RIDING THE DEBT WAVE

JONATHAN TROWER AND ADRIAN BOX OF CLOSE BROTHERS EXAMINE THE RISE IN POPULARITY OF FINANCIAL GEARING.

It has become increasingly difficult for UK companies to find the correct balance between debt and equity when financing both their operations and acquisitions. The as yet unknown effect of the recent atrocities in New York and Washington will make it all the harder. Over the past 10 years companies have used the debt markets as their main source of additional capital more and more frequently.

The last decade has also seen an increasing willingness on behalf of firms to replace equity with debt. As a consequence, the UK quoted sector has seen financial gearing rise to levels not seen since the last recession, particularly over the past three years.

UK GEARING. Close Brothers' Debt Advisory Group produces an annual survey of the financial leverage in the UK mid-cap quoted sector. The report shows that there has been a significant increase in gearing since 1999 in the FTSE 250 and that there is only modest scope for further increases without a noticeable loss of financial flexibility. Balance sheet gearing (net debt over net assets) has risen from a low of 32% in 1996 to the current 57%, representing an increase of 79% and a further increase of 5% on last year's high (see *Figure 1*).

The fall in the equity markets, within the sectors covered by this study, combined with rising absolute debt levels drove debt as a percentage of market capitalisation to a 10-year high. Perhaps more significantly net-debt-to-Ebitda has risen yet again and now stands at 1.75x, the highest since the last recession, and interest cover at 8.29x, on an Ebitda basis, remains comfortable but lower than at any time since 1991. The manufacturing sector shows a particularly high increase in gearing, with some measures of gearing rising more than 50% since 1999.

The survey is taken from a sample of 120 companies in the FTSE 250. The sample is specially selected to exclude financial, technology and utility companies, because of their insufficient history or specific borrowing patterns. The work undertaken by the Bank of England, contained in its *Financial Stability Review* (June 2001) and *Inflation Report* (August 2001), confirms our findings. It shows that, across a wider sample of non-financial companies, debt/profit ratios are now higher than in the depth of the last recession. However, income gearing, while rising, is still well below the 1991/1992 level.

THEORY VS PRACTICE. Finance professionals, both within companies and in the investing and intermediary communities, are increasingly aware of the theoretical and academic background underpinning the rise in gearing. While Modigliani and Miller's theories have long provided the intellectual framework to the business of finance, it is surprising how long the gulf has remained between the theory and its practical application. For as long as corporate financiers and analysts concentrated on earnings enhancement, to the exclusion of economic value added and the concomitant need to drive down the cost of capital, efficiency of capital structure was bound to remain a low priority for most boards of directors. Human nature being what it is, the safety and stability of capital structure remained of greater importance.

PRESSURE TO PERFORM. All this has now changed. Greater shareholder pressure on companies to increase the efficiency of their financial structures has ensured that more and more transactions are debt funded. Where financial resource, combined with a lack of adequate investment opportunity allows, shareholders increasingly expect a return of cash. Obtaining the right balance between capital efficiency and the avoidance of undue risk – usually arising as much from excessive exposure to refinancing risk as from excessive initial leverage – has become a difficult task for the board of most public companies. However, it is one which they ignore at their peril.

INVESTOR EXPOSURE TO DEBT. At the same time, non-bank investors have increased their exposure to debt products, as seen by the rapid growth and increasing complexity of the debt markets in recent years. Total UK corporate bond issuance increased from about \$5bn in 1990 to \$47bn in 2000, while loans rose from \$48bn in 1990 to \$200bn in 2000 (see *Figure 2*). In 1989, virtually all European corporate debt was financed through the loan market. By 1999 this was no longer the case, with about 30% of European corporate debt being funded through bonds. So far for 2001 this split is at 27%. Tax changes to pension funding rules, low inflation and the arrival of the euro have all played their part in causing this growth in demand for

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FIGURE 1
UK GEARING: 1990-2000.

