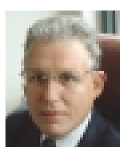
LOANS: THE HIGHS AND LOWS



THE LOANS MARKET HAS HAD MORE THAN ITS FAIR SHARE OF WOES THESE PAST 18 MONTHS, AS **DECLAN MCGRATH** OF ROYAL BANK OF SCOTLAND DISCOVERS.

The European syndicated loan market and its participants could never have predicted in their wildest dreams the various events that have unfolded over the past year. At the corresponding time of writing last year, it was too early to tell what the consequences would be of 11 September, plus the US economic slowdown, the early indications of a lack of M&A business and the capital absorption of the telecom sector.

The bankruptcy of Enron in the first half of the year was an event of such proportions that the effect of the immediate knee-jerk reaction and subsequent ripples of 'Enronitis' were to result in a significant blow to confidence, with a reduction in loan volume by nearly 30% in the first half of the year.

Enron, the apparently false profits reporting at WorldCom and deals such as KPNQuest putting a significant transaction in place three months before being declared insolvent, not to mention the breach of covenants scenario surrounding Energis, means there will be a greater demand for real transparency from banks and investors.

The negotiation and re-negotiation of structures with tighter covenants, more frequent monitoring and significantly higher pricing in conjunction with credit event situations have had a detrimental effect, along with everything else, on the loan volumes seen in Europe for the first half of the year.

It is really only the top quality clients that are finding it easier to borrow and, let's face it, they are on the decrease – the ratings downgrades for the past year demonstrate this to the fullest extent.

FIGURE 1
WESTERN EUROPEAN BORROWERS OF EUROMARKET LOANS.

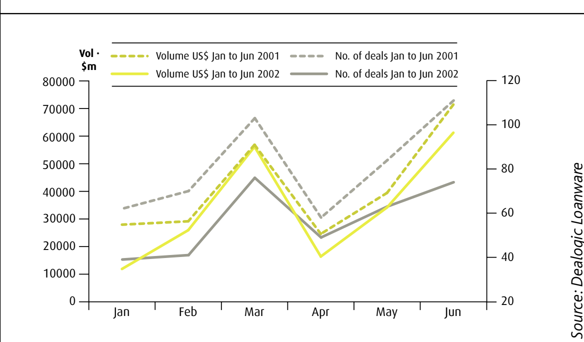
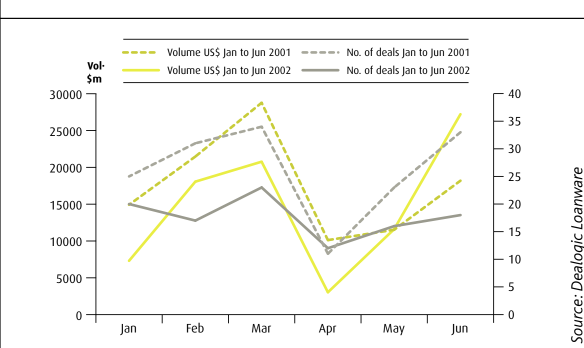


FIGURE 2
WESTERN EUROPEAN M&A ACTIVITY.



DIFFICULT ASSESSMENT. The concept of distribution within the loan syndication market has always been critical and never more so than at present. However, it is proving more difficult to assess the market for lesser names – and not just from a pricing perspective. Even with the concept of market flex being invoked more often, the last 25 to 50 million of a larger number of transactions are proving difficult to complete. Some arranging banks, particularly in view of the lack of volume, may be bidding a little over-aggressively at times as they fight for a position at the top of the league tables.

On the secondary loan business side, the volatility in the market is being viewed in a positive manner and the opinion is that this demonstrates another stage in its maturity. The LMA has made a significant contribution in making the secondary loan trade into a traded credit product in its own right. The first half of 2001 saw the continued growth of the secondary market in Europe, although the tragic events of 11 September showed how the secondary market is still heavily reliant on primary flow. A slowdown of the latter resulted in a quiet second half of the year.

