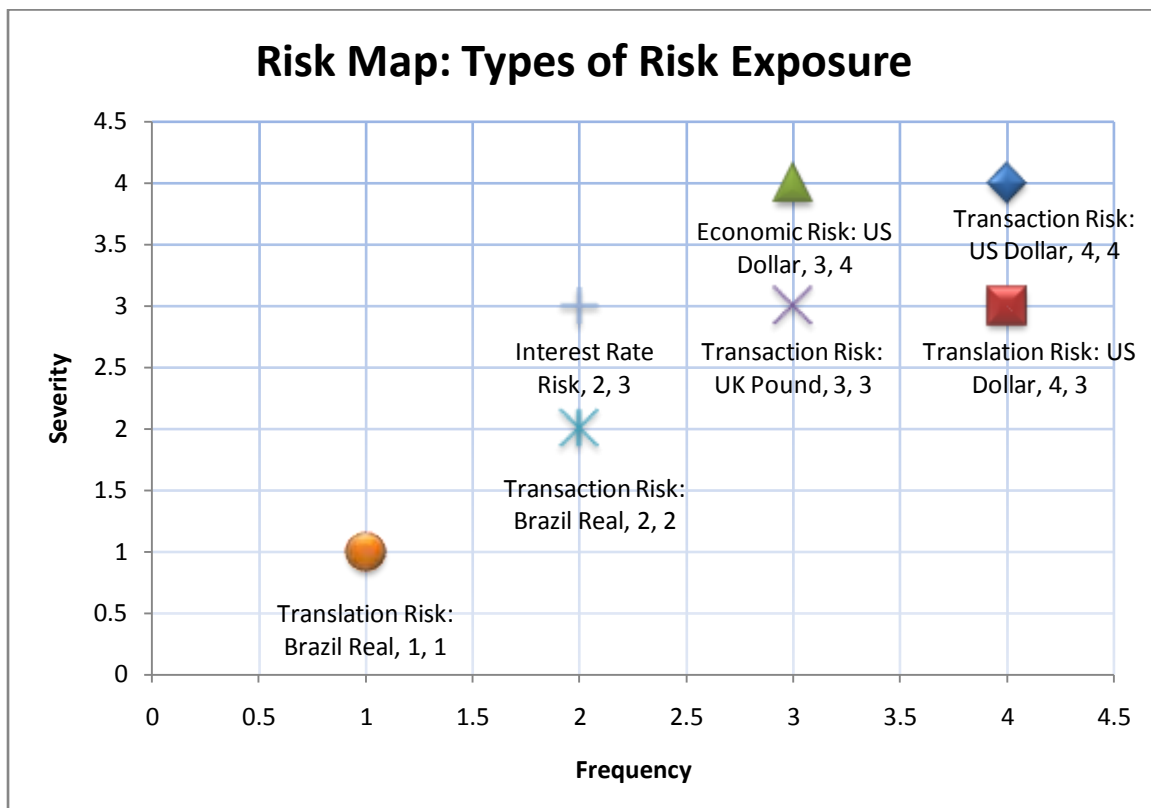




Notes: BG Group is heavily exposed to the movements of the US dollar and uses financial derivatives to swap debts denominated in other currencies into the US dollar. This is done in order to match the cost and revenues of BG Group in the same currency. Other currencies that BG Group is more heavily exposed to include the UK pound sterling and the Brazilian reais.

Justification: Individual risk identified in section 1 of this assignment is rated according to their severity and frequency according to data in appendix 1. The severity refers to how movements in a particular currency against the US dollar or UK pound would affect the company. The frequency takes into account the likelihood of changes in the particular value of a currency would affect the company.

Most of the Group’s revenues are denominated in US dollars. Hence, the risk map takes into account the cost of operations denominated in other foreign currencies.



Appendix 3: Hedging Methods

Table 7: Forward Contract

BG Group, a sterling base company invoices another company oil and gas worth US\$ 1,000,000 on 1st of January with payment to be made in three months (April 1st). The spot rate on 1st of January is US\$ 1.50 to £1. BG Group gets into a forward contract with a bank and agree to fix the forward rate at US\$ 1.495. No cash exchanges are made at up till now.

