THE LOANS MARKET IS LIKELY TO SEE ADVANTAGEOUS PRICING FOR CORPORATES AND THEIR TREASURERS, AS WELL AS LONGER TENORS AND MORE RELAXED COVENANTS. BUT WITH MORE MERGERS AND ACQUISITIONS ANTICIPATED, CAN THIS TREND CONTINUE? **IAN FITZGERALD** GIVES HIS VIEWS.

Lending corporates a hand with pricing

The key driver in the UK corporate loans market in 2004 has been a high level of bank liquidity, resulting from a prolonged absence of large event-driven acquisition facilities. The reaction to this from corporates and their treasurers has already set the pace of change for the year ahead.

Corporates have been refinancing outstanding facilities early in order to take advantage of low prices. The good news for treasurers is that as prices have fallen, tenors have also been pushed out, fees reduced and, in many cases, covenants relaxed. Banks, meanwhile, are retaining a larger portion of these facilities on their own books in order to absorb their liquidity.

This trend is likely to continue as long as bank loan books mature and corporate appetite for new facilities remains depressed.

Corporate treasurers must remain aware that banks are selecting their core relationships carefully and committing to them. At the same time, there has been a marked shift among top UK wholesale banks to larger commitments, as well as longer tenors. They hope to cement their long-term relationships in the hope of securing positions in potentially more lucrative transactions in the future. With business confidence rising and corporate balance sheets strengthening, increased borrowing is anticipated in the medium term.

Executive summary

- **Limited M&A activity has reduced corporate lending significantly, bringing favourable pricing, longer tenors, reduced fees and relaxed covenants.**
- **Loan volumes in the UK have fallen by 8% on last year, and transaction numbers are at an eight-year low.**
- **Cyclical data indicates that the loans market will see low prices for at least another year, benefiting corporates looking for refinancings and M&A facilities.**
- **Banks lending decisions are based on overall returns and credit quality with the capital adequacy provisions of Basel II – due to be fully implemented by 2007 – also making an impact. A corporate's credit rating will be imperative to those banks compliant with Basel II at a basic level.**
- **Although figures for the UK, French and German syndicated loan markets indicate convergence in pricing, loan volumes increased by 41% in France and 71% in Germany during the first half of this year.**
- **The trend on the continent is towards syndicated facilities with smaller bank commitments to individual borrowers.**

THE MISSING MERGERS. The relatively low levels of corporate borrowings are illustrated by *Figure 1*. Indeed, volumes in the UK market show an 8% reduction against the same period last year, with transactions at an eight-year low.

These reductions are the result of a slowdown in mergers and acquisitions (M&A) at the top end of the market. Financings such as the €30bn debt package arranged for Vodafone's takeover of Mannesmann now seem increasingly distant.

In an economy dominated by the service sector (70%), non M&A- related demand for loans, such as for working capital purposes, is not enough to absorb the excess bank liquidity in the market.

But are there signs of high-profile M&As that could stimulate activity? This could, of course, close the window for low-priced loans, an issue that treasurers must bear in mind.

The business confidence on which this turnaround will be founded is already appearing in the mid-market. Announced deal volumes for UK M&A transactions have shown a substantial increase in the first half of 2004 – up to £68bn from £58bn last year. However, this activity has yet to have an impact on the investment-grade syndicated loans market.

While the fall in prices is seen as a result of high liquidity among banks, it may also be viewed in the context of historic cycles. *Figure 2* shows a 20-year analysis of five-year benchmark pricing for BBB/A type corporates. The graph reveals a nine-year pricing cycle – as well as highlighting price compression and a density of transactions at the bottom of the pricing curve (see 1988 and 1997). Conversely, the graph also points to increasing price differentiation in credit spreads at times of market stress, or when bank liquidity is low.

According to the pattern evident from the graph, the market is likely to see low prices for at least another year – meaning both refinancings and, ultimately, M&A-related facilities will remain attractively priced for corporates. Companies that have already taken advantage of this include WM Morrison, whose £1.75bn facility supported the company's takeover of Safeway; this was priced at 30bps over Libor for the short-term element.

FUTURE PROFITABILITY AND BASEL II. Although banks may be willing to lend at cheaper pricing, such lending relies on two key factors. The first relates to the overall return from the relationship, and the second to the borrower's credit quality.

Banks must be able to balance low margins and low-risk premiums with income from their broader product range. Also, if loan prices continue to fall, even greater attention will be focused on this balance.

The second factor relates to borrower credit quality and the capital adequacy provisions required under the forthcoming Basel II Banking Accord, due to be fully implemented by 2007. The purpose of the Accord is to match banks' capital adequacy provisions more accurately to their credit risk exposures – achievable via a basic or advanced level of compliance by banks (see *Capitalising on Basel II*, page 47, *The Treasurer*, June). Those that comply at a basic level will see their capital adequacy ratios on loans largely dictated by the credit rating of the borrower. But those compliant at the advanced level will be able to determine their own capital adequacy requirements via the application of their own approved, internal credit assessment models.

CONTINTENTAL DRIFT? Some interesting trends arise when comparing the loans market on the continent to that of the UK. *Figure 3* illustrates the pricing curves for five-year loans to BBB/A-type corporates in the three main European syndicated loan markets: the UK, France and Germany.

