

# THE CREDIT CRUNCH: WHEN WILL LIQUIDITY RETURN TO THE MARKET?

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**Research suggests that the illiquidity characterising the international finance markets looks set to impact deal structures for the foreseeable future, say Tomas Gårdfors and James Dunnett of Norton Rose's European banking practice**

Are we seeing the correction that the European leveraged market was waiting for, albeit from an unexpected angle? While many commentators wondered whether a series of high profile defaults would have an impact on the buoyant leveraged finance market, no one expected that liquidity issues would have

a potentially more significant effect.

The ripple effect of the US sub-prime mortgage crisis is reaching far and wide. In Europe, the retreat of some institutional lenders from the syndication market and a general lack of liquidity mean that not only are arrangers reluctant to take on new leveraged debt, but some seem to have closed their books entirely.

## **Borrower terms**

In the last couple of years, the European credit markets have seen a surge in available liquidity, with lenders conceding ever more borrower-friendly transaction structures and documentation: second lien has pushed down returns on mezzanine lending whilst seeing increasing risk in the capital structure; prior to the third quarter of 2007 financial covenants allowed for more generous cure rights; and, as lawyers in Iberia will have seen, in 2007, 'covenant-lite' deals emerged in Europe.

What changes in transaction structuring and documentation will now have to be made to get deals done? To gain an insight, we interviewed over 100 banks, investment banks, private equity houses, corporates and hedge funds active in the leveraged finance market.

Our survey confirms some expected views, while also raising other interesting results. It will come as no surprise that respondents believe that leverage levels on deals will come down. Equally, almost 90% of respondents believe that the current turmoil will affect the pricing of debt, indicating higher pricing levels and the disappearance of 'reverse flex' – the ability of loan arrangers to reduce lending margins on syndication.

At present, around two-thirds (68%) of the respondents believe that it will take more than nine months for the market to find its way back to July 2007 activity levels, with 45% specifying twelve months as more likely. The recovery of the market will see a greater focus on financial covenants: while over half

(52%) believe covenant cure rights will remain standard, almost all (92%) are convinced that covenant-lite clauses will not return in the foreseeable future, and 85% believe that financial covenant 'mulligans' (where a fund may be forgiven its first default on a financing covenant) are unlikely to appear in new deals.

## Uncertainty

With lenders no longer experiencing the liquidity they had become used to, structuring of leveraged deals will be different. It is also interesting to see that the inability of lead arrangers to sell down debt seems to be combined also with a different concern: whether deals have sufficient credit quality. Over nine-tenths (91%) of respondents believe that, when the leveraged market does pick up again, it will mean a revival of the amortising A tranche and more than three-quarters (78%) say that it is likely, or indeed very likely, that the A tranche will increase relative to non-amortising B and C tranches.

El efecto dominó de la crisis sub-prime norteamericana está afectando a lo largo y ancho del mundo. Los estudios sugieren que la falta de liquidez característica de los mercados financieros internacionales parece que pueden llegar a afectar a la estructura de las operaciones en un futuro próximo, afirma Tomas Gíærdfors y James Dunnett del departamento financiero europeo de Norton Rose.

In uncertain times, people have less appetite for riskier debt. More than two-thirds (68%) say that less use of 'payment in kind' (PIK) loans is likely, or even very likely, in the immediate future. Equally, with 46% of

the respondents believing that second lien will still be used in capital structures, it seems that simpler, more traditional structures will be preferred.

Leveraged debt will be made available on certain funds terms in new deals coming to the market according to 71% of the respondents. However, the ability of sponsors to meet tight vendor deadlines is questionable: 89% of respondents agree that it is likely, or very likely, that the use of interim loan agreements and funded term sheets will decrease or disappear.

The credit crunch is also expected to see greater focus on the terms of documents: 83% of respondents believe that we will see less commoditisation of transactions. As a result, it looks like clients will be looking increasingly to bespoke financing arrangements, and placing greater emphasis on their lawyers to help them do so.

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