On 1st of April, there are four possibilities.

Spot rate 1 April	Dollars received by exporter?	Outcome
US\$ 1.65 = £1	Yes	Convert at agreed forward rate to sterling £ 668,900
US\$ 1.65 = £1	No	Bank will close out and will pay the customer £62,840
US\$ 1.35 = £1	Yes	Convert at agreed forward rate to sterling £668,900
US\$ 1.35 = £1	No	Bank will close out and will charge customer £71,840

Explanation of Close Outs:

If the dollars are not received, the spot rate on 1st April is 1.65, the bank will close out as follows.

Sell US\$ 1,000,000 at 1.65 = £606,600 (Dr) at spot
Buy US\$ 1,000,000 at 1.495 = £668,900 (Cr) at agreed forward rate

Net Credit to customer = **£62,840**

If the spot rate on 1st April had been US\$ 1.35, then the close out would have resulted in a net debt to the exporter's account as follows:

Bank sells US\$ 1,000,000 at 1.35 = £740,740
Bank buys back the US\$ at 1.495 = £668,900

Net Debit to customer = **£71,840**

Table 8: Currency Swap

BG Group for example, wants to borrow US\$ 20 m that is to be repaid over 10 years to finance its operations

Assuming that BG Group can issue sterling debentures at 8% fixed for 10 years, and that the following bank swap note is available:

Rate US\$	US\$ 1.5 to £1
Interest on US\$	5% fixed
Interest on £	8% fixed

The swap operate as follows:

Day 1

BG Group borrows £16m in the market and swaps it for US\$ 24m

Annual Interest Payments

BG Group will receive £1.28 m and will pay US\$ 1.2m

At maturity

BG Group will pay the bank US\$24m and will receive £16m in exchange

Day One



Table 9: Advantages and Disadvantages of Options, Futures, Forwards and FRAs

Options	Futures	Forwards and FRAs
Advantages		
Downside risk is limited but the buyer is able to participate in favourable movements in the underlying.	Can create certainty: specific rates are locked in.	Can create certainty: specific rates are locked in.
Available on or off exchanges. Exchange regulations and clearing house reduce counterparty default risk for those options traded on exchanges.	Exchange trading only Exchange regulations and clearing house reduce counterparty default risk.	Tailor-made, off-exchange. Not standardised as to size, duration and terms. Good for companies with non-standard risk exposures.

