WHITE PAPER:
What opportunities for borrowers does the current low rate environment present?

You’d have to have had your head well and truly buried in the sand recently to have missed the recent spate of record setting low cost funding deals hitting the headlines. With long term interest rates plummeting, investor demand still high for long term fixed rate debt product, and banks increasingly able to transact longer maturity hedging on favourable terms, it seems quite clear that long term borrowers have never had it so good. The current low rate environment presents a number of compelling opportunities for borrowers which are explored in this blog piece, but first we review the recent movements in long term rates and consider how borrowers should go about assessing the opportunity that this presents.

How much lower can rates go?
The 30 year gilt yield is currently trading at a near record low level of around 2.08%. Having already plummeted by over 130bps (!) in the last 6 months, an obvious question to ask is how much lower can rates go? The answer to this question is (at least in theory) “much lower still”. This is evident from looking at rates in other currencies, for example the yields of German and Swiss 30 year government bonds which are currently trading at around 0.94% and 0.34% respectively (in fact, 12 year Swiss government debt has been trading at unprecedented negative yields in recent weeks). While the dynamics of the UK rates market may differ significantly from that of Germany and Switzerland, it is clear from this analysis that the lower bound to rates is some considerable way below where gilt yields are currently trading:

As it will never be clear to anybody where rates are headed or whether the market has reached a turning point, we find it more informative to assess currently available borrowing and hedging rates on an absolute basis in the context of the business plan by asking the simple question “would we be happy to lock in this borrowing cost for the next X years?” For example, it is difficult to see how locking in a long term fixed
borrowing cost of 2.2% (as housing association Fortis Living recently did in a 30 year amortising loan deal from EIB), can be viewed as other than a “no brainer” funding strategy for its business. We would encourage clients to test the impact on their business plan of locking in long term funding levels at current levels as this is likely to generate meaningful improvements in forecast financial performance relative to the assumed level of borrowing costs or LIBOR which may now seem extremely conservative (we have provided some realistic figures below which clients can test in their plans).

What are the opportunities for borrowers?
The most obvious way to (fully) lock into current interest rates is to issue a vanilla bond or private placement. Richmond Housing Partnership last week became the most recent borrower to smash the housing sector record by issuing a 30 year bond at a coupon of 3.3%. However, this “pre-funding” approach often has the drawback of substantial early years negative cost of carry which can be quite off-putting for borrowers (albeit our calculations usually demonstrate that cost of carry often doesn’t amount to more than around 15-20bps in 30 year yield terms, which in the current rate environment might be just a few day’s market movement!). Aside from the vanilla bond/PP route, below we consider four other ways that we see for borrowers to lock into interest rates at current levels:

1) New interest rate hedging: we have recently seen renewed interest from banks to enter into interest rate swap agreements (standalone or embedded into loans) out to 15 years at very tight spreads from mid-market. Mid swap rates against 1 Month LIBOR at 5, 10 and 15 year maturities are currently trading at around 1.05%, 1.3% and 1.5% respectively. Although hedging in this way does nothing to mitigate borrowing spread risk, it is usually by far the most quick and easy way for borrowers to lock into historic low term interest rates. We have recently assisted a number of clients whose debt is already c70-80% hedged look to take advantage of the current market by increasing hedging levels into the 90-100% range, which in our view currently merits serious consideration as the downside of being “too fixed” (i.e. deflation exposure) is clearly reduced as rates move lower. The premium for entering into 1-5 year forward starting swaps relative to spot starting swaps has also fallen by over 50% in the last year.

2) Deferred funding arrangements: these structures have become increasingly mainstream with a number of investors now offering substantial deferral periods at borrowing spreads broadly in line with vanilla PPs. As long term rates have plummeted thus flattening the yield curve, so too have forward gilt yields off which deferred debt structures are priced. The forward yield premium for 1-5 year deferred deals has also fallen by some 50% over the last 6 months, although clearly over the same period the cost of carry spread on a vanilla bond issue has fallen significantly. Assuming a borrowing spread of 150bps, borrowers could now fully lock in funding costs in a 4 year stepped deferred structure (with even drawdowns at start of year 1-4) at around just 3.70%, with no associated cash cost of carry. The forward gilt yield premium in this example structure is just 11bps, while a year ago was around 25bps. When evaluating cost of carry, whether in the traditional sense or as a deferred funding premium, borrowers should take account of how much it has reduced over the last year as this may make prefunding and deferred funding strategies now look significantly more appealing.

3) Shelf facilities: these (usually) uncommitted arrangements allow borrowers to issue long term fixed rate debt in small size at very short notice (as little as 10 business days). As borrowers generally also have the ability to issue tranches of debt at a range of maturities (usually 10-40 years) under the agreement, we view this as a potentially valuable weapon in the treasury armoury which can significantly enhance borrowing flexibility and ability to rapidly respond to market conditions. The market for this product is also developing and we are aware of investors who are now prepared to offer shelf facility arrangements to any borrowers rated A3 or better, with initial and subsequent drawdowns of £15m and £5m respectively. We are also aware of investors prepared to offer committed shelf arrangements where borrowing spreads are agreed up front in return for a commitment by
the borrower to fully draw the facility over an agreed period (of say 24 months)

4) Callable swap restructuring: As rates have plummeted, so too have the values of callable options embedded in swap agreements which many RPs put in place with banks (as rates move lower, the value to the bank of being able to cancel the swap becomes less). As option values could have fallen by 75% over just a few years, this presents the opportunity for borrowers to exit these structures at record low cost (this can generally be achieved by agreeing with the lender to remove the cancellable options in return for increasing swap rates by 10-30bps, clearly dependent on the nature of the option structure). This opportunity is also a function of the very low level of interest rates and so a way of capitalising on the current market opportunity.

Centrus is happy to initially assist borrowers with assessing whether any of the above treasury strategies would be suitable in the context of their business plans and treasury strategies.

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