BANKING ON GOOD RELATIONS

ESTABLISHING A STRONG RELATIONSHIP WITH YOUR BANKS HAS NEVER BEEN SO IMPORTANT. IAN FITZGERALD OF LLOYDS TSB OUTLINES THE KEY ISSUES FOR BORROWERS.

The past two years have been the most fascinating of times across the global capital markets. Nervous equity, bond and loan markets in the second half of 1999, were followed by euphoria and substantial market volume growth in 2000, following the successful passing of Y2K concerns.

Much of the growth was on the back of bullish forecasts by technology, media and telecoms (TMT) analysts and the sheer weight of equity/investor capital available for the sector. Consequently, unprecedented amounts of funds were raised through the issuance of equity, bonds and loan market debt, in order to fund TMT and internet expansion, and the merger and acquisition (M&A) boom.

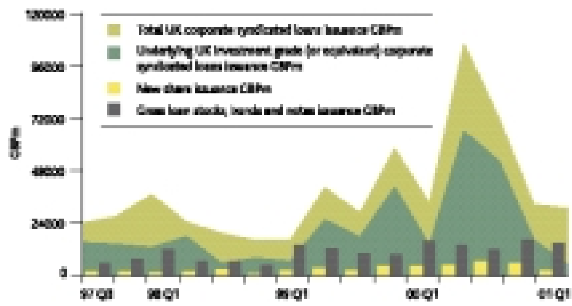
The perception grew that information technology was an area of assured growth. Fear of being left behind meant that more traditional businesses joined the rush to invest – which in turn fed the demand for equity and funding. On the TMT side, the telecoms companies raised huge amounts of funds from across the markets to invest in third generation (3G) mobile phone licences, in anticipation of growth – unfortunately, these have been unproven in terms of demand and therefore overpriced. The effect of overgearing and poor results from the sector has had a profound effect on share prices.

The bursting of the Internet bubble has led to many equity investors in young start-up companies getting their fingers burnt. The 10-year bull market – for so long driven by outstanding US economic growth – appears to have come to an end. A combination of stock market slowdown, overgeared TMT companies and declining M&A activity (down more than 50% for the first six months of 2001 and perhaps nearly 70% by the end of the third quarter) have substantially reduced volumes across the market. Consequently, the debt markets are becoming increasingly important for corporates.

The passing of summer, combined with the global reaction to the terrorist attacks in the US, has left the financial markets in a period of limbo, as we wait to see how pronounced the US and consequent global downturn will be. Equity values had fallen back to the trough of April, while bond yields were nearing all-time lows. This suggests that bond investors are expecting a long and deep recession, leaving corporates with the loan market to bridge the gap.

There are contradictory factors at work. Sustained regional house price inflation and consumer spending, supported by the easing of US and UK monetary policy, suggest continued economic growth, while industrial indicators are pointing to recession. Corporates appear to be targeting organic growth, having delayed capital investments plans, with inventories being run down, in the hope that employee layoffs can be minimised.

FIGURE 1
UK EQUITY AND DEBT PATTERNS.



Source: ONS and Dealogic Capital Data Loanware

Many UK corporates are fundamentally more conservative than their European counterparts and historically less geared than those in Germany, France and the US. They have therefore continued to rely on close relationship banks for obtaining cost-effective 'general corporate purpose' money from the syndicated loan market. They have refinanced facilities for the next three to five years – both side-stepping equity markets and maximising the benefit of lower overall funding costs.

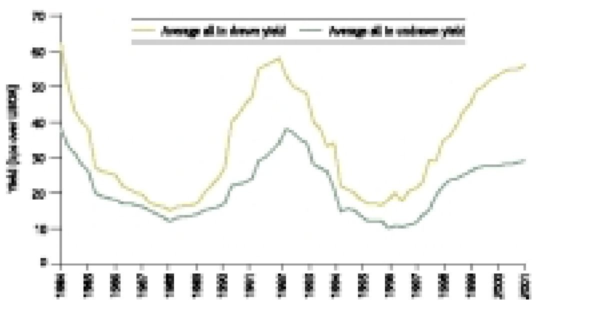
Figure 1 demonstrates this fact, by outlining the volumes of issuance across the various UK market segments, and shows that the most significant borrower category is the investment grade – or equivalent – corporate.

