Looking the

Executive summary

- Deal volume expected to remain healthy across all markets in 2006.
- Expect a more balanced relationship between supply and demand sides.
- An increasing focus on returns suggests banks will be thinking hard about narrow margins.
- Sub-20bp is not a generally accessible benchmark.

The Western European syndicated loan market again enjoyed a record year in 2005, with a sustained increase over the course of the year resulting in an estimated 1,500 transactions – representing a 10% rise on 2004. Volumes also rose sharply to $1.21bn (as at 12 December 2005), as shown in *Figure 1*. The UK market, however, shows a slight decline in transaction numbers (see *Figure 2*) and a sharper decline in volumes from first to second half. This indicates that most viable refinancings have now taken place in the UK, with the European market likely to follow a similar pattern in 2006. An increased focus on returns should make banks think twice about very narrow margins, as has already been seen in a flattening of the pricing curve.

BORROWER STRATEGIES Following a steady fall in 2005, the signs are that pricing has started to slow in its decline for all but very top-quality credit. Indeed, a pain threshold of about 20 basis points (bp) appears to be developing, beneath which large banks are likely to decline substantial standalone balance-sheet lending. This is in contrast to those relationships that yield a substantial amount of ancillary business, where sub-20bp lending for the strongest credits remains viable. Borrowers currently being funded at 15bp on a drawn basis include Vodafone, BMW, Nestlé and Tesco.

Indeed, the interrelation of cost of capital with relationship banking has ceased to be the clarion call for a few bankers. Instead, it has gained increased currency with UK treasurers – and become the publicly stated policy of some to allow core lenders to bid first for ancillary business. This philosophy extends beyond access to cheap money. It is also about banks understanding and meeting the strategic goals of clients through creative combinations of products.

Yet an alternative – and in some ways opposite – strategy has also emerged to bank funding. Borrowers are spreading debt requirements among large lender groups, which earn low fees on the small amounts committed. This type of facility may not, however, provide borrowers with the future support of a banking group with an interest in a company beyond small and low-yielding credit exposures.

Meanwhile those banks holding large exposures to their relationship clients and complementing these with ancillary services consist of an increasingly definable group of upper-mid-market champions. These banks sit between, on the one hand, a group of around eight international bulge-bracket banks and, on the other, smaller banks that may lack the critical mass to compete in this market. Indeed, tight margins at this stage of the pricing cycle have forced some banks to abandon an international presence.

While a more open European marketplace has seen smaller banks lose share, it has also provided the spur for regional champions to successfully consolidate within their home markets. The remainder of liquidity is supplied by larger European banks with a supranational reach – in turn helping drive a convergence of pricing and structures across Europe.

Borrowers have continued to capitalise on this inter-bank competition to win longer tenors. In the earlier part of the year, these came from adding extension options to a more standard five-year structure, resulting in a 5+1+1 structure, for instance. But these have since become outright seven-year terms negotiated at the outset. Furthermore, some of these longer facilities are even being signed with a bullet repayment profile, deferring all returns until the end of the loan period.

Such trends have been more marked in continental Europe, as has pressure on covenants. Some European borrowers have applied for significantly weakened covenants on their loan facilities, which is typically expressed via a reduction in – and in some cases, disappearance of – material adverse change clauses. Although there is some evidence that this trend is supported by the rating agencies because it reduces potential ratings volatility, banks will only relinquish the protection provided in such clauses for borrowers they know well and in which they have particular confidence.

Yet even as some borrowers succeed in accessing more liberal covenants, others have encountered increasing resistance from banks to aggressive loan structures. Taken with certain pricing trends, such as returning differentiation between stronger and weaker credits, these could be considered as further precursors of the end of the current credit cycle.

M&A BURIED IN LIQUIDITY For investment-grade, mid-market and leveraged finance alike, liquidity has remained the key driver. And the overall pressure of high liquidity and low borrowing costs has not been confined to the bank loan market.

