LAST YEAR MAY HAVE BEEN A RECORD BREAKER IN TERMS OF LENDING VOLUME, BUT THAT DOES NOT AUTOMATICALLY TRANSLATE INTO GOOD BUSINESS FOR EVERYONE. **IAN FITZGERALD** EXPLORES WHAT IS HAPPENING IN THE LOANS MARKET.

Boom time for borrowers

Although European loan volumes in 2004 eventually outstripped even those of 2000 – totalling a record $890bn – borrowing appetite was still focused on low-cost refinancings that saw pricing and fees continue to be driven down. When scrutinised, much of the lending took place at margins that would barely be economic without ancillary business. With arrangement fees also collapsing by around half over the year, a lot of lending has not necessarily translated into profit for banks.

The last quarter of 2004 brought the beginnings of a mergers and acquisition (M&A) resurgence in the US, which has continued into 2005. But this has proved a false dawn for those looking to corporate M&A as the saviour of the European market. Whereas debt issuance to support US corporate M&A has increased to $17.4bn, supporting 33 deals – against $6.1bn for 28 deals in the first quarter of 2004 – it has declined in Europe from $33bn backing 23 deals in 2004 to $8.3bn backing only 10 deals in the same period this year (See *Figure 1*).

It seems that while US corporates have had the confidence to take planned deals off the shelf and complete them, European companies are still cautious. Potential deals have been discussed – even to the point of mandates being awarded – though many have since stalled. This includes both Swiss company Xstrata's proposed $8.4bn bid for WMC in the mining sector, and the expected $3.3bn deal to support a telecoms buy-out between Spanish group Auna and rival Ono. Frustrating for bankers, though not necessarily disheartening – after all, the current wave of activity in the US was also preceded by a similar stop-start period, including for deals such as Kmart's $11bn acquisition of Sears. And Pernod's proposed bid for Allied Domecq has been seen by some as heralding a resurgence in European M&A.

STANDING BACK What, then, is discouraging European corporates from taking the plunge? With premiums for acquisition facilities now virtually subsumed in the scramble for investment grade debt, debt-driven acquisitions have rarely been so cheap. The answer appears to be an ongoing scepticism of mergers among both boards and shareholders – reflecting lessons learned in the wake of the M&A boom of the late 1990s as well as the financial conservatism that has permeated the corporate sector for the past four years. Witness the ousting of Werner Seiffert at Deutsche Börse following his two attempts to bid for the London Stock Exchange as a measure of how concerns over shareholder value can halt a proposed deal. Combined with strong competition from private equity sponsors for available targets, this has dampened the appetite for corporate mergers and trade sales. Instead, a generally benign economic backdrop has provided the conditions to de-leverage and focus on efficiency gains and organic growth strategies. In the UK at least, this has left company balance sheets quite strongly in the black – with no-one in a hurry to go back the other way.

However, the two main drivers of the European market can both partly be traced back to this mood among corporates. On the one hand, a focus by larger groups on their core activities has provided the private equity market with a target-rich environment for leveraged buy-outs. On the other, many recent borrowers have refinanced in order to further fine-tune their cost of funds.

Leveraged debt has, of course, been a high-profile driver of the markets. In the first quarter, it has shown continued growth of 20% against the same period last year, although UK first quarter deal flow has fallen from 76 deals in 2004 to 72 in 2005. Competition between private equity sponsors has been complemented by a deep lending appetite that has pursued yield from the largest deals – such as the acquisition of the AA by Permira and CVC – down to a multitude of small to mid-cap deals. And in the first quarter, this lending appetite has also extended spectacularly to recapitalisations, which have recorded a 137% increase on the previous year. The largest of these has been the £1.2bn recap for betting shop owner Coral Eurobet and

Executive summary

- The year 2004 was a record-breaking one in terms of lending volume. But low margins, the dominance of refinancings and intense lending competition are the factors still making it difficult for banks to generate sufficient returns in the loan market.

- Banks without a certain critical mass on their balance sheets are finding it harder to compete with those where the profitability of relationships is underpinned by structured products and wider 'soft' business such as the provision of registrar and cash management services.

- There has been whispering about the end of the 'credit boom' but what will happen for the remainder of 2005 is difficult to predict.