The graph indicates a convergence in pricing between the three markets. Whereas pricing in the German syndicated loan market peaked in late 1999 at around 55bps, with French and UK prices peaking in mid-2001 at around 62bps and 55bps respectively, all three markets now average below 40bps. Although moving average curves have been close in the past, they do not usually move in such similar directions.

However, while there may be similar pricing trends developing across Europe, this does not appear to be the case in respect of market volumes. The depressed volume trends we have seen in the UK are not being replicated on the continent.

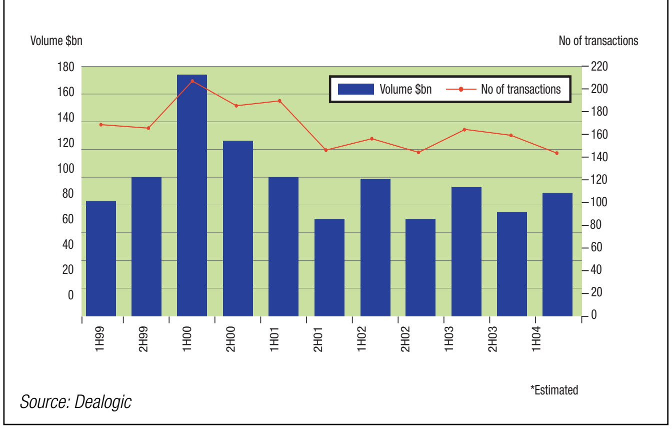
First-half volumes in France have increased by 41% this year to US$72bn, while in Germany an increase of 71% saw first-half volumes at US$58bn. Although a large part of these increases are due to refinancings, there is a significant difference in scale.

This is largely due to structural differences between the continental economies and that of the UK – a difference revealed by some of the corporates that have engaged in refinancing transactions, including France Telecom (€10bn), Volkswagen (€11bn), Daimler Chrysler (€6bn) and Suez Group (€4.5bn). These industrial manufacturing and centralised utility entities have an ongoing demand for working capital that is much less sensitive to downturns in confidence than the demand for large M&A facilities that have driven the UK market.

Refinancing in the UK has involved greater individual commitments from banks, whereas on the continent, there has been a trend towards the replacement of large bilaterals with syndicated facilities. Although these syndicates vary in size, the trend is towards smaller commitments to individual corporates rather than the larger commitments seen in the UK.

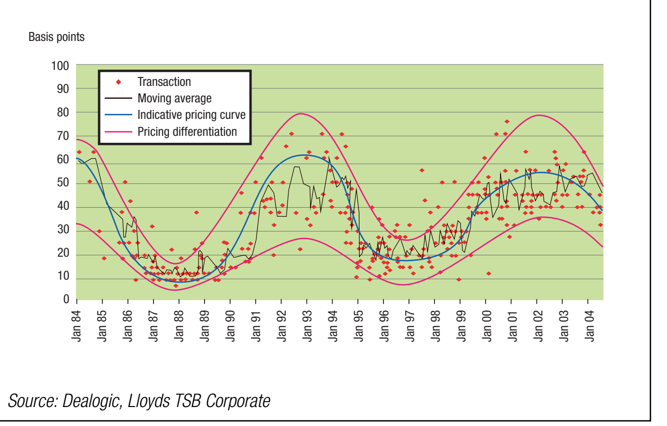
While this has the advantage of spreading low-priced credit risks across a widened portfolio, it also points to a different approach to credit quality. Smaller commitments imply a more transactional approach, with less attention paid to individual borrowers and a greater emphasis placed on loan trading for disposing of unwanted credits.

Figure 1. UK loan market volumes and number of transactions, 1999-2004



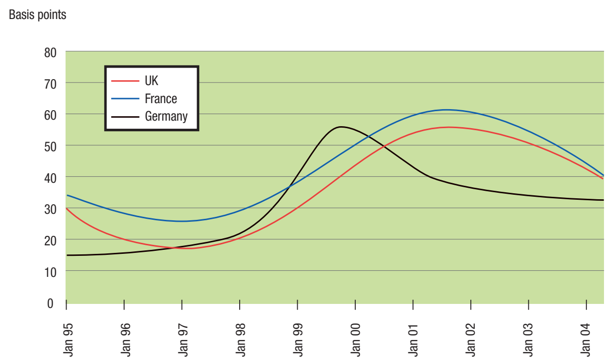
Source: Dealogic

Figure 2. UK five-year benchmark pricing for BBB/A type corporates



Source: Dealogic, Lloyds TSB Corporate

Figure 3. UK, France and Germany, five-year benchmark pricing for BBB/A type corporates



Source: Dealogic, Lloyds TSB Corporate

LOOKING TO THE FUTURE. The UK and the continental markets are awaiting increased activity from the improving levels of business confidence seen across Europe. Both, however, recognise that this confidence is still vulnerable to shocks. Obvious external factors include ongoing instability in the Middle East and potential acts of terrorism – both of which could cause shocks to oil prices or a fall in stock market prices. But there are also factors from within the global economy that may influence activity, including the future interest rate environment and the effect of the new International Financial Reporting Standards, particularly IAS 39.

As confidence returns, the logic of conducting M&As while risk premiums are still at a low will become likely. Also, a relatively limited number of large, high-profile deals could absorb bank liquidity in a short space of time – thereby impacting current pricing trends.

Strong and stable relationships between banks and borrowers will remain central for two reasons. First, they will provide corporates with the best defence against event-driven shocks to pricing. Second, they will create maximum price advantage as Basel II renews the focus on credit quality as the paramount concern for banks.

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