A turbulent year

THE DEALS OF THE LAST 12 MONTHS HAVE BEEN PLAYED OUT AGAINST ONE OF THE MOST DRAMATIC SHIFTS IN CREDIT CONDITIONS FOR MORE THAN A DECADE. **GRAHAM BUCK** REPORTS.

For much of the past 12 months, it appeared that the major story of the past three years would again be growth. As Ian Fitzgerald, Managing Director and Head of Loan Syndicate at Lloyds TSB Corporate Markets, observes, within the lending markets as a whole, the main driver over this period was private-equity driven leveraged buy-out/management buy-out (LBO/MBO) activity. Since 2004 growth in this type of lending went from 20% of total European market lending to a point where, mid-way through 2007 it represented 35% of the total market.

But the chorus of predictions that the buoyant conditions in the credit markets couldn't last forever grew steadily louder. As Europe's leveraged buy-outs regularly set new records in the early months of 2007, pundits wondered aloud how much longer the party would continue.

The answer came during the summer. After a couple of jittery periods earlier in the year, which proved fairly brief, the credit crunch suddenly bit with a vengeance.

So the past 12 months can be divided into two periods. The first stretched from the final months of 2006 to late July, when the wind suddenly changed. The second period, during which conditions have been markedly tougher, has seen buy-outs still taking place but generally on a smaller scale, with £1bn-plus deals much thinner on the ground.

There are signs of renewed calm after the storm, with confidence and sentiment both starting to revive. But weak economic data or another shock on the scale of Northern Rock's implosion could yet scupper the tentative recovery.

Not that the stock markets provide much evidence of the change. After falling back sharply on both sides of the Atlantic, they had rallied to near their peak levels by later October. Those in emerging markets managed to largely ignore the turbulence.

So what caused the summer storm? The main culprit was the contagion from sub-prime mortgages. "It's a market that has always existed and has catered to individuals who would otherwise be unable to get on the property ladder," says Daniel Morland, Managing Director for the European debt advisory group at Close Brothers Corporate Finance. "However, the volume has ticked up sharply in the past few years – particularly in the US and primarily in Florida and California."

As has been belatedly recognised, lending criteria over this period steadily grew more reckless. Lax conditions spawned what have been dubbed ninja loans (no income, no job, no assets) and liar loans (with self-certification enabling applicants to vastly overstate their true income). At the same time, deals were structured with very low teaser rates.

"People calculated what they thought they could afford on this basis and significantly over-estimated," says Morland. As a result, the sub-prime crisis started to brew over the early months of 2007 and had grown serious enough to hit the headlines by June.

The situation was compounded by the fact that mortgage originators sold the loans on an agency basis, rather than taking on any of the risks themselves. Those that did assume them used asset-backed securitisations and most of the bonds issued were investment-grade and so were funded fairly cheaply.

The ratings agencies faced accusations that they were asleep on watch, did not realise that default rates were potentially very high and were unaware of the extent of reckless lending. Once this became apparent, they downgraded the paper that had been issued and those who had invested lost significant amounts of money.

In their defence, the agencies point out that they began making their concerns known about affordability mortgage products back in 2005 and issued their first downgrades late last year. In addition, the majority of downgrades since 1 July have been directed at what were originally deemed the weakest-quality securities – originally rated BBB and below, denoting clearly that the credit quality of these loans was among the weakest – while the historical data on which the ratings partly relied has proven to be no longer so useful.

VIRAL POWER The contagion effect of the US sub-prime crisis was not immediately apparent, says Fitzgerald. The initial impact flooded over into leveraged products and when the market returned to work in mid-September it was clear that all the credit markets had repriced as a result.

Many of the investors affected by the crisis came from outside the US and had, it transpired, bought dollar-denominated securities without questioning too closely just what they were composed of.

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The resulting meltdown, although it took many by surprise, was therefore inevitable. Hopes that Europe might remain unaffected were soon dashed, as its securitisation structures proved only too similar to those used in the US sub-prime market. Those who had already lost money from the problems in the US immediately feared the prospect of a double hit, anticipating that the leveraged loans market was about to go down the same path.

