HERBERT SMITH FREEHILLS

ANNUAL CORPORATE DEBT SURVEY

ISSUE 2 - APRIL 2015

EXECUTIVE SUMMARY

Welcome to the results of our annual corporate client survey gauging trends in the corporate debt markets in 2015.

In summary, key conclusions include:

- a significant number of UK corporates surveyed are looking to increase overall debt levels, reflecting an increase in corporate confidence
- of those corporates increasing their debt this year, 42% intend to use that to fund capital expenditure and 33% to fund acquisitions
- despite the multitude of refinancings that have taken place over the last 18 months, corporate refinancings are set to continue at an accelerated pace well beyond scheduled maturities in 2015
- UK corporate borrowers will continue to be reliant on traditional bank debt but are continuing to diversify their sources of funding via the debt capital markets and alternative non-bank lenders – with a significant shift anticipated between 2015 and 2018
- 90% of UK corporates surveyed are of the view that a UKPP market would be helpful to them but many remain sceptical that a UKPP market will develop in the medium term, citing supply-side issues as a significant impediment to growth

We hope you find these results informative and would like to thank you for participating in our survey. If you have any feedback on the survey or its results, we would be very happy to receive it.

ABOUT THE ANNUAL CORPORATE DEBT SURVEY

The survey comprises responses from treasury and finance functions of over 60 large listed UK corporates, and was conducted in February 2015.

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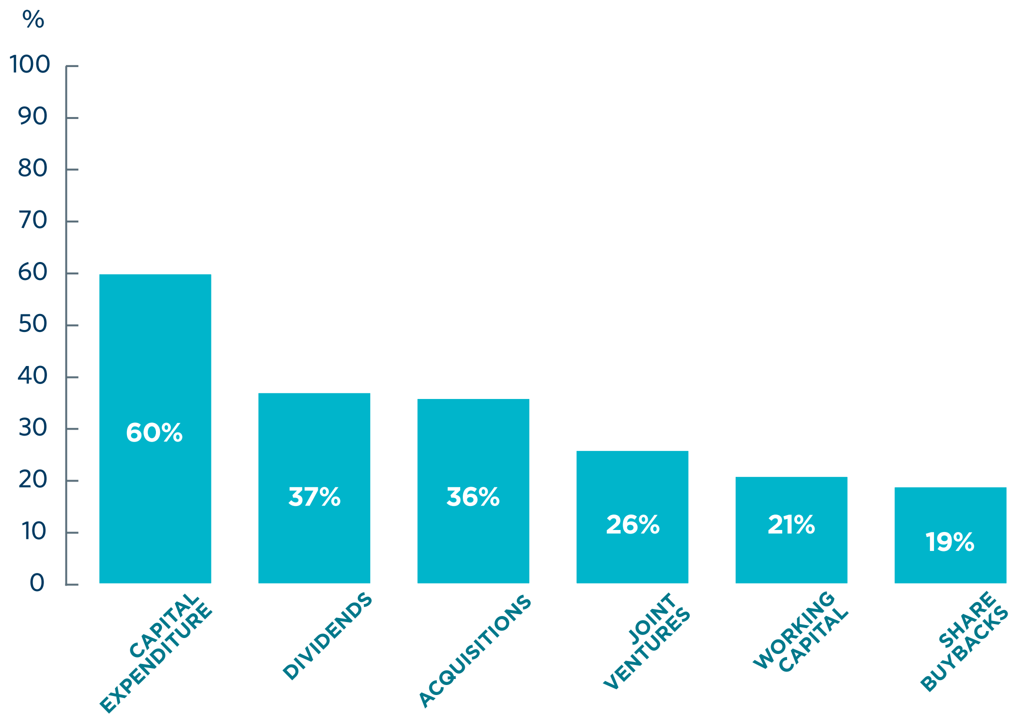
CORPORATE SPENDING IN 2015 vs 2014

Do you anticipate that your expenditure on any of the following will be greater this year as compared to last year?

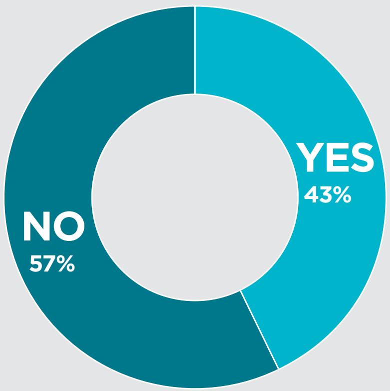
A broad cross-section of respondents anticipated increased year on year spending, particularly to fund capital expenditure, acquisitions and dividends. As we will come on to describe, a significant proportion of that spending will be debt funded, particularly in relation to capital expenditure and acquisitions. Comparing these results to our survey last year, capital expenditure (⤒20%) in particular is the focus of a year on year increase but with joint venture investments (⤒18%) working capital increases (⤒12%) and acquisitions (⤒9%) also being flagged as areas for increased investment.



EXPECTED INCREASE IN DEBT LEVELS IN 2015

Do you plan to increase your overall level of debt this year (other than as part of usual seasonal adjustments)?

Turning to the debt capital raising plans of corporates in 2015, 43% are looking to increase their overall levels of debt this year, almost double the percentage reported in our survey last year (23%). This year, buoyed by a more positive economic outlook, more corporates plan to take advantage of high levels of liquidity from a variety of sources together with better terms and keener pricing to set their debt capital structures over the longer term.



