Post Brexit debt markets - navigating uncertainty

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The outcome of the EU Referendum was like a sudden downpour during a British summer – a sharp and unwelcome shock after a warm spell.

Amid the turbulence and market volatility of subsequent days, many commentators drew comparisons to the start of the financial crisis of 2008. But while on that occasion, the economic thunderstorm caught many by surprise, this time most appear to have had umbrellas at the ready.

From a lending perspective, what was immediately striking in the wake of the Brexit vote was just how many deals were instantly put on the back burner, as companies and financial institutions took stock of the situation.

What has been equally surprising is how quickly some – though, not all - of these discussions have resumed – perhaps a sign that some of those carrying umbrellas are still prepared to step outside. This is particularly true in the middle market, which has arguably so far been more insulated from the shocks that rippled across the capital markets in the immediate few days after the vote.

Open for business, but ...

However, importantly, the Bank of England has continued to encourage banks to lend, coupled with decisive action - cutting the base interest rate and announcing a £100bn of lending support and a £70bn Gilt and corporate bond purchase program. And, in turn banks have been keen to stress that they remain on a 'business as usual' footing, making statements emphasising the strength of their capital positions relative to previous downturns.

But while they do remain open for business, there is no doubt that lenders are applying greater scrutiny to the potential implications of Brexit, including benchmarking against performance during the global financial crisis. Indeed, we have seen first-hand examples of banks demanding more in-depth management information from prospective borrowers, including forecasts predicated on the eventuality of a significant economic downturn. Perhaps an indication they foresee further storm clouds on the horizon.

The good news is that many companies who came through the last financial crisis are used to such requests for detail. While it does mean that processes are taking longer than they perhaps have done in recent times, this softening of confidence hasn't caused the terminal halt that some feared.

Large Corporates – Richard Dawson

Larger organisations in particular will already be used to coming under rigorous challenge from lenders and shareholders alike. But regardless of sector – and of course, some sectors will be more exposed than others to the ricochet caused by Brexit - now is the time for them to demonstrate their understanding of their core business and show they are taking appropriate steps to manage risks.

For example, a number of larger corporates have already faced increased scrutiny from shareholders to ensure that their hedging strategies are appropriately managing FX risks. Others are being asked to demonstrate they have a large enough liquidity buffer in place for at least the next 18 months.

Many are being advised to ensure their trade finance facilities – essentially, what they rely on for their day to-day trading – are in good shape, not least as these are often the first things that tend to be reviewed, and even cut, by banks during challenging times.

Carpe diem

Ultimately, being proactive – getting in front of stakeholders sooner rather than later – will help ensure lenders' confidence does not wane. Indeed, that tactic can be a stepping stone to taking advantage of some of the opportunities that periods of uncertainty and volatility can create.

The bank and bond markets are likely to be supportive of international companies with good credit characteristics seeking to make inbound acquisitions and investments.

We have already seen high profile examples of overseas organisations taking advantage of the fall in sterling to embark on strategic takeovers – Odeon, Poundland and ARM Holdings surely won't be the last to head towards foreign hands.

But bold and nimble UK corporates will also be seeking out strategic acquisitions, partnerships or joint ventures, particularly those that may take them into new markets or territories.

"Wait and see"

Elsewhere within the capital markets, we have already witnessed a flight to quality, with strong borrowers still able to get very competitive trades: indeed, a number of bond deals issued post-referendum have all but flown off the shelf. The recent monetary policy action by the BoE is likely to add momentum to this trend.

In the leveraged finance space, some deals have been pulled or temporarily put on hold. It is hard to tell whether this is being driven by sponsors or debt providers, with both sides pointing the finger at the other. Overall, a 'wait and see' mentality seems to prevail.

While high yield new issuance has not been widely tested, we would expect to see continued caution in this market and issuers may need to pay increased yield and potentially new issuance premium to attract investor interest.

Some will be well primed to take advantage of the current market dynamics – the underlying benchmark costs are cheaper, and risk premium appear stable, so it may be an opportune time to seek out new bank financing, or perhaps swap loans for bonds, to build up something of a war chest.

A word of caution: those who may have been considering dipping their toes into the syndicated loans market may find it's not as readily accessible as it was pre-referendum; capacity may be diminished with some banks uncomfortable with underwriting risks and certain international banks nervous around their exposure in the UK.

Ultimately, it's about readiness. Those who prepare and consult carefully and broadly, will be fleet of foot when opportunities do arise.

> **"Falls in some shares – particularly real estate, construction and retail stocks – highlighted their vulnerability to consumer and investor confidence after the referendum. We examined whether debt markets were similarly nervous."**

Real Estate – Simon Mower

The impact of Brexit on the UK real estate market has been one of the more immediate areas of debate. While concern is being driven by flows of international capital, it is worth remembering that whilst there are a large number of international investors who are showing caution with any UK real estate investment, there are some out there who are seeing opportunity - generally those with patient capital who are able to take a longer term view on the attractiveness of the market. Indeed, for dollar-based (or pegged) investors, values have already been rebased!

