THE ROAD AHEAD

WE HAVE ASKED A PANEL OF EXPERTS IN THE LOANS MARKETS TO PROVIDE US WITH THEIR FORECASTS FOR 2002. WE ASKED THEM THE FOLLOWING QUESTIONS:

- WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2002?
- DO YOU FORESEE AND SIGNIFICANT CHANGES IN THE WAYS INVESTORS MANAGE THE CREDIT RISKS OF THEIR LOAN PORTFOLIOS?
- WHAT PRICING TRENDS DO YOU ANTICIPATE IN 2002?
- WHAT TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURES DO YOU EXPECT?
- WHAT TRENDS DO YOU EXPECT IN INVESTOR APPETITE?
- SO YOU FORESEE ANY FURTHER REGULATORY, TAX OR OTHER HARMONISATION AFFECTING THE LOAN MARKET OVER THE NEXT 18 MONTHS?

THEIR ANSWERS ARE SET OUT BELOW.

FENTON BURGIN,
DIRECTOR, CLOSE BROTHERS DEBT ADVISORY GROUP.

MAJOR PROBLEMS AND OPPORTUNITIES IN 2002? Faced with a highly challenging business environment, many companies have slowed or put on hold their M&A activity and focussed on their core businesses. We expect those companies with conservative capital structures to weather continued difficult market conditions in 2002, while a number of high-profile UK corporates that took advantage of the high levels of leverage available in the bull market will require restructuring or will not survive at all. However, with low valuations, a number of sectors will continue to offer opportunities for cross-border European consolidation. Faced with reduced access to equity, any activity is likely to be financed in the bank markets.

ANY SIGNIFICANT CHANGES IN THE WAYS INVESTORS MANAGE THE CREDIT RISKS OF THEIR LOAN PORTFOLIOS? Market uncertainty and a number of high-profile restructurings in 2001 are likely to lead to banks' greater focus on portfolio management and more stringent applications of sector and credit rating caps. In 2002, borrowers are likely to experience tighter covenants, increased security packages and reduced target hold levels. Fewer banks will be prepared to take large sole underwriting positions. We expect more medium-sized vanilla deals to be arranged on a club basis, with large complex transactions being syndicated by way of a book-building exercise.

PRICING TRENDS IN 2002? Pricing, both in terms of fees and margins, will continue to rise. 11 September accelerated structural changes prompted by economic slowdown with those borrowers in non-defensive sectors or without significant ancillary business experiencing the greatest pricing increases. This trend will continue and the wide variety of risk-adjusted return on capital models used by banks and variations in the views of individual credit committees will lead to wider pricing variations. Infrequent borrowers may be surprised by the extent of the pricing rise resulting from these developments.

TRENDS IN CURRENCIES DEAL TYPES AND STRUCTURES? The euro-denominated market will continue to grow in importance, particularly for large corporate financings. We do not anticipate a recovery in the LBO market in the first half of 2002, despite many medium-sized companies continuing to face depressed market valuations and lack of institutional interest. Activity in the leveraged market is likely to be limited to secondary buyouts or refinancings, with many private equity houses facing markets that remain closed for all but the most conservatively structured transactions.

TRENDS IN INVESTOR APPETITE? Faced with reduced appetite for the TMT sector we anticipate investors moving across the credit spectrum to companies with more stable cashflows, including general industrials, consumer products and utilities. Longer maturities will only be accessible to higher grade credits, with loan structures remaining conservative. We anticipate greater focus on adverse change and market flex language that is effective.

FURTHER REGULATORY, TAX OR OTHER HARMONISATION AFFECTING THE LOAN MARKET OVER THE NEXT 18 MONTHS? Delays in the implementation of the Basel Committee's proposals on capital adequacy continue to cause confusion for many institutions active in the mid-market. A third round of consultation in 2002 looks set to add further to the delay. However, it may address many institutions' concerns that, as drafted, Basel II may make it uneconomic to lend to small- to mid-sized companies. Seperately, if as seems likely, the proposed G4+1 changes to the treatment of operating leases under UK GAAP are implemented, many banks will need to fully assess the implications for a wide range of UK companies.

DECLAN MCGRATH,
HEAD OF SYNDICATIONS, UK AND EUROPE, THE ROYAL BANK OF SCOTLAND.