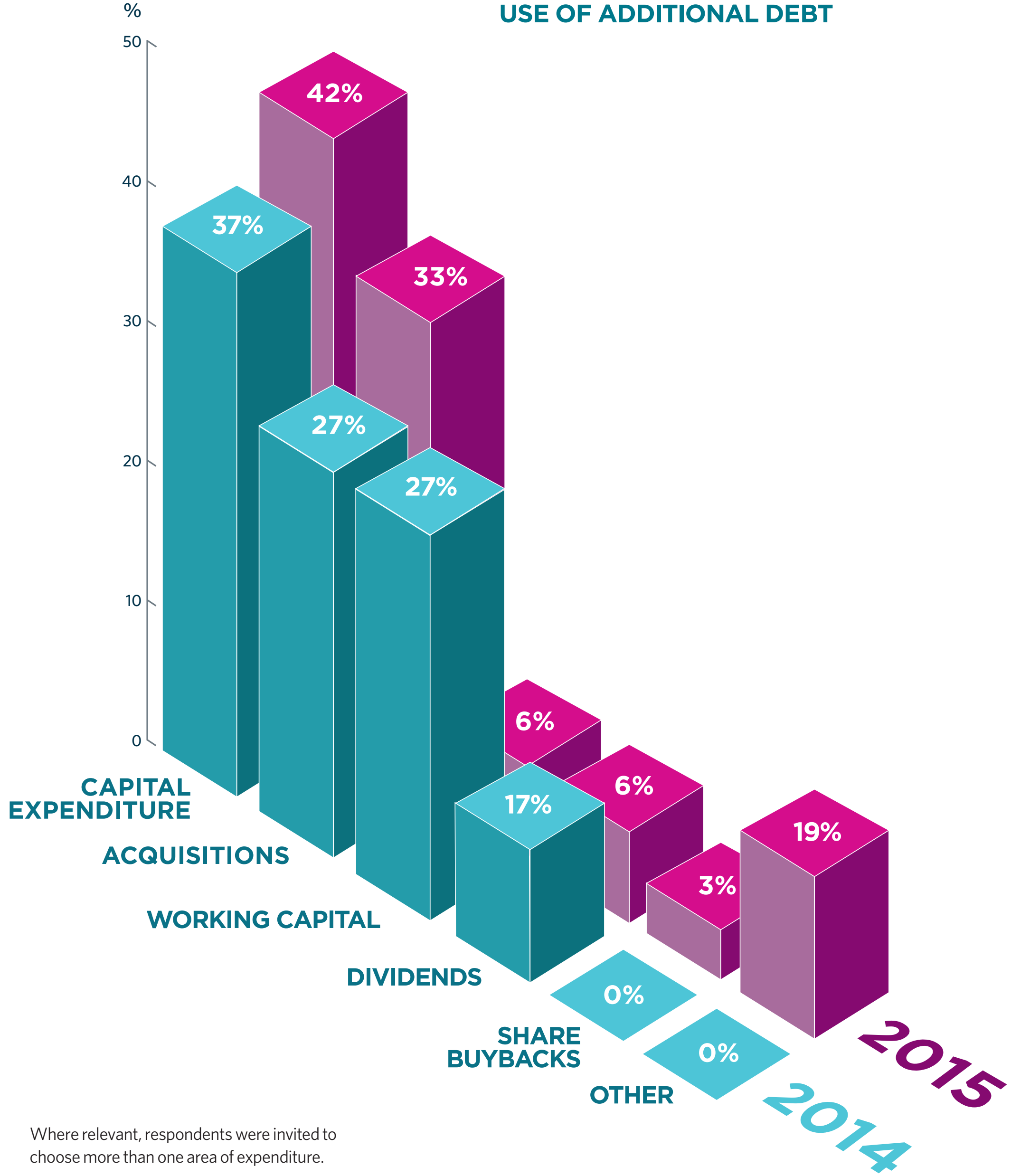
What will that additional debt be used for?

Of those corporates who plan to increase their debt levels this year, over 42% of responses indicate that additional funds will be utilised for capital expenditure, up from 37% in 2014. Funding acquisitions remains high on the agenda with 33% of responses indicating that the additional debt will be used in this way, up from 27% in 2014.

These numbers correlate with anecdotal evidence we have received pointing towards sustained confidence amongst corporates and a greater willingness to invest in the pursuit of increased growth (including non-organic growth by acquisitions).

Increased capex and acquisition spending plans may also be indicative of a more positive macro-economic environment characterised by comparatively strong GDP growth in Britain in 2014 and greater political certainty as to monetary policy in the US.

Anecdotal evidence also suggests that Eurozone uncertainty and the UK general election are not materially impacting on debt raising plans at this stage, though they may dictate the timing of deployment of those additional funds.



Where relevant, respondents were invited to choose more than one area of expenditure.

