

Research Report:
**The rich get richer and the
poor get poorer**

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02

Is financial pressure on European companies decreasing in line with positive economic indicators in Europe, or is corporate financial pressure increasing despite an economic upturn in some parts of the EU? What effect are these trends having on financial managers to seek lower-cost alternative financing methods?

Key findings

- In Europe's three largest economies, sub-investment grade companies are coming under increasing financial stress, despite the general economic recovery.
- For these highly stressed companies, profitability has fallen dramatically, while debt burdens have not been substantially reduced.
- In contrast, financial stress amongst A-rated companies has been stabilised and profitability is rising.
- Sub-investment grade companies, in particular, are caught in an expensive debt cycle, and are eagerly seeking ways of reducing their interest costs through asset based lending alternatives such as invoice securitization and other means.
- Post LBO companies are another community under financial pressure, usually with a low rating because of their debt levels, seeking lower cost financing alternatives

Introduction

It seems that 2004 is plagued with scepticism about the nature, depth and sustainability of economic recovery in Western Europe. Germany, after an optimistic start to the year has slumped into a generally pessimistic outlook, although Reuters research showing a recent upswing in Eurozone manufacturing has provided a positive counterblast to the sceptics in Germany and France. The UK economy has grown 7.2% since 2001, more than the Eurozone rate of 3.2%, but less than the US at 8.4% (although America has had a recession and a major hike in unemployment). Nevertheless, rising interest rates – designed to curb inflation – are also watched fearfully by those afraid that they will dampen growth and/or cause a house-price collapse.

As equity finance all but disappeared in the early years of the new millennium, companies were forced to raise considerable levels of debt finance, in some cases rapidly followed by dwindling trading expectations from which they had to finance that debt (witness the Marconi ‘transformation’). Consequently, there is considerable suspicion that the burden of servicing this debt legacy is suppressing profitability growth. According to research released in June by Grant Thornton, “Despite demand spreading to nearly all areas of the service sector over the past quarter, firms are struggling to increase profitability significantly with price rises well below expectations.”

The depressed capital markets value of many organisations has led to another phenomenon – an upsurge of interest in MBOs and LBOs. It is the aggregated view of various research bodies that around €150 billion (in equity) of LBOs will have been concluded in Western Europe between 2003 and 2005. However, there is also rising competition amongst sponsors for LBO deals, leading to a downgrading of return expectations. At the same time, the cost of debt is expensive as companies that have been subject to an LBO often have their credit rating downgraded to sub-investment grade status precisely because they are carrying

so much debt. It is in everyone’s interest, therefore, that LBOs rapidly seek alternative finance for replacement or development capital soon after deal conclusion.

Rise of Securitization

The combination of debt legacy and expensive LBO finance, is leading an increasing proportion of financial managers to explore alternative, less costly lines of working capital finance. Securitization of corporate assets, which enables better-rated asset based lending to be raised from the capital markets, has come onto the radar of most financial managers. However, two factors slowed the take-up of the securitization option. The first off-putting factor was the well publicised abuse of Special Purpose Vehicles in recent accounting scandals, where some of the mechanics of securitization were used simply for balance sheet engineering, rather than true financing. Second, was the perception that securitization was complex, costly and would tie up insupportable amounts of processing time for internal financial teams, already under pressure from compliance with current or impending financial regulation.

Both these ‘problems’ seem to have been largely overcome in the minds of corporate financial managers, as witnessed by the strong growth of securitization in general, and invoice securitization in particular. Statistics from the European Securitisation Forum show that the whole European securitization market is expected to grow by 19% in 2004. Demica research earlier this year revealed that trade receivables (sale of receivables) are the most popular asset to securitise, that invoice securitization is expected to accelerate towards 2005, and that the principal driver for invoice securitization is financial stress. The reduction in costs to be made are considerable, since where security such as invoice debt can be put behind the borrowing, interest costs are often reduced to just 50-100 points over Euribor.

Trends in Financial Stress

In the light of all these factors, Demica commissioned research into the current state of financial stress amongst non-financial European companies in various rating bands. The study measured financial pressure in a model centred mainly, but not exclusively, around interest cover (the relationship between profits on the one hand, and interest payments on debt commitments on the other). The most recently reported year of results were compared to the previous year in order to see whether financial stress had increased or decreased. Change in financial stress was measured for European companies in different credit rating classes, amalgamating the main global credit rating companies systems into: A-rated companies; B-rated companies; and Sub-investment grade.

The picture that emerges from the research tells a story of polarisation. Financial Stress has increased for all rated companies in Europe. However, the increase has been absolutely marginal for A rated companies (3%), substantial for B rated companies (36%), and punishing for sub-investment grade companies (49%). The sound appear to be getting sounder, but the highly indebted, some notable exceptions apart are in danger of becoming terminal.

This research emphasises the importance and urgency for sub-investment grade companies at the very least to reduce their weighted average cost of capital through lower cost alternative finance such as securitisation. This also has an economic importance, in that further company failure, or just severe difficulty, could dent the confidence of the current recovery, certainly in continental Europe, and could even slow down progress in strong economies such as the UK.

European Companies

Financial Stress Trends – June 2004

	Financial Stress Index	Profitability Index
Credit Status	(100 = Average)	(100 = Average)
All rated companies	112	108
A rated companies	103	126
B rated companies	136	85
Sub-investment grade companies (below BBB-)	149	44

Conclusion

This report has revealed that the gradual overall economic progress in Europe is hiding the fact that financial stress is increasing amongst more indebted companies. The cost of servicing current debt commitments is becoming more of a burden, and trading improvements have not been sufficient to halt the increase in financial stress amongst B-rated companies as a whole, and sub-investment grade companies in particular. It is therefore imperative for these highly stressed companies to seek alternative, lower-cost financing options. Previous Demica research unveiled a growing enthusiasm amongst European corporates for invoice securitization, employed as a true finding tool rather than a piece of balance sheet engineering. Asset based lending capital finance is focusing on the invoice as the most effective security to employ to reduce interest costs. Growth is predicted to be strong and accelerating. Finally, market drivers of securitization are various, ranging from sheer debt burden, to market downturn, to realising value from LBOs.

Methodology

- Research base – Non-financial companies in UK, France and Germany with a public rating status from one of the international rating agencies
- Research period – May 2004
- Two indices produced, both comparing statistics from the most recent reported year (in most cases to end March 2004) with previous year:
 - Financial Stress
 - Model incorporating: inverse interest cover; revenue change; profitability change; etc
 - Profitability
 - Model centred on EBIT as a proportion of revenue
- Verification tele-research also conducted sample of research base for standard validation purposes

Third party research sources included:

- The International Securitisation Forum
- The International Federation of Stock Exchanges
- CIMA
- AMR Research
- The Bank for International Settlements
- Central banks in major European countries
- KPMG
- PricewaterhouseCoopers
- TowerGroup
- Bloomberg
- Standard and Poors
- Moodys
- Fitch

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