The first quarter of 2002 has, in contrast, seen a strong bounce-back and the figures reported by the LMA for the first quarter of 2001 versus the first quarter of 2002 had increased by 60% to €9.016m.

The lack of M&A activity has continued to such an extent that must have the pure investment banks extremely worried indeed. In fact, in the first quarter of 2002, Europe really only had one deal of any serious size to help it save face and this was the €5.5bn facility for Imperial Tobacco, which backed its successful acquisition of tobacco group Reemtsma in Germany – and this deal had been mooted in the market two years ago.

Now, as we have completed the first half of the year, the small level of increased activity which was expected in late March/early

April has not actually materialised. Given that there may be some significant companies thinking strategically and not being so defensive, they are, nevertheless, being cautious and certainly will be unlikely to overpay for any strategic acquisitions.

The volatility recently experienced in the global equity markets has resulted in a number of large important IPOs being cancelled or put on hold until the market recovers again, which is not good news for the investment bankers. The fact is we have not seen such a lull in mergers and acquisitions on a global basis like this since 1997. Up to the end of June $448bn-worth of deals have been completed, compared with $1,020bn in the first half of 2001. This is a drop of 56%. The geographical split sees Europe down 49%, Asia-Pacific down 76% and the US down 61%. This has understandably resulted in severe revenue pressure and, coupled with the mounting pressure on share prices over the past 18 months, which looks set to continue, does not bode well for the investment banks.

On the positive side, the loan market is still very open for the right client at the right price and with the right structure, and there are now enough banks with unutilised balance sheet capacity and asset target requirements to provide that liquidity. That more questions are being asked is only a sign of the uncertain times we operate in.

The healthy tension that is likely to exist between portfolio managers who want to reduce exposure and their origination account officers who want to do business is probably healthy, if managed in a professional way.

WHERE IS THE FUTURE? Business has to continue, and even though we are in a bit of a trough in the economic cycle and we have experienced the credit events of the past 18 months, and the increasing flow of customers into the fallen angel category, the lessons we have learned are good ones. The loan market has grown in real stature over the past few years and, in may ways, is the initial instigator for most big transactions, which are likely to get refinanced through the capital markets – and it will continue to exist for a long time to come yet.

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EQUITIES: IMPORTANT ISSUES

GREG BENNETT OF CAZENOVE LOOKS BACK AT THE TRIALS, TRIBULATIONS AND MISFORTUNES OF THE EQUITIES MARKETS IN THE UK AND AROUND THE WORLD OVER THE PAST 12 MONTHS.

Against the background of 11 September, global equity markets faced significant uncertainty coming into the fourth quarter of 2001. For most commentators, recession was probable, for some inevitable. The impact on the global economy of reduced corporate and consumer spending, decreased business and manufacturing activity, and the perceived threat to world oil supplies would, it was feared, would force the US and other leading nations into negative sequential GDP growth.

In the end, events did not turn out quite as badly, aided by a sharp reduction in global interest rates, a consequent injection of liquidity into the world's financial systems and an unexpected fall in oil prices. While the US was in recession in 2001, there were signs of recovery in Europe. The UK remained a growth economy, with 1.9% GDP growth in 2001, the highest in the G7, and maintained its enviable combination of low inflation, low interest rates and low unemployment.

EQUITY STRENGTH. A strong recovery in equity markets after 11 September was enhanced by a faster than expected resolution of the action in Afghanistan and a consumer boom that remained unabated, greatly helped by the lowest interest rates since the 1960s in the UK and the US. Equity markets were responsive to equity offerings and major refinancings were successfully executed, notably in the telecoms sector, where Sonera, Colt and KPN restored stability to their balance sheets. December witnessed the highest level of equity placings in the past 12 months, including major IPOs from Converium and Credit Agricole. With hindsight, however, we see that this was a bear market rally, obscuring negative factors such as the Enron scandal, tough industrial conditions and a cyclical high in the number of profits warnings in the UK.[1]

In the meantime, investors put another year of disappointing performance in 2001 behind them (the FTSE All-Share closed down 15%) and approached 2002 with renewed optimism. Equity strategists argued cogently that the leading market indices would end 2002 higher than they had began. Clear evidence of a recovery in business activity and continued strong consumer confidence and spending gave credence to the positive market background. Investors increased their exposure to cyclical stocks, awaiting the positive impact that economic recovery would have on corporate earnings.