Fund raisings in this sector are for non-leveraged transactions (for example Debt:Ebitda < 3.5 x and below 125 basis points in margin) and are used for general corporate purposes, but can include acquisition. This sector is represented by the top 350 companies and includes loans for the most frequent borrowers, which constitute a benchmark for pricing. As you can see, this sector consistently makes up a minimum of 50% of UK volumes year-on-year. The nature and size of these top corporates means they have sophisticated Treasury teams and often a sizeable international business. This creates the need for a dialogue with a number of banks which might have different technical and geographical strengths. The quality of these relationships is key, and time needs to be invested by both the banks and the corporate to ensure these relationships are fruitful.

KEY POINTS. So what are the main considerations for corporates looking to approach the loan market? A mixture of external and internal factors are influencing the size and nature of banks' appetite for providing corporate loans, forcing them to reassess both their business strategy and the role they wish to play in meeting their customers' needs. The growing need of banks to create shareholder value has been a major driving force for change, and their principal response has been to improve returns through mergers and consolidation.

This trend has been aggravated by the advent of increased regulation in the form of BIS Basel II proposals for a revised capital

FIGURE 2
FIVE-YEAR UK LOAN MARKET PRICING FOR SINGLE A TYPE CORPORATES.



Source: Dealogic Capital Data Loanware and Lloyds TSB, Capital Markets

adequacy framework, which increase the importance of the relationship between credit and pricing and create a far more analytical- and ratings-driven pricing process. A further complication is presented by continuing discussions regarding possible changes in the requirements for Fair Value Accounting to be adopted by banks.

The effect of all these factors has been an increase in the unpredictability of the banks' appetite and a reduction in the overall supply of lending capacity over the last six months.

As the impact of these influences evolves over the next five years, the supply-side is likely to change materially, with many traditional relationship banks adjusting their stance and endeavouring to become intermediaries in the provision of finance, rather than end suppliers.

Working alongside these longer-term issues has been the pressure on banks to deliver results in the near term. This has focused the need to improve not only the quantity of earnings but also the quality and spread. The most influential changes in behaviour by banks has been caused by:

- the advent of a more portfolio driven approach to the management of risk;
- a stricter application of the risk and reward equation; and
- a tougher approach to the assessment of value within the relationship context.

So what is the real impact for the borrower?

AMOUNT. The increased influence of portfolio management techniques has meant that large exposures to individual borrowers are becoming less acceptable over the longer term. A clear trend is emerging, in that some institutions or banks may have been happy previously to lend 15% to 20% of a syndicated transaction but have now reduced this to 10% or lower.

The difficulty of this for a borrower may be that they will need a wider bank group, at a time when this is more difficult to achieve. Standardisation of the process means there is a more evident limit to the amount an individual borrower can raise, and there is a closer relationship between credit, structure and pricing.

PRICING. Pricing always remains the key focus, but it is driven by all the variable elements of the transaction: purpose, amount, tenor, structure, relationships, the sector and the like. The huge demand in 2000, and today's emerging credit conservatism, has led to greater price differentiation becoming more noticeable and measurable.

Figure 2 demonstrates pricing from 1984 to 2001 and the recent upward trend for single A type corporates. There are clearly definable levels emerging for differing credit grades. The variance in pricing at different credit strengths is now more marked and pricing for lesser quality corporates has risen but remains in a band of 25 basis points either side of the trend line. Overall, we do not see a significant increase in pricing for stronger, relationship-focused corporates, but there is, nevertheless, an underlying upward momentum.

STRUCTURE. As to documentation, the reaction to stricter credit controls and the tighter risk and reward requirements, has been that pricing and covenant structures – both financial and non-financial – have become more closely aligned to corporate performance. This is particularly relevant for those lenders that have more highly developed risk and capital allocation models.

The market is now finding it difficult to accept loosely covenanted packages, with interest cover and net debt-to-Ebitda (where appropriate) now accepted and almost required measures. In many cases. Borrowers requiring a larger amount find they have to agree to tighter covenants, more freely transferable loans and simpler loan structures – otherwise reduced flexibility to lenders will be reflected in the price.

So where does this lead our borrowers? The market and economic background is clearly uncertain, profit warnings are rife and credit downgrades have increased. The regulatory environment is much tougher and this, within the context of banking consolidation, is forcing banks to conform to a more disciplined and common credit approach.

Despite this, our experience is that well structured, relationship-driven transactions are continuing to be successfully completed, especially when the borrower has proven that they understand, control and manage their relationships, with a well qualified, house bank chosen as arranger.

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