The result was that liquidity quickly evaporated as the funds were no longer there to take the paper on offer. The leveraged loans market suddenly went dry in late July and the US and European stock markets fell back steeply from their six-year highs.

A number of banks were left holding huge underwriting positions on deals they had intended to syndicate. Examples included the proposed £6.1bn merger between motorist services group the AA and Saga (which had been announced only weeks earlier after overtures from Permira and CVC to Saga's majority owner Charterhouse) and the planned private equity buy-out of Alliance Boots, whose £10bn of debt suddenly became much harder to shift.

Conditions deteriorated in August. Banks continued to sit on huge underwriting positions, but none was willing to admit it was nursing large losses. Each of them wanted to conserve cash and were unsure which of their counterparties posed the greatest risk. The upshot was that they simply stopped lending to one another. According to Adam Applegarth, Chief Executive of Northern Rock, his group's already serious problems became overwhelming from 9 August, when the wholesale money markets seized up completely.

As a result, Libor, the key London interbank offered rate at which banks lend to one another, moved sharply up to reflect the lack of trust in asset-backed securitisations. The impact was felt most keenly by the commercial paper (CP), which shut down, while structured investment vehicles had to shut down as well or restructure.

As the bank that was the most reliant on the short-term money market, Northern Rock suffered by far the heaviest damage, although fears of a similar fate hit rivals such as Alliance & Leicester.

"The true impact of the market dislocation came dramatically to the fore towards the end of September with the virtual closure of the CP market and severe liquidity issues in the money markets, resulting in intervention from the central banks," Fitzgerald adds. "This means that banks no longer have access to the same variety of distribution vehicles and are more restricted in their usage of off-balance-sheet funding vehicles. The majority of lending instruments will therefore have to remain on-balance-sheet – restricting the amount of capital banks can allocate to corporates."

As a result, all lending became subject to much greater scrutiny at the pricing, structuring and documentation stages. Above all, says Fitzgerald, relationships have once again come into sharp focus and will be a key decision variable for banks when it comes to lending.

BOND REVERSAL It was also a story of sudden change in the bond markets, says Farouk Ramzan, Head of Debt Capital Market Origination at Lloyds TSB Corporate Markets. He says the first half of the year saw €87bn worth of issuance in Europe which, projected forward, gave all the indications of a bumper year.

However, this optimism could not account for the dramatic impact of the summer's liquidity crunch. "Irrespective of whether the markets should have seen this sub-prime lending problem coming, the impact has been to rebalance the dynamic between investors and issuers," says Ramzan.

He adds that issuers are in a reasonable position as regards balance sheet health and so can ride out the wider credit spread market now prevalent as regards the need for bond issuance.

"It is the resurgence of business-to-business M&A activity – as opposed to the retraction of the private equity bid for acquisitions – that will be the driver for corporate issuance in the primary markets," says Ramzan. "As a complement, investors are watching the primary issuance market as the entry point for them to invest, as this offers more value as regards a premium as opposed to the secondary market."

SILVER LINING The repercussions of the credit crunch were less dramatic for corporate buyers.

"They could even benefit," says Morland. "The corporate finance market wasn't hit anywhere near as much as the leveraged market, as it isn't similarly dominated by structured investment vehicles. The credit crunch is purely technical. Corporates aren't performing any worse than they were six months ago, whereas the sub-prime issue is absolute as the underlying commercial proposition is so dire."

There was proof in early September that banks were still willing to lend to corporates – albeit at a higher price. Deals such as AstraZeneca's $6.9bn bond issue were still able to get under way although it paid more than it would have had to a few months earlier.

And those deals that were still able to complete were offset by others, such as Enterprise Inns, which postponed its planned £750m debt refinancing as it judged the pricing to be too high.

What's the outlook for the year ahead? Much depends on the spending power of consumers in North America and Europe. A major squeeze already looked on the cards before the latest spurt in oil prices and the shortening odds on a major slowdown threatens more significant and long-term damage.