Corporate misfortunes, such as Tyco and Energis, and political uncertainties in the Middle East were sidelined as the financial reporting season produced few negative surprises and the IPO market reopened. The IPOs of Xstrata, Alcon and Autoroutes de Sud de France each raised over $2bn in March alone. The market was even more willing to fund existing quoted companies and major

offerings or rights issues from ICI, Centrica, HBOS and Imperial Tobacco tapped the relatively stable markets of the first quarter.

REVERSAL OF FORTUNES. Stock markets, however, were about to face a dramatic reversal of fortunes. The apparent loss of momentum of the global economic recovery, further problems in Latin America, the weakening of the US dollar and the aggregated effect of the corporate scandals in the US led to a sudden fall in global equity markets.

The willingness of investors to accept equity risk shifted and between May and July the UK FTSE 100 dropped almost 1,500 points and the S&P 500 fell 32% from its March high. There was a widespread failure in confidence in the reported financial results of corporates as investors asked themselves whether they could trust the reported earnings. The WorldCom announcements in late June answered this question in the negative. While Enron was seen as a failure of management control, WorldCom touched the worst fears of many investors, as long-term accounting fraud was alleged against the management. Allied to the continuing investigations into the independence of sell-side analysts, investors' concerns about corporate credibility undermined confidence in markets, leading to a de-rating of the US market.

The UK and European markets were unable to escape these influences and though European markets were widely seen as less overvalued than the US, the risk appetite of investors had diminished. Holders of defensive stocks, such as tobaccos and consumer non-cyclicals, showed significant outperformance against indices dominated by pharmaceuticals, technology and financials.

A BEAR MENTALITY. The old-fashioned metrics of free cashflow and dividends became key to confidence and valuation. Insurance stocks were hit particularly hard, as falling markets adversely affected their capital position, which led to rumours that they were selling equities, thereby exacerbating the market's problems. A bear mentality took hold in the markets, as financial pundits talked of the "point of capitulation" drawing on the "head and shoulders" market chart, which predicted further sharp falls, and hedge funds were once again blamed for everyone else's ills. The scale and speed of the falls resulted in some investors withdrawing from the equity markets to seek the relative safety of cash and bonds. The impact on equity offerings was almost immediate, with some having to price at or below the bottom of their indicated ranges, and others forced to withdraw altogether. Those that successfully completed their offerings included Wood Group, William Hill, Enagas, Kingfisher and Cookson.

Currently, the market seems finely poised as investors return after the summer lull. September and October are frequently seen as potentially difficult months and the traditional talk of a Christmas rally seems a long way away. The overriding wish for most market practitioners is for some stability to allow the market and investors to regain their composure and restore the risk/reward equilibrium.

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[1] *Bank of England Quarterly Bulletin Spring 2002*

BONDS: A YEAR OF CONTRASTS

2002 HAS SEEN LOWLY RATED CORPORATES RAISE BILLIONS AND HIGHLY RATED CORPORATES LEFT WITH POSTPONED TRANSACTIONS. WHAT LIES BEHIND THE EXTREMES? HSBC'S **PATRICK MACDONALD** FINDS OUT.

The environment for corporate bond issuance has been volatile over the past year and new issuance opportunities have been interspersed with periods of high demand and times when the markets have effectively been closed. The tail-end of 2001 witnessed strong demand for bonds as investors continued their structural switch out of equities. With borrowers also keen to lock in low fixed rates, a period of strong demand met with high levels of supply.

