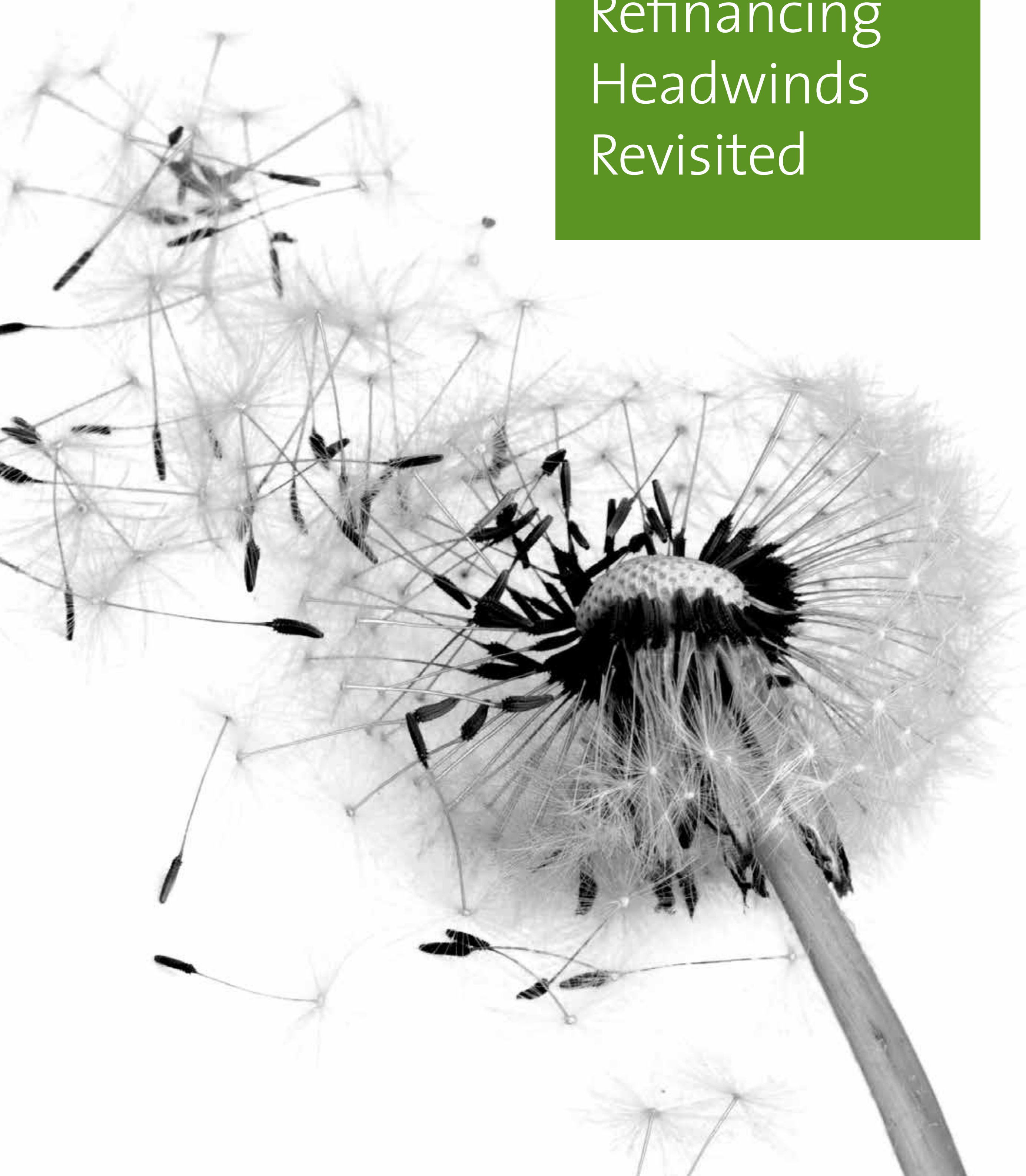
Refinancing Headwinds Revisited



Refinancing Headwinds Revisited

Last year we highlighted a number of headwinds affecting the loan market. We advised that CFOs, finance directors and treasurers take these into account when looking at timing, structure and terms for a refinancing of their core financing facilities.

We concluded that the banking landscape was changing and banks were recalibrating their strategies. We recommended borrowers should engage early with their banks, seek to understand the key drivers of bank behaviour and ultimately think very carefully about the timing of their next deal.

Twelve months on, these headwinds have, if anything, strengthened.

The loan market has been relatively benign for some time now. Since 2012 corporate borrowers have enjoyed access to bank funding at prices close to historical lows with liquidity in great supply. In addition borrowers have been able to negotiate longer tenors and increased flexibility in terms of covenants – both financial and non-financial.