Figure 1. Debt Issuance

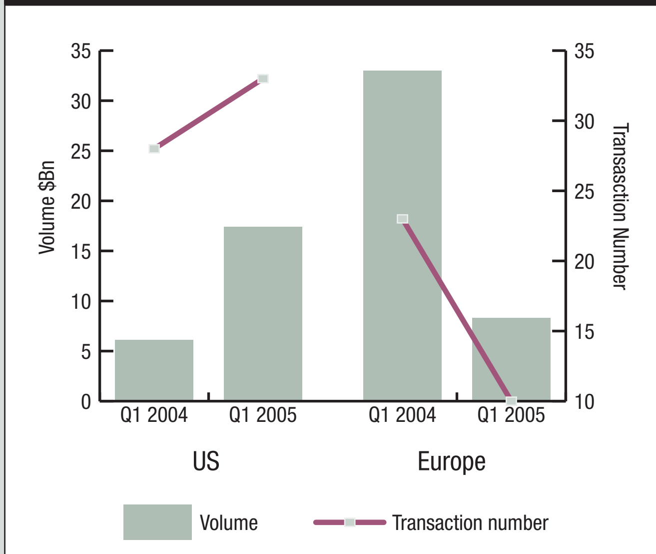
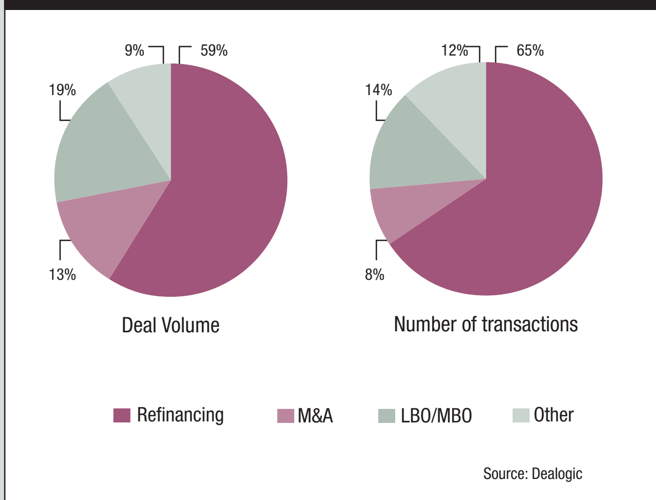


Figure 2. UK Market – Loan Purpose 2004



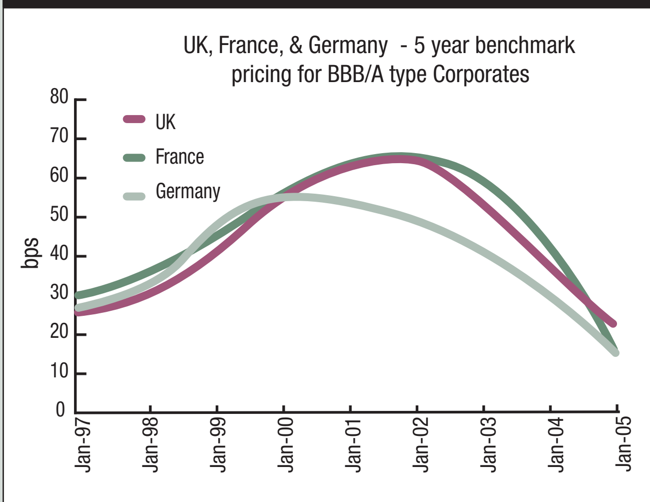
a £1bn facility for bingo company Gala Clubs. Indeed, for the whole of 2004, recaps accounted for 32% of leveraged lending, or $23.4bn.

Then there are corporate refinancings, which continued to drive the market to the tune of between 60% of all lending in the UK and up to 80% in France and Germany in 2004. *Figure 2* illustrates the role this has played in the UK market. But how far this core demand can continue to drive growth in the market has become a moot point in the City, as exposure from bilateral loans and other debt instruments transfers into the syndicated loan market. Also, European corporates are coming back to the market increasingly soon after original facilities have been signed. A case in point is the bumper acquirer Sanofi-Synthelabo, which refinanced the €1bn one-year tranche of its 2004 €16bn facility to buy rival Aventis in January 2005 – with a margin slashed from 40bp to 10bp. Then came the €5.5bn three and five-year term loans, refinanced in April. Similarly, at least half of Carlsberg's €1.56bn acquisition facility of March 2004 has since been refinanced at half the original margin.

Although some high-end M&A facilities have come through in the early part of the year – notably a €12bn loan to allow the completion of Telecom Italia's partial buy-out of Telecom Italia Mobile – with pricing already tight on these deals, it is not clear how much the market will further stomach similar refinancings.