DIVERSITY OF DEBT PRODUCTS

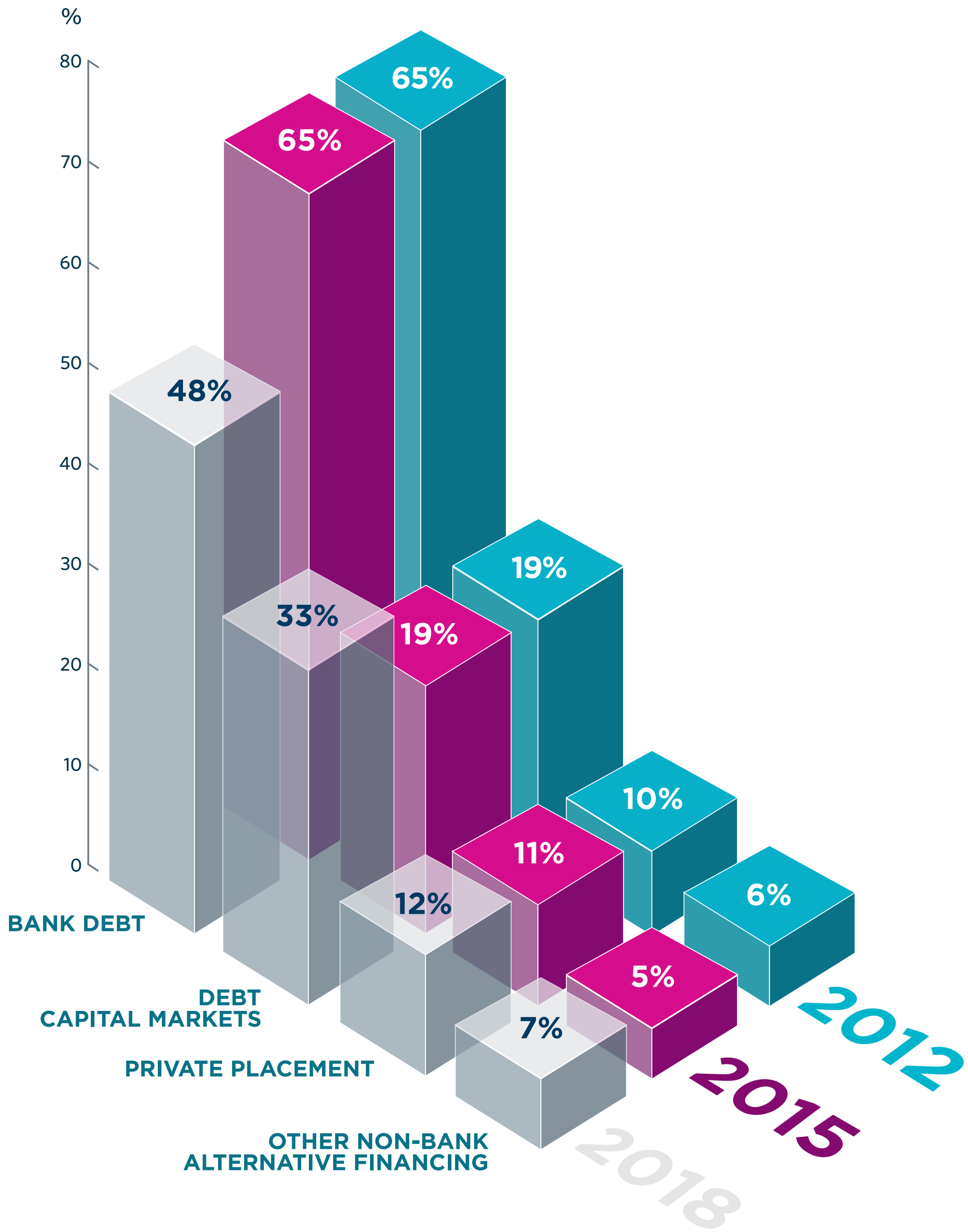
In 2012/2015/2018 approximately what percentage of your total debt funding was/will be provided by each of the following?

Looking ahead, whilst bank debt will remain the predominant source of debt funding, corporates predict that it will contribute around 17% less to their debt capital structures by 2018. Respondents also predict that they will increasingly rely on the debt capital markets, with issuance expected to increase to 33% by 2018.

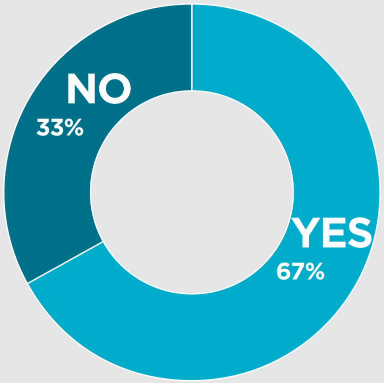
Despite the systemic trend towards the debt capital markets, the inherent flexibility of bank lending (coupled with keen pricing and ever longer tenors) means that bank debt remains dominant.

However, this may be a more general move towards typical US corporate debt capital structures which often include far greater reliance on the capital markets. Alternative non-bank lending is expected to contribute to around 7% of total corporate debt in 2018, not materially greater than the current position.

Whilst we will touch on this shortly, non-bank lenders have made significant strides in the last twelve months in increasing the profile and understanding of their debt products even as bank liquidity continues to be plentiful (and therefore the pressure to diversify debt funding sources in the short term at least is lower).



DEBT REFINANCING



Do you plan to refinance any of your debt this year?

Turning to the topic of refinancing, 67% of respondents indicated they plan to refinance at least some of their debt this year, up from around 50% in 2014. It is clear that despite the high number of opportunistic refinancings that have taken place in the last 18 months, a significant number of corporates have yet to come back to the market to take advantage of increased liquidity and better pricing and plan to do so this year. The dramatic growth of bank facility amend and extend exercises in the last 18 months looks set to continue as a cheap and fast way to refinance even though this may involve changes in bank syndicates. The attractive economics of the bank debt market are such that it is not uncommon for corporates to amend and extend financings that are only 12-18 months old.

