The art of refinancing

WITH RENEWED LEVELS OF PLAIN-VANILLA REFINANCING AFTER VERY LOW ACTIVITY LAST YEAR, **FENTON BURGIN** CONSIDERS THE STRATEGIC AND PRACTICAL ISSUES FOR PRIVATE AND PUBLIC COMPANIES LOOKING TO ACCESS THE LOAN MARKETS IN 2007.

Where is all the liquidity coming from? The answer is the institutional market in the shape of collateralised loan obligations (CLOs), collateralised debt obligations (CDOs), hedge funds and other non-bank investors. One of the key questions that a treasurer or finance director needs to consider at the outset of a refinancing exercise is the nature and make-up of the preferred lender group.

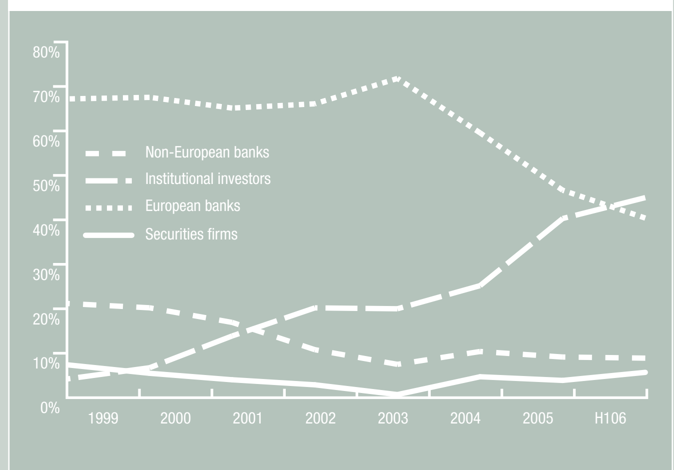
CAREFUL PLANNING Companies that achieve their refinancing goals adopt a carefully planned and executed competitive approach to banks. A typical process would comprise an initial invitation to a small number of institutions selected on the basis of relationship and their ability to meet the company's requirements. In any first stage, companies release broad information, summary financial projections and an indication of their preferred terms and conditions to potential lenders. Based on responses, more detailed information is released to a narrower field of potential lenders. On major refinancings, the days of any one bank being handed a mandate based on a historical relationship are largely confined to the banking textbooks.

HIGHLY COMPETITIVE PRICING Relatively low default rates and high liquidity in the market will keep loan pricing highly competitive in 2007. However, interest margins are unlikely to fall further. The activity in the leveraged buyout (LBO) arena has made it more difficult to push plain-vanilla transactions through the market as banks have more choice in a range of higher-yielding transactions.

Even if you are not looking at a major refinancing, you should consider if your loan facilities reflect market norms. In March this year, Lehman Brothers completed the first-ever US-style repricing for a European LBO credit after UK company Firth Rixson outperformed its budget and looked to reprice its September 2006 refinancing.

Market liquidity has also enabled UK companies to negotiate very competitively priced acquisition facilities; in February this year the £2.15bn facilities supporting UK housebuilder Barratt Developments' purchase of Wilson Bowden were launched at an initial interest margin of 60-65bps annually. Current acquisition premiums are running at 5-10bps annually on interest margins for blue chip borrowers, with 10-20bps a year not untypical in the mid-market.

Figure 1. Source of liquidity to European loan market



In the LBO arena there is no 'standard' corporate pricing grid, as was the case in 2005, but at an interest margin of 200bps on an A loan, the market must be close to the bottom given that this is many institutional investors' hurdle rate.

Executive summary

- A combination of low interest rates, a benign economic environment and the large amounts of cash being invested by private equity buyout funds has continued to dominate the European loans market in 2007.

LOAN STRUCTURES Last year a number of the other 'market standards' fell away; historically, there has been a significant element of amortisation in mid-market loan structures with a 50% distribution across the A and B tranches; today, larger amounts are being placed into the institutional-led, non-amortising tranches with smaller A loans that have heavily back-ended amortisation. It is also not uncommon for companies to seek and get an automatic extension option to the final maturity.

LEVERAGE MULTIPLES During 2007 some medium-sized companies will be able to access debt at multiples of operating profit historically reserved for far stronger credits. In part this liquidity has been driven by banks' ability to lay off more highly geared structures in the institutional market. Many bankers can point to deals they believe to be overleveraged; the real question for 2007 is which will not survive in their current form? Standard & Poor's has been reported as estimating that the average gross debt multiple on European LBOs increased from 4.2 times EBITDA in 2002 to around 5.5 times in 2006. At these sorts of levels you are not going to be looking at a simple covenant reset exercise when the company fails to meet business plan.

There is also growing evidence that PLCs are responding to shareholder pressure to run with higher leverage. Operating in this sort of environment requires the treasurer and finance director to focus on negotiating appropriate levels of covenant headroom for business plan projections.

OPCO/PROPCO Companies with a high value of property assets on their balance sheet should consider if an opco/propco loan structure offers advantages over more traditional finance. In these structures, a company's assets are geared with low-priced, secured property finance and then leased to an internal operating company that is itself geared with debt. Many investors are willing to accept the higher leverage generated by historically low property yields. Recently, the hospital company General Healthcare Group used this type of structure to refinance its LBO facilities; its opco EBITDA leverage was reported at 2.7 times, but aggregated with the propco debt on a look-through basis the multiple was reported to be closer to six or seven times EBITDA.

INFRASTRUCTURE FINANCING Infrastructure financing's hybrid blend of corporate and project financing risk offers the enticing combination of yield and relatively low risk by gearing stable cash-generative assets to LBO finance levels, allowing buyers to bid aggressively for cashflows. For companies with infrastructure assets, low volatility cashflows and high barriers to competition, it may be appropriate to consider this form of finance.

REVERSE FLEX Given market liquidity, treasurers or finance directors looking to raise new facilities should consider their ability to secure terms where the interest margin or fees are 'reverse flexed' or lowered in response to any oversubscription in syndication. Recent examples include the facilities backing Bank of Scotland's acquisition of McCarthy & Stone where the fees were reported to be reduced by in excess of 12.5bps.

DOCUMENTARY PROTECTIONS In recent months, borrowers have responded to growing concerns over who might hold their debt by securing a number of documentary protections on any new loans. Areas to focus on include minimum hold levels and other transferability provisions. In addition, lenders are increasingly being asked to agree 'yank the bank' provisions that allow a company to unilaterally prepay a dissenting loan syndicate member. In the current market, the more sophisticated borrowers will submit their own detailed term sheet to borrowers when requesting proposals.

IS THE BUBBLE GOING TO BURST? There are two obvious threats to current market trends: a sharp rise in interest rates, triggering a wave of defaults, or a loss of investor liquidity. But the cycle could as easily turn with a whimper as with a bang. Importantly, the presently very high levels of LBO activity ultimately increase the requirement for private equity owners to secure exits at even higher multiples. Recent signs of nerves, from the increase in distressed debt trading capacity to recent difficulties in sectors such as retailing and chemicals, suggest that raising the required debt is likely to become harder and may ultimately affect wider market sentiment. The message to the treasurer or finance director looking to refinance is clear: plan carefully, take advantage of current liquidity but prepare for rougher waters ahead.

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