THE TREASURER ASKS A SELECTION OF EXPERTS IN THE LOANS MARKETS TO PROVIDE US WITH THEIR FORECASTS FOR 2004.

A GOOD TIME TO BORROW?

- *What major problems and opportunities do you expect in 2004?*
- *What pricing trends do you expect in 2004? Is pricing based on rational credit evaluation or is it more influenced by an assessment of ancillary business?*
- *What trends in currencies, deal types and structures do you anticipate in 2004?*
- *Many treasurers comment that banks are increasingly reluctant to lend; some are reducing their lines, others (especially overseas banks) are cutting back altogether. Will this trend continue as economic conditions recover, or will treasurers have to learn to live with a much smaller percentage of their funding coming from the banking markets?*
- *How will active secondary trading and credit risk derivatives impact primary markets in 2004?*

IAN FITZGERALD
DIRECTOR AND HEAD OF DISTRIBUTION AND SYNDICATION AT LLOYDS TSB CAPITAL MARKETS

WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2004?
The key issue in the UK corporate loan market is the severe reduction in volume and activity of both event-driven and general corporate financings. This, of course, is more of a worry for the bankers rather than finance directors and treasurers.

Bank of England statistics show that UK corporates are now in aggregate cash positive, a fact that is probably due to low levels of investment and mergers and acquisitions (M&A) at their lowest level since 1997 – resulting in an overall lack of confidence.

Over the past few years, up to 40% of volume in the UK corporate loan market has been the financing of acquisitions. The problem for the banks, especially those that profess to be lead arrangers, is that the past three years have seen an almost continuous decline in UK loan market issuance, in terms of number and volume of transactions. Competition for mandates will continue to be intense and, with liquidity looking strong, borrowers in the right sectors have an excellent opportunity to raise cost-effective funds.

A problem for borrowers will be that, despite relatively robust bank liquidity and market stability, there are still negative influences on the banking sector. The well-publicised credit problems created by the large corporate failures over the past three years, have damaged confidence, especially that of foreign banks based in the UK. These banks have decided to focus on their domestic markets rather than pursue further international expansion. The markets are therefore polarising with fewer players prepared to provide general liquidity without sufficient relationship or product reasons.

Nevertheless, looking forward to 2004, both borrowers and bankers can take comfort from the state of the UK economy, which looks in good shape for the next 12 months. This should ensure that at least the UK banks, and especially those following expansionary strategies, will be able to support corporate borrowing requirements regardless of the liquidity problems affecting other banks. What is certain is that, although foreign banks are repositioning their lending priorities, 2004 will be an ideal time for finance directors and treasurers to source loan market funding.

WHAT PRICING TRENDS DO YOU EXPECT? IS PRICING BASED ON RATIONAL CREDIT EVALUATION, OR IS IT MORE INFLUENCED BY AN ASSESSMENT OF ANCILLARY BUSINESS?

A major influence on pricing is the impact of the forthcoming Basel II regulations. There is also a general realisation that there needs to be rational and relevant reward for risks taken. These factors have had an impact on credit and price modelling, resulting in more standardised bank/market practices and increased transparency. In essence, Basel II is already influencing banks to more accurately price fair value and this process is being helped by the wider circulation of information, such as secondary market quotes, credit derivative pricing, comparative bond pricing and third-party ratings analysis.

Fundamentally, all pricing remains subject to supply and demand factors and, at a transaction level, the relative amount of funds required will ultimately affect the price achievable in the market. This is where factors such as the size and make-up of the borrower's bank group come into play. If the borrower only needs to rely on its core group of banks, which will have all of its ancillary business, pricing will be lower than if the transaction needs to appeal to a wider audience, where pricing will move closer to a pure credit/market price.

The ability to secure ancillary business, from a portfolio-wide view, allows banks to achieve target levels of return on a relationship. Pricing is generally more attractive for borrowers that have large core banking groups, a global reach and a wider range of ancillary business. In 2003, the success of transactions such as Cadbury Schweppes and Smith & Nephew demonstrate that the pricing for strong corporate credits remains flat, with well-rated credits still being able to achieve competitive pricing. We believe this trend will continue into 2004. However, in most cases loan pricing will still depend on liquidity available in the market and the credit quality of the borrower. The trend is likely to remain flat if volumes stay subdued. Much will depend on the volume of M&A transactions in 2004.

WHAT TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURES DO YOU EXPECT?