SOURCES OF ADDITIONAL OR REFINANCED DEBT

If you plan to increase your overall debt or refinance any of your debt, how will this be achieved?

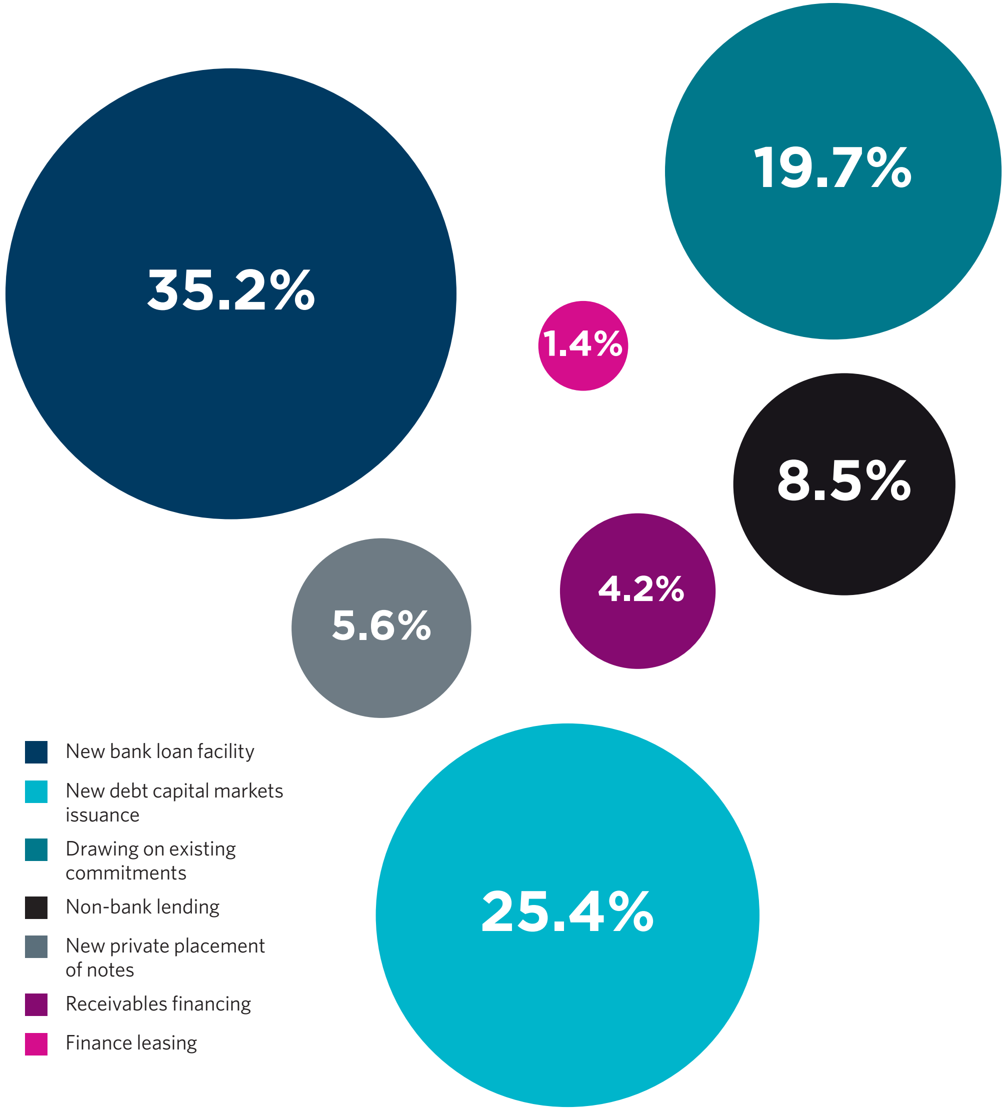
Around 35% said that new bank facilities will be entered into in 2015, about the same level as last year. However, this year sees an increase in the number of corporates who are also looking to alternative non-bank lenders. 8.5% of responses identify non-bank lenders as a projected source of debt in 2015, up from 4% in 2014. Also, this year, 25% of responses plan a debt capital markets issuance, up from 19% in 2014.

Despite being a high priority for most treasurers since 2008, ongoing diversification of debt funding is set to continue.

Macro-economic factors such as low levels of inflation, in part recently caused by historically low oil prices, have certainly lowered the prospect of interest rate rises in 2015. However if macro-economic conditions change or if there is a change in UK economic policy following the general election in May, corporates may be inclined to move away from traditional floating rate debt products towards fixed rate funding sources.

Despite its popularity in recent years, a relatively low proportion of responses indicate an intention to issue notes into the private placement markets as a method of raising debt in 2015. It is difficult to speculate why this might be given the depth of that market, the attractive historically low interest rates on such notes and the ability to fix rates for 10 years or more.

