The end of an era

DEALS OF THE YEAR JUDGE **IAN FITZGERALD** OF LLOYDS TSB CORPORATE MARKETS LOOKS BACK AT A YEAR IN WHICH CREDIT CRUNCH AND LIQUIDITY CRISIS BECAME FAMILIAR TERMS, EXPLAINS THE DEAL OF THE YEAR DISCUSSIONS, AND SUGGESTS THAT THIS MAY BE A TIME OF OPPORTUNITY FOR CORPORATE BORROWERS AS WE ALL FACE AN UNCERTAIN YEAR.

Every year, as market practitioners and commentators we are looking to identify trends, spot signs of change and work out how to react to them. We look at macro and micro economic factors, the geopolitical situation, industry sectors, trade cycles and ultimately, what is hot and not to advise and adapt accordingly.

One has to say that this formula has worked pretty well over the last ten years. Well that was up until last August, when a complete fracturing of the $500bn structured credit market caused substantial disruption across a whole series of markets, ultimately hitting inter-bank lending and creating market dislocation.

Despite these difficult conditions, some very good transactions were successfully executed in 2007 and thus made for a great debate as the panel sat down to review Deals of the Year. It is clear that transactions completed on either side of the market dislocation were not viewed in the same light, as we were looking at a year of two very different halves. The panel acknowledged that it was tougher to correctly manage a successful transaction in volatile circumstances racked by uncertainty of liquidity, pricing and investor confidence.

IMPACT ON INDIVIDUAL MARKETS The first category discussed by the panel was the bond market, which included private placements. This saw some of the best conditions ever, with the indicative iTraxx indices tightening every day. The appetite for risk allowed issuers to venture into longer maturities at competitive pricing. This lasted until the summer when the prospect of sub-prime induced losses damaged investor confidence. Price volatility and underperformance were accompanied by the disappearance of liquidity. Covered bonds market makers, for example, underwent a series of negotiations in an attempt to revive liquidity. Primary activities remained more subdued in the second half of 2007, yet recent issues offer evidence that investors are still willing to participate as long as issuers are willing to concede the necessary premia.

The private placement market once again proved its resilience to general market turmoil in the second half of 2007 with over $40bn priced by the year end. Unofficially, this makes 2007 the second most dynamic year since 1991 and, following three years of declining private placement volume, indicates an increase of roughly 17% on 2006 figures.

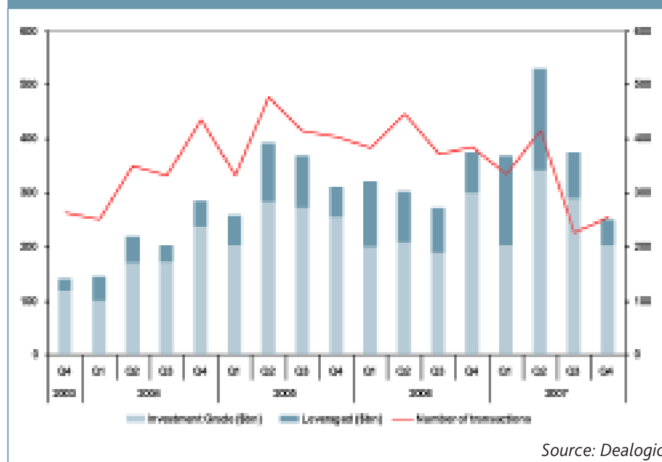
Higher credit spreads were considerably offset by the flight to quality rally in the Treasury market and as a result average all-in-coupons declined to 6.09%. This meant that the average cost of borrowing in the private market was the lowest it had been for over two years.

Hybrid transactions were the order of the day in the corporate securitisation market, as potential issuers and investors got more comfortable with the instrument, helped by rating agencies giving further clarifications. Although it is by far the smallest category, it is also the most interesting with hybrid debt offering an innovative re-structuring tool for corporates. Despite the recent volatile market conditions, we believe hybrids will continue to serve as an alternative for borrowers in 2008.

Equity markets suffered this year as the FTSE retreated into the red for a period during the third quarter, before bouncing back on rate cut expectations in the US. As a result, equity issuance in the UK (on the LSE) fell to £43.8bn in 2007 (£52bn 2006), as the LSE dropped behind its US rival, the NYSE, for the first time in two years. Both IPOs (£26bn) and follow-on offerings (£17.5bn) dropped off from 2006 levels as issuance volumes declined steeply in the third quarter on the back of the credit crisis.

Of all the categories, the largest is of course the loan market and this was probably the market that was initially most affected by the market dislocation, after structured credit. As elsewhere, the first half of the year saw strong growth, with European loan volumes increasing by almost 30% (see *Figure 1*). This story was repeated in the UK to a lesser extent with loan volumes up by 12%.

Figure 1: Western European loan market (transaction numbers and volumes for both leveraged and investment-grade debt)



Source: Dealogic

The extraordinary thing about 2007 is that global M&A activity still exceeded the levels transacted in 2006 (already a record year) by 20%, reaching a level of £2.4 trillion. This demonstrates how incredibly strong the market growth was prior to faltering during the summer – in fact, of this increase in M&A activity, almost 70% was completed in the first half of the year. Of course, everyone is aware this growth was led not only by corporate M&A, but principally by private-equity led leveraged transactions. General corporate activity levels were low because, as everyone in the treasury community is aware, the majority of corporate core/standby facilities were refinanced some 18 months to two years ago, taking advantage of fine pricing available at the time.

