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cutting through complexity

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Capital Letter

Capital Advisory Group

KPMG Capital Advisory Group comprises 70+ professionals who provide advice across the capital structure. In this first issue of the Capital Letter we consider some of the positives and the potential negatives from current debt market conditions alongside reviewing 2013 UK dividend trends. If you want to find out how we can help you, please contact us.

Taking the direct route

It can be argued that the debt markets have never been so benign since the credit crisis:

- Leverage is up;
- Pricing is down; and
- Terms are loosening.

Good news, right? Yes and no. We deal with the "no" separately, so let us focus on the "yes" for now.

Liquidity is brimming in the debt markets. The search for yield, low interest rates and the competition to lend and invest has created a market which many borrowers can take advantage of. The driving force of this positivity has been the prolific issuance in the bond market.

"So what?", one might say, "The bond market is not open to all and the banks are not as open as we would like". This is true, which is why the increasing profile of a select number of institutions, who have the appetite and capability to provide direct bilateral debt investment in US Private Placement or bond formats is so relevant.

Privately placed institutional debt is, of course, nothing new. However, the increasing focus of certain life and pension funds to bilaterally lend medium to long term fixed or floating rate debt is creating greater opportunities for companies to diversify their borrowings.

Flexibility in quantum, tenor, currency and interest rate benchmarks, coupled with historically low interest rates and a relationship driven approach can provide a compelling capability. Added to this attractive mix, is the absence of ancillary income requirements, so often a key requirement for banks. In short, such investors simply want to put their money to work.

But let's not get carried away. Such an option is not appropriate for, or available to everyone. The debt investor universe for such transactions remains small, for now. However, the pricing, terms and appetite for new opportunities that have been witnessed in recent transactions, strongly suggests that accessing this liquid section of the market is an option to be explored.

A real alternative?

No longer do businesses without access to the debt capital markets need to rely solely on the bank market for term funding. 2013 witnessed the steady rise of specialist credit funds looking to deploy capital across the balance sheet through a variety of senior, junior and whole loan instruments. Though 'unitranche' and mezzanine loans have been prominent in the sponsored (Private Equity backed) LBO market for some time, such funds are now turning to sponsor-less companies to increase assets.

What has driven this market evolution? In short, the search for yield, favourable supply and demand market dynamics and government support has fuelled the burgeoning number of funds and cash available. It is not uncommon to see funds clubbing together (and with banks) to provide facilities in excess of £100 million – without ancillary income requirements. As opportunities have increased, funds have become more flexible, more competitive on pricing and are giving all the signals that they are here for the long haul.

Are they truly here to stay? All indicators imply a "yes". Continued regulatory pressure on banks is unlikely to reduce funding costs for lending opportunities to SME's (despite

the recent amendment to the flagship Funding for Lending Scheme) and investors continue to seek yield. Funds appear to be balancing returns with meeting borrowers' needs and look on course to continue to raise capital.

So how accessible are these funds? Although access remains more likely for sponsored borrowers where yields are likely to be higher and sponsors seeking double digit equity returns provide comfort, funds are casting the net further afield. The desire to deploy capital and a traditional credit driven approach provides an attractive mix for an appropriate borrower.

Will we never learn?

When it comes to financial markets, we may forever be in a cycle of boom or bust. The amplitude and frequency of the cycles may vary but we seem incapable of learning from our mistakes. The world is recovering from severe financial crisis created by over-exuberant lending but it is doing so now on a diet of ridiculously cheap money and in the process creating flawed foundations that guarantee future problems. Across many of the world's major economies, returns on cash are negative in real terms, so cash chases yield. Yield comes in many forms but it also comes with risk.

Consider the following: leverage finance multiples in the US are nearly back to where they were pre crisis, yet around 50% of all this year's transactions have been "money out". In other words, debt investors putting in money to allow shareholders to take money off the table. "Covenant-lite" loans which offer fewer protections for lenders are back in the market and they already account for 55% of new leveraged loans[1]. Cov-lite loans are making up record levels in debt packages sold to investors. Sliced and diced collateralised loan obligations are back, some which permit up to 70% of their assets being in cov-lite loans. Elsewhere there are structures with PIK toggle notes, for the layman instruments where the borrower only pays interest when it can if it wants.

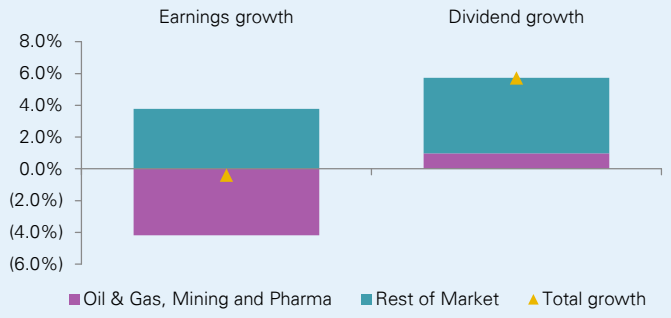
So we think the answer to our question is an emphatic "no, we will never learn".....but let us know if you disagree.

Source: [1]Financial Times

London market set for 6% dividend growth in 2013

Estimates of earnings growth for the FTSE All-Share have steadily declined through 2013 yet dividend growth has remained resilient. On the basis of consensus sell-side estimates for constituent companies taken from Thomson Reuters, aggregate 2013 earnings look set to be marginally lower than that for the prior year, which in turn was 4% lower than 2011. Dividends for the market for 2012 increased by 8% and the data is still showing a growth rate of almost 6% for 2013.

2013 estimated FTSE All-Share growth contribution



Source: Thomson Reuters, KPMG analysis

The earnings headwind

Earnings for Oil & Gas Producers and Mining stocks have deteriorated significantly over the past two years, as production declines, operational setbacks and the swing in the commodities cycle have all exerted significant pressure on profits at some of the UK's largest companies. In addition, we note that the Pharmaceuticals sector continues to face a stern test of its own as firms continue to navigate their way through patent expiries of blockbuster drugs whilst also dealing with an increasingly hostile regulatory environment. These three sectors are amongst the lowest rated by P/E in the UK market and, as a group, account for approximately 40% of profits[1] and 30% of the market's capitalisation[2]. In aggregate, they are expected to post a 2013 earnings decline of approximately 11%[3] but, given the strength of balance sheets and access to cheap borrowings, they are currently forecast to grow dividends by around 3%[3]. This is important for the health of the equity market overall at a time when investors are chasing yield.

Progress across other sectors

Elsewhere in the London market, Financials are expected to post earnings and dividend growth of 7% and 9%[3] respectively, while for the remainder of the market excluding Financials, Resources and Pharmaceuticals, earnings are expected to grow at 5%[3] and dividends by 6.5%[3] compared with 2012. The expectation that dividends will continue to grow reflects the strength of company balance sheets, relatively high levels of dividend cover and, to some degree, a lack of suitable investment opportunities. With this in mind, our insight into investor perceptions underscores the support for sustainable progressive dividends as part of a balanced capital allocation framework.

Source: [1]KPMG analysis [2] Bloomberg, KPMG analysis [3] Thomson Reuters, KPMG analysis

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