Borrowed time

THE CURRENT ROLE OF THE LOAN MARKETS, ACCESS TO BOND MARKETS AND OTHER NON-BANK LENDING OPTIONS WERE REVIEWED AT THE ACT'S LATEST CORPORATE FUNDING CONFERENCE. **GRAHAM BUCK** LISTENED IN.

The loan market has traditionally been the bread and butter of corporate funding strategy. But in recent years the business world has moved from an era of easy credit to one of crisis and, more recently, to patchier and volatile markets.

Treasurers who want to plan for the long term are looking to the various options for refinancing their business. The alternatives include a combination of bank lending and bonds, as well as the US private placement (USPP) market and the growing UK retail bond market.

The ACT's recent half-day conference on corporate funding offered an update of developments in the markets. It began with a presentation from Thomas Gelderd of the Department for Business, Innovation and Skills (BIS) business finance and taxation team.

He stressed that business secretary Vince Cable was keen to develop financing options for SMEs, one in three of which did not access any external finance and with the rest mostly dependent on the banks. Gelderd said that BIS has been working with the ACT on getting greater access to the capital markets for companies but that these initiatives had been overtaken by the chancellor's announcement in October that the Bank of England would buy up corporate bonds to create a new supply of credit directed at the small business sector. His speech also came a day before the Bank announced it was resuming its programme of quantitative easing and adding a further £75bn to its first-round capital injection of £200bn.

Gelderd said the BIS expected banks to have increasing difficulties in providing competitive funding solutions for businesses of all sizes over the coming years, as a result of the new regulatory demands in Europe and the US on banks' capital ratios. "The banks are also now more insistent on seeing a coherent business plan for going forward before they will lend," he added. BIS therefore regarded the development of "deeper and stronger capital markets" as essential in providing long-term funding for UK companies.

David Moseley, corporate loans market director at Lloyds Bank Corporate Markets, said that although conditions had not returned to the boom period of 2005 to 2007, loan market conditions this year for European markets had been buoyant despite concerns such as the sovereign debt crisis.

Five-year maturities were once again predominant, against the three-year deals common around 2009 and many three-year transactions taken out at that time had already been refinanced. The result would be a new "maturity wall" emerging in 2015 and 2016.

Other companies that originally intended to refinance in 2012 might be well advised to accelerate their plans to take advantage of potentially better pricing, as well as improved structure and tenor.

Moseley said the average credit default swap (CDS) of major lenders had widened since early August as concerns mounted over the impact of the sovereign debt crisis. "As a result, any loan market activity is currently regarded by the banks as a loss leader," he added. "The cost of funds exceeds the return they can get on any loan."

Banks would continue to support the refinancing needs of their core clients and they had a strong appetite to support event-driven transactions, which provided them with an entry to other non-balance sheet activity. There would also be a continuing pricing divide as banks increasingly focused on their core clients.

"As regards their core relationships, the banks see the current cost of funds as something that won't prove permanent," Moseley said. "So it's just something that they have to deal with in the short term."

A session on the investor's perspective was provided by Stephen Wilson-Smith, credit research director of M&G Investments, who said the key question was whether banks could afford to continue lending to corporates when their own cost of borrowing had risen sharply. The reduction in lending capacity from financial institutions had been accompanied by an increasing preference by long-term investors to lend directly to corporates rather than to financial intermediaries.

"Corporates have done a fantastic job in the past few years, given the difficulties they have faced," he said. "They have generally become leaner and, from a credit perspective, done all of the right things.

"M&G are long-term investors for 12, 15 or 20 years. We buy long, so we want to see a good corporate story."

Wilson-Smith identified three key elements that are commonly sought by bond investors: value (as represented by spread versus credit quality), liquidity (or compensation for a lack of liquidity), and a limit to the downside through covenants, which offer protection against adverse changes.

His tips for corporate treasurer? "They should be focused on the overall cost of financing, and not absolutely on spread," he advised. "However, it is good for issuers to issue when they don't actually have to – particularly as the cost of financing is expected to increase."

