LEARNING TO LIVE IN LEAN TIMES

WITH NOT MUCH ACTION ON THE M&A AND REFINANCING FRONTS IN 2003, THE BANKING COMMUNITY HAS EVERY REASON TO BE CONCERNED ABOUT 2004, SAYS LOAN PRICING CORPORATION'S **TESSA WALSH.**

A quiet summer in the highly liquid European loan market created near perfect borrowing conditions towards the end of 2003 but banks are now concerned about where next year's business will come from.

Respectable European lending figures of $376.47bn at the end of September 2003 show a healthy 7.9% increase on the same period of 2002, according to Loan Pricing Corporation. This is all the more remarkable as Europe is the only global region showing lending growth. The US and Asia are in reverse and, with several major economies in recession, Europe's recovery is still weak. The encouraging volume figures, however, mask a couple of significant problems for banks that are putting borrowers firmly back in the driving seat.

With little lucrative mergers and acquisitions (M&A) financing to speak of, banks are once again finding that refinancing companies' existing debt does not pay. M&A financing hit $9.58bn, its lowest quarterly figure since 1996 in the third quarter of 2003, and timing its unpredictable recovery is the market's chief preoccupation going into 2004. The other major issue facing the market is a sharp drop in the number of deals overall, which is increasing interbank competition and pressurising the already slim pickings of blue-chip refinancing, bankers say. The third quarter produced only 128 deals, the lowest quarterly figure since 2000. The 488 European deals completed by September is 21% down on 2002, leaving a highly liquid market clamouring for assets.

Margins remain historically high and many believe investment-grade pricing could freefall, although arranging fees are first in the firing line. To banks' dismay, Continental borrowers have caught on to the UK trend of experienced borrowers self-arranging deals to further cut their bills. As one banker said: "Things are getting pretty horrible out there, in terms of what people are prepared to do on bidding and fees."

This year was characterised by a run of high-grade refinancings driven by companies' fears of the effects of the war with Iraq on their liquidity. Many borrowers locked in funds, often well ahead of maturity, and most companies that can refinance have done so. These increasingly large refinancings are loss-leaders designed to cement borrower relationships and reel in other more lucrative lines of business that theoretically allow cheap loans to make sense. But not all banks are equipped to win this ancillary business and the investment-grade market's unappealing dynamics prompted smaller niche banks to look further afield in the hunt for yield, to the riskier non-investment grade markets that are home to lower-rated, more highly-geared companies, leveraged buyouts (LBOs) and emerging markets borrowers.

"It has been a tough year in terms of quality of business. There has been no M&A and most of the restructurings have already been done," said a senior banker. Fortunately, the dynamic European leveraged space that made up 19.5% of the market by September is offering opportunities, especially now he high yield bond markets are helping to take the strain, and is now showing 19% growth on the same period of 2002. In addition, the European LBO market remains on track for a record year, as companies continue to divest themselves of the unwanted fruits of consolidation.

A CHANGE OF HEART. Banks had a lot less to worry about in 2003 as the economic recovery strengthened, credit conditions improved and the capital markets started to co-operate with rising equity prices and smooth bond issuance. Easier operating conditions and reduced dealflow caused a widespread banking attitude adjustment and banks now actively want to lend to replace maturing loans rolling off their portfolios to show shareholders' growth, rather than focusing on economic return.

In the markets, this meant that bankers with budgets to fill became less discriminating towards the end of 2003 about the level of risk they would assume and snapped up everything they could get their hands on. This created heavy oversubscriptions on the few deals in the market at the end of 2003, and lenders turned to the smaller secondary loan trading markets to source assets. The European and US secondary markets are on track for a record year, as the rally in telecoms debt widened into a broader surge.

Despite the riches that are being laid before them, borrowers are not quite bold enough yet to sieze the abundant capital on offer despite banks' emphasis on encouraging profitable structured event-driven deals such as M&A or restructurings. Faced with the unpalatable choice of supplying more cut-price capital in the high-grade market or assuming yet more risk in the junk markets, injecting new money into the market by timing and catching the M&A wave is the loan market's mission for 2004.

Tessa Walsh, Vice President, Loan Pricing Corporation.
tessa.walsh@reuters.com
www.loanpricing.com