☐ **MAJOR PROBLEMS AND OPPORTUNITIES IN 2002?** There is no doubt that the world's financial markets have had to deal with many significant events, both positive and negative, over the past 75 years, but nothing could have prepared it for the events of 11 September 2001, or its consequences – some of which have already occurred and others which no doubt have yet to happen. However, we should recognise that prior to 11 September 2001 the global economic situation had been deteriorating, and what has occurred since 11 September is an acceleration of that. We have also seen less M&A activity, particularly in Europe, which has had negative effect in the monetary value and number of deals. However, in times of uncertainty, opportunities will arise, such as a more prudent approach to credit, and we are unlikely to see transactions being placed without strong financial covenants. There will be a flight to quality, which always happens in uncertain times. Pricing is likely to continue to increase, but it should be remembered that the loan market has always been the most dependable source of finance in times of difficulty, particularly when the bond and equity markets are experiencing volatility. This is unlikely to change.

☐ **ANY SIGNIFICANT CHANGES IN THE WAYS INVESTORS MANAGE THE CREDIT RISK OF THEIR LOAN PORTFOLIOS?** It has been said that bankers have short memories – when there are times of trouble they will pull up the drawbridge and retain balance sheet; when times are better they will revert to what is considered the norm and again start lending hand over fist at reduced pricing and looser covenants. I believe these days are truly gone and that credit committees and portfolio managers within most institutions have adopted a sophisticated model for their lending policies and will adhere to it. Yes, there will be some degree of flight to quality, certain sectors will be more favourable, such as utilities retail, food and possibly secured property transactions. In fact, those of us who operate as originators of business should be happy that this is the case and it should help us to manage the risk/reward ratio equation more effectively and efficiently.

☐ **PRICING TRENDS IN 2002?** Again, as one might expect, banks have learned valuable lessons from the past on the pricing front. Remember, banks, like corporates, have investors who require a reasonable return on their investments. The idea is to achieve a reasonable return on the utilisation of their balance sheet. It is fair to say that finance directors and treasurers have over the past few years accepted that the days of cheap money from their friendly bankers are past, and even where there is the potential for other ancillary business which in itself must be real, more and more each transaction must stand on its own merits. Banks have been, and will continue to be, ready to say no if the overall price and return is not adequate. Certainly, in the first half of 2002, it is likely that for transactions rated single A or above, pricing should remain stable, but deals being arranged for clients rated below A/A- but still investment grade there is likely to be upward pressure on pricing and structures will be more robust and conservative.

☐ **TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURE?** Since 1998 most of the big European transactions, and in particular the jumbo type associated with the telecoms sector and other key M&A activity, have been completed by being euro-denominated. This is unlikely to change, particularly since all legacy currencies will effectively cease to exist past 1 January 2002. The euro has allowed a great number of these transactions to be successfully completed which otherwise would not have been the case. The likelihood is that deals in all sectors are going to be more conservatively structured and of shorter term. While there is the view that there will be opportunities for some greater M&A activity next year, a lot of transactions are likely to be refinancings in whole or in part for investment grade-type clients. The leveraged market, which has seen much activity in 2001, is also likely to ease off, at least in the first two quarters of 2002.

☐ **TRENDS IN INVESTOR APPETITE?** Notwithstanding any significant further deterioration in the global economic climate, one must not forget that there will be new budgets, new targets to be achieved and balance sheets will be used to achieve asset targets for the new year. There will no doubt be greater selectivity, coupled with a flight to quality, but because of the asset requirements, well-structured and reasonably priced transactions in the right sector will be well sought after and it may make the syndication process a little easier. There will also be a requirement for assets as consolidation continues in many sectors across Europe, and there is likely to be a greater number of transactions across Europe, particularly France, Germany and Italy.

☐ **ANY FURTHER REGULATORY, TAX OR OTHER HARMONISATION AFFECTING THE LOAN MARKET?** One country where – as a result of tax and pension reform and the July 2001 agreement between the competition commission of the European Union and the banking authorities – there is likely to be reasonable activity is Germany. A compromise has been reached to ensure conformity with European competition law. While the Landesbanks have been given until 2005 to complete the process of non-dependence and to prove their worth as commercial banks, it is likely that corporates which have previously depended on the Landesbanks may have to consider funding from elsewhere, including the capital markets and the international loan markets in advance of 2005. The Loan Market Association has taken great steps in achieving significant standardisation of documentation which is of great assistance to the market. The internet will continue to be of benefit as more arranger institutions continue to use it for the downloading of information, that is, loan documentation and information memoranda.

CHRIS SHAWYER, MANAGING DIRECTOR, CAPITAL MARKETS, LLOYDS TSB.

