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New attitude emerging in the corporate finance market

Negative sentiment and intense competition characterise the corporate finance market at present. But there are early indications that in certain areas the outlook is changing.

With the dust beginning to settle following the enormous collapse of the banking market, some degree of perspective is beginning to emerge.

The UK corporate finance arena is starting to address the issues and see where the opportunities now lie for UK businesses and shareholders in these changing and challenging times.

The collapse of financial markets and rapidly declining asset prices hit the corporate finance market severely.

In addition, many businesses that survived 2008 are seeing a rapid decline in 2009. The resulting job losses, business failures and cost cutting have resulted in many investment programmes being curtailed.

However, the outlook is not entirely bleak, and there are many notable exceptions, such as healthcare, insurance and outsourcing services.

And now that the markets are starting to stabilise, albeit at a much lower level, buyers and sellers are beginning to emerge. Credit is still not flowing as it should, but for the first time in many months we are seeing tentative opportunities.

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Constraints on capital

Since September 2008 and the Lehman Bank collapse, credit terms and the availability of capital have tightened in a way that few have ever experienced.

In the UK, the number of lenders has shrunk and many overseas banks have retrenched to a domestic perspective, or worse still, collapsed.

And of the remaining UK banks, there are continuing moves to introduce far stricter lending policies and to monitor existing and new customer facilities more closely.

The result is intense competition for capital. To give a sense of how much competition we can expect, earlier this year Standard and Poor estimated that £140 billion of UK corporate debt will have to be refinanced between now and 2011. Of this, £70 billion is due in 2009 alone.

This is purely the market for refinancing existing debt, and does not include new lending.

"… a number of banks are keen to issue terms and lend where the business case is sound."

Much of this refinancing will prove difficult to complete. Over the coming months the risk profiles of businesses looks set to worsen and the banks' appetite and ability to lend remains severely constrained.

However, offsetting this, it should be noted that there is a considerable amount of equity waiting to come off the sidelines and be invested into the market. It will be a very welcome alternative or complement to the debt that is available.

Finance sources

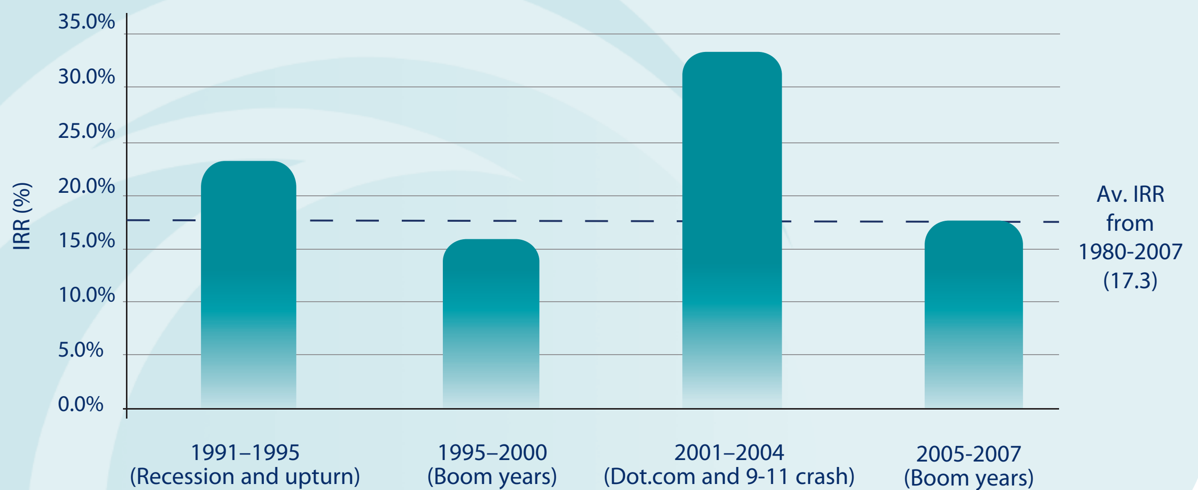
1. Debt

As outlined above, the number of lending sources has shrunk and the availability of capital has diminished.

However, at the lower end of the market (sub £20 million debt) a number of banks are keen to issue terms and lend where the business case is sound.

In general, lending is far more measured and a number of key components have changed since last year:

"Private equity houses anticipate that 2009–11 will turn out to be vintage years for investment. The last vintage years occurred after the early 90's recession and the dot.com/9-11 crash."



Cost of lending

Margins are now far greater – typically 2.5%–5% over LIBOR. However, given that LIBOR rates are now sub 2% (as recently as January 2009 they were 5.5%), the true cost of money has not been affected at present.

