RIDING THE REFINANCING ROLL

BUSINESS CONFIDENCE IS RISING AND MARKETS ARE LIQUID, BUT COMPANIES MUST PROCEED WITH CARE IN 2014 SINCE RISKS REMAIN, WARNS SIMON ALLOCCA

I would categorise 2013 as a year of refinancing as opposed to a year of expansion and new monies.

My prediction last year (see *The Treasurer*, February 2013, page 34) that banks and borrowers would have to get used to a 'new norm' seems to have been borne out in the past 12 months. I've seen them accept the inherent macro risks provided by continued uncertainty in the peripheral economies of Europe, while there's been a sustained steady deal flow in the loan market.

Having said that, I believe the continuing uncertainty over the future has been a big contributor to the lack of event financing.

Acquisition financing

My predictions also mentioned that CEOs needed to be confident that they could present an expansionist strategy to their boards and these overriding macro issues have, in my view, hampered that.

Over the past year, I've noticed a business concern that acceptable acquisition pricing on one particular day or week will rather quickly look off-market. When CEOs or CFOs are presenting opportunities to their boards, therefore, non-executive directors are more likely to question the rationale of an acquisition, asking whether it will add to earnings per share in the first 12 months. If not, these opportunities may have to be analysed in much greater detail than in previous years before being agreed.

2013 deal review

The first six months of 2013 seemed very strong in terms of deal flow, but as we went into the latter part of the year, this flow slowed. Although I, and other commentators, expected Q3 to be relatively low in deals, we thought Q4 would pick up, but this was not the case.

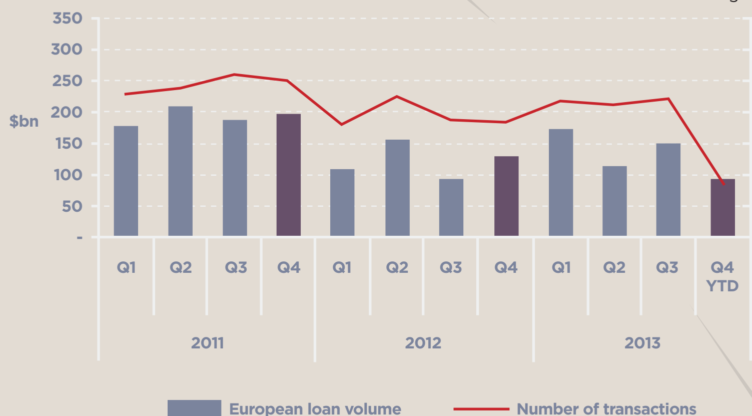
This maintained slowdown has been unusual for the loan market and could be due to organisations doing all their financing in the first half of the year. A rather more optimistic hope for lenders is that businesses have merely put back their financing to 2014. This does bring up a concern that, from a lender's perspective, transactions in 2014 could become even more aggressive than they were in 2013.

Changing terms and conditions

Throughout 2013, there was an increase in liquidity from banks and other investors, who have re-entered the market at a far quicker pace than anticipated. This has meant that terms and conditions for finance have become more aggressive. I am seeing that, within the corporate space – both investment grade and sub-investment grade – terms and conditions are becoming very similar to those prior to the financial crisis.

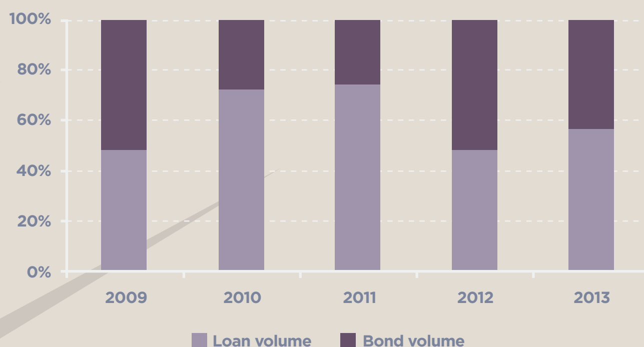
For example, in Europe, and specifically Germany, pricing has been as low as 35 basis points, meaning large organisations could be paying significantly less for finance than they were 12 months ago. In the leveraged space, the market is seeing some covenant-light and covenant-loose transactions that have, again, not been seen since pre-crisis times. And I've also seen banks re-entering

EUROPEAN LOAN VOLUME AND NUMBER OF TRANSACTIONS (QUARTER-ON-QUARTER)



EUROPEAN LOAN VS BOND FINANCING MIX

Source: Dealogic



the market, having previously exited, bringing appetite back to levels not seen for the past few years.