Overall, in terms of currency, the flexibility of the loan market is such that structuring transactions to cope with borrowers' differing needs is rarely an issue. The future impact of Basel II, the increased use of credit metrics models and changes in banks' attitudes to capital allocation will mean increased focus on high quality credit lending and preferences for shorter tenors.

The effect of these cross-market changes will probably reduce the use of 364-day facilities as they lose their zero capital weighting for all but the highest value credits. The focus of the evaluation models will bring pressure to make three-year average life financing a preferred option rather than the more standard five-year bullet.

MANY TREASURERS COMMENT THAT BANKS ARE INCREASINGLY RELUCTANT TO LEND. WILL THIS TREND CONTINUE AS ECONOMIC CONDITIONS RECOVER?

The trend treasurers are seeing may be true as far as overseas banks are concerned. Changes in European banking are being driven by long overdue restructuring, in particular in Germany and Italy. In Germany, foreign banks are gaining market share at the expense of the domestic banks, which clearly have problems. This restructuring, combined with faltering economies and banks being hurt by unforeseen investment grade and domestic credit losses, has affected market confidence. For the time being at least, many European banks are focusing on their home markets and contracting lending to all but their closest relationships.

In addition to this contraction, competition and the required economies of scale to provide an international wholesale banking service have reduced the number of truly global players. This is increasing competition in areas such as acquisition finance and creating more focused markets with a reduced number of providers.

For the moment, some European banks have retreated from international lending, but one can argue that these have been providers of additional, or even surplus, liquidity in the past. Without the presence in the market of acquirers of assets for pure yield plays, treasurers will need to adjust to the change in behaviour but should benefit in the long-term from more meaningful key banking relationships.

Although the issues raised are a concern and need to be taken into account when raising funds, recent transactions have proven that bank appetite remains strong and treasurers should not be concerned about suggestions of reduced liquidity in the bank loan market.

HOW WILL ACTIVE SECONDARY TRADING AND CREDIT RISK DERIVATIVES IMPACT ON PRIMARY MARKETS?

If this question is principally about pricing, the primary loan market for corporate borrowers has always included reference to secondary market pricing but has always taken into account relationship and ancillary business. Increased transparency and information flow across the markets has driven banks to adopt more rigorous pricing models and to seek, wherever possible, the appropriate risk-weighted return.

In all cases, relative value assessment ensures that the primary loan pricing will not only be compared with the secondary loan price and the price of similar credits, but also, where possible, with the bond and credit derivative price. The intrinsic difference between the bond/credit derivative markets and the primary/secondary loan markets is that the loan markets benefit from a documentary covenant package that will be substantially tighter and more secure than most bond and certainly most credit derivative packages.

As far as credit derivatives are concerned, it is an increasing reality that primary market pricing is being influenced, some would say artificially, by quotations given in the credit derivative market. A moot point in relation to the use of credit derivative pricing in judging fair value is that this market is very volatile and highly reactive to changes in rating and credit sentiment. However, credit derivatives can, on occasions, provide excellent value to non-relationship investors.

The primary and secondary loan markets have always interacted with each other, and the topic of the interaction of the primary and secondary loan markets could be an article in itself. Overall, borrowers should not be concerned about the secondary loan market, or indeed the credit derivative market, because, in general, the presence of both increases market appetite for debt.

SEAN MALONE
MANAGING DIRECTOR, LOAN CAPITAL MARKETS, DEUTSCHE BANK

WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2004?

In the absence of an improvement in the M&A market liquidity supply will continue to exceed demand and competition for mandates among the arranger cadre – evidenced by aggressive pricing and structures – will remain strong. In short, it will remain a good market in which to be a borrower. Unfortunately, from the banker's perspective, we expect borrowers to remain cautious, since many have witnessed the consequences of companies over-extending themselves.

Notwithstanding, or perhaps because of, such favourable market conditions, the greatest risk of a 'problem' lies in borrowers and arrangers taking the strength of the loan market for granted and pushing the edge of the envelope, either in terms of price or structure, too hard. The market remains unforgiving where the credit and ancillary, price and structure equation does not add up, as a small number of high-profile transactions this year have demonstrated.

WHAT PRICING TRENDS DO YOU EXPECT IN 2004? IS PRICING BASED ON RATIONAL CREDIT EVALUATION OR IS IT MORE INFLUENCED BY AN ASSESSMENT OF ANCILLARY BUSINESS?