In addition, fees on leverage lending have now moved to around 2%+ on the loan advance. Previously they were around1%.

Structure of lending

Invoice discounting (securing a facility against a business's debtors) remains very active and relatively plentiful.

Other asset finance – whether stock, property or other general assets – has experienced a considerable constriction. Both the amount of finance available and the terms of availability have been greatly affected.

Despite what has been widely reported, there is still some access to leverage debt (unsecured lending against future business cash flow). This is particularly true in the sub £20 million arena, however, such debt is far more limited in its offering and is now pegged at multiples of EBIT – typically at factors of 1.5 to 2.

Covenants (continual measures of lending risks) are being structured far more tightly and enforced.

Vendors

Existing shareholders and vendors continue to be strong providers of loan finance to businesses. However, there is a question about how much exposure (loan value and term) they are prepared to accept. Often this type of finance will provide the bridge for an otherwise unworkable deal.

> "Capital markets have struggled considerably both in value and liquidity, particularly for businesses valued below £10 million."

2. Equity

Institutional private equity

Private equity houses in the main are well endowed with cash and are looking for opportunities to invest.

With asset prices historically low, equity investment could offer extremely favourable rates of return. The PE houses' investment appetite now is as strong if not stronger than in the recent economic boom.

They anticipate that 2009–11 will turn out to be vintage years for investment. The last vintage years occurred after the early 90's recession and the dot.com/ 9–11 crash (see graph).

However, because of the restriction in debt finance, private equity is often being required to cover the full value of a transaction in order that it can be completed.

Accordingly, anyone relying on "full equity deals" can expect higher hurdle rates of return for private equity investment.

Business angels

The UK has around 30 angel networks, which provide £800 million a year. And although they tend to focus on early-stage funding (typically sub £100k), they are investing more aggressively.

Furthermore, a number of experienced individuals are seeking to assist management teams going through difficult times, with a view to benefitting from the eventual upturn.

Capital markets

Capital markets have struggled considerably both in value and liquidity, particularly for businesses valued below £10 million.

Many publicly traded companies are now questioning whether to remain listed, as the costs and limitations begin to outweigh the benefits. This is an area in which we foresee considerable movement over the next few years.

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Market Drivers

In a stable economic environment there is a balance between buyers, sellers and available finance.

Transactions arise where there is change in either a business's circumstances or its shareholding. Many transactions will be planned by the shareholders, however some will result from more immediate drivers such as a change in the business's market or financial position.

Sadly, the current economic uncertainty has meant that the primary source of vendors thus far in 2009 has been distressed sales – often known as the Four Ds: divorce, death, dispute and (financial) distress.

Timing – the tipping point for shareholders

As in all aspects of life, timing lends a hand and for many shareholders and management teams alike, this is at the forefront of their minds right now.

The balance of risk versus reward and the timing of investment and divestment are being very carefully considered. Many commentators believe that the tipping point has been reached for undertaking a transaction.

Businesses and financiers are now emerging with a keen appetite to buy and finance acquisitions.

The balance will tip when vendors recognise the changing landscape and adapt their outlook and price aspirations.

Right now, many observers believe that we are at the threshold of that point. In other words, shareholders' commercial or financial perspectives have adjusted and we have reached a new point of equilibrium.

On that basis, a number of non-distressed sellers should be about to reach the point of progressing to sell.

We can expect the following transactional opportunities to materialise in the coming months.

1. Non-core disposals

Many trading groups will look to dispose of non-core business units. This will be a strategic decision – either to focus on core activities or to realise cash because debt is not available.

2. Delistings

As the rationale for public listing becomes weaker, and in many cases disappears (especially for market caps below £10 million), many companies will elect to delist.

The drivers for this are deeply discounted market valuations and the stock market becoming increasingly illiquid.

In light of this, the costs of remaining on the market and the burden of full disclosure will push many companies back into private ownership.

3. Insolvency

A number of supply chains may well be at threat from insolvencies, driven by the external market and commercial factors outside their control.

A number of these businesses may well be strong in their own right, and some financial restructuring could present good commercial opportunities for the right buyer.

4. The pragmatic vendor

We have reached the point where we are beginning to see the emergence of the "pragmatic vendor".

The wider economic climate looks set to remain very uncertain for some time to come.

In view of this, many potential vendors are beginning to question the merits of waiting for market valuations to return to pre-2007 levels. They recognise that selling now (albeit at a lower level) may well suit their personal objectives.

The alternative is to live with an uncertain timeframe and endure continuing business risk and potential further investment into the business.

All the signs suggest that we are on the brink of a new outlook.

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