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Debt Market Snapshot: Potential Implications for UK PLC

Mike Beadle, Head of Debt Advisory, Numis

March Madness: The central banks moved fast and things broke

Cast your mind back a month: bond yields and credit spreads were finally falling, interest rate expectations were stabilising and the European leveraged finance market was getting back on its feet. Since then, as Ferris Bueller said,

> ***'Life moves pretty fast; if you don't stop and look around once in a while, you could miss it'.***

	20 Feb	20 Mar	Change
Swap-implied BoE base rate Aug-23	4.41%	4.12%	-0.29%
10-year gilt	3.47%	3.31%	-0.16%
£BBB yield	5.71%	6.00%	0.29%
£HY yield	9.05%	9.86%	0.81%
Itraxx Crossover CDS index	409bp	500bp	91bp
Euro Bank Contingent Capital index yield	8.34%	14.10%	5.76%
Number of banks named 'Silicon' or 'Suisse'	2	-	(2)

So what happened? No.1 and no.2 are a hopefully jargon-free account of the past 10 days – but if you've read or listened to enough then feel free to skip to no.3, which is the "so what?".

Silicon Valley Bank blew up

As a debt adviser, we liked Silicon Valley Bank (SVB): the European and US teams were knowledgeable, entrepreneurial and keen to lend. SVB seemed to be riding the collapse in venture capital (VC) valuations surprisingly well and was still expanding its banking team in Europe.

But it turned out its management had badly let down its staff on the ground: with an excess of large deposits from its tech clients, SVB struggled to find lending opportunities and instead opted to park its cash in US government-backed securities – but crucially decided to chase higher yields from longer-dated bonds.

As market interest rates rose, these longer-dated bonds fell in value. SVB had classified these bonds as 'Hold To Maturity', which avoided recognising the mark-to-market losses in its shareholders' equity – since the bonds would always be paid back at par at maturity. Due to a 2018 quirk in US banking regulation, SVB was lightly regulated and allowed to ignore $15bn of mark-to-market losses in its capital adequacy ratios, which would otherwise have made it insolvent.

However, SVB was also exposed to interest rates on its liabilities: higher rates led to reduced fundraising for VC / tech firms, requiring them to draw down deposits to fund operating expenses. To meet this demand for cash, SVB was forced to sell its bonds and realise these unrecognised losses.

Eventually, on Wednesday, 8th March, SVB announced it had sold $24bn of US Treasury bonds, realising losses of $1.8bn and announcing a non-underwritten equity raise via Goldman Sachs of $2.25bn (spoiler: this didn't go through).

In response, SVB's share price plummeted and its remaining depositors ran for the exit, getting jammed in the doorframe. This was compounded by the connectedness of its depositors: notionally fragmented, it turns out that via a few WhatsApp groups, its depositors comprised a unified herd.

$42bn was withdrawn on 9th March, which is by far the largest ever US bank run. The US government stepped in to cover all $150bn of uninsured deposits and take control of the bank.

Meanwhile last year, SVB's UK business became separately incorporated in 2022 (with its celebration party being cancelled after the Queen died), which meant that SVB UK was pretty much on its own – as was intended after the Lehman US / Lehman Europe mess in 2008.

HSBC rode to the rescue dressed as a white knight, swooping to buy SVB UK for £1, although we understand it has since pumped in many £billions of liquidity.

Over in the US, home of the rapid and much-envied Chapter 11 bankruptcy process, the authorities are *still* trying to sell SVB and the latest is that Silicon Valley Financial Group is currently in court trying to get $2bn from its accounts at SVB.

For good measure, the US also bailed out depositors in Signature Bank, which was similarly bust. We should also mention some more crypto-oriented banks that have either imploded (Silvergate) or are in trouble (First Republic). The US system is trying to calm depositors' nerves with a variety of measures, including repeated showings of *It's A Wonderful Life*.

Credit Suisse blew up (again!)

I've written many times over recent years about Credit Suisse's self-inflicted wounds: Greensill, Archegos, Tuna bonds and heated disputes between board members. It is incredible to think that 15 years ago, Credit Suisse was probably the leading European investment bank.

After SVB reminded everyone about bank risk, investors surveyed the US and European banks and came to the clear conclusion that Credit Suisse was by far the weakest bank standing, and started to sell – its share price falling by 20-30% a day. Credit Suisse's funding costs were escalating and deposits were flying out of the door. Just to add to its woes, its annual accounts had to be delayed due to a 'material weakness' in reporting.

By Friday last week, it was clear this couldn't continue. The only question was how would it end? UBS had risen like Lazarus since it almost collapsed in 2011 and didn't want Credit Suisse's array of toxic risks. The Swiss government didn't want to own its national champion, but Credit Suisse's plan to spin off its investment bank was planned to take *two years.*

And over the weekend, it was all over: UBS agreed a CHF3bn deal to take over Credit Suisse, apparently providing UBS with CHF45bn of equity (negative

goodwill!). The Saudi National Bank spent $1.5bn to buy 10% of Credit Suisse only three months ago – memorably describing one of the largest single investments into a European bank in recent years as '*just another cheque*'.