☐ **MAJOR PROBLEMS AND OPPORTUNITIES IN 2002?** Over the past two years, the market has become increasingly concerned about the likelihood of recession. An increase in corporate profit warnings and widespread redundancies continue to take their toll, while consumer confidence, which was holding up well before 11 September, is now showing signs of a decline.

A number of problems exist. Banks were already more focused on credit issues and tighter covenant structures, which will continue to make life more difficult for borrowers. Bank mergers and the requirements of Basel II have focussed attention on returns on capital, making bank appetites more selective and less predictable. The growth of bond structures and securitisation will continue to compete with vanilla lending, although in a perhaps less intense way than would have been the case in a booming market. Healthy lending relationships will continue to be crucial to corporates during the downturn in equity and bond markets. Sectors which have been suffering for some time (including telecoms and automotive), are now accompanied (post 11 September) by insurance, airlines and travel companies. Difficulties in these sectors will no doubt exacerbate the overall economic downturn, while declining consumer confidence could damage the retail sector.

But it is not all doom and gloom. There are opportunities on the horizon. The reduction of appetite among international banks for transaction based deals is leading to tighter liquidity and a trend towards lower commitments for take and holds. Underwritings are less popular, which means those banks which are prepared to use their balance sheet in support of their relationship customers will benefit. A somewhat contradictory feature is that the general shortage of transactions into the New Year and budgets based on previous boom years will lead to a 'need to do deals' by banks, causing better issues to succeed, even allowing for credit tightening.

☐ **ANY SIGNIFICANT CHANGES IN THE WAYS INVESTORS MANAGE THE CREDIT RISKS OF THEIR LOAN PORTFOLIOS?** There will be a continuing growth in portfolio management and the use of credit ratings as an indicator of pricing. The use of credit derivatives will continue to grow to manage balance sheet risk. Banks will undoubtedly pay closer attention to where value can be achieved. Relative value across the credit and risk products will intensify competition for available exposure, so putting further pressure on the cost of relationship based lending. Venture capital investors and loan funds will be looking at longer-time horizons for existing deals with the term increasing from 18-24 months to nearer five years, and this will require more consideration of medium term performance.

☐ **PRICING TRENDS IN 2002?** Further rises are anticipated, reflecting the economic climate and difficult market conditions, especially for lower-rated and leveraged transactions. Europe is likely to move to a more 'ratings- based' approach to lending, with more companies obtaining ratings, driven by the anticipation of Basle regulations. An increase in risk/pricing differentials to reflect asset weightings will occur. The portfolio management and relative value approaches mentioned earlier will push pricing higher.

☐ **TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURES ?** Currencies – post-January 2002, there is likely be a predominance of euro-denominated loans for non US-linked transactions. The impact of sterling remaining outside of the euro is still to be determined, but London is not expected to be undermined as a leading financial centre.

Deal types – M&A activity will be muted in view of the difficulty in raising equity capital (investor appetite has been damaged by declining stockmarkets) and uncertainty in the availability of medium to long term refinancing. The bond market is still unsettled, leaving vanilla lending as the main option for corporates to tide them over this difficult period.

Structures – these are becoming tighter, with stricter controls on borrowers, while deals are more likely to succeed the more standardised they are, in terms of covenants and restrictions. Leveraged and M&A deals will require a higher equity content and, in Europe at least, subordinated lenders will seek loan structures that are more favourable to their interests rather than just those of senior lenders. There will be more emphasis on due diligence, the robustness of financial models and assumptions.

☐ **TRENDS IN INVESTOR APPETITE?** The investor base has shrunk due to mergers and takeovers, although these changes have slowed, allowing the market to stabilise. A few re-capitalised banks are currently building an asset book, but in terms of the total market this is unlikely to cause any shift in pricing, tenor and the like. The appetite for longer tenor, project-type transactions appears to have slowed (to 27-30 year money).

In terms of bank appetites, transactions where performance is proven, and where relationships are strong, are likely to proceed successfully. But for any newer, less straightforward deals, banks may find it difficult to convince credit committees that now is the time to be venturing from well-trodden paths.

Non-bank investors, both direct and through CLOs will continue to play a part, but not to a level that will balance out the shrinking bank capacity.

☐ **ANY FURTHER REGULATORY, TAX OR OTHER HARMONISATION AFFECTING THE LOAN MARKET?** Banks are starting to anticipate the impact of Basle II regulations, while changes to the Landesbank State Guarantee in Germany has removed a downward influence on pricing.

Proposed changes to the UK Insolvency procedures could at best cause banks to seek asset-backed lending and at worst reduce supply and raise the cost significantly.