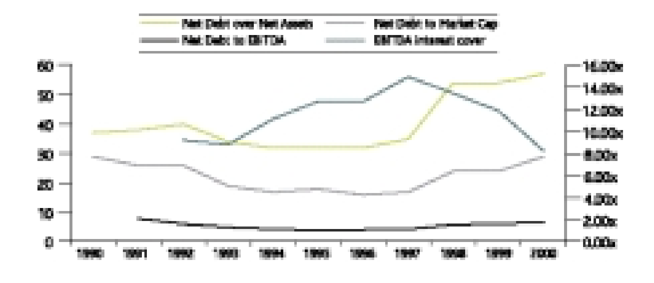
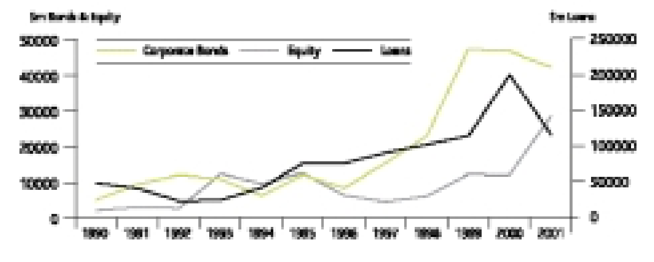


FIGURE 2
UK CORPORATE DEBT & EQUITY ISSUANCE: 1990-2001



debt products in the non-bank investor community.

A PLATFORM FOR HIGHER LEVERAGE. Shareholders may want to see higher levels of debt, while bond investors, mezzanine funds and banks may want to provide it. However, there are three other initial ingredients required to ensure that rising debt levels do not lead to rapidly rising chances of financial disaster. These are low interest rates, a stable macroeconomic environment and a sophisticated risk analysis on the part of the debt providers. UK interest rates are now lower than at any time since the 1960s. Over the past five years they peaked at 7.5% in August 1997, but are now back at a 37 year low of 4.75%. The macroeconomic outlook is now less certain than it has been for much of the 1990s. However, the as yet unknown impact of the World Trade Centre disaster aside it is, in relative terms, more stable than it has been for many decades. A long period of growth may have ended, the slowdown may turn into recession and debt ratios may deteriorate further as profitability falls below previous forecasts, while the impact of the excesses seen in the financing of the telecoms and technology sector may have further to run. However, few commentators are predicting a return to the boom-bust economy of previous decades.

Credit analysis techniques in the banking community have improved substantially in the last decade. The days when banks concentrated on balance sheet ratios and interest cover are long gone. Investigatory work is more thorough, reliance on ‘gut feel’ is increasingly rare, structuring of debt transactions has become more intensive, and the dialogue between debt provides and corporates has generally become more constructive.

Many of the techniques applied in the venture capital and securitisation markets are now also applied in the corporate debt market. While the consequence of this may create more work for the finance director and treasurer, it does make for a more robust approach to the analysis of risk and has led to a greater willingness to allow leverage to rise to levels that are closer to maximising capital efficiency.

Credit disasters will happen, and refinancing assumptions will continue to go wrong. However, it is difficult to see that the leading providers of bank finance will have the same level of problems stored up as they had in the run up to the last recession. Much of the credit pain resulting from higher leverage has been, and will continue to be, borne by institutional investors in the high yield market where credit experience and knowledge is more thinly spread.

LOOKING FORWARD. The quest to increase shareholder returns by obtaining the most efficient capital structure will result in leverage levels continuing to remain high by historical standards. The benefits of higher levels of leverage than those traditionally accepted are now so well understood that, provided the macroeconomic framework remains relatively stable, it is unlikely that debt levels will fall back to the lows of the mid-1990s.

The current economic slowdown has recently caused a number of poorer quality deals to fail as investors have turned away. However, despite this, the appetite for quality credits – even if leveraged – has remained strong. Therefore, the debt market is definitely open for well structured deals.

The combination of leverage at levels that are high by historical standards, and an economic environment which is likely to worsen before it improves, will ensure that increasing pressure is placed on the financial flexibility of UK companies. Inevitably, there will be some companies that will fail to successfully manage their capital structures and will have to restructure. However, Close Brothers has no doubt that the vast majority will be able to maintain sufficient financial flexibility to finance growth, while maintaining a more efficient capital structure. It will, however, be interesting to see the extent to which more sophisticated credit analysis enables current capital structures to weather the economic slowdown.

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