Market Insight

BISHOPSFIELD CAPITAL PARTNERS

Bank de-leveraging in practice - considerations for European corporates

London, 16 February 2009, by Mike Nawas

The debate on the need for and scale of bank de-leveraging has been put firmly back on the agenda recently, and this time it has been driven by a combination of researchers, regulators and investors. In this Market Insight we consider recently presented analyses and suggest what corporate borrowers can do – and many are doing – to proactively manage their way through a de-leveraging bank market.

In recent weeks, three sources of commentary impressed upon us, each in their own way, the economic need to actually achieve a reduction in the debt burden that governments, businesses and households are carrying, rather than debate the necessity. It started with the publication by the McKinsey Global Institute (MGI), McKinsey & Company's business and economics research arm, of a report with the ambitiously comprehensive title '*Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences*'. McKinsey has both a reputation and a long list of clients to lose, so their views carry a lot of opinion-leading weight for businesses worldwide.

MGI's report prompted a further reflection in PIMCO's February 2010 Investment Outlook, entitled '*The Ring of Fire*'. The article was authored by Mr Bill Gross, co-founder and Chief Investment Officer of PIMCO, the California-based global asset management firm that recently reported surpassing the awe-inspiring milestone of having more than $ 1 Trillion assets under management. When one of the most influential people at such an influential investment firm speaks, one should certainly listen to what he has to say.

And then there was an interview with Mr Jaime Caruana, General Manager of the BIS, at the World Economic Forum in Davos. He underscored the importance for regulators and governments to hold the line on the need for the banking sector to continue its process of de-leveraging. Similarly, when a senior representative associated with what is in essence the sole co-ordinating regulatory body on bank capitalisation globally speaks on the need for banks to reduce their balance sheets, it is a very reliable predictor of where the sector is likely to be heading.

The report, article and interview are easy to find, so rather than re-iterating or summarising the views expressed, we leave it to our readers to go to the original sources in case they want to delve into the broader context or the underlying data. MGI's recommendations mostly targetted policy-makers. Mr Caruana's comments were aimed at an audience of bankers and government representatives. And Mr Gross, finally, focussed on the implications for sovereign debt. We at Bishopsfield Capital Partners decided to analyse what the implications of bank de-leveraging could be for corporate borrowers in Europe and suggest policies that corporate customers should consider in order to position themselves strongly in their credit discussions with banks.

Scale of the challenge

In the current market, forming a reasoned opinion on the scale of the remaining

de-leveraging challenge isn't obvious. If you were to look at current bank capitalisation in isolation, one might legitimately be optimistic and conclude that the worst is behind us: the MGI report shows that in most major OECD countries by Q2 2009 the banks had rebuilt their capital ratio to a level close to the average of the 15 years preceding the 2008 credit crisis.
On the other hand, as Mr Caruana points out, when regulators are still considering a wide range of options to prevent future credit crises, it is very hard to give an indication of the scale of de-leveraging that banks will need to achieve in order to comply with future capital adequacy requirements. Moreover, on a macro-level, overall debt-to-GDP levels haven't declined in almost all Western economies as government borrowing was dramatically increased to stimulate the economies. The resulting current and future government borrowing requirements will push up base rates, further increasing the scale of the challenge. Finally, as PIMCO concludes, for Western Europe the consensus macro-economic outlook is one of prolonged belt-tightening; that would go hand in hand with a relatively long period of de-leveraging.

More specific to the corporate sector, there are two factors that further increase the likely length and volume of de-leveraging on top of the macro factors referred to above.
Firstly, as a result of banks' limited ability to supply credit and being faced with over-demand by their customers, credit margins are likely to go up, pushing all borrowers to alternative forms of borrowing. But as household borrowers typically have no alternatives to banks for borrowing, they will be more inclined to accept the increased margin than corporate customers who are able to attract funds via bonds or private placements. For corporate borrowers who haven't as yet developed such alternatives, this means a prolonged period of increased cost of capital.
Secondly, as discussed in earlier Market Insights, the mountain of corporate or corporate-sponsored debt that matures in 2011-2013 will flood the market and may crowd out borrowing requests by corporates seeking new credit lines to support their business.

