Buy now while stocks last!

THE ENVIRONMENT IS BUOYANT FOR MID-CAP COMPANIES LOOKING TO RAISE FINANCE. WITH A WIDE RANGE OF OPTIONS AVAILABLE, KEEN PRICING, STRETCHED LOAN TENORS AND RELAXED COVENANTS, THE MESSAGE FOR COMPANIES LOOKING TO REFINANCE IS 'BUY NOW WHILE STOCKS LAST', SAYS **JONATHAN BROOME**.

Small to mid-cap companies (with market capitalisations of £50m-£500m) have traditionally been the poor relations of large corporates, in terms of the array of financing products available to them and the ability to drive down pricing. Although these characteristics remain, the significant increase in the liquidity of banks (see *Lending corporates a hand with pricing,* page 22, *The Treasurer*, October), together with the modest increase in the number of banks servicing the mid-market has resulted in greater competition for a limited pool of assets. This is providing mid-cap companies with keener pricing and greater choice in their financings.

Increased bank liquidity means that the mid-market borrower now has an extremely attractive and liquid market in which to raise finance. This benign environment has been further augmented with European commercial banks developing their UK mid-market offerings and competing for financings. Examples include the Bank of Ireland and Allied Irish Bank, two of the most profitable banks in Europe in terms of earnings per customer, who are eager to put their excess liquidity to work in a country which is a logical next step from their home market.

Executive summary

- **Increased bank liquidity and an increase in the number of banks servicing the mid-market means greater competition for a limited pool of assets.**
- **The five major UK banks lent just £5.5bn in the worst year of the current economic slowdown, compared with £7bn of provisions during the worst year of the 1990s recession.**
- **Mid-market companies with leveraged balance sheets or inconsistent histories should look to the high-yield bond market to provide liquidity.**
- **Securitisation has become an increasingly popular financing tool – for example, in the football club sector.**

Additionally, Fortis Bank has built a significant presence within the UK, focusing on the lower end of the mid-market.

This means that mid-market companies have a wide choice of banks from which to borrow, as well as operating in a market that is heavily weighted in their favour. Banks are also extending their product range into deal sizes that previously would have been considered the preserve of the larger and more sophisticated borrowers.

In the late 1990s securitisation was the preserve of large borrowers such as the tenanted pubcos and the mortgage books of banks. However, it has become an increasingly popular financing tool – although, perhaps not an ideal form of financing – for small to mid-cap companies due to its complexity, high cost and inflexibility. However, it has been used extensively for relatively small financings by football clubs (see table).

Courts plc is another example of a mid-market company that has used securitisation. Through its subsidiary in Singapore, the company undertook a £45m revolving securitisation of its debtor book. This enabled the company to grow its hire purchase portfolio without placing its local operational cashflows under significant pressure.

Increased bank liquidity

The increase in bank liquidity is due to a number of factors, with perhaps the biggest cause being the fact that banks have not been through an economic recession since 1991. The five top UK banks: Barclays, HBOS, HSBC, Lloyds TSB and the Royal Bank of Scotland booked nearly £7bn of provisions in the worst year of the recession in the early 1990s, representing nearly 1.7% of total advances to customers. By contrast, in the worst year of the recent economic slowdown, the same banks made loan provisions of £5.5bn, representing a much lower 0.54% of total advances. If taken over a 10-year period, the difference between 0.54% and 1.7% of loan provisions represents around £20bn in additional capital which the banks have 'saved'. This equates to at least £200bn of additional lending capacity. This excess supply is helping to drive down the price of loans. One large European commercial bank recently said that it had capacity to make 40% more loans.

This liquidity is exacerbated by relatively low levels of loan transactions in the UK. For example, according to analysis by Dealogic, in the first half of 2004 there were around 140 transactions, representing a decline of over 30% from the equivalent period in the first six months of 2000. The decline in loan volumes is even more apparent, having dropped from circa US$170bn to approximately US$110bn in the corresponding period, representing a decline of 35%.

A similar trend can be seen for UK mid-market loans of £25m-£500m completed from October 1999 to September 2004. *Figure 1* shows that when the effect of the leveraged finance market is excluded, loan volumes have declined 30% from circa €37bn in the year to September 2001 to approximately €26bn in the year to September 2004. In the same period the number of transactions fell from 96 to 59.

‘FOR MID-MARKET COMPANIES WITH LEVERAGED BALANCE SHEETS THE HIGH-YIELD BOND MARKET CAN PROVIDE LIQUIDITY, ALTHOUGH THEY NEED TO DO ISSUES OF £100M’

HIGH-YIELD BOND MARKET. For mid-market companies with leveraged balance sheets or inconsistent past histories, the high-yield bond market can provide liquidity, although they would need to do issues of at least £100m in order to attract investing institutions. For the majority of mid-market companies, accessing this market is usually considered a last resort, due to the expense, the on-going quarterly reporting that is usually a condition of borrowing this form of finance and the exposure to US legislation (see *No shelter from the storm*, page 16, *The Treasurer*, October) which arises when issuing in the US. Furthermore, although a high-yield bond issue provides liquidity and benefits to cashflow, it is extremely expensive to refinance due to the non-call provisions that are included within its documentation.

Historically, both securitisations and high-yield bond financings have been used by companies that are leveraged in nature. However, as the leveraged loan finance market has recently shown, it is not unusual for companies which exhibit the appropriate cashflow stability to borrow in excess of seven times historic Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA), albeit with a mezzanine tranche that accounts for up to twice the EBITDA. These structures are cheaper and significantly more flexible, in that the borrower is usually able to prepay the loans without penalties after the first two years of the facility.

