LOANS IN A COLD CLIMATE

TREASURERS WHO NEGOTIATE A LOAN IN THIS CLIMATE CAN EXPECT A FROSTIER RECEPTION THAN OF LATE: HIGHER MARGINS, STRICTER FINANCIAL COVENANTS AND FEES THAT THEY DIDN'T EVEN KNOW EXISTED, SAYS **CHRIS HALL** OF BFINANCE.

While demand for credit has slowed due to economic uncertainty, thus reducing the scope for banks to widen margins, many corporates will enter debt negotiations in the next six months to extend existing facilities or meet new needs arising from strategic or operational imperatives. Recent deals suggest that banks may play a stronger hand than in recent years. A number of large companies have been forced to accept stricter covenants during recent loan negotiations. ICI asked relationship banks to assemble a syndicate for a $750m standby facility using existing documentation but had to bow to the wishes of banks now all too aware of the consequences of failing to impose financial covenants.

Banks have only themselves to blame for their E 3bn exposure to a junk-rated telecoms manufacturer without a financial covenant to protect their 40bp margin or cover their embarrassment. But it is the corporates which will pay. The Marconi deal – in tandem with predicted global economic slowdown – has put banks on their guard and protection via covenant is key. KPN, the troubled Dutch telecoms carrier, has already had its interest cover covenant tightened, as well as suffering a quadrupling of its credit spread (to 200bp over Euribor) for its recent 2.5bn loan.

Try as one might to vary the maturity of one's debt portfolio to avoid calling on new bank lines under the cloud of a credit crunch, all too often events force treasurers to enter debt negotiations when they have the least bargaining power.

When the economy is booming and cashflow is robust, loan fees are straight forward and low, covenants unimposing and remote. But as the credit cycle turns, bad loan provisions increase and credit committees begin to flex their muscles; relationship managers are called to account for the generous terms agreed with firms now exposed to the chill winds of recession. Negotiate a loan in this climate and a much frostier reception can be expected: higher margins or stricter covenants and fees that you didn't even know existed. In addition, the long-term convergence of the public and bank debt markets is also having an impact on loan pricing, now more transparent as fewer deals are subsidised by other revenue generating income.

To quote a senior syndications banker recently: "This market does not take to fallen angels", but even the most relationship-oriented of treasurers are finding that the impacts of a credit crunch on loan negotiations are far from uniform. Nevertheless, they can be split into four overlapping categories.

HIGHER MARGINS/NEW TYPES OF FEES. Loan costs consist of margins over Libor and other associated fees – both tend to rise as the credit cycle turns in favour of the banks. How far credit spreads have widened since the beginning of the year differs according to sector and credit rating. In certain ill-starred industries, even an investment grade credit might have to pay 70bp over Libor on a three-to-five year loan compared with 30bp in the first quarter. This kind of widening can be found all along the credit curve; the banks' focus on shareholder returns is dictating that margins adhere to internal credit models in order to win credit committee approval.

Commitment fees, which guarantee the undrawn portion of the loan, are seen as a necessary function of the impact of the loan on the bank's capital ratios, but the precise fee – calculated as a percentage of the margin – varies according to bank appetite, which may decline in times of economic uncertainty. Recessionary fears notwithstanding, commitment fees are also following margins up because of the ever-increasing emphasis by banks on return-on-capital ratios. The current review of bank capital adequacy by the Basel Committee only serves to increase the pressure on banks to justify loan business.

Other charges are applied with more discretion. Front-end arrangement fees and early cancellation fees, for example, have always been susceptible to market forces and treasurers are currently having to rebuff a range of additional charges. (Think itemised lawyers' bills and you will get the picture.) Moreover, with credit committees demanding more in-depth due diligence and credit analysis before authorising a loan, banks are looking to pass these additional costs onto the borrower.

Ultimately, how hard a treasurer wants to fight a bank on pricing will depend on the company's overall strategy. If operational flexibility is at a premium (for example, due to impending M&A

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activity), the treasurer may be willing to cede basis points in order to avoid stricter covenants. To offset pricing against covenants effectively, the treasurer must be able to measure the value of the different options he is buying via flexible loan terms against the balance sheet implications of higher loan repayments.