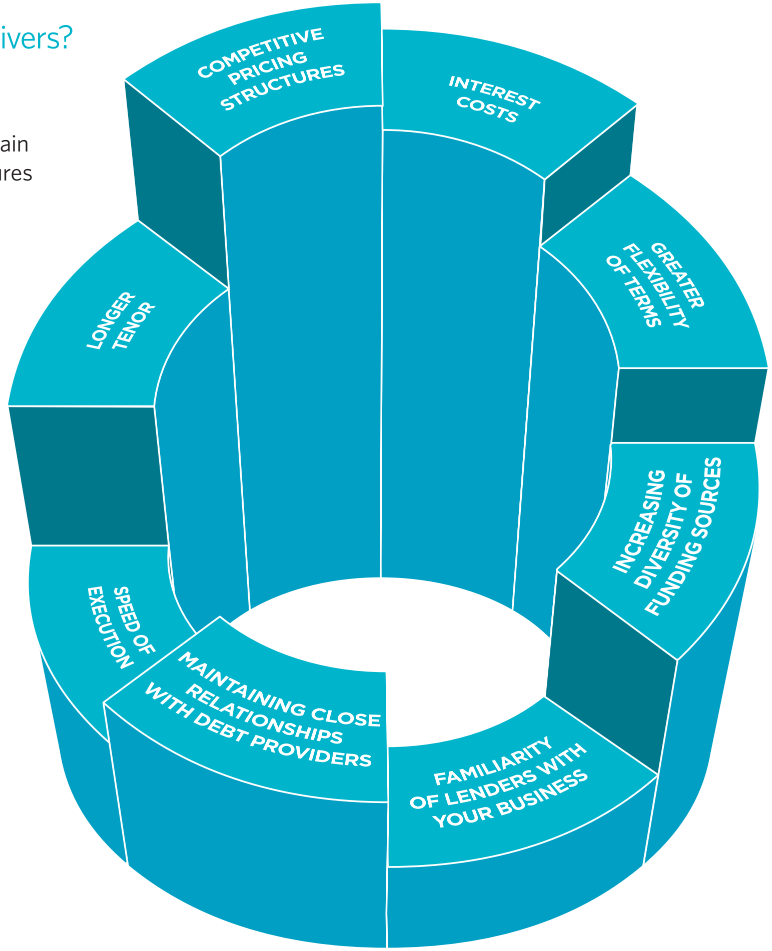
Respondents were invited to choose more than one debt funding source.



KEY DRIVERS FOR BORROWING

If you are considering borrowing this year, what are your key drivers?

The main drivers behind borrowing continue to remain competitive pricing structures and low interest costs, the same as last year and as would be expected. As shown in our 2014 survey, respondents are not influenced significantly by the familiarity of lenders with their businesses, the speed of execution or maintaining close relationships with certain debt providers. These weaker drivers are reflective of the currently benign conditions for borrowing in the corporate debt markets.



Answers were ranked on a scale of 1 to 8, with 1 being the 'weakest' and 8 being the 'main' drivers for clients from which this mean average was calculated

COSTS OF FUNDING

18% GREATER THAN IN 2014

41% SAME AS IN 2014

41% LESS THAN IN 2014

Do you anticipate that your costs of funding over the next 12 months will be greater than in 2014?

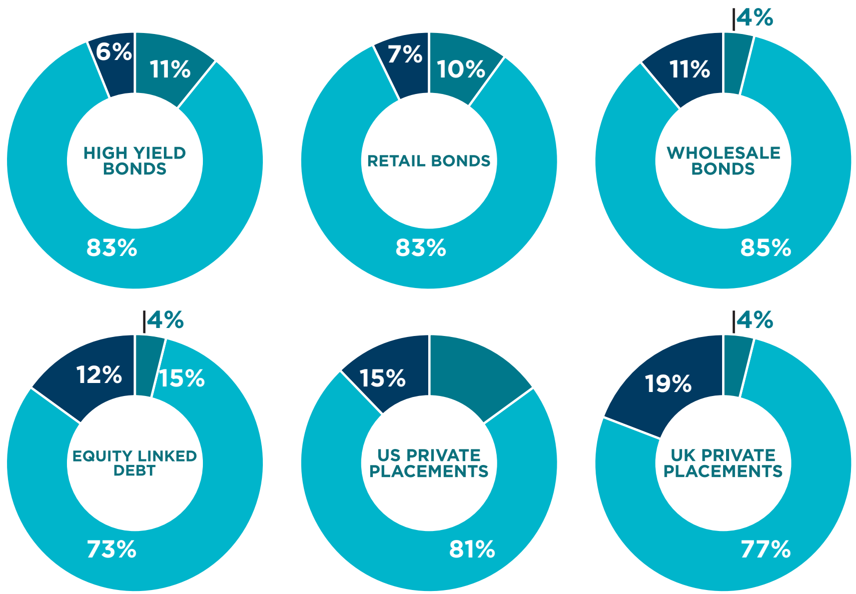
A key feature in the debt markets in 2014 has been historically low pricing driven by significant liquidity and competition to lend to corporates with sizable ancillary wallets. LIBOR/EURIBOR rates and other cost of funds benchmarks remain at historic lows with the expectation that this will continue into 2016. However, more than 80% of respondents believe that pricing will either remain at 2014 levels or will fall further in 2015. With margins for corporates at a fraction of the levels seen a few years ago, it is perhaps difficult to see how further significant margin reductions will be achievable. However, savvy corporate borrowers are deploying their ancillary financing requirements to best effect, ensuring that primary providers of debt capital are preferred in the allocation of corporates' ancillary business.