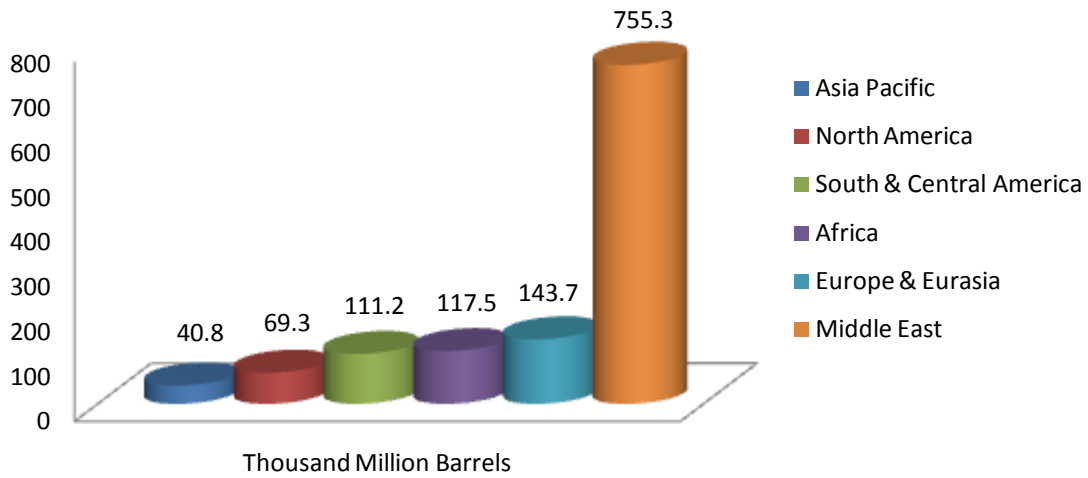
For many options there are highly liquid markets resulting in keen option premium pricing and ability to reverse a position quickly at low cost. For others trading is thin and so premiums payable may become distorted and offsetting transactions costly and difficult.	No premium is payable (however margin payments are required).	No margins or premiums payable. (Occasionally a good faith performance margin is required by one or more parties in a forward. Also credit limits may be imposed.)
Disadvantages		
Premium payable reduces returns when market movements are advantages	No right to let the contract lapse. Benefits from favourable movements in underlying are foregone.	No right to let the contract lapse. Benefits from favourable movements in underlying are forgone.
	In a hedge position if the underlying transaction does not materialise the future position owner can experience a switch from a covered position, the potential loss is unlimited.	In a hedge position if the underlying transaction does not materialise the forward/FRA position owner can experience a switch from a covered to an uncovered position, the potential loss is unlimited.
Margin required when writing options	Many exchange restrictions – on size of contract, duration (e.g. only certain months of the year), trading times (e.g. when euronext.liffe is open).	Greater risk of counterparty default – not exchange traded therefore counterparty is not the clearing house.
		Generally the minimum contract size is for millions rather than a few thousand (as on the futures or options markets).
	Margin calls require daily work for 'back office'.	More difficult to liquidate position (than with exchange-traded instruments) by creating an offsetting transaction that cancels position.

Source: Glen Arnold, Corporate Financial Management, 2008

Table 10: Hedging Transaction Risk	
Against	For
<p>Capital Asset Pricing Model (CAPM)</p> <ul style="list-style-type: none"> Hedging unsystematic foreign exchange risk is not necessary if the Group is holding a diversified portfolio of assets because movements in one currency would be offset by movements in another currency If the foreign exchange exposure is regarded as systematic risk, hedging would be futile as the cost of hedging would only destroy shareholder value 	<p>Capital Asset Pricing Model (CAPM)</p> <ul style="list-style-type: none"> Although holding a diversified portfolio of assets may cancel out all foreign exchange gains and losses in the long-run, the company may become illiquid in the short-run Financial distress may result in the Group breaching covenants with banks and increase the borrowing cost of capital which would further drain the Group's liquidity
<p>Modigliani and Miller</p> <ul style="list-style-type: none"> Individual investors can hedge for themselves the risk of the equity they are holding Hedging may be counterproductive if individual investors have already done so 	<p>Modigliani and Miller</p> <ul style="list-style-type: none"> Individual investors may not be able to hedge as effectively as big companies because hedging instruments contain minimum amounts
<p>The Zero Sum theory</p> <ul style="list-style-type: none"> In the long-run, foreign exchange gains and losses will net out and there will be no exposures to foreign exchange risk 	<p>The Zero Sum theory</p> <ul style="list-style-type: none"> The zero sum theory may be relevant to the whole market and all the companies within it. However, individual companies may bear the brunt of foreign exchange movements and go into financial distress
Economic Exposure	
Against	For
<p>Purchasing Power Parity</p> <ul style="list-style-type: none"> Changes in foreign exchange rates would be offset by price levels in respective countries 	<p>Purchasing Power Parity</p> <ul style="list-style-type: none"> Does not take into account the freedom of international capital flows, trade barriers and price stickiness
<p>Market Efficiency</p> <ul style="list-style-type: none"> Prices reflect all information held by the public and also by the private. Hence, there is no benefit from hedging in the long-run 	<p>Market Efficiency</p> <ul style="list-style-type: none"> Managers and employees cannot have a diversified portfolio of jobs. Talented workers would be motivated to stay in a company with less risk of financial distress

