Securing the future

Executive summary

- Companies are looking for funding security and are now keen to refinance at a much earlier stage than before the credit crunch kicked in. Forward start deals set up future corporate finance, which lies dormant until a current facility matures, but critics say that in pursuit of market share some banks are using such deals to offer corporate finance at below market price, providing no incentive to reduce the overall corporate debt level.

SINCE THE START OF THIS YEAR, A SERIES OF FORWARD START DEALS HAVE MADE THE BUSINESS PAGES. WHY HAVE THEY PROVED SO POPULAR? **GRAHAM BUCK** REPORTS.

The economic downturn has persuaded many companies to pay the closest attention to the full menu of funding options to ensure their future financing needs are met. Forward start deals represent a fairly simple means of arranging future corporate finance. Forward starts do not replace an existing loan, but lie dormant and are activated only when the current loan expires, so in theory there should be no risk of companies doubling up on an existing loan facility.

Despite this simplicity, forward starts are a relatively recent phenomenon, having steadily gained popularity since July 2008 when engineering company Meggitt became the first UK corporate to test the water. Although the group had a $680m facility with nearly two years to run at the time (expiring in May 2010), it secured a $500m extension facility available on the maturity or early cancellation of the $680m facility. The $500m extension runs to July 2013.

Many others have followed the industrial group's lead, with the volume of forward start deals accelerating since the start of this year. Prior to the credit crunch, companies took a relaxed attitude towards arranging new loan facilities, typically doing so only when their existing facility was drawing close to its maturity.

But the days of low and declining bank margins are past. Companies now seek security and are keen to refinance at a much earlier stage than in the pre-2007 boom period. Meggitt, for example, is currently looking at a possible forward start for its other current facility for $1,170m, even though it is not due to mature until March 2012.

Meggitt's head of treasury and tax Derek O'Neill, who gave a presentation on forward starts at this year's ACT conference, says that his group's forward start deal was actually suggested by one of its lead banks, HSBC, and that the company was also guided by its lead banks on appropriate pricing for the deal. He adds that he was very receptive to the terms of the deal, which retained the attractive pricing of the group's old facility while keeping its security in place for as long as possible.

THE DAYS OF LOW AND DECLINING BANK MARGINS ARE PAST. COMPANIES NOW SEEK SECURITY AND ARE KEEN TO REFINANCE AT A MUCH EARLIER STAGE THAN IN THE PRE-2007 BOOM PERIOD.

BANK BENEFITS Forward start facilities have considerable appeal to indebted companies. They offer companies a way of securing long-term debt without the banks needing to pay any new money upfront. Instead, lenders to an existing credit agreement commit themselves to providing financing to replace loans as and when they mature.

Not all lenders will necessarily agree to such an arrangement. When Anglian Water recently finalised a two-year forward start, three of the banks on its existing facility declined the opportunity to continue participating. Anglian's assistant treasurer, Tim Parsons, explains that the three were all Europeans bank looking to retrench

"A NUMBER OF BANKS REGARD FORWARD STARTS AS A REAL OPPORTUNITY TO INCREASE THEIR MARKET SHARE AT THE EXPENSE OF RIVALS THAT ARE RETRENCHING."

by withdrawing from international business and focusing on their home market. However, the group was able to line up five potential new syndicate members, of which four – two of them already lenders to the group – agreed to participate on the forward start.

While arranging a forward start may necessitate changing some of the banks in the syndicate for the existing loan, most banks are attracted to them. They are able to charge fairly sizable one-off fees and usually get a price increase for the new facility. This has, in turn, limited their losses on existing loans following the sharp increase in the cost of funds. For the borrowing company, the increased cost still compares quite favourably against the alternatives of new loans or bonds. Some commentators even suggest that many of the forward start loans agreed so far this year have been driven by banks' need for business and that the risk has been correspondingly underpriced.

FIRST IN THE FRAME Initially, forward start loans proved popular with small and mid-size businesses unable to issue bonds to maintain their liquidity. Pitcher & Piano chain owner Marston's was one of the first in January, when it secured a £295m facility that carried an additional 0.2 percentage points in interest, raising it to 6.3% against 6.1% on an existing £400m credit line due in 2010. As a result, the group will now have access to credit until 2013. At the time, one analyst praised the deal as "a rather elegant solution" to the liquidity constraints afflicting both banks and companies, as it enabled companies to keep their lenders in place through the incentives of upfront fees and higher margins.

More recently the appeal has spread to blue chip companies, sparking complaints that their move into the forward start arena to keep their borrowing costs down has led to smaller firms being crowded out. As banks inevitably direct their money to larger, more highly rated companies, those with more restricted financing options suffer in consequence.

Nor have forward starts necessarily found favour with all corporate lenders. Those banks that are less keen criticise them as risky long-term bets, enabling companies to secure financing at below market price and offering them no incentive to reduce their overall debt levels. They also accuse some banks of being overly aggressive in their promotion of forward start deals, which they say are generally restricted to larger, well-rated clients, are not carried out at market levels and involve little or no discussion with regulators as to how they should be accounted for.

In addition, some non-UK companies have been able to agree forward start deals as much as three or four years in advance, despite the likelihood that market conditions could change significantly over the interim period. In this country, many forward starts have been for two years; so far, the maximum period achievable appears to be three years.

