# Liquidity returns

**IAN FITZGERALD** STARTS 2011 WITH GOOD NEWS – THE LOAN MARKETS LOOK BETTER PLACED TO PROVIDE FUNDING THAN THEY HAVE FOR SOME YEARS.

The syndicated lending market enjoyed a resurgence in 2010, with big-ticket loans returning to the sort of pricing levels not seen since before the crisis. While some large global firms enjoyed a rush of liquidity on favourable terms, smaller and medium-sized companies also began to benefit as banks put capital to work. Wholesale corporate deleveraging across the credit spectrum gave banks the capacity and appetite to increase lending.

However, the lending environment has undergone radical change and a "new normal" has emerged, shaped by defined lending commitment targets agreed between governments and banks, while treasurers have been left with a smaller group of committed lenders to work with. Maintaining close relationships with banking groups has rarely seemed more important as peripheral lenders that were once a source of liquidity during the boom years have retrenched to their home markets.

**FLIGHT TO SCALE** Big multinational companies were able to secure funding at price levels not seen since 2007 as the bank market returned to support the likes of oil major BP and mining giant BHP Billiton, which secured $45bn in funding at short notice to finance its bid for Potash of Saskatchewan. The transaction proved the bank market was healthy as banks adopted a club approach to lending larger syndicates, with each individual member underwriting a smaller portion.

**IMPROVING SENTIMENT** Despite the escalation of the sovereign debt crisis in April, liquidity in the loan market returned to lower-rated companies as a lack of deal flow, coupled with increasing corporate deleveraging, pushed banks that exhibited greater certainty over their own position to find opportunities to employ capital. This has seen more favourable terms becoming available for a greater number of corporates that are able to demonstrate robust credit metrics.

Average pricing for rated corporates has fallen dramatically across the credit spectrum (see Figure 1) but at different intervals during the year. With increasing liquidity and more confidence in company performance, banks have been happy to trade tenor for pricing.

In February, Telecity, a pan-European operator of datacentres, demonstrated that innovative financing was available. Telecity needed a five-year bank loan to fund a new datacentre in an environment where facilities lasting longer than three years were not available.

The transaction was closed successfully at the beginning of February 2010 and announced to the market off the back of some very positive 2009 annual results. As well as gaining a five-year tenor unprecedented in the UK market (see Figure 2), the company diversified its banking group with the addition of HSBC and RBS as new lenders, alongside Lloyds Bank Corporate Markets and Barclays.

**MARKET SIZE** Comparing issuance in the capital markets from 2009 and 2010, it is clear that the loan market remains an important source of funding in Europe. In the aftermath of the financial crisis, more European companies tapped the bond market as a means of funding but talk of a shift towards the US model, where companies look to the capital markets for more than half of their total funding needs, has proved premature. Companies still depend on the loan market for the bulk of their financing needs (see Figure 3).

If anything, the sovereign debt crisis provided an important lesson about the balance of funding between bank and capital markets. The crisis temporarily froze capital markets as a source of funding, particularly for financial institutions, and may have provided a catalyst for a revival of the loan market, which was affected less by the short-term volatility as transactions take longer to gestate.

In a similar way, the BP oil disaster in the Gulf of Mexico damaged the company's credit rating, and during a period when it was uneconomical and perhaps impossible for the company to issue bonds its core group of banks rallied round to provide term financing.

**BOND MARKET CONTINUES TO TAKE UP THE SLACK** European companies rely on loan financing as their life-blood – a trend that was set in 2009, when companies sought financing via the bond markets to fill the funding gap created by a lack of bank lending.

In 2010 this trend continued as some global banks rationed their balance sheets to their biggest clients, while treasurers became increasingly sophisticated in diversifying their funding sources and tenor. There was an influx of bond issuance in 2010 from unrated or first-time borrowers with a compelling credit story exploiting low interest rates by locking in borrowing at near-record lows.

**CONTINUED DELEVERAGING** Greater regulation in the form of Basel III ensures that banks will continue to use their balance sheets in a more strategic and profitable way, while the largest national banks cut back their non-domestic lending – a constituency that provided strong lending support for UK plc during the years leading up to the crisis. Europe's lending community has shrunk in size, leading companies to review their long-term banking relationships. While syndicates might be bigger, the number of relationship banks that a company can rely on for all-round support has dwindled.

**M&A – LATE SIGNS OF RECOVERY?** Banks resumed lending in the second half of 2009, but the market remained subdued due to a lack of M&A activity. Hopes were high that 2010 would herald a revival in deal-making. In reality, this failed to materialise in any significant way as sovereign debt concerns disturbed the euro zone and battered

confidence. Insurance giant Prudential re-opened the big-ticket M&A market with a $35.5bn bid for AIG's Asian business. However, Greek debt woes and concerns that the Pru was overpaying meant confidence evaporated and Prudential scrapped its plans. There was a flurry of M&A activity in the FTSE 250 but the acquirers were generally larger foreign predators able to do deals with excess cash rather than through the loans market. Bank appetite for jumbo M&A financings remained untested until the summer, when BHP launched its $40bn bid and raised $45bn in a heartbeat. The deal failed but BHP proved that ample liquidity existed.