DOCUMENTATION/TIGHTER COVENANTS. Having been left red-faced by not imposing financial covenants earlier this year, bankers are not about to make the same mistake twice. Recent negotiations aside, banks will always seek more assurances on the borrower's ability to meet repayments in times of lower revenues and tighter cashflow. Therefore, covenant-free loans will be the exception for the foreseeable future (Finnish telecoms manufacturer Nokia may be the exception that proves this particular rule) and even the best credits are considered unlikely to achieve lower than three times interest cover at present. In addition, it is increasingly common for loan documentation to insist on higher payments in the event of a credit downgrade in order to protect banks' capital requirements.

Another way in which banks are seeking to avoid 'event risk' is the inclusion of a market flexibility clause which reserves the right of lead arrangers to renegotiate pricing if circumstances arise that jeopardise syndication of the loan at the previously-agreed price.

Interest cover is still the favoured tool for monitoring the relationship between debt and cashflow, but debt-to-Ebitda (earnings before interest, tax, depreciation and amortisation) is increasingly favoured in a low interest environment. The tangible net worth covenant has declined in use following changes in accounting treatment of goodwill but is regarded by banks as a valuable control on M&A activity. Alternatively, a minimum disposal clause may be added to documentation to the same end.

Relationship becomes key when it comes to use of waivers. When renegotiating loans, corporates with strong relationship backing should be able to use majority bank waivers to fend off minority support for a tightening of covenants. Any borrower requiring unanimous support is likely to have to start again from scratch.

RELATIONSHIP/CROSS-SELLING. The meaning of 'relationship' changes according to the stage of the credit cycle. Many treasurers practice the principle of concentrating banking business on a few core providers to reward each with sufficient business to earn their support in times of need. But some have used their bargaining power to tie underwriting and other lucrative fee-based business to provision of credit. With the boot now firmly on the other foot, banks may feel less obliged to support relationships with corporates that have over-played their hand in the recent past.

Loan Pricing Corporation's European Loan Market Pulse recently quoted one lender: "An important lesson for the borrowing community about the value of relationship is being demonstrated at the moment. For borrowers to treat their banks well gives them access to the most valuable commodity of all – which is credit."

Banks are unlikely to participate in loans without the existence or promise of ancillary business. Having done their sums to identify their most profitable relationships, banks are allocating resources accordingly. For many, the return on capital from a drawn facility to a single A-rated credit may only be regarded as worthwhile for the revenue streams it unlocks. But with M&A fees creamed off by investment banks, there is rarely enough non-core business to go round. Therefore, margins may have to be sacrificed when putting together a large syndicated loan.

Of course, all banks have different target markets, product lines and return on investment models, but a strategy that does not take account of relationship profitability may limit the field of future banking partners.

TRANSFERABILITY. The structure of the loan market has changed since the credit crunch of early 1990s. Use of credit derivatives, the secondary market and other loan-book management techniques has become increasingly sophisticated. Lenders that are stuffed to bursting with telecom debt are still able to find room for mm02 and KPN should they desire further sector exposure. In the early 1990s, when relationship banks may have been unable to take on more debt even if they wanted to, funding could be sourced from foreign banks looking to establish relationships through 'money renting'. Now banks can service and protect valuable relationships while corporates concentrate management resources on fewer banking partners.

It still irks some treasurers to see their debt traded on the secondary market, but transferability is increasingly accepted (except in cases of indecent haste) as enabling a consolidated banking market to allocate loan exposures effectively, therefore increasing overall liquidity.

However, the ability of banks to offload debt does impose obligations on the treasurer, particularly in the light of reduced ancillary business for syndicate participants. Banks that have been forced to underwrite too great a proportion of a loan can simply dump the exposure at a large discount on the secondary market, causing potential embarrassment to the issuer.

In the current environment, parallels with the bond market are increasing. Larger deals are now being structured specifically with the secondary market in mind. For example, BT directory services spin-off Yell's recent 'jumbo' was priced and constructed to ensure its future liquidity. Similar-sized deals have suffered in comparison.

OPEN TO NEGOTIATION. The outcome of any loan negotiations will be a function of judgment and compromise that will inevitably vary according to prevailing circumstances (internal and external). Extracting the last basis point on a deal in the good times may backfire in the bad times. In the short-term, reduced corporate profits and economic uncertainty may be strengthening the bargaining power of the banks, but the treasurer must be aware that longer-term trends may be equally powerful.

All the signs are that bank consolidation is far from over and that banks are scrambling to maximise returns on capital to ensure they are the hunters, not the hunted, in any future M&A dogfight. In any analysis of the most remunerative corporate accounts, those deemed 'excess baggage' will be dropped as banks prepare for a new round of survival of the fittest.

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