All in all we conclude that continued bank de-leveraging, which actually began in 2008, is likely to pose a significant challenge to European corporates. Moreover, these conditions are set to continue until the refinancing programmes near their completion in 2013.

Pockets of excessive leverage

MGI made a laudable effort to specify in which sectors the scale of de-leveraging is likely to be felt most. Of the data they compiled, we found the section on asset classes specifically useful as it sets out where globally the pockets of excessive leverage were concentrated. MGI highlighted two asset classes in particular: debt related to leveraged buyouts (LBO-debt) and debt related to commercial real estate (CRE-debt).

The statistics are staggering. For most mature economies, between 1998 and 2008 the leverage of the corporate sector overall was stable or declining, with interest coverage ratios improving year-on-year as a result of low base rates and strong company earnings. For CRE and LBO-debt however, the picture was wholly different. The available data (based on the US, but we think that for Western Europe the trend would be materially the same) shows that in 2008 the debt to book equity multiple averaged 3.1 for CRE versus 0.8 for non-CRE corporate borrowers. Ten years earlier the multiple for CRE debt was 'only' 1.6. So in the 10 years preceding the crisis, the double gearing that the CRE sector had, compared to corporates, doubled again. No wonder many corporates sold their

real estate to property companies ready to take it off their hands backed by increasingly aggressive syndicated loans.

In the LBO market, MGI noted a similar trend: in the US, in 2002 businesses acquired in LBOs were on average 2.7 times more geared than non-LBO corporates, rising to 4 times in 2005. In Europe the financial sponsor driven LBO boom continued beyond 2005 until 2008 and, in addition, in those years the Corporate Leveraged market grew in Europe, allowing acquisitions by corporates to be funded LBO-like, i.e., with no recourse to the acquiring company, covenant-light and highly distributed to end-investors. So we have no doubt that, in Europe too, LBO-debt formed a pocket of excessive leverage. Importantly, just before the crisis, the so-called OpCo-PropCo model was frequently applied to finance acquisitions, allowing for a combination of CRE and LBO leverage in one and the same acquisition. Many investors and banks are still licking their wounds from the resulting positions they have on their books. It is clear that in both these sectors of the syndicated loan market the likelihood of de-leveraging is the greatest. That is not to say that no new LBO or CRE deals will be done, but rather that sponsors will have to be much more selective and accommodating to their banks.

Considerations for corporate borrowers

The analysis allows us to suggest a number of recommendations to corporate borrowers that are seeking to position themselves strongly vis-à-vis their banks in the inevitably toughening credit negotiations:

Diversify – proactively seek out alternative sources of funding that reduce your reliance on syndicated bank loans to fund your ongoing business and/or growth initiatives.
Wallet-size – notwithstanding diversification to other funding sources, banks will remain important and they are likely to prioritise their credit appetite to clients that offer them sufficient cross-sell revenue. So, carefully, and not too thinly, spread your banking wallet across those banks that will provide you with most bang for your buck.
Extend – avoid being forced to tap the market during potentially awkward times, i.e., in the years 2011-2013, when there will be enormous competition for credit lines.
Stress-test – borrowing costs will rise and sales growth may disappoint. Debt service capacity should remain robust in such a stressed scenario to convince banks of your credit story. This is not a time for ventures with back-ended debt-service contributions.
Structure – banks' capital charge can be mitigated by appropriate debt structuring. Consider how to best utilise your sources of collateral and credit enhancement.
Benefit – de-leveraging LBO and CRE markets suggest that acquisitive opportunities will once again be firmly in reach of corporates after years of M&A activity driven by financial sponsors that relied on aggressive gearing for their business models to work. Consider grasping that benefit.

These suggestions can help enable corporates to pursue a growth agenda even in a de-leveraging market, giving them a competitive advantage in their corporate development – with the wholehearted backing of their banks.