Crying wolf?

RATINGS AGENCY STANDARD & POOR'S WARNS THAT A MASSIVE REFINANCING CHALLENGE MAY BE IMMINENT FOR EUROPE'S NON-FINANCIAL CORPORATES. BUT IS TALK OF A "$46 TRILLION PERFECT STORM" A WILD EXAGGERATION? **GRAHAM BUCK** REPORTS.

Europe's companies could face a growing challenge in refinancing their maturing debt over the next five years, ratings agency Standard & Poor's has warned.

S&P has issued a report with the alarming title The Credit Overhang: Is a $46 Trillion Perfect Storm Brewing? It is based on the agency's calculations that companies globally will need between $43 trillion and $46 trillion in new funding and to refinance existing debt between now and 2017.

Despite the report's title, its authors are confident that global banks and debt capital markets will meet most of that demand, although various developments could undermine this scenario. They include greater credit rationing as banks attempt to restructure their balance sheets and the likelihood that bond and equity investors will reassess their risk-return thresholds. The continuing euro zone crisis, a soft US economic recovery from the recession and the prospect of slowing Chinese growth all add to the downside risk for credit markets.

Also noted are the recent signs of a backlash in several European countries against the austerity measures introduced.

The challenge is likely to be greater for European lenders. "Specifically, European banks have to adapt to a weaker economy and uncertainties relating to sovereign debt sustainability while managing more highly levered balance sheets," says the report.

On a more positive note, S&P believes that the credit quality of many con-financial corporate issuers has improved in recent years. This is due in part to an economic rebound following the 2008–09 recession and also higher cash balances resulting "from higher discretionary cashflow and retention of earnings".

As a result banks have been able to roll over existing term debt but a "flight to quality" by the lending markets has made life more difficult for the middle market and small business segments, which face greater funding challenges.

CORPORATE BORROWERS IN EUROPE STAND TO BE MOST AFFECTED BECAUSE OF THEIR GREATER DEPENDENCY ON RELATIONSHIP BANKS FOR FUNDING.

Corporate borrowers in Europe stand to be most affected because of their greater dependency on relationship banks for funding. Further afield, US banks may also limit loan growth, both because of their higher regulatory cost of capital and the possibility they may voluntarily return excess capital to shareholders rather than lend it. Asian banks are expected to continue lending, although at a slower rate in line with slackening economic growth.

S&P also believes that, overall, rated debt issuers will fare better than non-rated issuers because they "tend to be more proactive with establishing and maintaining capital market relationships".

Asia's corporate debt issuers rely most heavily on bank financing, followed by those of Europe, while US issuers rely on banks least. These factors will influence the effects of any credit rationing by banks.

Europe's banks are grappling with a number of issues that include higher leverage, the economic downturn, the sovereign debt crisis and Basel III's proposed funding, capital and liquidity requirements. In this context, they must also attempt to reconcile their shareholders' wish for higher returns on capital.

A likely response will be that European banks prioritise their domestic markets in future and reduce their levels of cross-border and international business.

Although US banks share many of the same issues, S&P believes that it will be several more years before they have to incorporate Basel III into their regulations as they only recently fully incorporated the provisions of Basel II.

However, the Volcker Rule – which as part of the Dodd-Frank Act reforms in the US separates the investment banking, private equity and proprietary trading arms of financial institutions from consumer lending – means that traditional relationship banking may become more expensive and/or less available for corporations even where they are of high credit quality.

The report also contrasts the relatively mature debt markets of the US, which have "demonstrated ability over the past three years to provide over $400bn per year of new corporate funding", with Europe's less developed corporate bond market.

"If we assume European corporate issuers tapped the market for 50% of their respective new funding requirements (up from about 15% historically), this would imply $210bn to $260bn of net new yearly issuance by European non-financial corporate borrowers," the authors write. "There have only been two years in the past decade when net new issuance by euro area companies has exceeded $100bn."

The conclusion is that this could be regarded as a significant growth opportunity for European debt market investors – or stark evidence of the challenges confronting non-financial corporate borrowers in Europe.

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