WHAT DOES FUTURE HOLD FOR LOANS?

WE HAVE ASKED A PANEL OF EXPERTS IN THE LOANS MARKETS TO PROVIDE US WITH THEIR FORECASTS FOR 2003.

- *What major problems and opportunities do you expect in 2003?*
- *What pricing trends to you anticipate in 2003?*
- *What trends in currencies, deal types and structures do you expect?*
- *What trends do you expect in investor appetite (and, if 2003 is going to be an investor driven market, what compromises will issuers have to consider to get their deals completed)?*
- *What price ancillary business and what are the possibilities that certain cross-sell activities will not be appropriate in the future?*
- *How will active secondary trading and credit risk derivatives impact upon the primary markets?*

FENTON BURGIN
Director, Close Brothers Debt Advisory Group

MAJOR PROBLEMS/OPPORTUNITIES IN 2003?
It is remarkable that despite the bond and equity markets remaining largely closed to all but a few issuers in the second half of 2002, the Euroloan market continued to demonstrate its ability to support in excess of €133bn of facilities in the four months to October 2002, including 'major' transactions for Vodafone plc (€3.5bn), Imperial Tobacco plc (€4.0bn), Scottish & Newcastle plc (£2.8bn) and E.On AG (€15bn). Despite general risk aversion, an increasingly narrow retail market and speculation about future lack of liquidity, banks continue to compete aggressively for investment grade mandates. In the event that current volatility in the bond markets extends into 2003, it remains to be seen if the depth exists in the Euroloan market to continue to absorb similar levels of new issuance, particularly if more issuers follow Brake Brothers, Hutchinson Whampoa and Hewlett Packard's example in 2002, and put plans to access the bond markets on hold. We see market liquidity as one of the central issues in 2003, not least in the light of current concerns about the European banking environment.

PRICING TRENDS IN 2003?...
Despite much talk about increased loan pricing in 2002, margins and fees for investment grade credits remained relatively stable with investors bidding aggressively to secure fewer numbers of 'flagship' transactions and protect profitable ancillary business. In the second half, BAT plc, RWE AG and Volkswagen AG were all examples of companies taking advantage of the 'flight to quality' to secure sub 50bp margins for committed medium-term facilities. Continued low levels of M&A activity means that this trend will continue next year. The future pricing for non-investment grade

credits is more difficult to predict. In a risk adverse credit environment, those borrowers in defensive sectors with strong cashflows and established relationship banks will continue to attract fine pricing. However, those companies that are perceived to be more marginal credits or those that seek to approach non-relationship banks may find they have to pay a significant premium to secure funding. Invensys plc and Vivendi Univeral SA were both examples of companies that were reported to be 'stressed' credits paying close to leveraged buyout margins to secure facilities in 2002. For issuers looking to access the markets in 2003, the message is clear – ensure that your approach to investors is carefully planned.

■ ...AND STRUCTURES?

The Euroloan market will continue to dominate issuance with €238bn of loans raised in the first ten months of 2002. In the first half of 2003, continued low levels of activity in the equity, high yield and corporate bond markets combined with low interest rates mean that issuers will continue to see the loan markets as a primary source of finance. However, banks are increasingly more selective about the types of structures in which they invest.

In the aftermath of Marconi's financial restructuring and other high profile 'fallen angel' situations in the corporate loan market in 2002, a number of institutions have shifted their balance sheet resource to the LBO market. Greater due diligence and on-going reporting requirements, more extensive documentary restrictions and the involvement of an active private investor mean that many credit committees now see the higher returns achievable with credits such as Jefferson Smurfit and Legrand SA, as more attractive than fine margin, unsecured corporate lending. In the mid-market, reduced access to equity capital in 2003 will continue to drive PTP activity. But, the questions many private equity sponsors are asking are "how deep is the LBO loan market and will the liquidity be there in 2003?" In the last months of 2002 there is evidence of growing resistance to high leverage levels and a requirement for greater equity contributions. Nevertheless, the success of the CDC led LBO of Coral Eurobet, whose facilities were reported to have closed 40% oversubscribed with 16 banks and 8 institutions committing to the deal at a 5.6x initial Debt to Ebitda ratio, demonstrates the continued demand for soundly structured transactions. For the corporate borrower in 2003, it will be important to evaluate the implications of these market developments and to assess the available alternatives at an early stage.