There is a growing sense that this is changing. As we approach the next refinancing cycle, which is expected to peak from 2019 through 2021, bank strategies are evolving. The focus on return and ancillary business is increasingly acute. These shifts in focus and consequent subtle changes in the approach to lending, and relationships generally, are likely to signal more testing years ahead for borrowers, whether they are refinancing or seeking to raise incremental capital to fund capex or M&A activity.

Headwinds remain

There is little doubt that the headwinds we highlighted last year remain. 2018 will be a pivotal year in terms of political and regulatory activity.

General macroeconomic and geopolitical uncertainty persists. Negotiations over Brexit will dominate 2018 with banks having to put in place contingency plans given the significant continuing uncertainty as to how, and indeed when, the UK will exit the European Union. The Eurozone economies have shown some encouraging signs over the past 12 months. However growth remains muted and the UK is experiencing the inflationary pressures we forecast last year. The US political scene remains unpredictable, which casts a shadow over an otherwise robust economic recovery. Looking further afield, the economic outlook for China remains uncertain and tensions persist on the Korean peninsula.

The regulatory landscape remains a significant issue for banks. The need to comply with a raft of new measures introduced by Basel III/CRD IV remains. Banks are currently struggling with MIFID II and many banks may well not be in a position to fully comply with IFRS 9 which will govern the way they provide for expected losses.

Finally, while rising interest rates (in the US and UK at least) may well help banks in terms of net interest income, they may also dampen capital expenditure and acquisition activity as the "all in cost" of borrowing increases.

Ring-fencing

A FURTHER HEADACHE FOR ALL CONCERNED

A further headwind, particularly relevant for those borrowers reliant on the UK banks, is that from 1 January 2019, the largest UK banks must separate core retail banking from investment banking.

This is known as ring-fencing. Ring-fencing was the central recommendation of the Independent Commission on Banking chaired by Sir John Vickers and was introduced through the Financial Services (Banking Reform) Act 2013.

Banks are adopting materially different approaches to the issue of ring-fencing. The line between their ring-fenced activity (retail, commercial and corporate) and their non-ring-fenced activity (investment banking) is, depending on the bank in question, being set at significantly different levels. As a result, the impact on the banking relationships of corporate customers with their affected UK banks will vary.

How will this affect the loan market? Unfortunately it is really too early to tell, especially as banks are still working on structures and the interplay between ring-fenced and non-ring-fenced entities. There are some banks that will be lending to corporates from inside the ring-fence, but which will provide ancillary business/products from outside. There are others where the whole relationship will be run and funded outside the ring-fence (effectively in the ''investment" bank). That will present its own challenges.

At this stage we would simply recommend an open debate between borrower and lender about possible changes in cost of capital/funding associated with both the provision of lending and associated ancillary products.

2017 – liquidity the key

Last year we explored the theory that banks were changing tack in the way they were assessing lending requests.

Faced with an increased cost of capital, due in part to the increased regulatory burden and an uncertain macroeconomic and political environment, banks were starting to focus on their stronger relationships and consider more closely ongoing and future returns when lending to corporates.

Evidence suggests this is now established practice and many of the major lending banks have declined, and will continue to, decline lending requests and/or exit relationships if ''return on equity" criteria are not met.

The question is when will such behaviour start to affect the pricing, tenor and terms available in the loan market. Until now, most would subscribe to the view that bank lending supply is greater than demand and thus there is sufficient excess liquidity to mitigate against a wholesale shift in any of these parameters.

We are generally thought to be at the bottom of the refinancing cycle. Investment grade/corporate lending activity has been subdued, with Q3 2017 seeing a four-year low in terms of volume of lending and deals done. This suggests there has been no great rush to refinance this year. There has also been no significant increase in the demand for M&A-related financing. This has created a market with excess liquidity, and capacity to absorb any shortfalls caused by exiting banks.

Further evidence of the effect liquidity can have on any credit market can be seen in the corporate and government bond markets around the world that have seen record levels of activity and spreads tighten to previously unimaginable levels on the back of various central banks' quantitative easing policies. The leveraged loan market provides us with a further example with volumes having seen a significant increase as borrowers see opportunities to secure tighter pricing and better terms on the back of excess liquidity driven by banks and the emergence of significant liquidity from new alternative lenders/debt funds.

Changing market dynamics

Most market participants foresee an increase in volumes over the next three years as we begin to move towards the busier point in the refinancing cycle.

As macroeconomic and geopolitical uncertainty persists and banks continue to wrestle with regulatory change, the supply/demand imbalance may well level out. Any fall in excess liquidity will inevitably put increased pressure on pricing, tenor and terms. Borrowers should factor this into their strategies when looking at raising funds or indeed when considering the timing of their next refinancing.

Expectations on both sides will need to be managed.