Transaction volumes and debt market conditions had started to slow and moderate before the referendum. Volumes in H1 2016 were markedly reduced against 2015 and debt terms had started to gradually tighten.

Post-referendum, lenders do remain open for business, but again, caution and thoughtfulness is the name of the game, due to uncertainty around how valuations will shift over the next three, six, 12 and 24 months. After all, lenders don't win any prizes for writing loans now that default on valuations in six to 12 months' time.

Syndicated deals tougher

Deals that were already underway, or which are founded on solid, existing relationships and some mid-market transactions are less likely to be put on hold, but borrowers can expect to see a tightening of terms, lower leverage, increased pricing and slower, more considerate processes. Large deals which require syndication are likely to be more difficult – the syndication market will slow in these conditions.

Institutional lenders with a longer term view and an annuity matching requirement are more likely to continue as usual, albeit valuation remains an issue for them. Their pricing might increase, but underlying benchmark rates have fallen and so all-in pricing may remain attractive.

Funds should have an opportunity to benefit from a fractured market, but a number of them are raising capital at the moment and might find this more difficult, so expect those with closed funds to figure most frequently in discussions.

Creeping nerves among international banks

A number of international banks had firmly come back into the UK real estate market over the last 24 months offering competitive pricing and terms, but as one might expect, we have seen nervousness creep into these institutions since the referendum. This will no doubt mean a degree of retrenching for a period of time and materially wider pricing.

Development finance had also opened up more widely before the referendum, but this is likely to be the area most hit by the current conditions. Development is viewed as higher risk and so borrowers looking to access loans in this market will need a very clear business case and might expect an extra layer of conservatism.

From a sector perspective, the impact of Brexit is likely to be mixed, with office and retail at greatest risk of taking a hit to value given the perceived risks of multinationals moving out of the UK and reduced international investor appetite. Central London residential property is also high risk and indeed had already started to reduce in value earlier in 2016 following changes to stamp duty.

Sectors such as logistics and student accommodation may prove more defensive given their intrinsic characteristics.

No return to 2008

For those who are viewing the market and seeing shades of 2008, there are still some important positives to note.

Banks are better capitalised and have been more conservative in their approach to the real estate sector over the last five or six years. Funds have soaked up more of the risky positions. In theory, this should mean banks are better placed to provide a more consistent lending platform.

Coupled with this, borrowers have also been more conservative in general – a look at the UK listed companies in this space, for example, shows gearing in the 30-40% loan-to-value band.

Institutional investors are in a similar place. As such there should be less distress in the asset base, absent large falls in value.

Building and Construction – John Miesner

Housebuilders took the full brunt of the immediate Brexit shockwave, with shares tumbling by around 40 percent. Since then, we have seen a number of cautious statements from housebuilders as they consider slowing the pace of development and purchases of land, due to uncertainty around how the vote will impact consumer confidence.

However, there is an argument that the collapse in share prices is perhaps somewhat overblown.

Certainly the sector is stronger financially than it was before the 2008 crash: it is significantly less leveraged and has the experience to adapt to dramatic shifts in the market. Low interest rates and government schemes such as Help to Buy are also supporting the market. The recent base rate cut will also help mortgage-holders, meaning house prices may not fall dramatically as many fear.

So while lenders will be cautious about their lending to the housebuilding sector – requiring a demonstration of post Brexit reservation performance – there may not be a significant loss of appetite to lend to the sector.

Wider construction concerns

However, in the wider construction industry, the uncertainty feels somewhat more pronounced. Already operating on tight margins and at the mercy of political decisions and investor sentiment, companies are now hit by raw material inflation as the pound depreciates. They are also vulnerable to deep concerns around the impact of the Leave vote on its workforce.

With sustainability of profits at risk, so too comes potential covenant pressure. That in turn could lead to stress across the sector.

Retail – Peter Bate

For some time, the retail and consumer goods sectors have divided the opinion of lenders who seek to target niches such as speciality or value retailing and casual dining – especially when it comes to M&A and private equity.

It is too early to tell how Brexit will affect mergers and acquisitions activity over the longer term. However, we have already seen a number of transactions either falter or be paused because of growing concerns about consumer confidence and the associated spectre of recession.

Many retailers will already be feeling pressure on margins because of the weaker pound, so lower footfall and consumer demand will likely damage already-thin like-for-like sales and growth opportunities.

Retailers who already have strong lender support will retain it as institutions continue a flight to quality. Nevertheless, leverage for transactions is likely to be lower and margins may well start to see a risk premium added. The bar for credit and the sensitivities applied will also undoubtedly be higher than pre-23 June levels.

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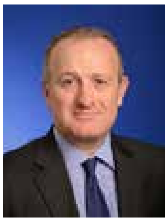

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