■ TRENDS EXPECTED IN INVESTOR APPETITE?

Continued risk aversion and more pro-active portfolio management will see investor appetite focused on defensive sectors such as utilities, industries, tobacco, food and beverages. The market's reported cautious response to Télédiffusion de France's recent £1.3bn debt raising is symptomatic of current market nervousness about certain sectors. In the corporate loan market, fewer banks will now take on large sole underwriting positions and a reduced retail market means that more deals will be structured with clubs at the arranger level. RMC Group plc's recent £1bn refinancing was notable in that it was reported to have 5 banks at mandated arranger level. Those issuers refinancing in 2003 may be surprised by the extent to which they will have to accept that market standards have moved in areas such as security, financial covenants, effective material adverse change and market flex language.

■ WHAT PRICE ANCILLARY BUSINESS?

With fewer banks active in the secondary market, issuers will need to be more sophisticated in the allocation of lucrative ancillary business across their relationship banks. This is particularly the case for non-investment grade borrowers where it is no longer sufficient to make vague undertakings on ancillary opportunities. The situations where investors are prepared to provide use of their balance sheet for low margin returns will be increasingly few and far between in 2003. With regard to cross selling, post Sabanes-Oxley and Enron, many issuers are now questioning the independence of the 'advice' that they receive from their investment banks. Ultimately, this may lead to institutions in 2003 simply being more open about the product driven nature of their approach to their corporate clients.

■ ACTIVE SECONDARY TRADING AND CREDIT RISK DERIVATIVES?

With many arranging banks now running shorter primary syndication and underwriting phases and with fewer deals reaching general syndication, the secondary market may be the only place in 2003 for those banks seeking smaller participations to secure loan assets. Secondary activity may also be stimulated by CDO funds starved of assets in the high yield bond market moving into the loan markets.

With regard to credit derivatives, many issuers now routinely use credit default swaps to spread their risk. According to the BBA, the overall market will be worth a staggering €1,952bn by the end of 2002. Should the corporate borrower be concerned? Many analysts argue that the widespread use of credit derivatives will make the future European major restructurings extremely challenging given the widespread nature of institutions likely to be involved.

IAN FITZGERALD
Director and Head of Distribution and Syndication at Lloyds TSB Capital Markets

■ MAJOR PROBLEMS/OPPORTUNITIES IN 2003?

Is this a market in which one can discuss opportunities? The market is open and good quality well-rated companies are raising funds successfully – but there is no doubt that the market has become very nervous.

The shockwaves following the spectacular corporate failures of investment grade companies such as Enron, Worldcom and more recently, TXU and ABB to name but a few, have badly damaged the confidence of lending bankers and credit committees across all sectors. The suggestions of fraud and creative accounting in high profile cases have undermined faith in many previously fashionable segments of the market.

The trends over the last 3 years, such as the impact of Basel II, bank mergers, risk/reward models, credit derivatives, asset securitisation and/or bond and vanilla loan structures, are still affecting attitudes. We now find ourselves in a simpler and yet

more difficult market, in which 'back to basics' principles will prevail. Risk reward remains a focus, but ensuring the successful completion of transactions and avoiding potential losses are the major priorities for most lending bankers.

An ongoing issue in the UK is the increasing conservatism of foreign lenders who are clearly pulling back from lending to the corporate market. This phenomenon is not driven by specific UK issues but more by external factors including the continuing poor economic performance of the global economy and problems in banks home markets. This, in turn, is adding increased pressure on domestic banks to bridge the gap.

As we look to 2003 borrowers can take comfort from the state of the UK economy which has remained in comparatively good shape and that despite some ongoing concerns about retrenchment and its effect on liquidity, cost effective fund raising, should, with careful planning and consideration remain a realistic expectation.

PRICING TRENDS IN 2003?...

Supply and demand are the key pricing drivers. It is becoming very clear that sector differentiation is increasing and that there are different pricing levels for varying industry groups. The increasing use by banks of portfolio management and relative value calculations means there is a growing transparency in pricing – which when we look across the sectors is predicted to stay flat for top quality single 'A'/investment grade borrowers and increase as one goes down the credit curve. The shorter the tenor the better pricing will be, three years is currently the optimum.

...AND STRUCTURES?