While an increase in M&A activity would see an improvement in the liquidity demand/supply balance, the bank markets remain so liquid that M&A levels would need to rise dramatically before any significant upward pricing pressure would occur. In the absence of an M&A uplift, downward pricing pressure is likely to continue, as the lack of supply may lead certain banks to lower their return hurdles. However, the dichotomy between the pricing of 'relationship' and 'market-driven' transactions will persist, regardless of activity levels, as the availability of ancillary business and the strength of borrowers' lending relationships becomes increasingly important to lenders' decision making. That this will be the case should not suggest, as the question does, that the pricing decision is irrational. Rather that lenders base this decision on far more than a simple credit evaluation.

WHAT TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURES DO YOU ANTICIPATE IN 2004?

Notwithstanding that the implementation of Basel II is due in 2006 (that is, within the duration of any new medium term facility), we do not anticipate the development of any dramatically new transaction structures in the near term. In the event that our crystal-ball gazing has failed us, the loan markets have proven themselves sufficiently flexible over the years to rise to the challenge. Far more likely is that the market will continue its steady evolution with the following issues moving up the agenda: more creative/structured pricing mechanisms ahead of Basel II; bond-like freely transferable term loans to meet borrowers' core borrowing requirements in response to the growth of the secondary loan market; and commercial paper (CP) back-stop facility pricing more accurately reflecting the nature of the beast (that is, thin commitment fees, but markedly higher drawn cost) as it does in the US.

MANY TREASURERS COMMENT THAT BANKS ARE INCREASINGLY RELUCTANT TO LEND. WILL THIS TREND CONTINUE AS ECONOMIC CONDITIONS RECOVER?

The broad trend of banks' reluctance to lend was initiated by the spectacular corporate failures that reached their climax in 2002. Assuming that economic conditions recover in 2004, the trend away from lending may well come to an end, with the pendulum swinging back for some banks such that more capital is available to support lending – much as is currently the case with the Japanese. However, even following an economic recovery, the market is unlikely to return to pre-2002 conditions. Borrower defaults have not been the only driver of banks' lending behaviour (for instance, the prospective loss of government guarantee in the case of the Landesbanks) and, in our view, the number of banks willing to lend on uneconomic terms, where the broader relationship does not justify it, has permanently diminished. As a result, treasurers will have either to drag the free-riders that have taken ancillary business without lending into a credit relationship, to squeeze ever bigger commitments from their core-relationship banks, or accept that the relationship bank market will meet a smaller proportion of their funding needs.

HOW WILL ACTIVE SECONDARY TRADING AND CREDIT RISK DERIVATIVES IMPACT PRIMARY MARKETS IN 2004?

Banks selling in the secondary loan market and buying credit risk derivatives (CRD) typically do so to manage their balance sheets to enable them to lend increased amounts both generally and to specific names. Banks buying in secondary markets are frequently looking to source assets that would be unavailable to them in primary syndication. Therefore, the biggest consequence of the growth in secondary loan and CRD trading is a wholly positive one for borrowers, as the resulting liquidity increase enables primary lenders to price loans more competitively.

Second-level consequences for the borrower community, however, would probably not be viewed so favourably. Examples include more transfer requests to banks outside the relationship group, the development of bank groups that, come refinancing, do not reflect borrowers' ideas of which banks their relationships are and potential destabilisation of corporates' CRD pricing, particularly if lenders front-run the primary syndication process.

In the longer-term, we anticipate further convergence between loan market and CRD pricing as investors increasingly focus on relative value. That said, the 'relationship' pricing discount that exists where borrowers control extensive pools of ancillary business and strong bank groups is certain to persist.

'THE MARKET REMAINS UNFORGIVING WHERE THE CREDIT AND ANCILLARY, PRICE AND STRUCTURE EQUATION DOES NOT ADD UP, AS A FEW HIGH-PROFILE TRANSACTIONS THIS YEAR HAVE DEMONSTRATED'
SEAN MALONE, DEUTSCHE BANK

DECLAN MCGRATH
MANAGING DIRECTOR, HEAD OF SYNDICATIONS, UK & EUROPE, THE ROYAL BANK OF SCOTLAND

WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2004?

The market dynamics of the syndicated loan market have changed dramatically over the past nine to 12 months. We have seen a distinct lack of M&A activity for most of the year, a significant number of larger transactions being refinanced as well as a significant amount of maturing debt not being refinanced. The combination of these events has resulted in a lack of available assets for most banks and to some extent has created a downward pressure on pricing, particularly for higher quality companies. The asset requirement scenario will be difficult to overcome unless there is significant M&A activity in the first six months of 2004. If the shortage of assets continues, the competition could intensify, as no doubt the view would be that some assets are better than no assets at all.