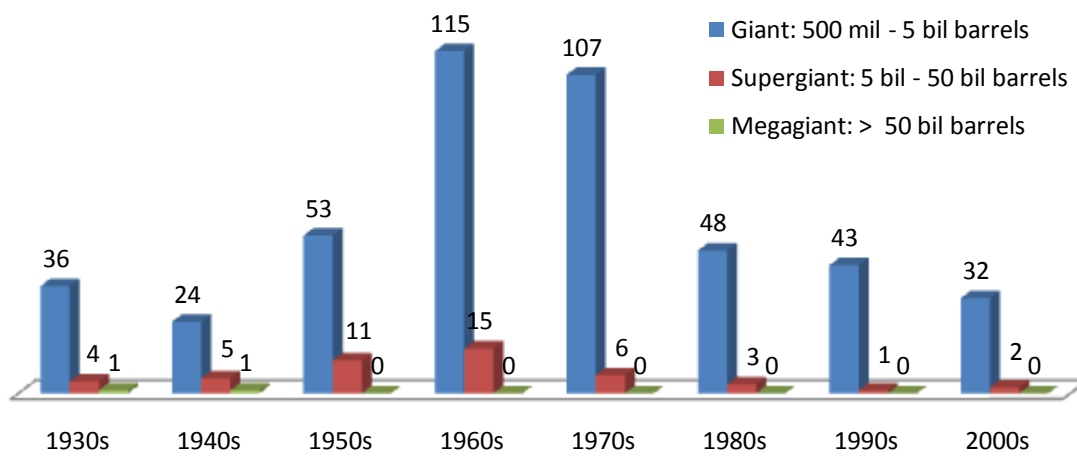
Appendix 4: Data on Oil and Gas

Figure 10: Proven Oil Reserves (2007)



Paul Roberts, June 2008, *Tapped Out*, National Geographic, Vol. 213. No. 6, National Geographic Society, United States, pp87-91

Figure 11: Oil and Gas Discovery



Paul Roberts, June 2008, *Tapped Out*, National Geographic, Vol. 213. No. 6, National Geographic Society, United States, pp87-91

Appendix 5: Economic Data**Table 11: Economic Outlook of the United Kingdom**

Economic Growth	2007	2008	2009e	2010f
GDP	3.0	0.7	-3.8	-0.3
Domestic demand	3.5	0.6	-3.9	-0.3
Output trends				
Services	3.5	1.5	-2.2	-0.5
Manufacturing	0.2	-2.6	-14.3	1.5
Construction	2.8	0.3	-6.0	0.5
The Personal Sector				
Disposal income	0.2	2.2	-0.5	0.0
Household expenditure	3.0	1.4	-3.5	-1.9
Retail sales	4.3	3.5	-2.0	-0.5
Unemployment rate (% of workforce)	5.4	5.7	8.5	10.0
House prices (Halifax survey, q4 on q4)	5.6	-16.5	-10.0	5.0
International Trade				
Trade in goods balance £bn	-89.3	-92.9	-85.0	-80.0
Current account balance £bn	-40.3	-24.5	-20.0	-15.0
Inflation and base rate				
Consumer Prices Index	2.3	3.6	1.6	1.1
Bank base rate (at year end)	5.50	2.00	0.50	1.00

Notes:

1. HSBC forecasts are as at 2nd April 2009.

2. Data and forecasts are subject to revision.

Source: Meredydd Davies, HSBC Economic Review, Spring 2009 Issue 52

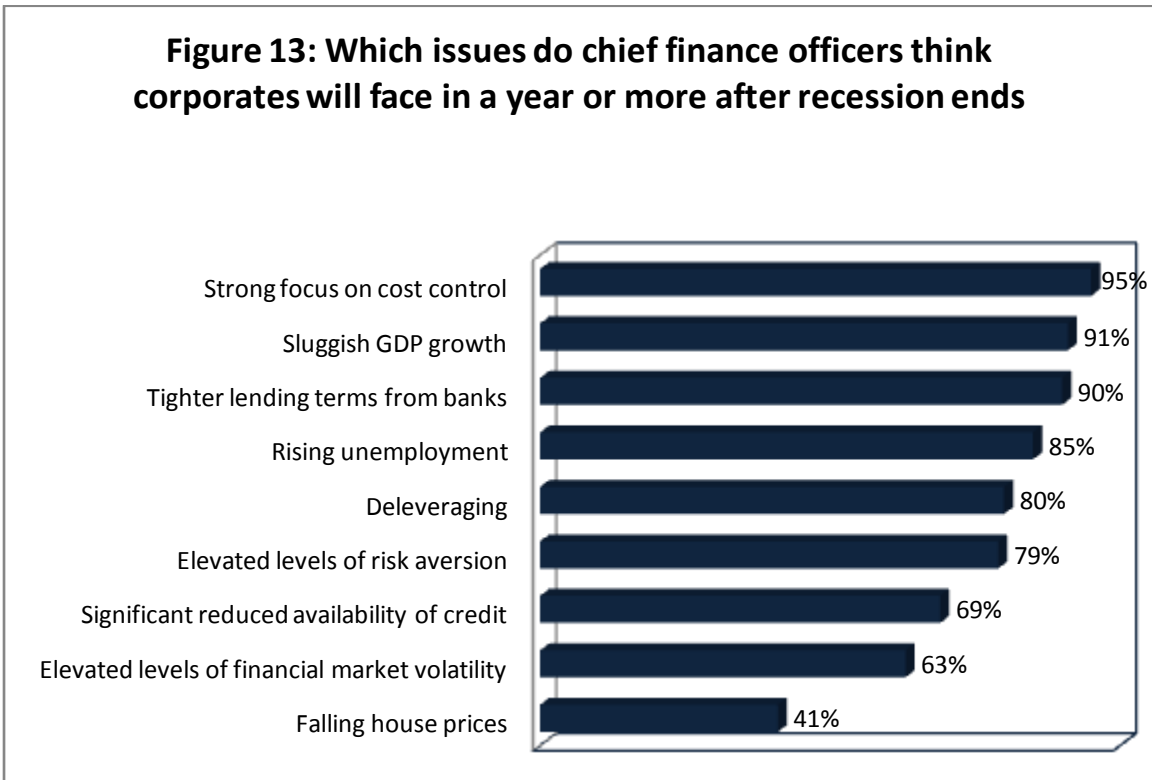
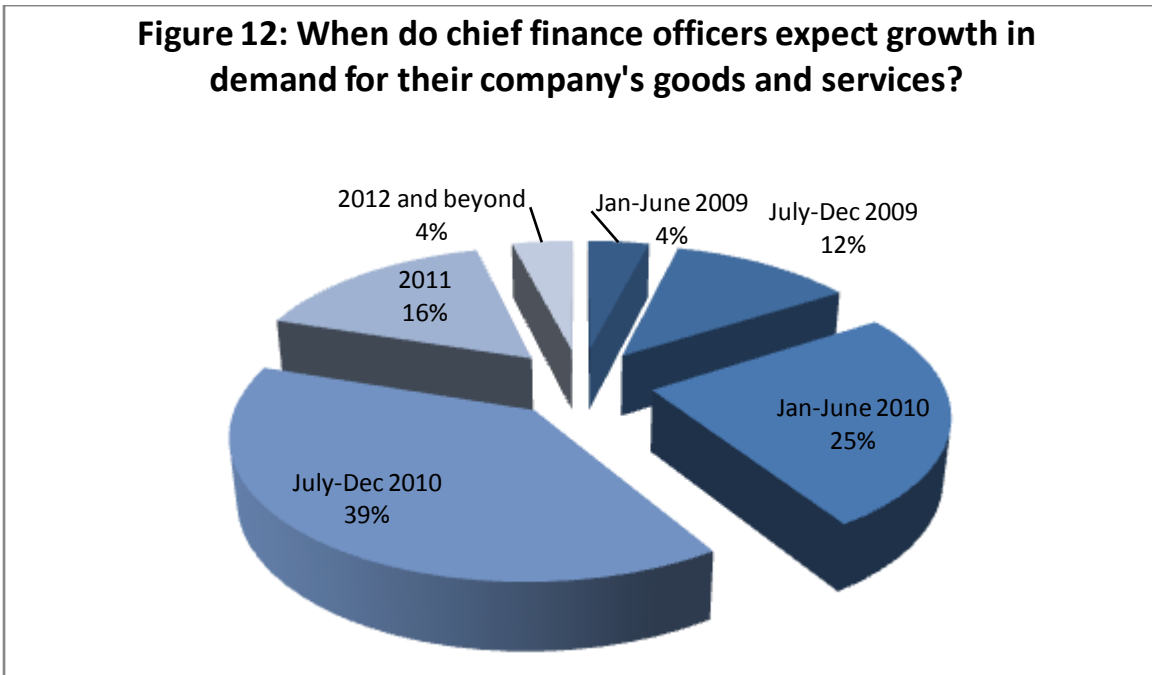
Slowdown in the United Kingdom