As far as currencies are concerned there appear to be no major issues, for very large transactions there is more liquidity in euros and US Dollars. Overall, the advent of the euro has passed well and has certainly simplified matters for continental European fund raising.

The major reduction in volume of M&A activity has seen a corresponding drop in related financing. The result of this is that outside the Acquisition Finance market there is a clear decrease in the number of multi-tranche facilities. There is a definite preference amongst banks and indeed borrowers for as little complication as possible – the more complex the less liquid.

There have been, and are likely to remain, a number of 'core relationship' revolving credit type transactions in the market. An interesting factor amongst these is that when the amount is of a good size and a bond refinancing is likely, borrowers are requiring the bond houses to take and hold a shorter term 'bridging' for the bond issue on the understanding that the bond houses will benefit from the 'bond economics' and can therefore afford to keep relatively large amounts. This reduces the need for wide general syndication.

TRENDS EXPECTED IN INVESTOR APPETITE?

As we discussed earlier the loans market is now typified by a conservative approach from banks, all are concerned about the difficult international credit environment. This means that there are very few banks that are pure 'investors' left in the loans market. Most that remain active lenders are looking for some form of active relationship as well as lending assets.

So, yes the market will be more investor driven, and borrowers will need to be more flexible on agreeing structures, covenants and pricing to ensure they create supportive bank lending groups.

WHAT PRICE ANCILLARY BUSINESS?

A common discussion on a relationship loan transaction is the value of ancillary business. The argument is that the price of the loan added to the return on the additional business makes up the economic return to a bank and thus justifies the return on the necessary capital commitment.

In recent years corporate bankers have been interested in selling other products as a preference to lending. The focus being on capital efficiency, as balance sheet usage becomes a scarce resource.

Few corporates have sufficient ancillary business to share round large bank groups and therefore one of the reactions from Treasurers is to slim down their banking group, which in turn leads to the requirement for larger initial tickets with possible credit capacity issues. Therefore, the strong bargaining position for a corporate is to have enough ancillary business to distribute to its banking group.

However, the competitive nature of the markets suggest value for mid-tier banks of swap, forex and perhaps other treasury products, has to be questionable and therefore of little or no economic value.

This leads one to argue the 'excuse' for exiting a relationship due to lack of ancillary business is actually because of uneconomic standalone pricing and/or lack of value of that ancillary business.

ACTIVE SECONDARY TRADING AND CREDIT RISK DERIVATIVES?

In the aggressive M&A driven market of the past, active secondary trading spun off from the need for banks with an investment banking attitude to sell down their positions to the levels acceptable to their portfolio approach. The slowdown in the volume of major M&A transactions and the increasing reticence of the banks involved in this business to lend money has reduced the volumes in secondary.

The issue with the credit derivative market is that volume of trades completed for anyone but the highly rated names is minimal. The activity in the credit derivative market is driven predominantly off the hedging of bond and other portfolios and is mostly in areas where the paper is highly liquid. Therefore, for the majority of corporate treasurers credit derivatives do not have a major impact fund raising and the relative value effect is minimal.

DECLAN MCGRATH
Managing Director, Head of Syndications, UK and Europe at The Royal Bank of Scotland

MAJOR PROBLEMS/OPPORTUNITIES IN 2003?

The consequences of the events that have occurred since 11 September 2001, including the US economic slowdown, the realisation of a severe lack of M&A business, the capital absorption of the telecom sector, 'Enronitis' and indeed the degrees of difficulty experienced as a result of WorldCom, KPN Quest, Marconi, etc will not be short-lived. It is increasingly likely that harsh lessons have been and will continue to be learnt as we go

into the next cycle. We have seen over the last few months a significant amount of refinancing for well rated borrowers at aggressive pricing and there is a view that these deals, which to date have been completed successfully by and large, will have achieved the best pricing available and the likelihood is that pricing will continue to increase as we go into the first half of 2003.

The structure of transactions will continue to be robust and one would like to think that the major mandated lead arranger banks, while continuing to be competitive, will support this continued robustness. In terms of opportunities, while it is very difficult to call the potential for an uplift in M&A activity and when one looks at the degree of difficulty currently being experienced in the global debt and equity markets, it is likely that the senior debt market has the potential to be the busiest in 2003.

PRICING TRENDS IN 2003?...

