Ask the experts:
Only slowly shifting

Is the credit cycle turning?

Kit Juckes, Head of Fixed Income Research, RBS Global Banking and Markets

In a word, yes. 2006 will see a modest upturn in corporate default rates. Credit ratings are likely to slip. Consumer loan defaults and personal bankruptcies will be higher, albeit the rise will occur against the background of very low absolute levels. Corporate cash and profit generation will also slow.

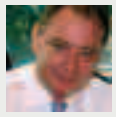
But this is only part of the story. In a typical credit cycle, as inflationary pressures rise, so central banks raise interest rates to slow demand growth. Borrowers are therefore hit with the double-whammy of weaker demand and higher loan costs.

In the current cycle, however, inflation has remained both low and stable, reducing the need for rate increases and dampening the credit cycle. UK rates peaked at a mere 4¾% and the European Central Bank kept rates at 2% – zero in real terms – for two years until December. And the US has only now returned rates to 'neutral' levels. At the same time, trillions of dollars in currency reserves, accumulated to prevent Asian currencies from appreciating against the dollar, have been recycled into bond markets. This has further depressed longer-term borrowing costs for both governments and the corporate sector.

This low-rate world has stretched out the economic cycle. It has also allowed companies to refinance debt at more favourable terms, keeping default rates low and allowing companies to clean up their balance sheets.

However, companies and private individuals have also increased their levels of indebtedness. Mortgage multiples are up, and companies are tolerating increased leverage and lower credit ratings to finance increased capital spending and mergers and acquisitions (M&A). And leveraged buy-outs are a growth industry.

Increased debt levels are not without risk, particularly if the dip in inflation proves to be only temporary. But for the rest of this year, the deterioration in credit conditions promises to be, in historical terms, very mild.



Ian Fitzgerald, Director and Head of Syndication and Distribution, Lloyds TSB

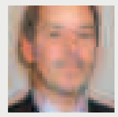
Overall volumes in the European loan market increased from a 2004 record of $886bn to a gigantic $1.35 trillion in 2005, evidencing ongoing liquidity in the market. In terms of the breadth of borrowing appetite, the volume increase has been matched by a sustained rise in transaction numbers from 1,029 in 2003 to 1,713 in 2005. However, most transactions in 2005 took place in the first half, which is a departure from the previous 18 months of steady half-yearly growth. In the UK market, volumes also contracted from the first to the second half of 2005, bucking the previous trend.

While this does not necessarily represent the beginning of a long-term decline in borrowing, it does indicate that the market is moving away from early refinancing driven by falling margins. While margins are still tight, they are no longer falling steeply enough to merit this kind of activity. The pricing curve may therefore flatten out as refinancing wanes in 2006. Although banks will still compete heavily on pricing for new loans, they will also look more closely at the overall economics of each client relationship, as well as the risks and the covenants.

One area that may absorb liquidity is a continued upsurge in debt-funded European M&A deals – following Telefonica's £18bn acquisition of O2, funded with relative ease at margins of below 40bps. Yet the outcome of current M&A activity remains uncertain, including the future credit quality of merged entities.

Perhaps the highest-profile users of liquidity are private equity buyers, who have continued to increase the scale of leveraged buy-outs as well as the leverage ratios used – the average quantum increasing from 4.5 times EBITDA in 2004 to 5.5 times last year. This has become the area of the market most vulnerable to a credit event or general decline in credit quality.

Overall there is no real evidence of sufficient changes in the economic and geopolitical environment to say the cycle is turning.



Blaise Ganguin, Chief Credit Officer for Europe, Standard & Poor's Ratings Service

The rising tide of M&A and private equity deals in Europe threatens to undermine credit quality among companies in the region over the next 12 months. Credit rating downgrades are expected to increase among industrial companies from the low levels of the last two years, and are likely to significantly outstrip rating upgrades. Nevertheless, with economic conditions remaining relatively benign, we believe defaults will stay low in 2006 before picking up in 2007.

Overall credit quality for industrials, banks, and insurers in Western Europe weakened only slightly in 2005 – the downgrade ratio was 1.2 downgrades for every upgrade.

On closer inspection, the variation between industrials and financials was marked – the industrial sector had a downgrade ratio of 1.7, while only 0.7 financials were downgraded for every upgrade.

The biggest risk for creditors is the continuing abundance of liquidity from private equity firms and hedge funds, which we expect to persist well into 2006, given recent heavy fundraising by buy-out investors.

Debt leverage in buy-outs has reached record levels, surpassing the peaks of the 1990s and suggesting bubble-like conditions in this market. Additionally, covenant structures, which should provide creditors with increased security, have weakened.

Partly on account of this, lenders are expected to focus on loss given default (LGD) as risk increases with leverage in 2006. The magnitude of private-equity-sponsored buy-outs has grown exponentially in 2005, to the point where major companies are alluded to as potential takeover targets, with transactions of up to £10bn regularly cited.

Although Standard & Poor's expects to see transactions of this size in 2006, financial markets will not fund multiple such transactions. Therefore, deals will have to be satisfactorily structured and lenders potentially well secured.