The JWG proposals on fair value accounting could have a significant impact on the way banks conduct business, provoking them to trade loans more openly and force banks to shorten tenors as their loans mature.

NICHOLAS VOISEY,
HEAD OF GLOBAL SYNDICATIONS, EUROPE, NATIONAL AUSTRALIA BANK LIMITED.

☐ **MAJOR PROBLEMS AND OPPORTUNITIES IN 2002?** Against a background of continued political and economic uncertainty, made more acute by events of 11 September, banks are reassessing their credit risk profiles. As banks react with different degrees and speeds to these risks, understanding the revised credit profile of their counterparties will be one of the problems facing arrangers and borrowers.

Opportunities for the loan product will undoubtedly arise as historically it has been demonstrated that at difficult times the loan market remains more accessible and robust compared with other debt markets. Borrowers who have maintained stable and informed relationships with their banks will benefit from their loyalty, as lenders are likely to remain more open to clients who have, or are willing to provide them with additional business. Equally, lenders who are less risk averse will have the opportunity to gain improved relationship status and overall market share.

☐ **ANY SIGNIFICANT CHANGES IN THE WAYS INVESTORS MANAGE THE CREDIT RISKS OF THEIR LOAN PORTFOLIOS?** Expect to see more dynamic portfolio management, particularly from those institutions that include a component of equity price movements in their risk measurement models. This becomes more relevant in a bear market because it leads to rapid internal downgrades, usually before a corresponding move from the credit ratings agencies.

In addition, sector and geographic concentrations, as well as large exposures, will be evaluated more actively. A scenario of further economic deterioration will also increase the number of 'distressed credits' which will require management time, further slowing the appetite and resources available for new business.

☐ **PRICING TRENDS IN 2002?** The relationship/non-relationship pricing trade off will come even more into focus, as an increasing number of banks incorporate RAROC, RoE and Economic Value Added, as criteria for lending to new and existing clients. Many companies will have to accept a shift towards a lenders' market and be prepared not only to offer but quantify ancillary business opportunities upfront to meet lender hurdles. With greater fungibility between debt instruments, more attention will now be paid to any perceived discount available in the Syndicated Loan Market *vis à vis* other markets, and a tangible rationale for it is more likely to be required than previously.

Overall, expect pricing to remain stable or rise slightly for quality credits and increase materially for those in adversely impacted sectors, particularly if they need to refinance with no other available markets for funds.

☐ **TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURES ?** In the final months of this year the market has yet to regain confidence. Several recent deals have not acknowledged sufficiently the new world and have proved unable to stabilise conditions, with structures more in keeping with better times. A return to 'plain vanilla' corporate deals is to be expected in the short term, with increased security and lower senior debt multiples being requested for leveraged or ring-fenced facilities, a difficult task given the reluctance of equity and junior debt providers to commit at this time.

Even stronger rated credits will be required to accept more restrictive and tighter structures including stronger and enforceable Material Adverse Change clauses and flex language. The euro will continue to be the currency of choice for most European borrowers offering a wide and deep investor base and mitigated exchange risk.

☐ **TRENDS IN INVESTOR APPETITE?** In uncertain times, the syndicated loan market has previously shown itself more resilient than others, providing, as it does the anchor role in most client relationships. However current and expected market conditions, the need to deliver increasing shareholder value, along with how banks are and expect to be regulated, have led them to reassess how their balance sheets are employed, with more focused lending a result.

Under continuing uncertain economic conditions, the market will experience a 'flight to quality' so accentuating the already seen divergence between the higher risk areas and perceived acceptable defensive sectors, with borrowers classed as 'winners' within their industries being the principal beneficiaries.

☐ **ANY FURTHER REGULATORY, TAX OR OTHER HARMONISATION AFFECTING THE LOAN MARKET?** It is unlikely that any changes will become effective over a period of 18 months, however the various consultation papers concerning capital adequacy requirements and fair value accounting will continue to gain momentum through this period and will start to concentrate minds as to the consequences of their eventual implementation. With the higher rated credits affording banks lower capital weightings this should further reinforce the trend towards higher quality credit names and pricing for risk. It will also incentivise banks to look at their loan portfolios from a different angle and continually assess the value of their assets. The standard process of 'marking to market' a principle already well established for trading books, may start to migrate into loan portfolios, thus contributing further to close the gap between 'lending' and 'trading' books.

'IN UNCERTAIN TIMES, THE SYNDICATED LOAN MARKET HAS SHOWN ITSELF MORE RESILIENT THAN OTHERS, PROVIDING THE ANCHOR ROLE IN MOST CLIENT RELATIONSHIPS'