I believe the scene has been set in 2002 for what is likely to happen at least in the first half of 2003. We have seen the pricing differentials increase significantly as you go down towards the lower end of the credit spectrum. Indeed, there has been movement initially from BBB+ downwards to BBB- where at the beginning of this year we experienced a widening in spreads. More recently, however, the gap has started to widen higher up the spectrum for certain names at the A- rating. This trend will continue, even taking into consideration the lack of M&A business likely for the first six months of the year and the competition for business. The risk reward ratio conundrum will continue and again, while it is likely that there will be some exceptions for some A+ and AA names to continue to achieve finer pricing, there are not all that many clients in this range of credit who come to the market anyway and it is more likely that we will be dealing with A flat or lesser names.

...AND STRUCTURES?

There is no doubt that the euro will continue to be the major currency for the vast majority of syndicated transactions in Europe as we go forward. There have been quite a number of refinancings so far and the expectation is that these will continue, again, in particular, as we do not believe we are going to see very much M&A activity. However, as banks who maybe have not made their budgets in 2002 either on an interest income basis or a fee revenue basis, it is likely that they will want to come out of the blocks as quickly as possible in 2003.

If this proves to be the case there is a distinct possibility that there will be a greater number of bilateral transactions being completed. However, once we get past the first six months of the year there is a likelihood that there will be a more realistic approach on the corporate acquisition front where realistic prices will be looked for and paid and this could provide some added deal flow towards the latter half of the year.

TRENDS EXPECTED IN INVESTOR APPETITE?

For the first six months of 2002 there was a lot of discussion in the general market with respect to lack of M&A activity, decreasing volumes, credit concerns, etc. In the latter half of 2002, while the credit concerns obviously still remain and there has not been a great increase in M&A activity, there has been less chat about lack of volumes. This has been primarily driven by the flood of investment grade activity which really started around about the middle of September as some of the higher rated borrowers moved to take advantage of the demand for assets from "flight to quality" credits. In one period of a week there was close to €40bn of new activity and most of these were either refinancings of previous acquisition-related facilities or indeed just straightforward refinancings. While the general expectation is that this activity will continue but to a lesser degree, pricing for the higher quality names will continue to remain stable and indeed competition for mandates could put some pressure on margin and fee pricing. However, for the lesser rated names the differential will continue, the credit reviews will remain critical, the structures will continue to be more robust and pricing will almost certainly increase.

WHAT PRICE ANCILLARY BUSINESS?

Clients will have to decide how best they are going to provide ancillary business to their banks and for investment grade names it is likely that fewer and fewer banks will be required as they try to protect the future ancillary business with higher take and hold amounts in individual deals.

This will of course put the pressure on the client to deliver the ancillary business and the fact is that if the banks do not obtain this ancillary business they are quite prepared to say no. With the contraction in the bank market, the likely global economic environment for the next 18 months, plus the huge potential for event risk, banks will be endeavouring to obtain the required returns on capital and therefore this will provide healthy tensions in discussions and negotiations with clients.

ACTIVE SECONDARY TRADING AND CREDIT RISK DERIVATIVES?

Secondary market activity over the past couple of years has in certain cases replaced the traditional general syndication phase of many corporate deals.

This has been driven by reverse pyramid syndication structures plus the increasing need by banks to actively manage their loan portfolios. It is also noticeable that the majority of corporate treasurers in Europe have come to accept loan trading as normal for their relationship banks, indeed some encourage it to make more lines available for new business.

When any primary syndicator prices a new deal they will now compare prices not only to similar companies who have raised funds in the loan market, but will also check prices with their secondary loan desk, bond desk and credit derivative desk.

However the primary price will still have built into it the intangible relationship angle, plus the very tangible better covenant structure and recovery rates attributable to loans. For this reason both the primary and secondary prices will be lower than comparable bonds and credit derivatives. Indeed the credit derivatives market more closely reflects the sensitivity of the equity markets than it does the stability of the loan market. Whilst the unfortunate events of 11 September 2001 resulted in a lack of liquidity and where there was liquidity large pricing hikes in the bond and credit default markets, the syndicated loan market, both primary and secondary, continued to operate, albeit with slightly increased yields.

In addition banks actively managing their portfolios continue to favour secondary loan sales over the use of credit derivatives because the former completely removes risk from the balance sheet and is generally cheaper than the credit derivative. In addition a vast variety of loan types, borrower types and country risk can be sold into the secondary loan market that cannot be covered by a credit default swap.