This year, in contrast, with the exception of January, has been characterised by weak equity markets, accounting 'mis-statements', corporate defaults and a general loss of confidence in the economic recovery. More recently, a build-up in geo-political tension has increased investors' risk aversity. Such concerns and, in particular, the realisation that even well-rated credits can quickly deteriorate (particularly given a greater apparent willingness by the rating agencies to make aggressive downgrades), has seen some investors re-allocate funds into higher-rated paper. This led to even lower than normal levels of corporate issuance throughout the summer months.

CONTRADICTIONS. The recent flight to quality appears to contradict the continuing trend of steadily increasing issuance by BBB rated borrowers. Since October 2001 corporate issuance by BBB rated borrowers has increased by about 8%, while single A corporate issuance has fallen nearly 10%.

This issuance has seen periods of strong demand leading to highly oversubscribed orderbooks for Triple B corporates.

This increased issuance partly reflects the growing phenomenon of fallen angels, such as telecom companies which still have substantial funding needs, and investors moving down the credit curve in a bid to increase yields in a low interest rate environment (see *Figure 1*).

SECTOR STANCE. In terms of sectors, 2001 saw unprecedented issuance from autos and telecoms, as issuers refinanced investments in third generation (3G) licences and termed out commercial paper (CP) to the tune of more than $44bn (in all currencies). In contrast, 2002 issuance from these sectors has been a more modest $23bn. This dramatic decline in issuance from these two liquid sectors is also reflected by a drop in the number of jumbo euro issues.

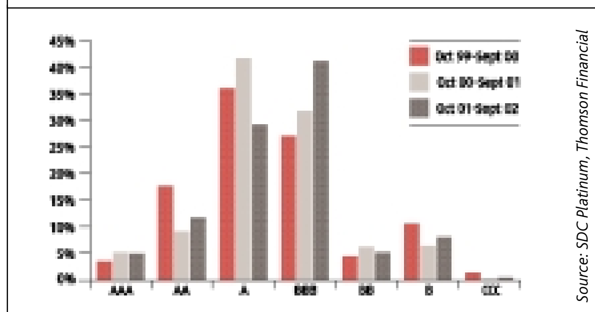
In contrast, again, the sterling market, sometimes still wrongly viewed as a niche market with relatively modest depth, has witnessed increased jumbo issuance, namely issues for GECC, RWE and E.ON totalling more than £4.4bn, and all within a four-week period.

Further evidence of this market's ability to accommodate larger deals can be seen by the increase in the number of £200m-plus deals with a 136% increase year-on-year to 64 for the period 1 October 2001 to date. A key driver of growth has been the shift to bonds in anticipation of the introduction of FRS 17, although this may now be delayed.

A related trend has been an increase in dual currency (euro and sterling) transactions. Over the past 12 months, 17 companies have tapped both markets, allowing them to diversify their investor base, reduce the overall transaction risk and achieve a size not otherwise possible in a single currency. Accessing both currencies concurrently also allows issuers to tap liquidity in medium-term maturities from the euro market, while at the same time taking advantage of sterling investors' preference for long-term debt.

However, the dual currency format will not necessarily benefit all comers, especially given the negative sentiment currently depressing the market (at the time of writing). Certain borrowers have been able to achieve lower cost of funding through issuing in just their home market, where they benefit from substantial name recognition. Investor contact is also something which, given volatile market conditions, is becoming increasingly important. Investors have made it clear that even well-known names are expected to conduct a roadshow encompassing all major investor centres, enabling investors the opportunity to conduct their due diligence, prior to launch. The consequence of not meeting investors has resulted in a number of postponed transactions in 2002.

FIGURE 1
CORPORATE ISSUANCE SPLIT BY S&P RATING.



Source: SDC Platinum, Thomson Financial

SURVIVAL OF THE FITTEST. The essential contrast of the past 12 months has been that while overall investor liquidity in corporate bonds has been at unprecedented levels, market volatility, corporate shocks, rating agency actions and now political factors have given rise to a highly dislocated market. In this new market paradigm, it is those borrowers who are able and willing to react quickly to opportunities that will prosper most.

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