In July, the £1.33bn acquisition of VT Group placed Babcock International on the cusp of the FTSE 100 index and marked the re-opening of underwritten mergers and acquisitions for UK mid-market corporates. Lloyds helped to successfully arrange the appropriate funding structure to ensure a seamless execution of the transaction, within a tight timeframe, while positioning Babcock for future access to the capital markets.

By the end of 2010, the outlook was promising for M&A activity. A survey published in December 2010 by the Boston Consulting Group and UBS Investment Bank found that nearly one in six European companies plan a large-scale acquisition in the next 12 months.

**SUPPORT THROUGH THE CYCLE** Bond markets have become a more active and important source of financing for medium-sized companies, but their life-blood remains the bank lending market, which continues to face challenges. Since 2008, foreign banks have been retrenching to local markets, while big global investment banks have prioritised their lending to a small cadre of blue chips. Lloyds has continued to fill the funding gap with the provision of credit to companies crucial to the UK's economic recovery.

**PROJECT FINANCE REMAINS CRITICAL** Nowhere is the importance of bank lending more critical than in project finance and this will be a big theme for 2011. Governments are looking to raise revenues through the sale of projects to private investors, which will require funding. Moreover, those projects that remain government priorities will rely more and more on private bank financing in the absence of public money. Non-bank investors are returning to project finance because they see inflation-plus returns.

Bank financing is crucial to ongoing infrastructure projects because they are long term and require certainty of funding. As an example, the 25-year, £2.7bn Private Finance Initiative for maintenance and management of Birmingham's highways – the UK's biggest local government highways sector PFI – was led by public service provider Amey and funded by Lloyds alongside five other commercial banks. Typically, highway maintenance is funded on an annual basis within a five-year contract but that does not guarantee either certainty of funding or delivery. This scheme provided highway improvements while meeting performance metrics over a 25-year contract period.

**CONTINUED REHABILITATION** In 2010 liquidity returned to the lending market as banks stepped up to provide facilities. Some of the most important deals were done in the middle market, where companies do not enjoy the same diversity and availability of capital.

Midmarket companies are increasingly looking to the bond markets as an alternative source of finance, and firms like Virgin Media and Matalan are examples of this. Meanwhile, project finance rebounded strongly in 2010 and will continue to be a strong part of the UK economy with big investments in infrastructure planned.

**Figure 1:** Loan pricing for rated corporates

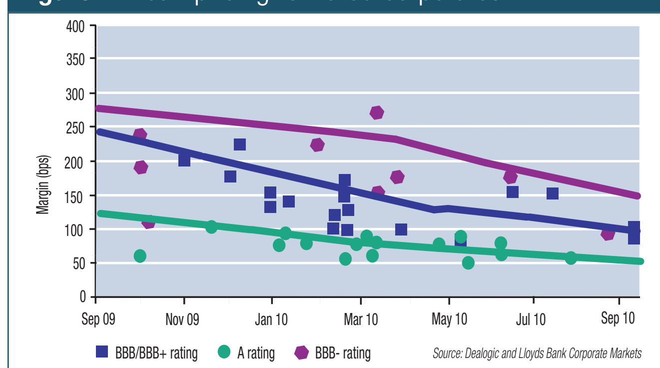



**Figure 2:** Tenor of loans, 2009 to 2010

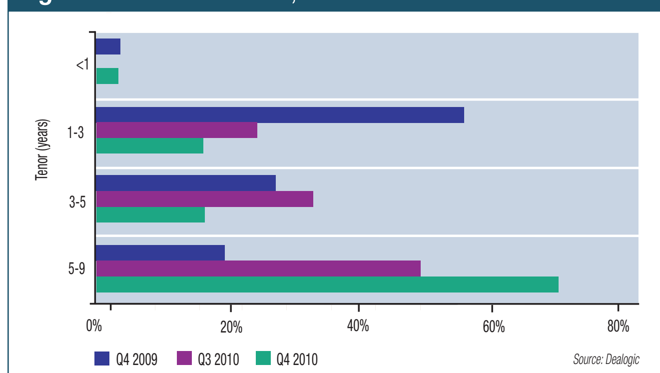
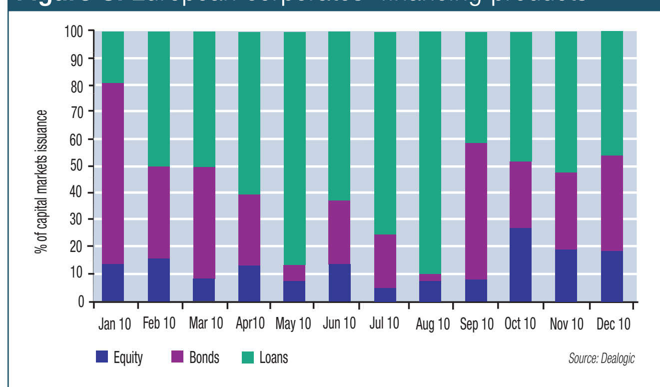



**Figure 3:** European corporates' financing products




Projects such as the building of hospitals and roads will rely more than ever on reliable bank funding as previous overseas providers of loans continue to focus on providing liquidity in their home markets.

Overall, despite concerns over the euro and continued uncertainty about sovereign markets, the loan markets seem to be better placed now than they have been for the last few years to provide appropriate funding solutions to businesses. We must look forward optimistically to seeing a continued rehabilitation of the markets in 2011.

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