PRICING AND STRUCTURE *Figure 3* shows a pan-European price decline, with France now leading the way. And as pricing has fallen, there has also been a compression between stronger and weaker credits in the market. While headline pricing for 'AA' rated corporates in Europe dropped by 26%, 'A' and 'BB' rated borrowers have seen margins fall by 32% and 19% respectively. This has seen some banks widening their franchise in order to try to pick up more business from mid-cap and regionally-based companies, while some smaller European banks have bowed out of foreign markets entirely. Indeed, a consolidation is now underway that has resulted in the majority of

Figure 3. European Benchmark Pricing



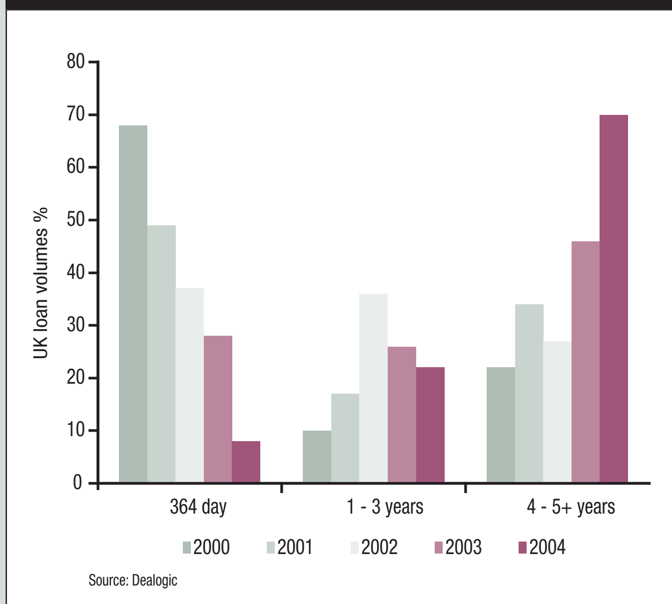
UK investment-grade market liquidity being provided by the top 12 banks. And in the western European market as a whole, a similar proportion is provided by a mere 20 top tier banks.

It is therefore clear that banks without a certain critical mass on their balance sheet are finding it harder to compete with those where the profitability of relationships is underpinned by structured products and wider 'soft' business such as the provision of registrar and cash management services.

A similar process has taken place with tenors. Borrowers have pushed banks into longer tenors that have not been seen since the late 1990s. Initially, this came in the use of extension options, with 'five plus one plus one' structures initially being offered in order to avoid a return to straight seven-year terms. These found acceptance in some high-profile deals, such as French utility Suez group's €4.5bn refinancing in mid-2004. A further 25 mostly continental borrowers followed suit with the same maturity profile during the rest of 2004 (totalling $52bn of debt). However, this was soon superseded by an outright seven-year tenor on a $2.5bn refinancing for Philips – terms that were replicated on part of the above mentioned refinancing for Sanofi-Aventis (as the new entity is called).

Figure 4 shows the return of longer tenors to the UK market. They will be likely to find continued acceptance, especially if they can be situated within existing strong bank-borrower relationships.

Figure 4. UK investment grade loans by Tenor



A GENERALLY BENIGN ECONOMIC BACKDROP HAS PROVIDED THE CONDITIONS TO FOCUS ON EFFICIENCY GAINS AND ORGANIC GROWTH STRATEGIES. IN THE UK AT LEAST, THIS HAS LEFT COMPANY BALANCE SHEETS QUITE STRONGLY IN THE BLACK.

OUTLOOK Compared with previous cycles, pricing would seem to be approaching a cyclical trough in the UK. With credit jitters emanating from many sources – including widening bond spreads in Europe, automotive downgrades in the US and a consumer spending slowdown in the UK – there has been whispering about 'the end of the credit boom'. Precisely how this will impact the syndicated loans market is uncertain. On the one hand, aggressive structures, high multiples in the leveraged market and uncertainty about a pending M&A resurgence could expose the market to pricing shocks from either sudden demand, a high-profile default or a failed leveraged syndication.

On the other hand, both transparency across the European market and risk-transfer techniques have improved greatly in the last decade, including the emergence of a new generation of credit derivatives for hedging purposes. Especially given the impending arrival of the new Basel II Accord – which devolves substantial responsibility onto banks for their credit risk assessments – the last thing banks are doing is lending blind.

Exactly what will happen for the remainder of 2005 is therefore difficult to predict. Despite bank concerns over returns and relationship profitability, there is substantial liquidity embedded within the system – as evidenced by continued oversubscription to deals. The market is being driven by a relatively strong global economy and a stable geo-political outlook. For this situation to change dramatically will ultimately require a major shift in at least one or more of these factors. And although concerns are emerging over certain sectors of the global economy, at present there is no apparent shift strong enough for the underlying situation to change dramatically.

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