In the process, the Swiss National Bank used the T&Cs of some of Credit Suisse's debt to write off $17bn of '*contingent capital debt*', even while the shareholders weren't zeroed. This drew gasps from bond investors and criticism from the Bank of England (BoE) and the European Central Bank (ECB) (even though this was flagged as a risk factor in the bond prospectus).

So what?

SVB: If you banked with SVB UK then you are now with a highly-valued but non-guaranteed subsidiary of HSBC. For now, it's 'business as usual' but it's not clear how it plays out in the medium term.

- Mid-market corporates: HSBC already has a good lending and commercial banking presence here and while SVB may give it a small number of new relationships, there is probably a lot of overlap – and HSBC will be required by regulators to consolidate all *group* credit exposure to corporate clients. We expect HSBC to reduce its aggregate hold back towards the levels of other lead banks – not immediately, but most likely in 1-2 years (probably when the next refinancing takes place).
- SME tech: SVB had a great reputation and presence in smaller tech clients. The challenge for HSBC is to be nimble and embrace a segment of the market where its risk appetite has previously been limited.
- Venture capital funding: SVB's loan book was 60% to venture capital funds, enabling them to smooth their calls on investors capital through 'subscription lines'. HSBC has limited activity in this market in Europe, as it can't be done inside the UK ring-fenced bank. This comprises perhaps half of the total £5.5bn loan book that HSBC acquired, so this may provide a great platform.

Credit Suisse: Not many of our corporate clients borrowed from, or banked with, Credit Suisse. It had been for many years the leading European leveraged finance underwriter, but this had vanished in recent years. Credit Suisse was still a leading market maker, until other banks got too nervous to deal with it last week. Its M&A franchise was also diminished. And in fact, all of the above could apply to UBS. Honestly, the direct impact of the failure of Credit Suisse on UK mid-market corporates is limited.

AT1 meltdown: The unexpected write-down of bank capital bonds could have a big indirect impact on bank lending if it means more ordinary equity, which is more expensive than these bonds. The ECB and BoE are trying their best to dampen this down by reinforcing their view that bank capital bonds are more senior than equity. I don't love these 'bonds': at best, they convert to equity when bank capital is too low and at worst, they are written off. They attempt to be debt to investors and equity to regulators / tax authorities – which means that neither are happy (but the regulators will always win). Normal convertible bonds have downside protection and upside participation – these have neither.

Refinancing: Given heightened financing risk, we recommend borrowers consider refinancing earlier and ensuring the credit proposition is structured as carefully as possible so that banks have a straightforward and compelling lending case to consider. This may require more pragmatism on some terms to achieve the key objectives, such as liquidity or acquisition flexibility.

M&A: The debt financing markets had steadily been improving since the doldrums of 2022, but this turmoil will make banks more cautious about underwriting new debt deals, particularly for highly

leveraged private equity deals – this could well advantage bidders making more use of equity, such as listed corporate buyers. For example, despite being a stalwart of the leveraged finance market, INEOS yesterday pulled its €820m-eq term loan financing for its MBCC Admixtures acquisition. If leveraged finance markets pull back, private credit funds will become even more prominent for sponsor-led deals and we'll see more club financings like Ideagen, where Bridgepoint, Five Arrows, Hayfin and Partners are financing Hg's take-private and further M&A. For a deeper dive into recent M&A trends, read our latest research, An Inside-Out Study of UK Mid-Market M&A.

Interest rates: There may be one or two interest rate rises left for each central bank, but the extra 1%pt is off the table. US markets are even pricing in 50bp cuts this year, which also seems unlikely. More likely is that rates continue at the 3.5-4.5% level – which is still the highest since 2008.

Counterparty risk: Corporates face four sources of credit risk from their banks: (1) deposits; (2) ability to fund undrawn commitments; (3) ability to honour derivative contracts; and (4) ability to provide services, such as operational cash banking and other agency. Corporates need to monitor these risks, looking at market signals such as equity and CDS prices, as well as qualitative factors such as credit ratings. We also expect to see even more people switching from bank deposits to money market funds. More corporates may add a back-up operational bank.

Diversification: SVB serves as a reminder that banks need a diversity of both liabilities and assets; the read-across for borrowers is maintain access to as many forms of debt as possible, and keeping options open with potentially willing lenders. More broadly, borrowers should be careful of schemes such as bank-provided supplier finance, which concentrate funding risk, changing multiple and diverse trade creditors to a single bank.

Legal entities and obligations matter: As debt people, we are always focused on which entity is making which promises, but often (particularly in equities) the inner workings of groups is not normally significant. When things go wrong, contractual details matter – SVB UK vs US, AT1 bond write-down, the fine details of guarantees.

As ever, we're happy to share what we're hearing from lenders and investors and to give views on how best to approach debt financing in turbulent times.

Contact us

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