There will be bumps in the road and certain borrowers from certain sectors may well find the market a little more difficult to access than others. Unforeseen events will add to the current high degree of uncertainty facing the market and liquidity may well get squeezed such that demand exceeds supply. If this happens the market will need to be at its innovative best to ensure solutions are found to get deals done. The loan market has a long history of finding its way through such periods of uncertainty (witness the emergence of forward start facilities in the years following the financial crisis).

Conclusion

We live in uncertain times but as always liquidity remains paramount and should be a borrower's first priority when refinancing is discussed.

That said, the loan market has always been an innovative, sympathetic, flexible and resilient market for borrowers. This is because it is first and foremost a relationship-driven market. That will always be its key strength over other credit markets. As long as borrowers and lenders are having ongoing and open discussions about all of the issues discussed above, the market should remain liquid, but perhaps a little more challenging for borrowers than in the recent past.

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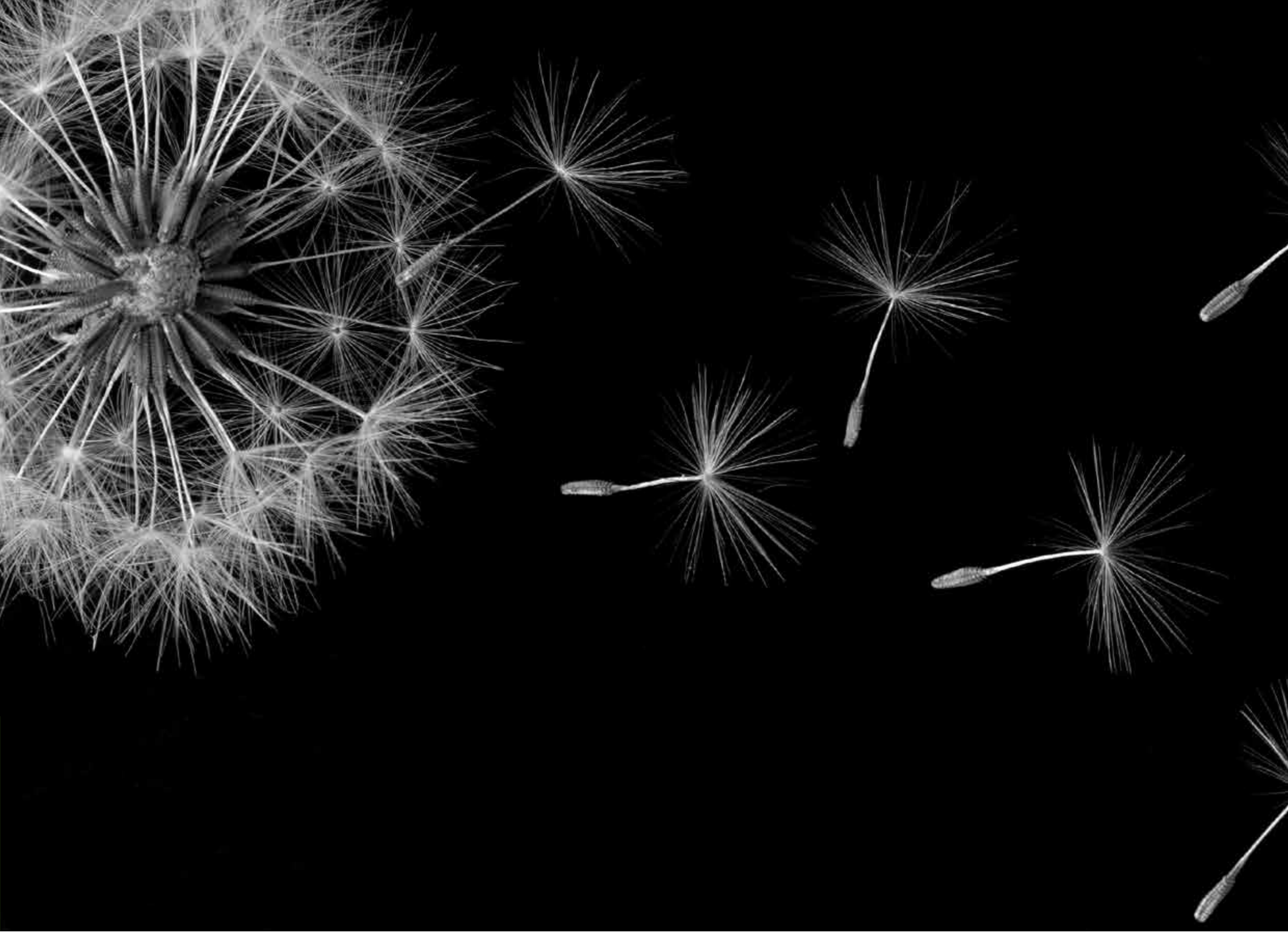

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