The bond markets have seen increased investment from institutional investors, such as pension funds that have withdrawn money from equity markets in recent years. This has resulted in falling spreads and oversubscriptions to new issues. Further mirroring the bank market has been an openness among bond investors to new structures, such as a debut 32-year subordinated bond from GECC. Benign bond market conditions mean more competition for bank lenders, even though the latter can provide a relatively more stable debt platform in the event of credit deterioration and ratings actions. One middle path to accessing institutional liquidity while avoiding

over horizon

RECORD VOLUMES IN 2005 MAY BE THE LAST BIG PUSH BY BORROWERS BEFORE THE END OF THE CURRENT MARKET CYCLE, WRITES **IAN FITZGERALD.** EXPECT BANKS TO USE LIQUIDITY MORE GUARDEDLY IN 2006.

the capital markets is private placements, which have also been subject to record investment levels in 2005.

Many bankers had hoped a substantial amount of available liquidity would be absorbed by a resurgence in mergers and acquisitions (M&A), resulting from low stock market valuations and cross-border consolidation in some sectors. Yet these hopes have been partly dashed given that big-ticket M&A activity did not ultimately look to the debt market for funding. Even some very substantial transactions – such as Dubai Port's £3.3bn acquisition of P&O – have been cash-funded.

Indeed, the virtual cash mountain put on deposit by European corporates is itself a driver of bank liquidity, as well as displacing debt in funding many M&A deals. As *Figure 3* shows, the UK corporate sector profile has bigger cash balances, allowing growth and acquisition to be funded from within.

Other M&A deals, such as the £7bn merger between Allied Unichem and Boots, have been able to take advantage of gaps in the equity markets via share issues.

Yet a comparison with 2004 reveals that lending banks have enjoyed some benefits from increased M&A in 2005. The percentage of loans financing Western European M&A went up from 7% in 2004 to 15% in 2005. For the UK, the percentage increase has been shallower – from 7% to 13% – although given the decline in overall volumes, this could still represent an absolute increase in M&A lending. As a demonstration of banks' eagerness to fund M&A, those deals that have employed debt funding have enjoyed some reduction in acquisition premiums.

LEVERAGE BOOMS Liquidity has also been the driving force of the leveraged finance market in 2005, on both debt and equity sides. Large inflows of capital into new and existing private equity funds – again, largely at the expense of public stock markets – has sharpened competition both within the private equity community and between buyout houses and potential trade buyers.

This has been expressed in numerous ways. Upward pressure on company valuations has itself been partly driven by a willingness among banks to increase leverage ratios. Structures are being stretched in order to back-end load repayment profiles. Although this is intended to provide target companies with a grace period to consolidate cashflows following buyouts, some worry the moves may have created the condition for late-appearing distress in some deals. This is likely to be tested going into 2006 as the debt service obligations on many of these companies now begin to increase. Any significant deterioration in economic conditions will certainly hit highly leveraged buyouts first.

Figure 1. Euro volumes

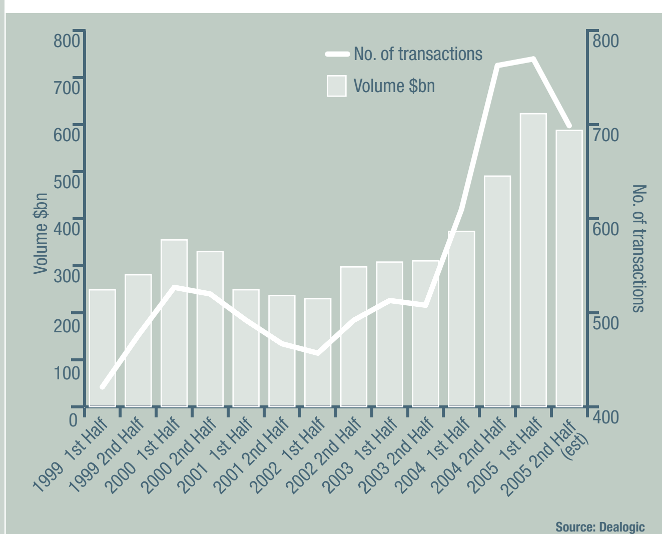
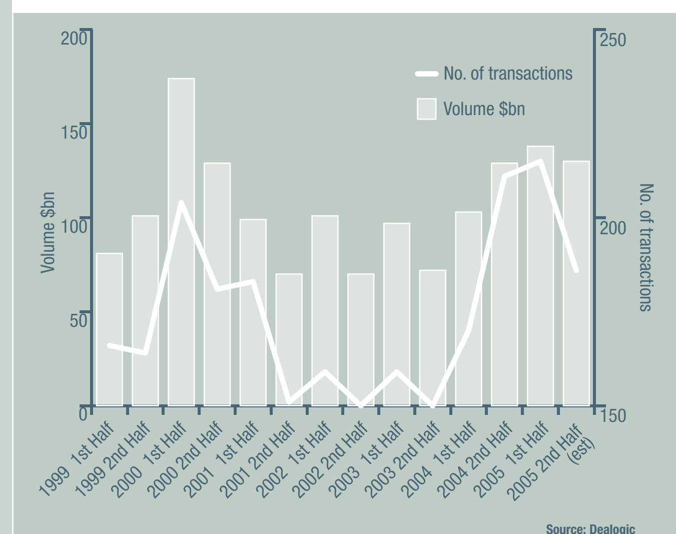