Although the jury is out over whether economies will suffer no more than a slowdown in growth or tip into full recession, the conditions that supported a series of record-breaking deals for leveraged buy-outs earlier in the year are unlikely to return in the near term. Private equity simply can no longer manage quite such high prices. Despite this, stock markets have bounced back and corporates should again be able to contemplate acquisitions that until recently were priced too highly.

But, as Morland warns, there will be a time gap during which the expectations of sellers will gradually settle back to match those of buyers. The latter may, for example, offer a price based on nine times EBITDA rather than 11 times. If the party is not completely over, any revelry over the coming months may prove more subdued.

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2007 Deals of the year

IT SEEMS A LONG TIME NOW SINCE THE MARKET WAS PULLING OFF MEGADEALS, SO **GRAHAM BUCK** LOOKS BACK TO SOME OF THE MARKET HIGHLIGHTS FROM THE EARLY PART OF THIS YEAR. NOMINATIONS FOR THE DEALS OF THE YEAR AWARDS ARE NOT RESTRICTED TO THE DEALS COVERED HERE, BUT MUST BE IN BY FRIDAY 23 NOVEMBER.

The closing weeks of 2006 witnessed UK rail infrastructure company **Network Rail**'s return to the Australian debt securities market in November, 16 months after its first foray. It issued a further kangaroo bond, this time a 10-year for A$500m (£215m) and upsized from the initial sum of A$300m in response to strong demand. Samantha Pitt, its Head of Corporate Finance and Capital Markets, said the group was likely to pay a return visit down under every 12 to 18 months. More recently, the group has been in the market with a £1bn, 20-year index-linked offer in May, followed three months later by a 40-year issue to raise £500m.

Other deals late last year included French-based building materials group **Saint-Gobain**'s £600m fundraiser, in a buoyant sterling bond market, to help refinance its £3bn acquisition of UK plasterboard group BPB. The total comprised a 10-year £300m bond yielding 100 basis points over the 2015 gilt and a further £300m via an 18-year bond yielding 125 basis points over the 2025 gilt.

Mining giant **Xstrata**, which had already launched a $5.5bn rights issue in October to help fund its $17.5bn acquisition of Canadian copper and nickel producer Falconbridge, quickly followed it up with a $2.25bn multi-tranche, fixed and floating dollar-denominated bond issue. The latter comprised a $1bn 10-year bond, a five-year $750m bond and a floating-rate note.

SUPER-UTILITY The last big deal of the year was the creation of a £43bn energy giant, Europe's third-largest utility company, through **Iberdrola** of Spain's takeover of Scottish Power. The deal valued Scottish Power shares at 777p, with 53% of the consideration in cash, and the group's entire equity at £11.6bn.

Meanwhile, the European junk bond market ended 2006 on an all-time high, raising nearly €40bn with high-yield investors. The year's final big deal was a €1.4bn multiple issue from Greek mobile phone operator **TIM Hellas**, after its private equity backers Apax Partners and Texas Pacific Group reconsidered plans to sell the company and opted instead to take a dividend. The company sold a €960m floating-rate note paying 600 points over Euribor and due in January

2015, plus a new dollar-denominated $275m floating-rate note priced at 575 points over Libor and due the same date.

There was still an appetite for the riskiest form of debt as 2006 closed. Italian telecoms group **Wind** launched what were, at €1.7bn, the biggest payment-in-kind (PIK) notes to date. The group wanted to buy out a 26% stake held by Italian energy group Enel for €1.9bn and opted for PIKs – high-yielding but the lowest-ranking form of debt.

RED, GREY AND YELLOW The new year began quietly, but February saw transport operator **FirstGroup**, best known here for running London's red buses and FirstGreatWestern train services from Paddington, pick up a US icon. Its $3.6bn acquisition of Laidlaw International made it not only the largest operator of the yellow buses that ferry US schoolchildren, but also the controller of the famous long-distance Greyhound buses. On announcing the deal, the company entered into a two-tranche senior loan facility, comprising a term facility and a revolving credit facility – with HSBC, JPMorgan Chase Bank and Royal Bank of Scotland.