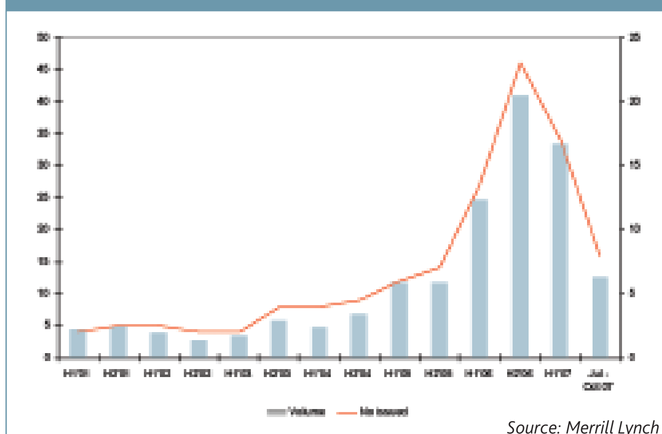
The common thread distinguishing the two halves of 2007 was the rise and subsequent fall of the leveraged debt market. Up until June, the structuring and pricing of leveraged buy-out (LBO) deals continued to be aggressive. This was facilitated by the massively increased demand from collateralised loan obligations (CLOs) for leveraged loan assets. CLOs had effectively replaced banks as the principal liquidity providers in the leveraged loan market over the past two years (see *Figure 2*).

The impact of dislocation in the structured credit markets immediately impacted the syndications of many of the most aggressively structured leverage finance transactions. CLO investors retreated from participating in primary transactions as the mark to market values or their portfolios plunged on the back of a complete market revaluation. Many aggressively structured transactions, notably the £9bn of Alliance and Boots, to name but one, were withdrawn from syndication. And, as we look at year end figures, there is still an estimated £20bn worth of long syndicate positions continuing to clog up syndicate desks underwriting books.

The impact of the turn in the leveraged market did not immediately feed its way through to the corporate loan market, and it has to be said that there were some notable transactions that deserve mention for quality syndicates, over subscription, structure and pricing – but did not make the final shortlists. This was mostly because they were completed "pre-turn". These included the €20bn Porsche deal in the European section, the $2.5bn refinancing by Smith & Nephew and the groundbreaking $1.5bn acquisition facility for Meggitt in the UK major corporate section.

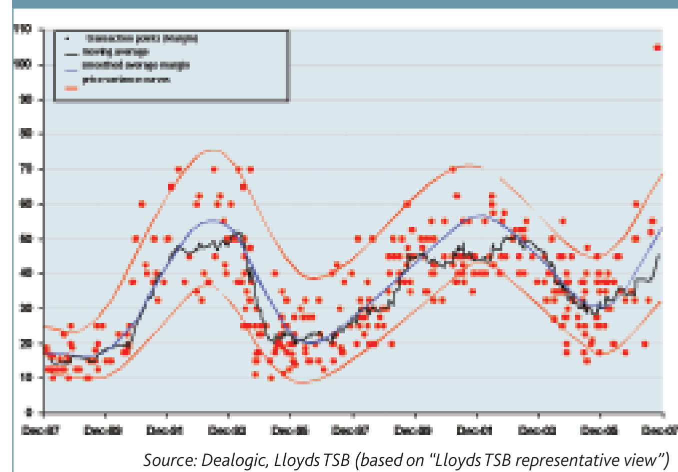
In the mid-market, the Northgate Information Solutions deal was a classic example of a well executed crossover transaction, syndicated in the early days of May and June and signed in August, holding its syndicate despite all the adverse headlines. Overall, the mid-market continued to see steady activity and transactions continued to get closed, albeit many were structured as club transactions. There is no doubt though that the $40bn Rio Tinto deal is the benchmark transaction for 2007 and 2008 across all markets, both bond and loan, as many bankers wait to see the result of both the syndication and the now likely substantial bond refinancing that is due early this year.

Figure 2: European collateralised loan obligation issuance (number and volume issued)



Source: Merrill Lynch

Figure 3: Indicative UK investment-grade pricing within BBB+ to Aaa range



Source: Dealogic, Lloyds TSB (based on "Lloyds TSB representative view")

The markets have calmed – mainly in the run up to the New Year – a little like the run up to the millennium. Volumes of transactions completed dropped but there again so had M&A. Nevertheless, transactions were still being well syndicated and completed. Loan pricing has now turned, and like the previous cycles will take some time to come back (see *Figure 3*).

Despite all of this, the volume of transactions under discussion remains strong, even the leveraged market is seeing reasonable deal flow – albeit on a totally different basis from six months ago.

SO TO THE FUTURE... As a cloud hangs over the global financial markets in January 2008, it is worth remembering that a turn in the credit cycle is usually caused by a combination of volatility and dislocation – but this usually leads to fitter and stronger markets in due course.

To highlight this landmark year, Guy Hands, CEO and founder of Terra Firma, sent all his bankers and sponsors a copy of J K Galbraith's *The Great Crash 1929*. There are some interesting lessons to be drawn from this book – mostly because standard deviation levels during the current dislocation approached those not seen since the Great Crash of 1929. But the modern financial world is much bigger and better connected and there remain substantial pools of liquidity within our global markets, which will give treasurers some comfort. Overall, corporate treasurers must remember that the bank to corporate rationale has always been governed by relationships, built in most cases on knowledge, reciprocity and trust. While the next few months may see further uncertainty emerging, and yes the cost of funding has changed, the market for strong corporate debt has probably not changed. And now that the firepower of private equity has diminished, there is no doubt that there will be M&A opportunities for corporates in 2008, with funding available for treasurers to pursue them.

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