



ALIGNING CAPITAL WITH STRATEGIC PLANS IN A MIXED MARKET

By **Steve Woods**, EVP and Head of Corporate Banking | Published November 2023

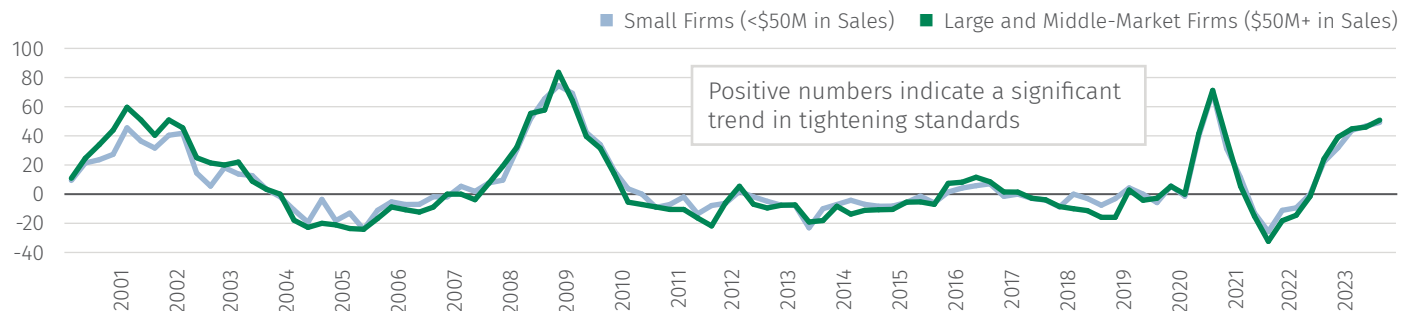
Why it Matters

- Higher interest rates – and the cost burden they impose – are driving a cycle of deleveraging and cash conservation at many companies, though some would rather be investing for growth
- At the same time, tighter lending standards are dampening credit availability as well as prompting higher loan pricing, higher fees and the increasing importance of existing banking relationships
- Managers are balancing the need to offset higher interest expenses and lessened credit availability while also addressing competing demands for strategic capex or M&A
- A mindset of financial flexibility can help companies align their capital with their strategic plans even in tighter credit conditions

For middle-market companies, financial priorities can be obvious in extreme environments. As a downturn sets in, it's about preserving liquidity. In times of recovery and growth, it's about investing. But in mixed market conditions, financial priorities are murky. Managers may need to deleverage and cut costs to lessen the burden of higher interest rates, but they must also weigh investments for the future. Meanwhile, credit is less attainable (or terms and conditions are less favorable) as lending standards tighten.

LENDING STANDARDS TIGHTEN ACROSS DOMESTIC BANKS

Net % of Domestic Banks Tightening Standards for Commercial and Industrials Loans to:



Source: Federal Reserve Bank Senior Loan Officer Opinion Survey on Bank Lending Practices

If financial priorities are unclear, the mixed market conditions are partially to blame. As interest rates rose, business managers struggled to forecast what would come next – something that even policymakers and futures markets have grappled with. The specter of a recession could still materialize in response to the cumulative effect of higher interest rates and softening demand – or the economy’s growth could continue on, supported by a robust job market, strong consumer demand, and easing inflation.

