Back to the future

THE UK MID-CAP DEBT REFINANCING PROBLEM IS PARTICULARLY ACUTE.

After more than 12 months of extremely difficult credit markets we are beginning to see a loosening in market conditions for the largest corporate issuers. Mid-sized and smaller companies, however, are unlikely to benefit. Since the government is unable to solve funding problems for all companies, it will largely fall to treasurers to find alternative means of financing, including sourcing funding from pension funds and insurance companies rather than simply looking to their banking syndicates. Ultimately, we could see a return to company financing closely resembling that of the 1970s and 1980s – and a corresponding change to the investing habits of pension funds. This will allow pension funds and insurance companies to avoid benchmarks which are dominated by financial issuers and larger corporates.

The troubles of the world's banking system have been well documented, playing out in the full glare of the international media. Even so, the impact of this on the UK corporate lending market – the double-headed blow of an unprecedented decline in the amount of lending capacity and a rapid rise in credit spreads – has taken many by surprise. Unfortunately, this has compounded the problem we see today, as significant numbers of otherwise solvent businesses faced with large bank borrowing facility maturities over the next few years confront the facts that there are no opportunities to refinance at the same level, and fewer willing lenders to deal with. Unhelpfully, it has coincided with the point in the economic cycle when companies need more, rather than less, liquidity.

Executive summary

- The UK Companies Financing Fund has investors that are pension funds and insurance companies determined to provide a way out of the financial crisis for mid-sized and smaller companies. This initiative aims to provide a pool of liquidity and diversity for capital providers. Marketing of the fund began in earnest at the beginning of 2009 but there is still some way to go.

MID-CAPS FACE A HARSH REALITY The problem is particularly acute for mid-caps – broadly the 50-350th largest companies in the UK – because they have become reliant on what used to be a vibrant international syndicated bank debt market providing the lion's share, if not all, of their debt finance. Many of these companies have put off early renewal of bank facilities over the last 20 months in the belief, which was widely shared by most financial professionals, that the banking crisis would soon resolve itself and that credit spreads and lending capacity would return to normal. As we now know, this has not happened.

Much of the analysis of the mid-cap refinancing problem has ignored the role of international banks, both in the rapid growth of the syndicated loan market and their part in its current malaise. The Icelandic banks had become reasonably large players in the loan market, but the impact of their demise is generally overstated. The much more important trend has been the ongoing retrenchment of international banks as they focus on their own national market, in many cases encouraged tacitly or even explicitly by individual governments.

Sadly, UK mid-cap companies will suffer the most from this trend as this part of the market has become extremely over-banked because the City of London has acted as a magnet for foreign banks' overseas headquarters. A typical syndicated loan of £200m-£500m in size to a mid-cap company will typically have anywhere from eight to 15 banks. The majority of these banks will have non-UK parents and therefore will be largely free from any political pressure to continue to lend to a UK corporate. The merger of some major UK banks has reduced the available syndicate size even further to as few as five or six banks.

HOBSON'S CHOICE The various government initiatives to restart lending have started to focus much more on this mid-cap sector. However, the government's fundamental problem in this market is how do they direct money to the right companies? We define that to mean those that both need the money and have a sufficiently robust business model that they can pay it back. In this regard the government is faced with Hobson's choice: it can either pump more money into the UK banks in the hope that this somehow finds its way

to the right bits of the economy (a separate and distinct aim from ensuring the banks have enough capital to survive), or it can order the Bank of England to buy corporate liabilities indiscriminately.

Regrettably, while the situation is sufficiently serious that all help is welcome, neither route is terribly efficient. In the first instance there is the potential for both a conflict of interest and the risk that, particularly in the case where the government is a significant shareholder, lending decisions become politicised. In the case of the Bank of England buying rated corporate bonds or commercial paper, there is a risk that the effort serves mainly to subsidise the largest corporates, whose issuances (ironically along with debt issued by banks), dominate bond benchmarks. They also are the companies with credit ratings; most – generally publicly rated single A or better – can still borrow in the primary public bond markets.

PERFORMANCE MEASUREMENT The issue of benchmarks is an important one. Over the past decade, the public bond markets have become dominated by a relatively small number of banks and large companies who have been able to issue large sterling bonds. These bonds have been used to form benchmarks for investors, such as the Merrill Lynch or iBoxx indices, which have become the standard way for pension fund consultants and trustees to measure investment performance. In order to be accepted into these indices any bond issue requires at least one credit rating and must be over £100m in size at issue. For smaller companies it is impractical to concentrate their borrowings in such a one-off bond issue. Furthermore, most mid-cap companies have not wished to incur the expense, or time, of obtaining a public bond rating.

Since the banking sector and the government will find it difficult to renew or replace funding for companies, and the public markets are likely to remain virtually closed to them for the time being, another pool of capital is required. The most obvious source of capital is to be found in UK insurance companies and pension funds, investors that are already large holders of public equities for many of the companies facing refinancing difficulties. Historically, medium-sized companies were able to obtain access to this funding through direct privately placed means such as convertible unsecured loan stock (CULS), an instrument fairly common in the 1960s and 1970s. Insurance companies and pension funds bought these assets to build a diversified bond portfolio.

Over the past two decades, as the City of London grew with the influx of international banks, these smaller debt markets withered. In many cases the expertise within insurance companies to analyse these investments faded away as well. The majority of institutional investment in corporate debt, whether pension fund or insurance company, is now made with reference to the now standard benchmarks. The providers of corporate bond funds have therefore concentrated on these benchmarks when developing products for pension funds. The result is that only a small number of investors are able to conduct in depth due diligence into non-benchmark securities and some of these investors may not have the long-term experience of lending to these kinds of companies.

HELP IS AT HAND Prudential, and its European investment arm M&G, have maintained investment in the more unfashionable areas of the corporate bond market throughout the last decade – we remain Europe's largest investor in privately placed corporate debt securities. We can see the desperate need for channels that allow pension funds, and our own insurance company, to gain access to debt issued by smaller companies. This is vital now, when the lack of available financing to these type of companies could result in "the collapse of a solvent but illiquid company", according to Richard Raeburn, chief executive of the ACT in the Financial Times in 2008.

Prudential and M&G are setting up a fund aimed solely at direct lending to UK companies to help them through any immediate funding difficulties and to move over the longer-term towards a more stable and diversified balance sheet. The fund is only a small part of the answer, but we hope that it will be a part of a solution for good companies unfairly hindered by the lack of liquidity. The fund will work together with a company's leading banks and advisers to help fill gaps in financing, offering five-year term debt that can be extended if required. We are aiming for a fund size of between £2bn and £5bn. At this size, the fund can make a material difference to companies but also provide the investment diversification required.

Key to the success of this fund – the UK Companies Financing Fund – are subscriptions from other pension funds and insurance companies in order to provide a meaningful pool of liquidity and also diversity for the providers of capital. To this end Prudential has already committed £500m to the fund raising. The marketing of this fund started in earnest in Q1 2009 and initial feedback has been very positive, but there is some way to go.

We are confident that this will provide one way out of the new century's first financial crisis and presage a return to the debt products of a prior era. We hope that other UK pension funds and insurance companies will recognise it is in their interests to be part of this process. This may lead to pension funds and fund trustees looking more closely at how they allocate their long-term capital to protect their existing holdings as well as taking advantage of possible opportunities from this financial crisis.

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(To request more information on this fund, please contact info-uk@mandg.co.uk. This financial promotion is issued by M&G Investment Management Ltd)