The United Kingdom is also severely affected by the global economic slowdown with a full blown recession according to HSBC's 2009 estimates. Domestic demand is likely to fall and fears of deflation is now looming. The manufacturing sector shows a huge drop in production while unemployment is poised to rise to 8.5 percent of the total workforce. Furthermore, the bank base rate is at its lowest in 300 years at 0.5 percent.

Survey and interview results of Chief Finance Officers of the FTSE 100 on the economy

Figure 12 shows the results of a survey and interview from Deloitte CFO Survey shows that most CFOs believe the economy will partially recover in the second half of next year. However, this recovery will be gradual and coupled with tight credit lending policies from banks. This implies that economic activity would take a longer time to return to pre-crisis levels and that the credit crunch is far from over.

Figure 12: Interview and Survey Results of Chief Finance Officers of FTSE 100



Source: Deloitte CFO Survey (July 14, 2009)

Appendix 6: Information in Ratings Book

Information	Details	BG Group
Industry Risk	<ul style="list-style-type: none"> Economic importance of industry Too big to fail? Level of protectionism International competition Barriers to entry Competitive situation Cyclical factors 	<ul style="list-style-type: none"> Major supplier of liquefied natural gas to the United States Gazprom, Royal Dutch Shell, British Petroleum Industry dominated by big players Volatile energy prices
Market Position	<ul style="list-style-type: none"> Competitive position Product importance Product diversification Geographical diversity Major suppliers Distribution network 	<ul style="list-style-type: none"> Leader in natural gas Natural gas is used to generate electricity Geographically diversified Oil and gas pipelines
Ownership, Management and Support	<ul style="list-style-type: none"> Ownership Structure of ownership Access to capital markets Corporate goals and outlook 	<ul style="list-style-type: none"> Public listed company Conservative management Derivatives not used for speculation
Accounting Quality	<ul style="list-style-type: none"> Reporting & disclosure requirements Auditors and audit opinions Consolidation of financial statements Revenue recognition policies Fixed asset valuation methods Goodwill and intangibles treatment Depreciation methods Contingent liabilities 	<ul style="list-style-type: none"> Conservative revenue recognition policies Other data found in the annual report
Earnings & Cash Flow	<ul style="list-style-type: none"> Sustainable earning power Discontinued operations Profit margins Retained earnings for internal growth Volatility of cash flow Liquidity levels 	<ul style="list-style-type: none"> High cash generation business Stable cash flows
Capital & Debt Structure	<ul style="list-style-type: none"> Gearing (debt/equity) Leverage (total liabilities/debt) Sensitivity analysis Adjustment with off-balance sheet activities 	<ul style="list-style-type: none"> Low level of gearing
Funding & Financial Flexibility	<ul style="list-style-type: none"> Ability to raise new capital in a short amount of time Standby lines of credit Ability to attract capital Margin of safety 	<ul style="list-style-type: none"> Committed lines of credit