# Focus shifts as mood darkens

HALFWAY THROUGH 2011, LOOMING UNCERTAINTIES TRIGGERED SHARP REACTION FROM THE CAPITAL MARKETS AND A REASSESSMENT OF BANK LENDING STRATEGIES, BUT **SIMON ALLOCCA** REMAINS OPTIMISTIC.

Last year could hardly have had two more different halves. Since the summer, all banks have been driven to a deep reassessment of their loan strategies as the market has deteriorated. As a result, the relatively benign conditions of much of the first half of 2011 are now a distant memory.

Until the summer, banks had been looking to support their clients with reasonable levels of liquidity, borrowers were much more able to dictate documentation and structure, and the bond markets were very much open for business and performing in an orderly manner.

Bond and loan investors alike were still managing to take in their stride the sovereign debt challenges emerging in southern Europe and did not necessarily interpret those difficulties as a reason to stop doing business for their corporate clients. The leveraged finance business also remained extremely buoyant, driven by high levels of collateralised loan obligations (CLO) investor liquidity.

All that has now gone and the reasons for the change are clear: the euro zone sovereign crisis has deepened, the pressure on banks' credit ratings has intensified and banks' own funding costs have increased.

**SOVEREIGN DEBT** The markets, in the broadest possible sense, are now reacting to the sovereign debt crises in southern Europe, as well as the continuing instabilities in North Africa and the Middle East. They have been heavily influenced by the growing perception that there is no clear or obvious route to a resolution of these instabilities.

This is the biggest factor now affecting market sentiment. It has become apparent that there is no single answer to the problems flowing from the euro zone crisis, that the measures of the last two years have been simply a stop-gap, and that more remedial work is needed within those sovereign states and through external action.

But it is the lack of clarity about the action agenda that is now driving markets most. It is clear that neither the problems nor the solutions can be confined to individual countries or even groups of countries. It needs to be resolved globally and not locally. Trying to deal with the euro zone sovereign issues piecemeal is not going to provide the key solution the markets are craving – that of stability.

**BOND MARKETS ARE VOLATILE** In this febrile environment, the products first affected are those most sensitive to macro-market uncertainties. All bond markets – the high yield, the unrated and the investment grade – can close quickly and remain volatile.

The loan market remains open but clearly that too becomes more difficult if banks do not want to absorb new money with no expectation of being repaid through bond markets that are closed. The big issue for the banks going forward is not if but when all these bond markets will fully re-open. Until they do, it is bound to inhibit transaction underwriting, M&A activity or other investments that companies may want to fund through debt.

**LOAN PRICES AND TENORS** These evolving uncertainties have affected both the pricing and tenor of loans. Over the last 12 months, there has been significant downward pressure on loan pricing, resulting in a reduction in margins on every rating class of borrower.

That has now stabilised and been replaced by upward pressure on pricing. The significant issue here is the effect this has on driving up the internal funding costs of lenders themselves. As lenders' costs rise, that increase will be a significant determinant of the pricing of loan products that banks are able to provide their customers.

Loan tenors have also altered, as you would expect. Following the 2008 financial crisis, tenors had come in but they have now gone back to where they originally were – effectively five years for strong corporate borrowers. We have not witnessed any movement on that in the current market and, indeed, we do not expect to see any.

These pressured circumstances have noticeably and rapidly altered the operational perspectives of several banks. Some strong global players have narrowed the focus of their businesses to a much more regional arena. Similarly, prominent regional players have shifted to a super-domestic perspective – one that is highly selective about the countries and sectors in which they are happy to do business.

In this testing environment, some banks are overresourced and overengineered. Under the changing regulatory regimes that all banks are facing – particularly Basel III and Solvency II – bank products will have to become more capital-light. Banks are being driven to a product mix that is much more traditional and much less exotic.

That trend will intensify as banks' cost of funding – whether denominated in euros, dollars or sterling – increases in tandem with the concern of investors about the future of those currencies, about the credit rating of the sovereign states, and about the solvency of some banks themselves.

The impact of all this on pricing is just as plain. We have seen a significant number of banks pull back from the markets, impacting liquidity, which means that pricing has to meet higher return hurdles required by those banks that continue to have appetite. Finding pools of liquidity is becoming harder and we are seeing pricing structures tightening right across the credit spectrum.