Figure 2. UK volumes



Yet for the time being, the market remains bullish. Perhaps the most striking feature of 2005 in the leveraged market has been a coming of age for consortium deals – namely, those involving several equity sponsors. At certain points in the year, there were several group deals a week coming to market. Clearly, these jumbo deals have required higher hold levels from the bank markets, and this has been reflected in some of the larger syndications seen this year.

Yet most syndications have been successful. This is partly because the credit quality of the very large buyout targets is stronger by dint of their size and market profiles. Business risk on a company like the AA, for instance, is still affected by numerous factors – but, in the absence of a big surprise, its debt service capacity would be very unlikely to fall below the level agreed in its buyout.

The debt facilities on two such bumper deals can be taken as good indicators of the directions this market could take in 2006. On the one hand, a refinancing for the Seat Pagine buyout was successfully concluded in June 2005 – less than a year after the original buyout. The €2.6bn facility refinanced around half of the company's total €4.3bn of leverage at a margin reduced from standard 225bp and 275bp for the A and B tranches to 185bp and 235bp respectively, while also extending the tenor to seven years. The new terms on this facility and the ease of its syndication indicate continued confidence in, and comfort with, this leveraged asset at least.

But when the largest ever leveraged buyout needed funding in the first half of 2004 – the €9bn buyout of Wind Telecoms – the market was not so forgiving. The deal spent much of the middle part of the year in syndication, and it was necessary to raise pricing on €700m of second lien debt by 100bp to 625bp to attract lenders. This part of the debt was finally transformed into a junk bond in order to be successfully distributed. It is also thought that some underwriting MLAs were left with larger tickets than they had originally envisaged. Although multi-deals are clearly here to stay, it is likely that future record breakers will proceed with more caution.

OUTLOOK Most corporate borrowers have taken advantage of their strong position in the loan market to refinance debt on favourable terms. This is especially the case in the UK, as evidenced by a fall in overall deal volume during the second half of 2005. Yet deal volume is expected to remain healthy across all markets during 2006. Even without a return to the M&A underwriting heyday of 2000, M&A volume is nonetheless expected to expand. Without a widespread credit decline causing several defaults, leveraged volumes will also remain considerable.

In terms of general purpose corporate lending, however, the coming year will almost certainly see a more balanced relationship developing between supply and demand sides. The overall stability of the European loan market is supported by greater homogeneity between national markets and increased transparency in risk pricing, along with general economic wellbeing. The current stability of the global financial system amply proved itself in 2005 by absorbing both individual financial shocks, such as the collapse of Refco, and geopolitical events, such as the London bombings.

As such, we are unlikely to see a rapid, blanket reversal as a result of individual third-party events, such as those which followed the Asian financial crisis of 1997. Instead, banks should remain well disposed to lend competitively within good relationships, mitigating an overall reversal in pricing to a more gradual upward trend than sometimes seen in the past. But as has already been seen in most areas of the market in 2005, sub-20bp prices should not be considered generally accessible benchmarks. Borrowers will still need to apply holistic relationship management strategies to maintain bank optimum funding in 2006.

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Figure 3. UK corporate sector profile 1995-2005