FIXED RATE DEBT INSTRUMENTS

Given the likelihood of interest rate rises over the medium term, compared to last year, are you more or less likely to consider the following fixed rate debt products?

More than 80% of respondents said that the threat of interest rate rises would not impact on their appetite to issue high yield bonds, retail bonds, wholesale bonds or borrow equity linked debt. This accords with our findings which show that interest rate risks will instead continue to be addressed through derivatives. However, 19% of respondents said that they would be more likely to consider fixed rate UK private placements this year as compared to just 4% in 2014 and 12% would consider US private placements. This suggests that, despite the lower projected issuance into the private placement markets noted earlier, of all debt products (aside from derivatives) these are most likely to be used to hedge interest rate exposures. However, these results should be considered against the background of historically very low cost of funds rates and a perception that this situation is unlikely to materially change in the short term.

LESS LIKELY
NO DIFFERENCE
MORE LIKELY



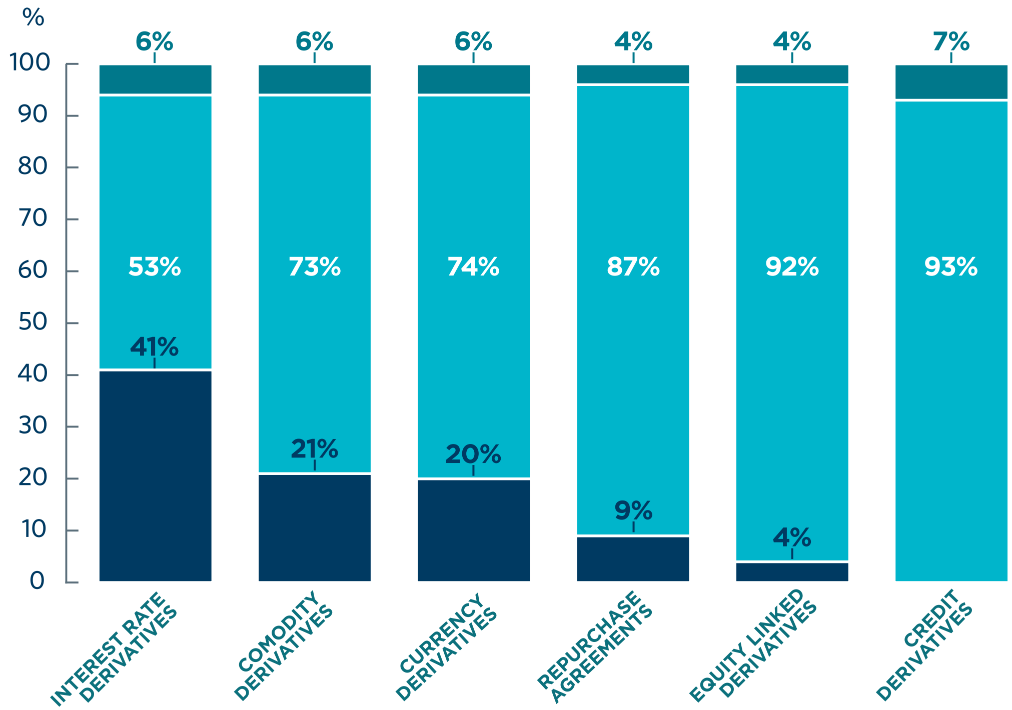
DERIVATIVES

Do you anticipate that you are likely to enter into greater or fewer of the following products in 2015?

Over 40% of respondents said that they were likely to increase their interest rate derivatives positions in 2015 compared to 2014 and around one in five said they would be likely to enter into additional currency and commodity derivatives in this year. Greater appetite to hedge interest rate exposures potentially reflects the current low prevailing interest rates and the opportunity to potentially lock in overall cheaper debt funding rates over the longer term.

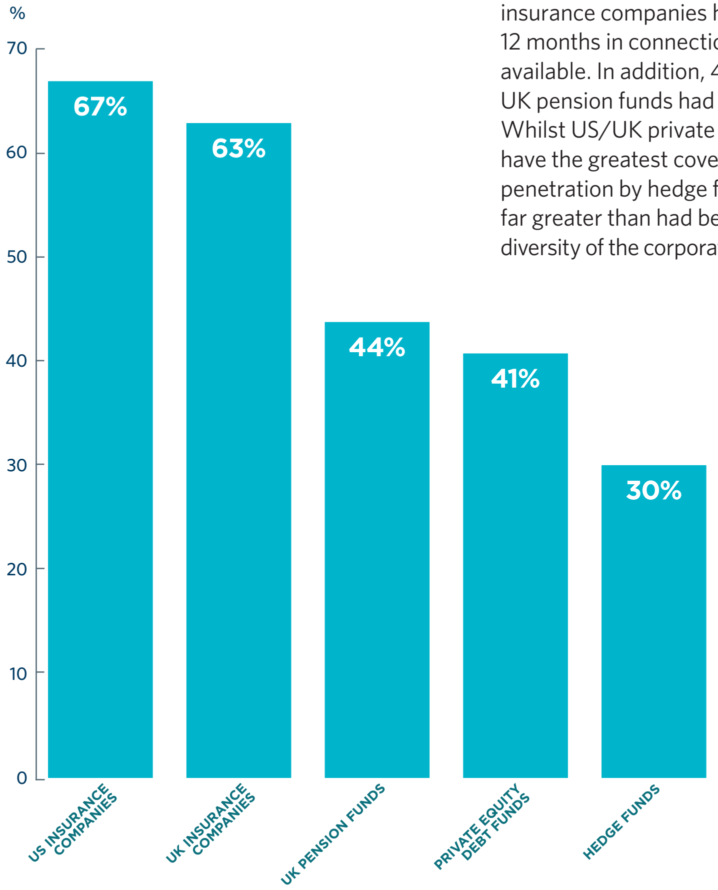
Interest in credit and equity linked derivatives remains very low. However, there is a greater interest in repurchase arrangements, possibly as a method to increase the yield on funds otherwise sitting on deposit through structured repurchase arrangements.

