IN SEARCH OF SECURE FUNDING

EQUITY DOLDRUMS HAVE MEANT MORE MID-MARKET FIRMS ARE HAVING TO LOOK ELSEWHERE TO SATISFY THEIR FUNDING NEEDS, SAYS **SIMON TILLEY** OF CLOSE BROTHERS DEBT ADVISORY GROUP.

This year began with the UK equity markets falling to their lowest levels since 1995 and market commentators speculating that a sustained recovery is unlikely in the short term. Concerns about the economy, low manufacturing output, faltering retail confidence and the potential impact of a realignment in the UK housing market, as well as wider geo-political concerns, continue to affect investor sentiment.

Nevertheless, in the mid-market there are signs of life in certain sectors and for those companies contemplating corporate activity, access to the debt markets remains key. I have considered market conditions and in this article will provide some advice to those contemplating raising debt finance in 2003.

Research published by Gresham Trust in January found that the majority of UK mid-market companies remain cautious about their prospects in 2003. 'The Gresham Monitor' indicated a record low (10%) number of companies feeling "very optimistic" about their prospects, while a record 21% stated that they were "very pessimistic". That said, Gresham also found that 23% of companies expected to raise external finance in 2003 and, importantly, nearly 19% expected to make an acquisition, taking advantage of current valuations and the need for many to restructure overstretched balance sheets.

EXPLORING OTHER OPTIONS. Against this pessimistic backdrop, there is activity in certain sectors with cash-rich buyers who have retained the confidence of their investors investing for future growth. In the technology sector, over-supply is driving larger numbers of companies to look at strategic consolidation. The recent all-share merger of Logica with CMG was a good example of two companies that combined to deliver substantial cost synergies and leverage their combined market share.

Indeed, the technology sector has demonstrated a robust level of activity following its extended fall from grace, where the combined capitalisation of the software, computer services and IT hardware sectors – some 200 companies – now accounts for less than 1% of the stock market's value. However, a number of companies have adopted a practical approach to the problems of volatile investor sentiment and capital constraints with the recent sales of Orchestream and ECsoft to larger US competitors and the recently launched MBO of Rolfe & Nolan.

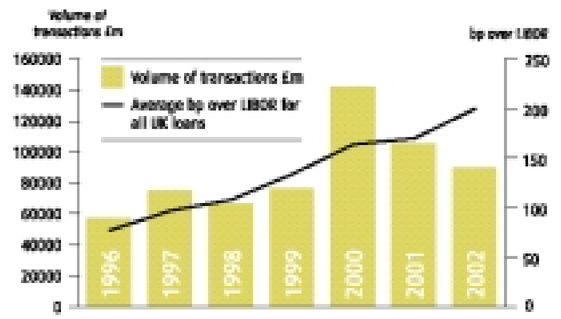
Looking further afield, while transacting in the key European markets remains difficult, distressed M&A is providing opportunities for some UK companies. In France, there are considerable assets on the blocks, although these are tending to come from larger companies such as Vivendi Universal and Suez, which are reported to be under pressure to restructure their balance sheets. "While for some there is a clear focus on domestic retrenchment, European consolidation is at the heart of French international expansion," notes Olivier Dousset, Managing Director of Dôme Close Brothers in Paris. Interestingly, he says that "there are an increasing number of French companies looking at UK-based targets, a reversal of the position 18 months ago, following the decline in UK valuation multiples".

LEARNING THE HARD WAY. The Spanish M&A market was very quiet in 2002, with most of what activity there was being domestically oriented. However, the medium-term prospects in Spain are encouraging – the country's economy is in reasonable shape and consumers are continuing to spend. It is also apparent that the gulf in price aspirations is narrowing as expectations are realigned. According to Leon Benelbas, President of Atlas Capital, one of Spain's leading independent mid-market advisers: "People have learnt on the buyer's side that the world is not falling apart, that people are still making profits, and on the seller's side they have learnt they cannot get a 20% increase in EBITDA every year for ten years."

Across Europe, one of the fundamental issues facing the mid-market is a shift in institutional investment criteria, the scale of which many mid-market companies continue to underestimate. In the UK, of the 2,300 or so companies whose shares are traded on the London Stock Exchange, nearly 70% are presently capitalised at less than £50m, and nearly 80% at less than £100m. As more companies effectively become sub-scale for the mainstream investment managers, the pressures on many to question whether the public markets continue to reflect their strategic objectives will increase in 2003.

FIGURE 1

AN INCREASE IN MARGINS SINCE 1996.



Source: Dealogic Loanware

'BANK DEBT, EITHER BI-LATERAL OR SYNDICATED, CONTINUES TO BE THE SINGLE MOST IMPORTANT SOURCE OF CREDIT FOR MID-MARKET COMPANIES, ALTHOUGH INCREASINGLY MID-MARKET FIRMS ARE USING OTHER FORMS OF FINANCE'

With the equity markets remaining difficult, access to the debt markets will be key. In the current economic climate, bankers share many of the concerns of mid-market managers and investors. Debt providers – in all their guises – are focusing their attention on leverage (both earnings and balance sheet), sustainability of financing structures and the balance of risk and reward. In the light of this backdrop, mid-market companies looking to access the debt markets to refinance or raise new facilities should thoroughly examine all of the options available in advance of funding requirements falling due, whether for short-term liquidity or acquisition finance. Bank debt, either bi-lateral or syndicated, continues to be the single most important source of credit for mid-market companies, although increasingly mid-market firms are using other forms of finance.