THE BLUE CHIPS MOVE IN Regardless of these reservations, a number of major names have used forward starts in recent months. Anglo-Dutch publishing group Reed Elsevier was one of the first to follow Meggitt. In February it signed a £1.4bn deal that extended its debt, originally due to expire in May 2010, a further 24 months into 2012. Its timing coincided with similar deals for Spain's Telefonica and steelmaker Arcelor Mittal. All three deals attracted criticism that the pricing was too low, with the cost for each company considerably less than what they would have paid for new loans and bonds.

At the end of February, bookmaker William Hill secured a total of £588.5m in forward start loans from its existing banks, coupling the deal with a £350m rights issue. The figures consisted of £538.5m of forward start term loans and revolving credit facilities to commence in January 2010 and mature in March 2012 based on margins of between 250 and 300 basis points over Libor. From the same start date to February 2011, the company also has access to a one-year £350m incremental forward start term loan that pays a margin of 450bp until June 2010 and increases thereafter.

By early March, companies that have suffered most in the recession had joined the trend. Building materials supplier Wolseley, with a debt load close to £3bn, responded to a widely held view that it would need to recapitalise by announcing a combined share placing and rights issue to raise just over £1bn. This was coupled with a £1bn committed two-year forward start debt facility to be provided by five of the group's core relationship banks, which will not take effect until August 2011.

While companies in notably hard-hit sectors such as retail and construction have been looking at means of forward financing, a number of utilities have also been active in recent months. Several water companies have raised debt to offset increased borrowing costs and revenues tightly controlled by the industry regulator Ofwat. Anglian Water, whose existing £225m facility matures in July

"THERE IS NO POINT LOOKING FOR A SEVEN-YEAR DEAL WHEN THE MARKET IS AT THREE YEARS. FIND OUT WHERE THE MARKET IS AND GO TO THE BANKS WITH A DEAL THAT YOU KNOW THEY CAN TAKE TO THE CREDIT COMMITTEE. AS A CORPORATE THIS IS NOT A TIME TO BE DOGMATIC OR HASSLE ABOUT 10 BASIS POINTS."

2010, needs sufficient working capital to maintain 12 months' liquidity as a securitised utility company.

Parsons says that the company first heard about forward starts early this year, although it was the Meggitt head of treasury's presentation at this year's ACT conference in April that helped publicise them as a response to turbulence in the banking market.

"We also explored other obvious options such as raising capital in the bond market, but the heavy cost of carry made this a more expensive option than the forward start option," he explains." This was despite the sizable fees attaching to the latter option, which included a utilisation option of 175bp.

Anglian wanted, if possible, for its facility of £225m maturing July 2010 to increase to £300m for the two-year forward start, but had concerns that it might not attract enough subscribers. In the event, it was oversubscribed and attracted total orders of £365m. Canvassing of the deal began in April when the 175bp margin was established and the pricing remained unchanged until the deal was concluded in July.

Parsons adds that two Chinese banks joined the syndicate for the forward start, which reflects a new keenness on the part of China's financial institutions to lend to the UK market. "A number of banks regard forward starts as a real opportunity to increase their market share at the expense of those rivals that are retrenching," he says.

Global paper manufacturer Sappi – profiled elsewhere in this issue – has also employed forward starts, although its most recent facility saw the company offer to reduce the banks' exposures and to shorten maturities. Group treasurer Jörg Pässler says: "You have got to go to where the market is. There is no point looking for a seven-year deal when the market is at three years. Find out where the market is and go to the banks with a deal that you know they can take to the credit committee. As a corporate this is not a time to be dogmatic or hassle about 10 basis points."

THE LATEST CONVERTS More recent recruits to forward starts include packaging group Rexam, whose £860m refinancing package announced in June included £647m in forward start commitments, and International Power, which in July signed a $780m two-year forward start facility that will commence when its existing $850m facility matures in October 2010.

Drax, the operator of coal-fired power stations, signed a £235m forward start loan deal in early August that extends the maturity of an existing term loan and a revolving credit facility by two years, from the maturity date of December 2010 to December 2012. The forward start pays a margin of 350bp but is variable according to the rating that the company attracts, reducing to 300bp for a rating of BBB and above, but increasing to 500bp should the rating deteriorate to BB+ or below. Drax is currently rated BBB-.

August also saw a forward start deal for the world's biggest operator of shopping centres, Australian group Westfield, which secured commitments of more than $1.4bn for a $1.25bn loan after successfully approaching banks in Singapore, Hong Kong and Taipei. Asian banks have proved receptive to other groups, such as brewer Fosters, which have sometimes had less success in Europe and in the US, where more banks are retrenching.

Westfield is extending its existing credit line, which matures in July 2011, by a period of 18 months and its new loan will cost 240bp above Libor against 35bp on the existing facility.

So will forward starts stay around for the long term or prove merely a passing fad? Their future appears to be contingent on whether normal conditions return to the banking sector over the next few years and there is a return to five-year finance deals. Once the differential between companies' old and new facilities diminishes, the attraction of forward starts will also shrink, but it seems highly likely their popularity will be maintained for at least the next 12 months.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.co.uk