High interest rates and the deleveraging cycle

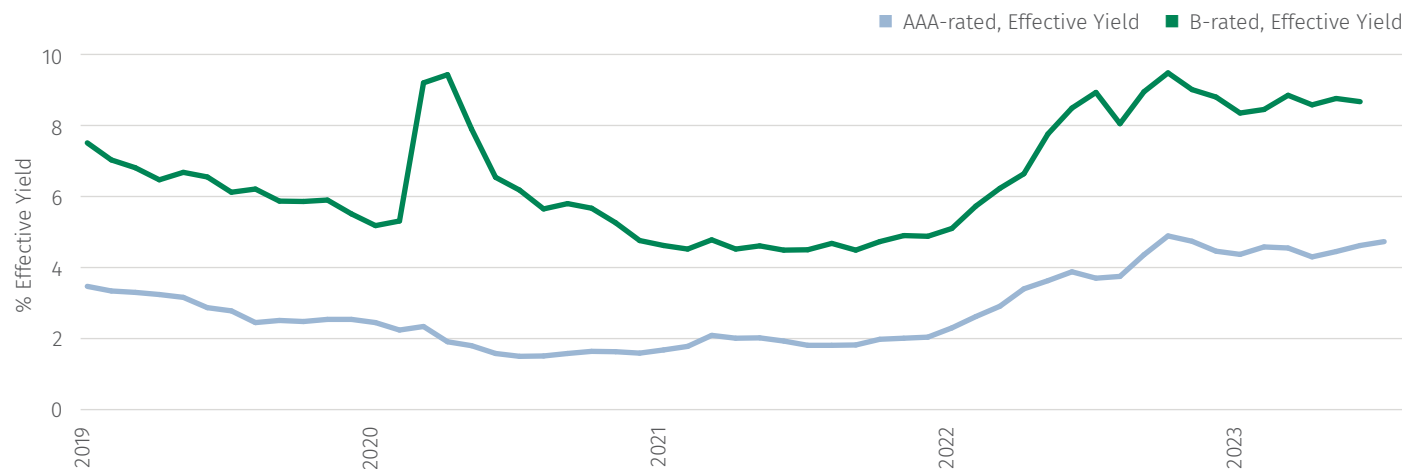
These conditions pose an unclear path for the interest rate cycle. If a recession materializes, rates could retreat. If it doesn’t, rates could stay steady or even go higher,

depending on inflation trends and the Federal Reserve’s (Fed) view. Companies who are waiting for clarity on rate trends may miss the opportunity to support their strategic goals in the present.

Higher rates have already prompted a deleveraging cycle. With steeper costs to issue new debt or refinance, some companies must consider measures to reduce liabilities in an effort to contain interest costs. Meanwhile, one of the typical cost-cutting strategies – cutting back on labor – is risky for many companies. After facing labor shortages during and after the pandemic, managers are wary of paring back staff, reflecting the tight labor market.

THE SOARING COST OF REFINANCING DEBT

Cost of Bonds Has Nearly Doubled for Corporates Since Pre-Pandemic



Source: St. Louis Federal Reserve Bank

At banks, clients use less credit while lending standards also tighten

Banks have seen another angle of the same trend. Middle-market companies that rely on lines of credit for working capital and capital expenditures (capex) are pulling back somewhat on their line utilization. They are deleveraging by prioritizing working capital assets (or collecting accounts receivable more quickly and reducing inventory positions), while also focusing on reducing interest expenses. Fortunately, credit quality has remained steady, by and large, as companies make financial tradeoffs to keep their income statements and balance sheets in good condition.

Tighter lending conditions also play a role. In the Fed’s surveys of senior loan officers, an increasing share of banks have reported tighter lending conditions. Higher fees and pricing are the norm, and companies increasingly find that they must move deposits or increase other ancillary banking business to appeal to banks. It’s also an environment where it’s not just about credit pricing – it’s also about the relationship. As banks become more sensitive to their loan-to-deposit ratios, some may be hesitant to underwrite any loans that are not accompanied by additional deposits or strategic relationships. Companies may find that they need to commit additional deposits to a bank if they aim to secure a new loan.

The mix of priorities companies are balancing

As companies navigate this murky environment, three priorities stand out in market trends.

1. Looking for strategies to manage (or offset) higher interest costs

According to an October 2022 report from the [Kroll Bond Rating Agency](#), 16% of mid-market borrowers could struggle with interest payments with a federal funds rate of 5.25% - a rate it indeed hit in spring of 2023. But the matter is pressing for all companies, not just for borrowers with shakier finances. With elevated interest costs, many companies must look at other expense line items to offset.

This environment also represents the first credit cycle for an emerging generation of managers. After more than a decade of low rates, newer companies and younger leaders are contending with higher rates for

the first time. They are exploring strategies to manage an era where working capital and capex come with a higher price tag.