The world's biggest brickmaker and owner of the UK's Baggeridge Brick, Austria's **Wienerberger** aimed to raise €400m through hybrid bonds paying a coupon of 7.25%. In the event, it raised the figure to €500m after receiving up to €5bn of orders.

Australia's financial powerhouse **Macquarie** completed a multi-tranche refinancing of the UK's largest water utility, Thames Water, through its consortium vehicle Kemble. The total of £8bn paid by Kemble comprised £4.8bn paid to the previous owner, German power company RWE, and the assumption of a further £3.2bn in debt. Kemble used four banks to oversee the refinancing of just over £3.9bn.

February was also the month that **Vodafone**'s long-held ambition to break into India's mobile phone market finally came good as the UK giant clinched an $18.8bn deal to gain a 67% stake in Hutch Essar, one of the country's four main operators. The deal, which pushed Vodafone's debt to around £23bn ($46bn), included $11.1bn in cash and the taking on by the group of a further $2bn in debt. Within a fortnight of the deal being announced, Vodafone launched a $3.5bn mix of fixed and floating-rate notes, led by Morgan Stanley and Lehman Brothers.

A growing trend for hedge funds to debut on the stock market was reflected by the €770m flotation of **BH Macro**, which issued 45 million shares priced at $10, 27 million shares at €10, and 10.5m shares at £10. The newly quoted company invested the proceeds into the $11bn Brevan Howard Master Fund run by hedge fund manager Brevan Howard Asset Management.

The first bout of volatility in the equity markets occurred in late February, but it proved short-lived and didn't prevent a host of deals in March. They included **GlaxoSmithKline**'s £1bn 35-year corporate bond – the first corporate issuer to manage this figure at the ultra-long end of the curve – which managed to attract investors without even a roadshow. Joint bookrunners HSBC and Lehman Brothers began marketing at 9.15am and had attracted £1.3bn of orders by the time they closed the order book at 2pm the same day.

Supermarket giant **Tesco**, whose 50-year £500m sterling fixed-rate bond in February was more than three times oversubscribed, followed up in March with a €600m euro-denominated 40-year bond, which enjoyed a similar response. The group, whose offer was lead-managed by Deutsche Bank, HSBC and RBS and priced at 78 basis points over mid-swaps with a coupon of 5.125%, said it was attempting to diversify its book.

Advertising giant **WPP**, which initially indicated a £350m fundraising, hiked it to £400m and still saw the offer five times oversubscribed despite the jitters in the worldwide equity and credit derivative markets. It priced at 98 basis points over gilts, against initial guidance of 100 to 105 basis points. The 10-year fixed-rate issue, lead-managed by Barclays, Citigroup and HSBC, paid a coupon of 6%.

Shell International then followed up its $1bn debut offering in the US dollar market of 2006 with a $1.25bn 5/10 trade. The five-year priced at Libor plus 0.5bp and its outstanding issue of 2011 was quoted with a bid of Libor minus 6bp.

THE MAY DAYS In May, just weeks before the credit crunch really began to bite, the last remnants of the once mighty **Hanson** empire fell to a £9.5bn takeover from HeidelbergCement. The German group offered 1100p per share – a 30% premium on where Hanson shares had traded before news of the takeover approach. Heidelberg refinanced the deal through a €500m placing of shares underwritten by its major shareholder, Adolf Merckle, the sale of €2bn of hybrid bonds and further disposals on top of the €1.4bn sale of its French building materials unit Vicat.

The hybrid bond, after becoming the height of fashion in continental Europe, made its London debut in June when packaging group **Rexam** issued a £500m hybrid security to part-finance its $1.565bn acquisition of US group OI Plastic Products. Although heralded as likely to be the first of many such financial instruments sold out of London, it was put to bed just before the credit crunch hit with a vengeance the same month.

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The winners' show: the victorious treasurers of the 2006 Deals of the Year Awards on parade with their certificates after the Awards lunch.