A question and answer session that completed the conference saw the panel joined by David Cleary, corporate debt capital markets director for Lloyds Bank Corporate Markets, who was asked about accessing the UK bond market. "A lot of B and BB companies want to use it at the moment, but it's not opening up to them," he said. "However, history suggests that at some point in the future it will do so once again."

An audience member said that SMEs could not place too much reliance on securing finance from bond investors. "Lloyds approves 80% of SME loans, which seems quite a high percentage," Cleary responded. "So banks are still doing a pretty good job of getting the capital needed out there."

Roger Morgan, The Co-operative's treasurer, said that he had found the comments made by politicians "quite baffling". He added: "Regulation is tying up the banks and squeezing the credit available to SMEs, yet they are calling on them to lend more while at the same time they are making it more difficult!"

ACT deputy policy and technical director Martin O'Donovan asked the panel whether members were opposed to the banks' practice of loan trading. Babcock group treasurer Bill Mason replied that his company was opposed to any bank trading Babcock loans for a number of reasons, not least because the company devoted time and resources to developing relationships with its core banks. Morgan agreed, adding: "We are always mindful of who our stakeholders are and which banks they want us to do business with."

Asked whether there was currently much appetite for issuing index-linked debt, Morgan said The Co-op was not currently considering it but regarded it as having a valid place and so did not rule it out at a future date. Wilson-Smith added that M&G was in favour of a larger index-linked corporate market being developed.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org

Case study: The Co-operative and the bond market

The Co-operative is an industrial and provident society, the world's largest consumer-owned co-operative and the UK's fifth-largest food retailer. "If we were capitalised, the figure of £4bn would make us a top 40 company," said its treasurer Roger Morgan.

Recent group strategy has focused on reducing reliance on bank finance and diversifying the investor base, smoothing the existing maturity profile and arranging some early refinancing before UK corporate peak redemptions in 2012–13.

The other main objective has been to raise significant medium-to-long term debt. As a prelude The Co-op secured a credit rating for the first time in early 2010 but did not publicise this initially while it researched the various debt capital markets. Having considered the options of US private placements and the European and US bond markets, it ultimately decided on the sterling Eurobond route.

For its bond offering, the group chose Lloyds, HSBC and Barclays as joint bookrunners and elected to restrict its investor roadshow to the UK rather than extend it to Europe, thanks to its "good name recognition" at home.

The result in May this year was an £800m dual-tranche sterling bond issue for nine and 15 years, applied to early part-repayment of the group's syndicated term loan, which takes much of the pressure off maturities originally due in 2013.

"The banks are coming under pressure – other retailers have followed us in reducing their reliance on them," said Morgan. "Tesco and Sainsbury, for example, are both up to 60% to 70% in bonds. Bonds are increasingly becoming the financing of choice."

Case study: Babcock and the loan market

Babcock is the UK's biggest engineering support services organisation, and got bigger with its £1.5bn acquisition of VT Group in July 2010. Group treasurer Bill Mason said the deal had been funded through 50% debt and 50% equity. It left Babcock with a post-acquisition gearing of 2.8 times – since trimmed back to 2.5 – and £1bn of debt that required refinancing. The coalition government had just taken office and speculation was rife over how Babcock would be affected by the comprehensive spending review and strategic defence spending review.

The group drew up a proposed new capital structure before deciding its approach to the refinancing. It considered tapping the public bond market but ultimately decided that the US private placement market was "the natural choice", said Mason. It found healthy competition in the market for its first USPP, with the number of banks seeking to be part of the transaction exceeding the participants needed. Lloyds Bank Corporate Markets and JP Morgan were selected as lead arrangers.

Discussions with lenders took place over the first quarter of 2011. "There were a lot of questions from potential investors about our defined pension scheme and how the UK defence cuts would impact on Babcock," Mason said. "We sat down with them and explained it in detail – US investors generally take a long-term view and will give you a fair hearing."