Refinancing costs rocket

With £500bn of corporate debt looking to be refinanced in the UK between now and 2027, companies could face an additional £25bn-a-year burden in the current high-interest environment

Corporate UK is facing an increase of up to £25bn in the annual cost of its debt, as a wall of refinancing builds up in the next three years. This could then have a knock-on effect for future valuations for many listed companies, consultants are warning.

According to an analysis by Big Four firm EY, the cost of debt financing has increased, on average, by three to six percentage points since January 2022, the point just before central banks began to increase their bank rates. The firm calculates that, between 2024 and 2027, £500bn of private and corporate debt will need to be refinanced by UK listed companies, costing an additional £20-25bn in annual debt-service costs.

In 2024 alone, the firm reckons that more than £100bn will need to be refinanced.

The root cause of the issue is well known. As Luke Reeve, head of debt advisory at EY, says: "The post-pandemic surge in inflation, followed by rapid tightening of interest rates, has led to economic stagnation since late 2021. While rates are easing, the markets anticipate the cost of debt will be between three and six percentage points higher for the average company, or even greater for more leveraged businesses, compared with only two years ago."

Defaults on the rise

The UK is not alone – Fitch Ratings is also warning that, in the US, it anticipates that leverage loan and high-yield bond defaults will increase, reflecting the pressures of greater interest expense burden and the challenges stemming from an expected slowdown in economic growth. The credit ratings agency says 2023 saw an increase in credit defaults, with US institutional leveraged loans and high-yield bonds defaulting at 3.3% and 3.0% respectively.

"Although outstanding syndicated leveraged loan volume remained flat and the size of the high-yield market contracted, issuance volumes for each were up in 2023 compared with the previous year," Fitch reports. "Repricing and refinancing activity rebounded, with borrowers coming to market to address looming maturity walls. M&A and LBO activity also fell as higher rates depressed appetite for new issuance, amid uncertainty surrounding an economic slowdown."

In Europe, Fitch says it has found that the trailing 12-month (TTM) European leveraged loan default rate rose to 3.8% in February 2024, from 3.3% in January 2024. "We expect bond default rates to rise from 2Q24 towards our 4% YE24 forecast for both loans and bonds," it says.

Slow road to cuts

But if corporates were relying on reductions in interest rates, and so the cost of capital, this year to ease their refinancing concerns, they could well be disappointed. Earlier in 2024, many economic commentators expected central banks to begin cutting bank rates in the second quarter of the year. Now, this is looking more likely to begin in the summer months or even later.

And, according to EY, inflation may not fall in a linear way, meaning rates may not be cut as quickly as markets expect. In particular, renewed geopolitical disruption – including in the Red Sea, Israel-Gaza and around Taiwan – risks feeding through to rising oil prices and supply chain bottlenecks, in turn adding new fuel to inflation.

Even with the 100-125bps of reductions that have been priced by markets for 2024, and absent further external shocks, interest rates will be well above the levels that businesses have grown accustomed to since 2008. Also, it should be remembered that many businesses took advantage of government support and ultra-low interest rates to raise finance in 2020 and 2021, on fixed deals, and hence have been largely insulated from rate increases so far.

Valuations challenge

EY also warns that a more negative economic outlook, rise in cost of capital, higher discount rate and softening demand are now putting pressure on valuations. As the UK and global economies emerged from the pandemic

in spring 2021, there was a fair amount of optimism about the economic trajectory. GDP rebounded rapidly, and confidence was high. Finance in many cases was raised on expectations of continued economic growth and stable price levels — the actual outturn since 2022 has of course been very different.

As Mats Persson, partner at EY-Parthenon, says: "A combination of higher financing costs, challenging trading conditions and discount rates means a valuation gap is now emerging."

This is particularly relevant for the £300bn of deals transacted in the UK in 2021 – often financed on ultra-low rates, with valuations at record levels, and with exit multiples based on assumptions of continued recovery and stable margins. The economics on some of these deals may well start to unravel.

"To protect their balance sheets, companies should be looking for opportunities to deleverage ahead of refinancing events and explore strategies to improve liquidity and access to working capital," Persson says. "It's also critical that companies continually conduct stress tests and scenario plan to understand the resilience of their business, and develop a strategy to mitigate risks."

PwC adds that the ceiling on how much businesses can borrow is likely to be lower because of the increased cost of debt and more prudent appetite from lenders. For example, a company that could previously achieve a five-times levered arrangement may now be looking at three-four times.

But the firm adds that private credit funds still have plenty of dry powder that they're motivated to put to work. "We estimate this to be more than €50bn across Europe at the latest count," the firm says. "We've seen them offering finance to some of the larger corporates as an alternative to the high-yield bond and leveraged loan markets. By clubbing together, private credit funds can provide significant levels of finance to large clients, while sticking within their individual credit ceilings."

Philip Smith is editor of *The Treasurer*

A FOUR-STEP PLAN

What should corporates that are looking to refinance their debt do? PwC suggests four steps to take to ensure they are not caught out when they come to refinancing their debt.

1. Act now and stay ahead

Businesses that are slow or late to act may reduce the options available to them.

As arrangements come up for maturity, refinancing should be agreed well before the next set of year-end accounts are finalised. This avoids the risk that uncertainty over future funding could make it difficult to sign-off accounts, but means preparations for refinancing may need to begin at least 18 months before current agreements mature.

2. Consider all the options

Understanding the funding options that are available and most appropriate is key. Consider a greater quantum from a different lender or different debt structure.

If revenues and profits are currently constrained, target asset-based lenders who will base loan approval on the value of debtors, plant, inventory and other assets, rather than solely on cash flows.

3. Have a credible business plan

Lenders will want to deal with any further shocks and uncertainty ahead by identifying the worst-case scenarios and mitigation plans. This includes detailed cash-flow forecasting, contingency planning, and demonstrating the ability to respond with agility and speed. The numbers and scenarios also need to be realistic and justifiable.

4. Prepare the story

Clear articulation of plans, funding requirements and trading performance are all hugely important to get lenders buy-in. It's become more apparent through COVID that it's not just a solid business plan that lenders need to back; it's the strength of the management team and the ability to adjust and adapt to situations. Good preparation ahead of lender meetings may be a clinching factor in securing debt financing.