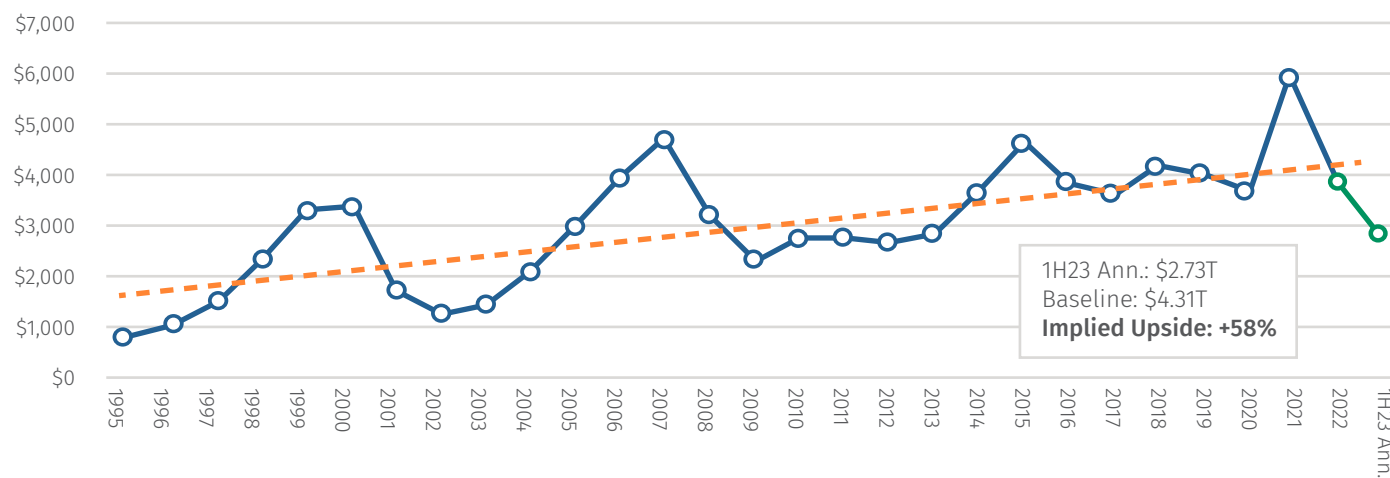
2. Still considering M&A as a path for growth

M&A activity did slow considerably amid tighter lending standards, dampened valuations and uncertainties about the broader economy – yet growth-by-acquisition remains a priority in the marketplace. In the [2023 M&A Outlook: Second Half Perspectives](#), Citizens' M&A experts noted that more early-stage deal discussions were emerging compared to the first half of the year.

As far as sellers go, some middle-market companies may find themselves looking to divest non-core businesses to fund core-growth acquisitions. Among buyers, there could be increasing urgency among private equity firms to resume dealmaking after a period of low activity. PE firms face expectations from their investors that they will put committed capital to work, regardless of the market environment.

M&A TRENDLINE SUGGESTS PENT-UP DEMAND

Global Announced M&A Trendline \$B



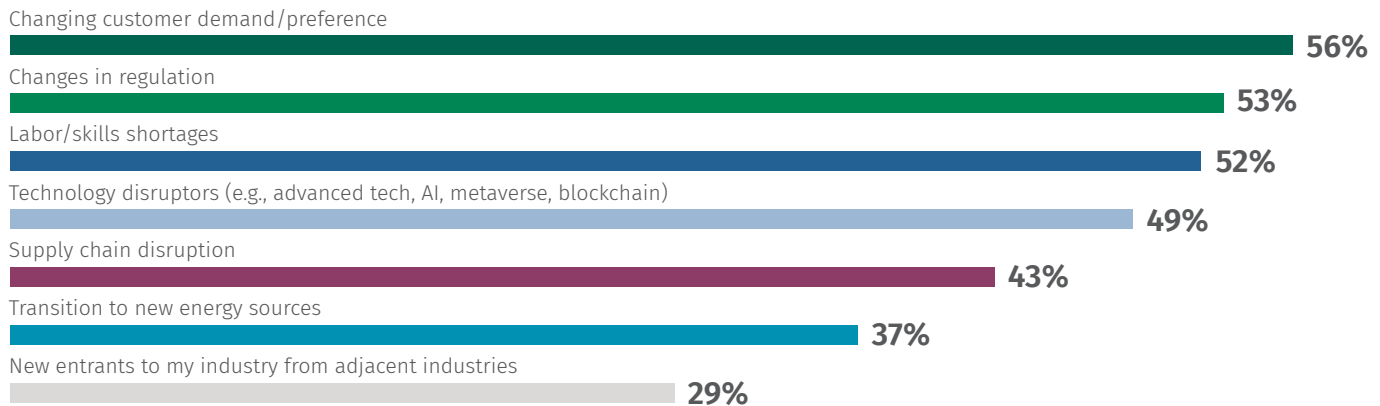
Source: Citizens 2023 M&A Outlook: Second Half Perspectives

3. Aiming to make strategic capex investments

According to a May 2019 article by [McKinsey](#), capex spending was one hallmark of the “through-cycle outperformers” in the financial crisis of 2008-09 and the recovery that followed. McKinsey’s analysis revealed that outperforming companies escalated their capex by 90% during the recovery, compared to a 25% increase among peers.