NEW ISSUES. Access to the public bond market in the first half of 2003 is likely to remain limited to top quality, investment grade credits. Since the start of 2003 France Telecom, Olivetti and Deutsche Telecom have successfully issued 30-year bonds (see page 39). These long-dated issues are seen as significant, particularly in light of an increase in the number of companies such as Diageo, Vodafone and Deutsche Telekom issuing at the shorter end of the curve in 2002 and the early part of 2003, as a means of accessing liquidity. In fact, for high quality credits, demand is strong, resulting in margins and fees remaining relatively stable.

The European high-yield bond market, in the past a source of finance for mid-market MBOs and private equity investors, continues to suffer from short-term unpredictability in demand. Current returns – about 7-8% over gilts when trading at par – are, at face value, attractive, but pricing reflects relative risk and investors are continuing to exercise caution in an uncertain market.

The interminable debate between banks and bondholders about structural subordination has severely impacted new issuance. This perhaps explains the contrast between Europe and the US, where the market is strong and new issuance levels robust. Presently, rather than new deal activity, there is much market interest in the so-called 'fallen angels' that have been downgraded from investment grade to high-yield status and 'cross-over credits', which straddle the border between investment grade and sub-investment grade.

For those UK mid-market companies looking to access long-term finance, the private placements market benefits from more predictability in demand. The second half of 2002 saw some sizeable deals, including the record-breaking $850m offering from Scottish & Newcastle, which underlined the depth of this market (see page 48). Other issuers in the second half of last year included Cobham, Johnston Press, Grant Thornton and Clifford Chance. George Wimpey was similarly successful and raised a total of $365m from 17 US institutions in November 2002 to finance the acquisition of John Laing's housebuilding division.

Continuing the trend of last year, 2003 is likely to witness a robust private placement market as mid-market borrowers seek to diversify their sources of liquidity.

SEARCHING ELSEWHERE. A number of market commentators also report greater numbers of mid-market companies evaluating securitisation in the first months of 2003. In its simplest form, securitisation – the issuance of bonds secured against long term income streams – provides the issuer with access to capital upfront, rather than through future operational cashflow and, as such, can be an attractive, and effective, means of financing corporate transactions in industries that benefit from visible or contractual income streams. The current pipeline is heavy with issues expected in the utilities, leisure and transport infrastructure sectors. The market is also expecting tap issues of existing pub securitisations as a means of funding capital expenditure with the market speculating about Unique Pubs and Punch returning to investors for additional finance. Moody's Investor Services predicts issuance in the European securitisation market to hit €400bn in 2003, up from €347bn in 2002.

Similarly, the asset-based finance market is reporting increased activity as asset intensive companies look to capitalise on inherent balance sheet value as a means of securing liquidity. US-style, asset-based finance – more than just debt factoring – has grown strongly in the UK in recent years, as some of the key US players, including Bank of America, GE Capital and First Union, have introduced flexible asset-based finance tools to the UK market and have been joined by more aggressive approaches being taken by the domestic banks.

Asset-based finance – raising debt against plant & machinery, property and inventory as well as the debtor book – is particularly appropriate for low margin, asset-intensive industries such as wholesaling and distribution. Palmer & Harvey McClane used £160m of asset-based finance to support its management buyout in 2002 without the involvement of private equity, a transaction that has caught the attention of a number of companies. **>>**

<< A VITAL SOURCE OF LIQUIDITY. However, bank debt remains the single most important source of liquidity for mid-market corporate borrowers. The second half of 2002 saw a weakening in bank appetite for underwriting risk and larger numbers of transactions being arranged by a club of banks. Margins have almost doubled since the low point in 1995/96 (see *Figure 1*) as banks seek to improve returns in thin markets. In addition to pure margin returns, banks are increasingly focused on total returns and borrowers should not underestimate the value of ancillary banking business.

THE IMPLICATIONS FOR MID-MARKET COMPANIES. Businesses need to be aware of their financing requirements and plan ahead, whether they are raising debt facilities to support an acquisition or expansion programme, or merely refinancing existing facilities. Companies which delay putting new facilities in place or, worse, do not keep their lenders appraised of trading performance for fear of losing access to credit, risk securing new facilities on less attractive terms.

'THE DEBT MARKETS, WHILE NOT EASY, ARE OPEN FOR BUSINESS AND THE PRIORITY FOR TREASURERS IN 2003 WILL BE TO ENSURE ACCESS TO SUFFICIENT LIQUIDITY'

Ensuring a professional approach is as important as timing and, while there will always an element of unpredictability as to market sentiment when it comes to the timing of the approach, the nature of the approach is entirely within the borrower's control. A well-prepared borrower will maximise its prospects of securing the deal it wants on optimal terms.

Companies facing more difficult financing issues should take independent advice early in the process. Financial restructurings have become much more prevalent, given the economic climate, and banks have increased the resources of their 'workout groups' to enable them to identify and monitor potentially difficult situations earlier than was previously the case. According to Martin Gudgeon, a leading restructuring practitioner: "The economic climate of the past 12 months has resulted in more boards seeing a restructuring process as providing an opportunity to take positive action to improve profitability, rather than as an embarrassment or admission of failure."

The general weakness in the financial markets and the inability to access new equity at an acceptable cost has resulted in companies looking to the debt markets to satisfy their funding needs. The number and nature of the issues impacting the equity markets means that this situation is unlikely to reverse in the short term and these are the same issues which are impacting credit appetite, deal structuring and pricing in the debt markets. The debt markets, while not easy, are open for business and the priority for treasurers in 2003 will be to ensure access to sufficient liquidity. A thorough examination of the options available and a well-considered approach to the market in advance of the funding requirement falling due is essential.

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