CORPORATE ACQUISITON FINANCE MARKET. The competitiveness of the corporate acquisition finance market can be seen in the facility recently arranged for Meggitt plc. When it bought Dunlop Standard’s design and manufacturing division, Meggitt plc took on leverage in excess of three times the EBITDA, but was able to finance this at just 70bps over Libor, with a margin ratchet that takes the margin to 40bps over Libor if leverage is taken below one-and-a-half times the EBITDA.

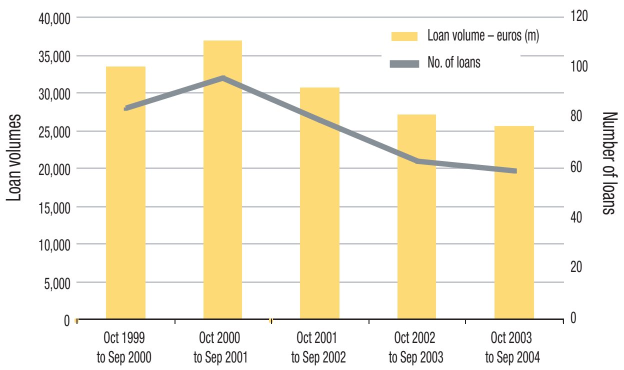
Recent football club securitisations

Club	Amount	Date	Notes due
Manchester City	£13.7m	July 2003	2018
Norwich City	£15m	April 2003	2018
Everton	£30m	March 2002	2027
Leeds United	£60m	September 2001	2026
Leicester City	£28m	July 2001	2026
Ipswich Town	£25m	July 2001	2026
Southampton	£25m	May 2000	2026
Newcastle Utd	£55m	September 1999	2016

Source: FT

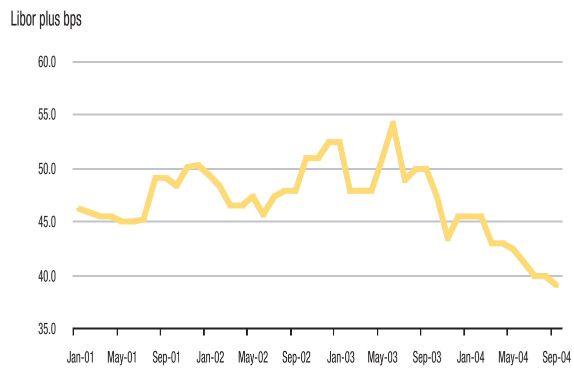
PRIVATE PLACEMENT MARKET. On top of this range of liquidity is the private placement market. This is similar to the public bond markets in that debt is likely to be more expensive than traditional bank debt and flexibility low due to high prepayment penalties. However, with issuance being solely to US institutions, private placings avoid the cost and exposure to Securities & Exchange Commission (SEC) regulation and reporting requirements. Like a bond issue, the notes are generally structured so there is only limited amortisation, thereby improving the

Figure 1. UK loans of £25m-£500m in October 1999 – September 2004
(Excludes LBOs and acquisition financing)



Source: Dealogic

Figure 2. Decline in margins paid by BBB-rated companies



Source: LoanConnector

company's cashflow. The simplicity and the fact that public ratings are not required has made this an attractive market for investors on the boundaries of the investment grade market. Cookson plc and Arriva plc are two examples of companies that have utilised the US private placement market having borrowed US$570m and £104m respectively.

FINANCIAL INSTITUTIONS. Mid-market companies with asset-heavy balance sheets can approach a number of financial institutions which specialise in lending to companies like them. Asset-based finance – raising debt against plant and machinery, property and stock as well as the debtor book (see *A secure opportunity*, page 29, *The Treasurer*, November) – is particularly appropriate for low margin, asset-intensive industries. The cost of these loans may be in excess of a vanilla bank loan, typically ranging between 250bps and 400bps above Libor. However, due to the asset-backed nature and the coverage ratios that are necessary, it is possible for borrowers to raise significantly more than they could from a cashflow lender in some circumstances. For example, Waterford Wedgewood recently secured €210m and US$30m in facilities secured against its stock, debtor book and property assets.

Despite the increasing use of alternative financing tools, bank debt remains a very important source of liquidity for mid-market corporate borrowers. Competition and excess liquidity are driving borrowing costs and arrangement fees to extremely low levels.

Figure 2 illustrates the rapid decline since May 2003 in the average margins that BBB rated companies are being charged by their banks. From the banks' perspective, loan pricing is only one side of the coin, as they also consider the profitability of the relationship. For 'relationship' banks, ancillary business is increasingly important when deciding whether or not the loan is profitable. The pressure to increase returns from this avenue will only increase further with the introduction of the forthcoming Basel II Banking Accord (see *Capitalising on Basel II*, page 47, *The Treasurer*, June), due to be fully implemented by 2007. Basel II is designed to match banks' capital adequacy against their loan exposures. Mid-cap companies will be rated more lowly than their larger peers and hence the revenue earned by banks from these credits will need to be correspondingly higher in order to achieve the necessary returns.

However, banks are not currently achieving these returns through higher loan pricing. Indeed, loans are increasingly viewed as 'loss leaders', offered to capture the ancillary business on which their profitability increasingly depends. This largely accounts for the exceptionally fine margins that borrowers can currently command.

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