LESS LIKELY
NO DIFFERENCE
MORE LIKELY



ALTERNATIVE NON-BANK LENDERS

In the last 12 months, have any of the following alternative non-bank lenders discussed lending to you?

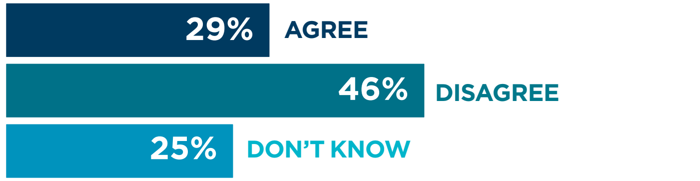


In 2014, alternative non-bank lenders broke through in the UK and European markets, with their aggregate deal count up 43% on 2013 according to the Deloitte Alternative Deal Tracker 2014. Based upon the large amounts of investment funding raised by insurers, pension funds and others recently, alternative non-bank lenders are set to continue to provide increased liquidity and depth to UK and European debt markets in 2015.

This is borne out in our survey responses with around two thirds of respondents saying that UK and US insurance companies had approached them in the last 12 months in connection with making new lending available. In addition, 44% of corporates noted that UK pension funds had similarly approached them. Whilst US/UK private placements were expected to have the greatest coverage of corporates, the level of penetration by hedge funds and private equity funds is far greater than had been anticipated given the size and diversity of the corporate debt market.

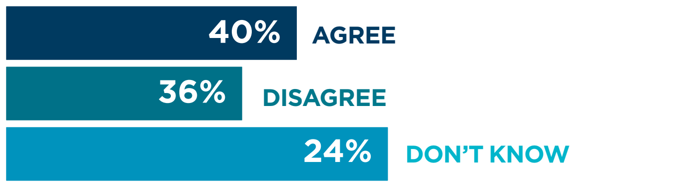
Respondents were asked whether they agree or disagree with the following questions:

Alternative non-bank lenders in the loan markets are or will become increasingly central to funding our business activities?



Alternative non-bank lenders in the loan markets are more likely to lend to companies on a bilateral basis?

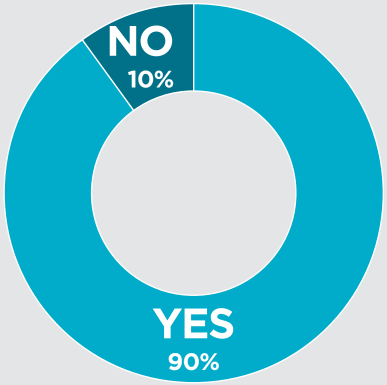
Alternative non-bank lenders in the loan markets are more likely to lend to non-investment grade opportunities?



A third of corporates took the view that alternative non-bank lenders in the loan markets are or will become increasingly central to funding their business activities. However, considering this in conjunction with our results on page 3, in relation to sources of corporate debt, it may be the case that the move to non-bank lending is a longer term aspiration rather than something which will be implemented in the shorter term (as noted in the projection, only 7% of responses indicated that non-bank lending would form part of their capital structure by 2018). Although alternative non-bank lending is perceived as important to a significant number of corporates, its adoption does not appear to be a priority for treasury teams at this stage.

UK PRIVATE PLACEMENT MARKET

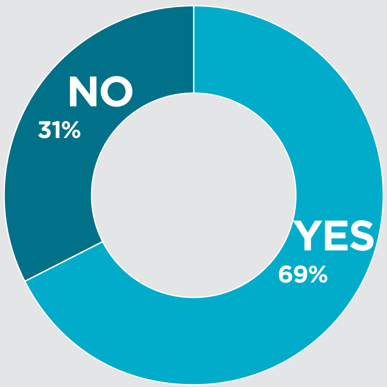
Do you think a UK private placement market would be helpful as a way to providing UK corporates with access to further debt funding?



In light of the Autumn Statement where the UK government committed to introducing withholding tax exemptions for private placements, 90% of our respondents think that a UK private placement market would be helpful as a way of providing UK corporates with access to further debt funding.

HMRC previously published a technical note setting out proposals for a new exemption from UK withholding tax on private placements. The conditions are that the security is a loan relationship of the debtor and is not listed on a recognised stock exchange. Draft legislation also provides for further conditions but these have yet to be published.

Given the success of both the US private placement market and the domestic private placement market in Germany, do you think that it is likely that a UK private placement market will develop in the medium term?