Indeed, the timing of capex is a strategic decision for companies, and some middle-market leaders are actively pursuing upgrades and investments. Some are looking to invest in automation. After the labor shortages they faced during the pandemic – and the continued tightness in the current labor market – many are taking the long view on the investments that will streamline their operations.

CEOS ANTICIPATE CHANGING CUSTOMER PREFERENCES, CONTINUED LABOR SHORTAGES



Source: 2023 PwC Global CEO Study

There's also the matter of changing customer preferences. This is the number one issue that CEOs cite as a threat to profitability in the next 10 years according to a January 2023 study by [PwC](#). As technology disrupts old consumer patterns, companies across sectors are looking for ways to use capex to stay ahead of peers in meeting the shifting demands of their buyers.

Restoring financial flexibility

Capital priorities are clashing at the moment. M&A and capex spending drive the need to finance or source new capital. But higher interest costs pressure companies to buckle down on expenses and preserve cash flow – a powerful trend prompting a broader deleveraging cycle among companies. For others, the tighter credit conditions are a stumbling block.

Academic researchers have found evidence for a theory of financial flexibility when it comes to capital management. Whenever firms take on more leverage, they prefer to deleverage in the following quarters or years so they have room in their credit lines to ramp back up as opportunities arise. What goes up must come down, so to speak – and in the case of debt levels, companies deleverage in order to restore their debt capacity for the next phase.

These dynamics are at work today. As leaders balance higher expenses, including interest expenses, with pressing strategic investment choices, we see them pursuing flexibility and readiness for whatever comes next – while still acting with caution in the near-term.

How to align capital with strategic priorities in a mixed market

Companies can consider these strategies and tactics to help find the right balance between investing and deleveraging in murky market conditions.

- **Stress-test cash flows.** Higher interest costs suggest that companies have lower interest coverage ratios. Amid economic uncertainty, companies could encounter liquidity risks and cash flow shortfalls quickly. Consider scenarios that could hamper liquidity and assess what the outcomes would be. Running 13-week cash flows on a continuing basis is a “best practice” among many middle-market companies.
- **Trim inventories where possible.** When working capital is more expensive to fund, it's in every company's interest to streamline their working capital. De-inventorying could pose an opportunity to trim working capital levels.
- **Stay on top of receivables.** Receivables are the other obvious place to look for opportunities to tighten up working capital. By shortening timelines on receivables and/or lengthening payable timelines, companies can generate some incremental working capital without encountering costs.
- **Scrutinize financial operations and consider outsourcing for less-efficient processes.** Periodic housecleaning can uncover places to trim expenses – or in some cases, to outsource. For instance,

certain companies can outsource collection of receivables or processing of payables for some operational improvement.

- **Consider capex geared toward automation.** With continued tightness in the labor market, companies may see extra relief from directing capex toward automation – not just in cost savings, but in lowering the need for specialized labor to fill critical roles, a burden that could continue given the demographic mix of the workforce.
- **Be creative about securing new bank loans.** With extra pressure on their loan-to-deposit ratios, banks are more likely to consider new loans that also come with new deposits.
- **Consider risk-management strategies.** Every company faces different risks, and a hedging strategy may be appropriate for those who face foreign exchange rate or interest rate exposures in particular. Layering in fixed-rate debt on longer-term maturities with variable-rate debt for debt that can be prepaid early is also a good hedge against interest rate exposure.



Steve Woods, Executive Vice President and Head of Corporate Banking, is responsible for Citizens' nationwide coverage business efforts for clients within the Middle-Market, Large Corporate, Franchise Finance, Asset-Based, Not-for-Profit and Professionals Banking line of business units.

**For more information about all our offerings and services,
please visit citizensbank.com/commercial.**

CORPORATE FINANCE | CAPITAL MARKETS & ADVISORY | TREASURY & RISK MANAGEMENT