corporate financial management
NON-BANK LENDING

More fish in the sea

Should UK companies be taking a closer look at non-bank lending? After all, while the typical European company relies on the banks for 70% of funding, the corresponding figure for its US counterpart is only 30%. And company treasurers now need to consider what effects the increased regulation of the banking sector will have on their ability to secure funding from the banks.

The ACT's decision that a breakfast briefing on non-bank funding would be timely was well judged, if the strong turnout for the recent session, sponsored by M&G, is any guide.

As ACT president Gerry Bacon observed, the latest Bank of England inflation report again stressed the need for banks to repair their balance sheets, and while the Bank of England's base rate has been at a record low of 0.5% since March, bank lending rates have been edging steadily upwards. Quantitative easing is helping to restore banks' capital, thanks to a policy of low interest rates and no caps on the rates at which they lend.

The opening speaker at the briefing was Barbara Ridpath, chief executive of the International Centre for Financial Regulation (ICFR), who observed that politicians on both sides of the Atlantic were seeking to regulate to prevent future financial crises, "although I'm not convinced that this will solve the problem".

What will happen and when is still clouded by much uncertainty. While Europe proposes to set up three new regulatory authorities, as well as a supervisory European Systemic Risk Board, the parliamentary treasury select committee is urging against an "over-hasty" timetable. In the US, president Obama wants the six US regulatory agencies increased to seven, while senator Chris Dodd wants the job of overseeing banks taken away from the Federal Reserve.

What is evident is that in future banks will have to hold more assets and a raft of impending new regulation will inevitably affect the cost of bank lending. It is also clear that regulation will need to be introduced in stages. "Regulators realise that they can't introduce all the planned new legislation at once without the risk of killing off a nascent recovery," said Ridpath.

She noted that only 50% of UK lending comes from UK institutions, which are unable to compensate for the loss of capacity resulting from many foreign banks withdrawing from the market since the credit crunch began. This has left the better-capitalised foreign banks in a commanding position and able to choose exactly where they want to increase their market share.

Executive summary

- As the number of banks shrink and the difficulty of getting loans from them rises, so treasurers need to consider diversifying their sources of corporate funding.

"The apparent scenario for banks is that they lend less and/or charge more in future," Ridpath said. "However, this is based on the assumption – which I personally think is fallacious – that they will need to go on producing the same returns that they have done over the past two decades."

She also noted a "sea change in behaviour", as increasing numbers of German corporates decide they can no longer rely on German banks for funding. UK companies are also diversifying their sources as the number of reliable banks diminishes, due in part to consolidation. This is despite some banks still treating loans as a loss leader and underpricing them so they get access to customers' other business.

Ridpath's advised treasurers to expect change and prepare for it in their banking relationships, to consider the all-in costs and reliability of funding suppliers, and to seek to diversify their sources of funding.

THE BUNZL EXPERIENCE One company that has successfully explored non-bank lending sources is the FTSE 100 distribution group Bunzl, a major supplier of non-food consumer items such as the cups, lids and stirrers used by high-street coffee shop chains.

Bunzl group treasurer Tim Hayter said the group was acquisitive and in recent years annual spending on takeovers had regularly exceeded its cash generation. Bunzl's approach to bank funding is relationship-driven. It has a core group of 14 banks and has resorted

NON-BANKING LENDING HAS NEVER ENJOYED AS MUCH DEMAND IN EUROPE AS IT HAS ACROSS THE ATLANTIC. BUT AS A RECENT ACT BRIEFING SHOWED, ALL THAT COULD BE ABOUT TO CHANGE. **GRAHAM BUCK** REPORTS.

"DURING THE CRUNCH WE HAVE COMBINED MORE BANKS, SO THE SYSTEMIC RISK HAS ACTUALLY INCREASED."

to them for funding when this has been freely available.

However, since 2001 – when it successfully raised $225m to fund an acquisition – the group has regularly opted instead for the US private placement market. A further deal followed in 2006, for $385m, and since the onset of the credit crunch it has utilised US private placements. Its most recent deal was last February when it found the bank market almost completely shut down. Bunzl anticipates that, collectively, the banks' collective appetite for lending will be reduced even further in the years ahead.

Hayter outlined the advantages of the private bond market as offering flexible terms, maturities than can be set from three to 15 years and – unlike the public bond market – no requirement for the company to provide a rating although the pricing of each market is fairly equal. The private placement market has also remained open for business when times are hard. In return for these advantages, a borrower must be ready to live with the need to provide covenants.

Hedging had also been an important activity for Bunzl in recent years, said Hayter, with the group focusing on the US market, largely comprising fixed-rate dollars. The choice of hedging adviser was important, he added. "It needs to be a bank that you can trust and choice will partly be determined by whether it will underwrite the swap auction for you." Bunzl also gave ancillary business relating to its hedging to eight other banks, as well as ensuring that good relations with investors were maintained by appointing an investor relationship manager.

DIVERSIFICATION DRIVE "The credit crunch provides excellent opportunities for UK companies to achieve diversification away from the banks," declared Mark Hutchinson, head of alternative credit at M&G Investment Management, which is seeking to develop the UK private placement market. The institutional investor, which is the investment management arm of life insurance giant Prudential, recently launched its UK Companies Financing Fund to provide long-term private debt finance to mid-sized UK corporates.

M&G was one of the first European private placement investors, but Hutchinson stressed that the group only invested where it perceived relative value. "Most European private placement deals continue to be reliant on US investors, though, due to a lack of European participants," he added. The reasons for this include different regulatory treatment to the US and the need to have specialist credit teams.

In the post-credit crunch era only repeat issuers in favoured industries have accessed the private placement market. "A large number of mid-cap UK corporates are still reliant on a shrinking amount of bank finance," said Hutchinson. "But how consistent are the lending targets likely to be for bailed-out banks that will need to reduce their reliance on the wholesale markets in the long term? The real securitisation markets are still effectively closed to new issuance and the majority of asset-backed securities paper is placed with the central banks, which isn't sustainable."

With the number of active banks already reduced and the whole UK banking sector needing to shrink over the medium term, non-bank lending is particularly important. Yet for companies too small to access the private and public placement markets there are no real alternatives to the banking sector, Hutchinson suggested.

M&G's view is that the UK needs to move to equity-based, longer-term non-bank lending, with the banks providing working capital and acquisition finance. Hutchinson said it was "a model that has proved successful in the US" that would allow companies to use the "best in class" for each part of its ancillary business. M&G's new fund is based on the premise that the UK private placement market is poised for lift-off, particularly as doubts persist over how sustainable the supposed recovery in the banks and credit markets will prove.

The topics raised in the Q&A that ended the briefing made clear there are also concerns as to what could happen in the post-quantitative easing period. The money that has been pumped into the system since the crisis broke has distorted the market, with risk appetite quickly reviving to become greater than ever.

That appetite was unlikely to be dampened by the introduction of the Solvency II capital requirements, suggested Hutchinson, but it could alter the length of investment made by groups such as M&G. "We look for long-term assets, while the EU evidently differs from this view," he said.

Ridpath also expressed concerns over what the crunch could be storing up for the future. "People who want to turn back the clock are unrealistic, but what does worry me is that during the crunch we have combined more banks, so the systemic risk has actually increased," she said. "We need to create new institutions as the only way to increase diversity is through different models. And a lack of diversity means a greater risk of contagion."

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