**Figure 1:** 2011 European corporate loan/bond volumes

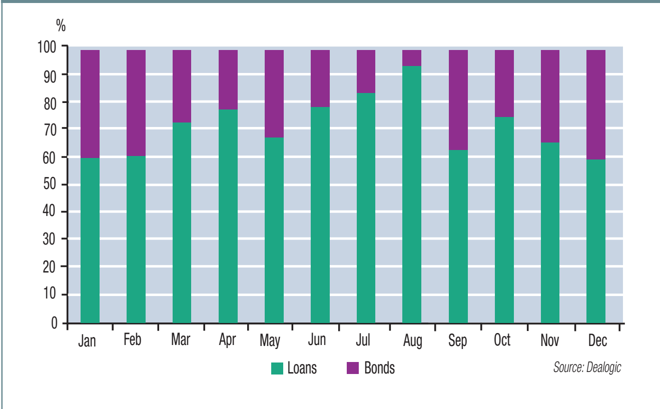



**Figure 2:** European corporate pricing

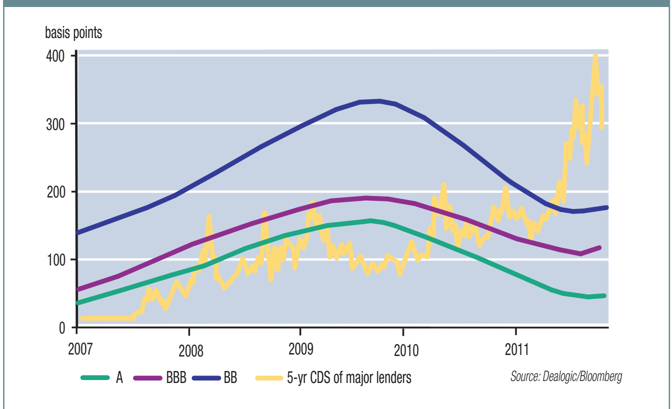
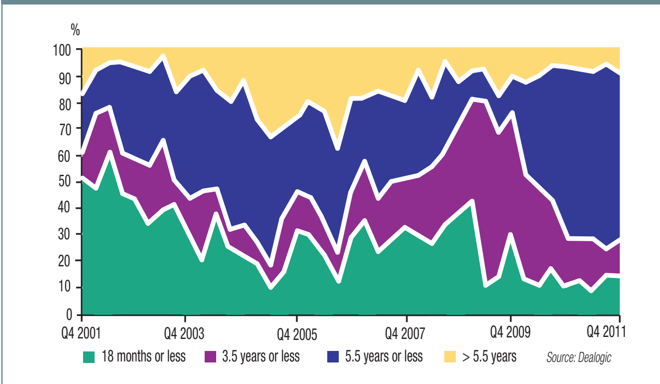



**Figure 3:** European corporate loan tenors




**REASONS TO BE CHEERFUL** In spite of all this, I am optimistic about the coming year for two reasons. In the first place, many corporates are in a very good position to exploit opportunities. There will clearly be M&A opportunities for strongly managed corporates; for example, as sectors and industries within sectors consolidate.

The nature of good bank-funded opportunities (which we will see more of this year) were well illustrated by several transactions in 2011:

- **Wolseley** The plumbing giant completed what its CFO John Martin hailed as an "innovative" £820m refinancing. Two 5¼-year revolving credit facilities replaced the company's £1.6bn facilities that were due to expire in August 2013. The new loan agreements, to support growth plans, were completed simultaneously in two jurisdictions – a €750m European facility and a $270m facility. "They allow Wolseley to take advantage of attractive pricing," said Martin, adding: "The high level of demand for the new facility is indicative of the quality of Wolseley's credit."

- **Hunting** The international energy services group paid $775m (£475m) to acquire TSI Acquisition Holdings and its subsidiaries, including Titan Specialties. Lloyds Bank was joined by two other banks in underwriting the transaction to £375m. Titan is a leading provider of specialist equipment used in the drilling, completion and maintenance of oil and gas wells. The acquisitions strengthen Hunting's capacity to capitalise on an anticipated increase in on-shore shale oil and gas production and increases in US land drilling and completion spending.

- **Investec Bank** The specialist bank and asset manager, dual-listed on the LSE and Johannesburg Stock Exchange and a FTSE 100 company, successfully completed $750m or euro-equivalent two-year loan facilities. The company's oversubscribed transaction demonstrated that, even in a more challenging loan market, support from relationship banks for quality credits offering sensibly structured and priced facilities remains available.

The second reason for optimism is the adaptability of banks in supporting attractive opportunities by ambitious corporate partners. The truth is that, in today's increasingly volatile environment, the sense of partnership between banks and their corporate clients has never been stronger. Those banks that fully engage with and support their clients, and can demonstrate a good and flexible product capability, are the ones most likely to win a good share of a client's fee and ancillary business wallets and make the returns they seek from the overall relationship.

But the opposite is also true. It is when banks, borrowers and their advisers push too hard on, say, pricing, terms or ancillary business that the partnership is most likely to break down.

Banks are very well aware of the nature of the risks inherent in today's environment. For our business partners, it is the spread of banking capability that's most often critical – the mix of expertise in loan and capital markets, the experience in helping to manage FX risks, and the expertise in beneficially managing interest rate or currency derivatives.

It is that range of competencies that companies now seek to support them right along the debt axis, with solutions wholly appropriate to their current needs and aspirations. It is seeing how imaginatively banks are positioning themselves to meet these challenges of partnership that confirms me as an optimist. Clearly, there is no denying the seriousness of today's macro-economic conditions, but there is equally no doubting the determination of the banks to help their clients fulfil their ambitions.

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