

## **Debt re-financing challenges September 2009**

A key issue facing the markets is how to refinance the mountain of debt that has accumulated during the debt fuelled leveraged buy-out and property boom of the recent past. European leveraged buy-out debt to be refinanced from 2009-2014 totals €133bn. Meanwhile, £155bn of UK commercial property bank debt matures during the same period.

The question is who is going to refinance all this debt?

Banks will certainly continue to be the major provider but no where near the scale they provided previously. The dilemma they face is that on the one hand banks are under pressure from Government to support industry, particularly SME's, yet on the other they are being required by the regulator to shrink their balance sheets, de-lever and increase their liquidity and capital. This inherent conflict places banks' management in a dilemma - but have no doubt the requirement on banks to scale back their lending will prevail – despite Government's protestations to the contrary.

Compounding this problem is the fact that there are now fewer banks in the UK market willing to lend. The Icelandic banks have collapsed; a number of peripheral commercial banks and CLO vehicles who relied upon the uncommitted inter-bank or securitisation markets to fund themselves can no longer operate. Their business models are effectively broken and their loan books are in run off. Various European banks have retreated from the UK market to support their own domestic customers. Meanwhile the UK clearing banks continue to re-organise and work through significant legacy bad loan portfolios and prepare themselves for more bad debts. The latter will arise in their consumer finance and corporate loan books as UK unemployment rises, companies fail and the economy struggles to emerge from recession.

Given this uncertainty, companies need to start addressing their refinancing plans early. Methods for dealing with this include issuing bonds with longer dated maturities, paying banks to extend current debt facilities – known as “amend and extend”, buy-in debt at a discount using spare cash if available, accelerate disposals or asset sales to generate cash, consider IPO's should conditions permit or, depending on the scale of a company's difficulties, consider some form of debt/equity conversion.

Recognising a shortfall will arise between the volume of debt to be refinanced and banks' inability to fully cover this, a number of new entrants are stepping into the market. Pricing for new debt has increased so much that now is regarded as a tremendous time to be a lender - especially for an entity unencumbered with legacy bad debt, access to liquidity and deal flow. For a borrower, this provides some alternative sources of debt, albeit on more expensive terms. But who are these new entrants and how can one access them?

New entrants include pension funds, sometimes in conjunction with a bank. M&G for example has announced plans to launch a UK Companies Financing Fund that will lend in £100m tranches to mid-sized companies. ICG has also recently raised £351 m of fresh capital to support the growth of its mezzanine loan book. Established asset based finance and invoice discounters such as Eurofactor are keen to grow their market share. Hedge funds like Och-Ziff and GSO Capital Partners stress their ability to invest in debt instruments which can be housed for the medium to long term within their “side-pocket” funds. Standard & Poor’s leveraged commentary recently reported the formation of 13 new credit start-ups specialising in riskier debt to fill the gap left by banks which have all but pulled out of this market.

For borrowers facing a refinancing or the need to raise new debt, not only have the terms and conditions of finance increased significantly, but there is also considerable uncertainty where such debt can be sourced. The price and availability of debt will vary on a case by case basis but we are seeing margins for corporate credit in the range 200-350bps and fees for arranging new money of 200bps. Leverage finance is still showing low levels of activity and margins of 400-475bps. Mezzanine margins are in excess of 1500bps and arrangement fees can be around 400bps. Encouragingly the bond markets are extremely active – not only for highly rated issuers but also speculative grade as well.

The takeaway from this commentary is the debt financing landscape is rapidly changing and likely to remain unpredictable whilst funders adjust their business models to suit the new environment. This uncertainly presents an added challenge for Finance Directors and Treasurers and explains why McQueen has recently hired Charles Keay, formerly of NM Rothschild & Sons, to provide its clients with independent expert advice on the financing options available to them whilst navigating these difficult times.

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