However, the expectation is that there will be an increase in M&A activity. It is difficult to assess the quantity at this stage, but the market should be optimistic, bearing in mind that for the past two years most companies have been strategically positioning themselves to tidy up their balance sheets, cut their costs, dispose of non-core businesses, and to essentially get themselves ready for any opportunities that may arise.

WHAT PRICING TRENDS DO YOU EXPECT IN 2004? IS PRICING BASED ON RATIONAL CREDIT EVALUATION OR IS IT MORE INFLUENCED BY AN ASSESSMENT OF ANCILLARY BUSINESS?

Again, it is difficult to predict what to naturally expect in terms of pricing. However, with the polarisation that has taken place in the market over the past year in particular, there are two distinct camps. First, there are the banks that are ready, willing and able to play the relationship card and to place substantial balance sheet capacity at the disposal of their clients. Naturally, this will be at aggressive pricing for the better-rated names. However, the quid pro quo is that there must be real ancillary business to follow, otherwise banks will say no, as has been demonstrated a number of times this year.

The other side of the equation is that banks which do not have the balance sheet capacity and are reluctant to lend at fine pricing will look to purchase assets either in the secondary market at discounted rates or they will only get involved in transactions that meet those banks' individual hurdle requirements.

With regard to rational credit evaluation, this will stay. I do not believe there will be much of a tendency to usurp the credit strengths that have been put in place over the past three years in most institutions in order to win business. Credit assessment will continue to be strong and, if this is allowed to loosen in order to win business, it could be seen as short-term gain and long-term pain.

WHAT TRENDS IN CURRENCIES, DEAL TYPES AND STRUCTURES DO YOU ANTICIPATE IN 2004?

The major currencies – sterling, euros and dollars – will no doubt be actively catered for. In the UK, the majority of the finance will be in sterling, except where there are match funding requirements either for cross-border acquisition activity in Europe or the US, where you would be likely to have part of the financing in euros and dollars. Re-financing of investment grade transactions will continue and there will be a certain increase in M&A activity. We are likely to see a reasonable amount of 364-day facilities, particularly for some of the more difficult names – for example, fallen angels on their way back – with the opportunity to be taken out by high yield bonds, bonds and private placements. There will also be a lot more focus on Basel II and what the real implications are for financial institutions. This no doubt will be coupled with the implications of the 31 International Accounting Standards (IAS), which are currently under review.

MANY TREASURERS COMMENT THAT BANKS ARE INCREASINGLY RELUCTANT TO LEND. WILL THIS TREND CONTINUE AS ECONOMIC CONDITIONS RECOVER?

Consolidation in the banking industry will continue to take place, which will continue to reduce liquidity, and some of the smaller institutions are pulling back their lending capacity. The economic situation over the past two years in some countries has necessitated banks within these countries going back to basics and focusing more on their domestic market to tidy up some of their excessive lending practices of the previous three to five years. As previously mentioned, the polarisation that has occurred over the past year is dictating that the bigger players are having to utilise more of their balance sheet capacity to make up for the shortfall of the smaller players who are walking away from deals. However, it is not this alone having an affect, but also the fact that the vast majority of clients have a preference for smaller groups of lenders with significant capacity and to whom they can reasonably provide ancillary business to with an acceptable degree of certainty.

The requirements for diversity of funding from a number of treasurers will, by nature, dictate that other forms of funding will be given greater consideration, particularly with respect to extending maturity debt profiles – for example, seven-, 10- or 12-year money in the private placement market.

HOW WILL ACTIVE SECONDARY TRADING AND CREDIT RISK DERIVATIVES IMPACT PRIMARY MARKETS IN 2004?

Again, one does not have a crystal ball, but as a guide the secondary market in 2003 was responsible in the first six months of the year for a number of syndication houses achieving or being well on the road to achieving their budgets for the year. So if a number of significantly sized transactions materialise in the first three to six months of next year, it would be fair to suggest a reasonable degree of similar activity. It should also be remembered that not all of the major players in the market like to utilise their balance sheet and, therefore, as a result of the fact some banks have more aggressive selldown targets than others, even in an asset-hungry environment, we could have a year similar to the one just gone.

In terms of credit risk derivatives, and again without any real degree of quantum, there is a view in the market that these vehicles were utilised three times as much in 2003 as they were in 2002. It is difficult to tell whether this is fact or fiction. There are cases where one can see real value being generated, but unless there is dramatic activity in the M&A market I would be surprised to see credit risk derivatives being utilised much more than is currently suggested.