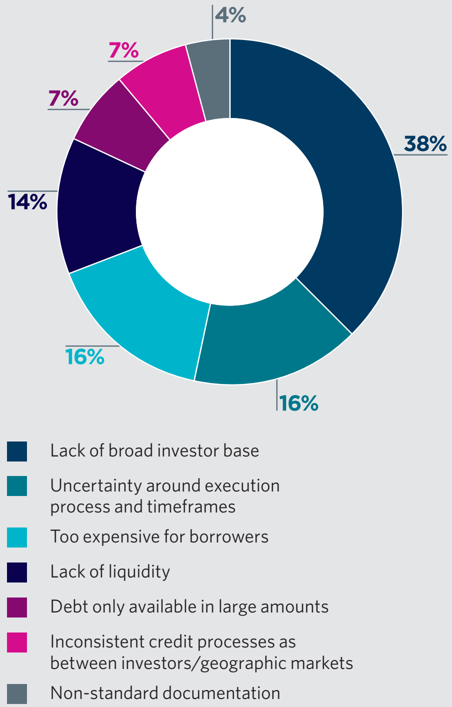


It is clear that a UKPP market faces a number of headwinds (see top right). In addition to those referred to opposite, the entrenched position of the USPP with its standardised documentation and issuance process could form a significant obstacle. Over US$51 billion was raised by companies in the USPP market in 2014, and UK borrowers accounted for around 17% of the debt borrowed and for 15% of issues*.

In addition, increased interest in the portability of other similar products from other jurisdictions (notably the Schuldschein in Germany and the nascent French bond market) could well prove to satisfy UK corporate debt demands for this type of product without the development of a UK-specific market. Whether the withholding tax exemptions and the recent publication of the suite of PP style documents by the LMA will be enough to keep the development of a UKPP market on track remains to be seen.

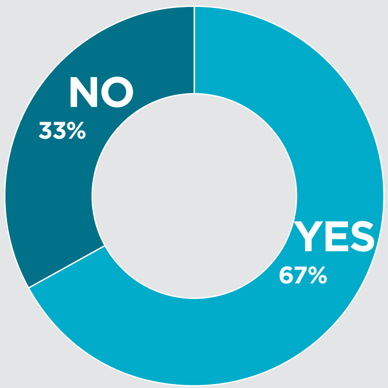
*Source: Thomson Financial

A UK private placement market is yet to develop in a meaningful way. Why do you think that is?



When asked why a UK private placement market was yet to develop, more than half of respondents cited creditor supply-side issues, including 38% noting the lack of a broad enough investor base and 13% citing the lack of market liquidity. 16% felt that UKPP debt would be too expensive and another 16% had concerns around uncertain deal execution processes and timeframes.

Do you think that a UK private placement market could adequately service pan-European private placement requirements?



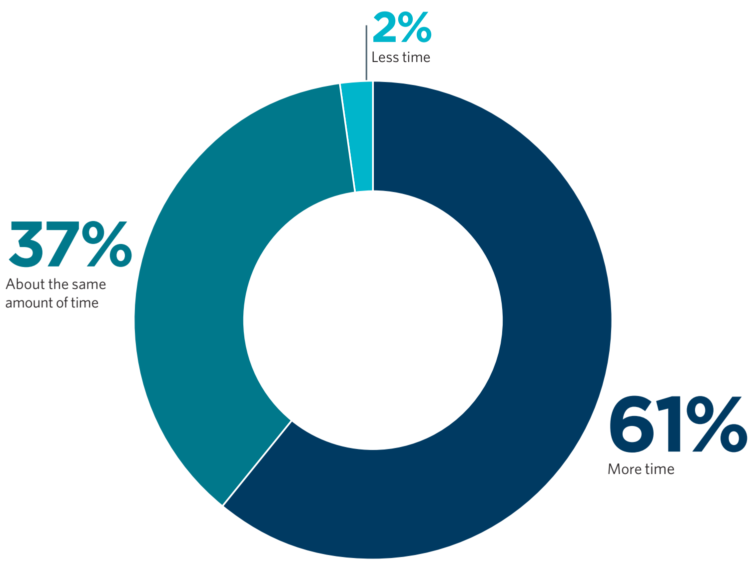
Whilst two thirds of our respondents were confident that a UK market could meet pan-European requirements, it remains to be seen whether this will come to fruition. The obstacles described above could ultimately prove too great unless the initiative is gripped by a cohesive set of potential investors who are supported by both industry bodies and government in order to develop a substantive domestic practice in the first instance.

COMPLIANCE RELATED MATTERS

Are bank compliance procedures around sanctions, anti-bribery and KYC taking up more of your time as compared to last year?

Around 60% of respondents indicated that AML and sanctions issues are taking up more time as compared to last year. This is something we have also observed as both lenders and borrowers take more time to ensure AML and sanctions provisions in debt documents provide the requisite protection for lenders without exposing borrowers to the risk that immaterial matters result in drawstops or events of default.

Negotiations of terms are often protracted due to the mismatch between the far-reaching sanctions provisions lenders would like and the fact that corporates are rightly unwilling to accept sanctions provisions which prevent them from doing business that does not breach applicable sanctions laws. The key is to address sanctions requirements early in any financing process to ensure that expectations are aligned and to avoid lengthy due diligence and delay.



FIRST EDITION

If you are interested in reviewing last year's survey please click the image below to download a PDF, or email sian-elizabeth.cullingford@hsf.com to request a copy.

Please do also get in touch with feedback should you have any regarding this year's edition. Contact details are in the executive summary of this report. We hope you have found the survey results informative and if you would like to discuss any of the issues touched on please contact us.

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