“An unprecedented rise in interest rates"

There's more than one challenge lurking in corporate finance right now. Interest rates, for example, are climbing faster than ever. SMEs might therefore consider alternatives to bank loans, says Johannes Schmittat of Houlihan Lokey.

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By Heidi Rohde, Frankfurt

Rarely have companies had to cope with such a toxic mix when it comes to financing. The war in Ukraine, soaring energy and commodity costs, and global supply shortages that require unfamiliar inventory management and thus higher working capital. All this means that in many cases companies have to maintain a significantly higher liquidity reserve than has been the norm for years. From December to March, the credit volume of German companies swelled by 33 billion euros, even setting the previous record in the first quarter of Corona Year 2020.

At the same time, banks are also "taking a much closer look at what and who they are financing" when it comes to lending, given the crisis-ridden environment, stresses Johannes Schmittat, head of corporate clients in Houlihan Lokey's debt capital markets team. "In principle, software companies with stable revenues can still get easy financing. Anything that has to do with retail or with combustion engines becomes more of a problem." Liquidity procurement is also difficult for companies that still have remaining business partners in Russia and may have to compensate for payment defaults.

In view of the interest rate turnaround, however, the question for many is not only how much liquidity they need. "Recently, more important is also how much interest burden a company can actually afford," says Schmittat. After all, the jump from virtually zero to at times more than 2% in midswap rates in the three- to five-year range is "an unprecedented rise in interest rates in the Euromarket" within such a short time, as the expert estimates. "That's when forgotten ratios like the interest cover ratio suddenly come back into fashion." This has not yet found its way back into standard covenants, he says. "But that could come soon."

Hedging comes into fashion

Another instrument that was virtually never needed during the zero interest rate years is also reappearing on the radar: the rapid rise in interest rates in the medium-term range is fueling fears of levels that will be difficult to sustain in the future. For this reason, hedging is also definitely once again an instrument "that companies should think about." Although it is also conceivable that inflation will subside in the foreseeable future and that the central banks will be able to avoid further, stronger interest rate hikes, "only those who can afford it should speculate on that," says Schmittat.

In any case, he says, every treasurer would be well advised to check the maturity profile of liabilities and refinance at shorter maturities. The expert believes it is conceivable that banks will also "reach the limits of their balance sheet capacities" if demand for credit remains strong. While the bond market is open to large corporations with the appropriate rating quality, as are a large number of debt funds, the situation is often different for SMEs. It could become tight for companies in the "non-investment grade" segment, because the "high-yield market has been virtually closed for months.”

However, Schmittat observes that debt funds in particular are significantly expanding their radius and can also become a real alternative for many SMEs. "The funds have broadened their teams, so that you can now also talk to them in German," he emphasizes. A criterion that should not be

underestimated for a conventional medium-sized company, he adds. Financing through debt funds is particularly interesting "if the company has an interesting story to offer, for example if capital is needed for a takeover," says Schmittat. This is also generally worthwhile for companies if the loan can be repaid quickly.

Basically, the expert assumes that small and medium-sized companies that are not considered "investment grade" by the banks will increasingly have to turn to alternative financing instruments. There will "certainly be a strengthening in subordinated loans." Mezzanine lenders had already recognized the opportunities of the crisis during the Corona pandemic. The number of lenders active in the segment is growing, and mezzanine has so far become a standard especially in real estate financing.

ESG merely a hygiene factor

In the case of such subordinated loans, what has become a "hygiene factor" elsewhere, as the growing market for green bonds shows, does not yet play a role: the link to ESG criteria. Schmittat points out, however, that "ESG ratings are relatively on the decline." Instead, loans are "often dominated by freely agreed ESG performance metrics," he knows. So far, the manager has not been able to identify any significant influence on credit costs.

One difficult customer group in terms of debt financing is young technology companies, to which numerous lenders had turned during the past record-long low-interest phase, so that ample equity capital was available. Classic bank loans are hardly an option for start-ups "unless they have assets as collateral or at least annual recurring revenues," says Schmittat. Venture debt is an alternative for some, but an expensive one. "That usually involves interest rates of 15 and more."