Right across Europe, pricing, covenants and maturities have all relaxed or weakened, bringing an imbalance in supply and demand. There's a huge amount of liquidity and very little demand for new monies, so the transactions coming to market are re-financings as opposed to new monies.

Bond issuance

In terms of bonds, I saw 2013 bring a reversal of 2012, with the split between the two products revert to the norm, and loan issuance exceed bond issuance. In my opinion, there's a real probability that, in 2014, with conditions for borrowing in the bank market ever improving, the bond market could be negatively impacted in terms of levels of issuance.

In addition, 2013 also brought, for some of the better rated credits, revolving credit facilities with extension options to potentially take the facilities out to seven years. This means the need to go to a bond market for a short-dated bond is being somewhat reduced. Clearly, long-dated financing will always have to go to the bond market, but corporates need to get the right balance between shorter-dated and longer-dated debt.

Improving confidence

Barring any major macro events, confidence does seem to be improving and there have been positive messages from the Bank of England, the UK chancellor and other market commentators. What now has to happen is today's GDP growth engine needs to move from the consumer to industry. If that happens, I'm optimistic that we'll start to see a recovery in transactions, event financing and M&A funding.

Predicting 2014 confidently is difficult, however. Despite analysing the same economic indicators for the UK in the next 12 months, different commentators are ranging their growth predictions from around 2.5% to 4% – and that's quite a big variance. This brings a lot of uncertainty in both the market and the economy.

UK sector growth

Over the past year, the corporate real estate sector has started to move forward and, at Lloyds Bank, we are again beginning to both originate and distribute transactions to market participants, including banks and other loan investors. This return to confidence has proven a real positive and one we believe will be sustained through 2014.

> I'm adamant that there's sufficient liquidity to meet the requirements needed to invest in the UK

We've also started to see some developments in the infrastructure and energy space, which was heavily in the public eye throughout 2013 for good reasons (investment in new projects and available liquidity increasing) and for bad reasons (fuel pricing and continued uncertainty over renewables).

We continue to see a number of insurance companies and pension funds engaging with banks to investigate ways of achieving their desire to match long-term assets with long-term liabilities. The market witnessed one or two transactions in 2013 that fitted this model, but I expect to see more innovation in this space than in any other requiring debt finance during 2014.

Arguably, the biggest issue for non-bank investors in infrastructure and energy is construction risk, so banks, policymakers and investors need to come up with appropriate solutions to mitigate construction risk and funding requirements. With the pipeline that we are seeing over the next five years, it's important that the financial markets solve this funding conundrum so that the level of investment that's required in the UK can be met.

I'm adamant that there's sufficient liquidity to meet the requirements needed to invest in the UK, but we need to unlock it – and I believe we'll see that innovation over the next 12 to 18 months.

The impact of regulation

During 2013, the cost for banks of doing business continued to increase as a result of new regulation, either directly or indirectly (for example, increased capital and liquidity charges). These costs will continue to rise and, as a result of this, banks will need to obtain a higher return than they were happy to accept in the past. As a consequence, and with regard to lending, banks are looking at the overall return on the relationship to justify the returns on a standalone basis.

Therefore, if corporates push the pricing element too far in 2014, we could see banks withdrawing from the relationship because they will not be able to meet their required returns. So it could be expected that, throughout the year, an increasing number of relationship-type conversations to discuss this exact issue will take place.

Borrowers seeking finance in 2014 will need to find the appropriate balance between having the ideal banking partner to support their ambitions both now and in the future, and having the most aggressive terms and conditions for their financing. Getting that balance right, as well as maintaining a continuous relationship to support future financing, is going to be critical.

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