

Fragile equity markets have made corporate bonds attractive to investors. Former fund manager Jonathan Hourigan explains how the markets work and where the opportunities lie for issuers.

## UK LAGS ON CORPORATE BONDS

**IT'S A SIGN OF THE TIMES**, I suppose, but it seems like the only thing that matters in global economics these days is Fed-watching. In the UK we're equally obsessed with monitoring the every move of the Monetary Policy Committee and the European Central Bank. And if interest rates are at the very heart of modern economic policy-making, the best place to observe their influence is in the global bond markets.

Bond markets originally developed to trade government debt. State borrowing remains dominant, accounting for more than half of the \$36 trillion of debt securities issued and still outstanding within the advanced economies. The vast majority of government debt is issued within domestic capital markets and the largest single issuer is the US.

While monetary authorities determine the official, short-term interest rates, the global capital markets determine interest rates as they extend across the various currencies' yield curves – from short-term money market instruments to 30-year government and private sector bonds. The markets accommodate a huge range of securities, with numerous variables including issuer creditworthiness, and interest rate structure. Innovative capital markets practitioners are devising ever-more sophisticated interest-bearing instruments and strategies for both issuers and investors.

### UK CORPORATE BOND ISSUES IN 2001

SECTOR	AMOUNT (\$M)	ISSUES
Industrials and conglomerates	2,831	2
Airline	357	1
Automotive	170	1
Engineering	26	2
Chemicals	680	3
Healthcare and pharmaceuticals	350	1
Retailing and consumer goods	2,695	15
Energy/utilities	4,965	21
Telecoms/communications	9,907	8
Oil, coal and gas	1,193	5
Food and drink	4,963	30
Hotels and leisure	263	2
Tobacco	897	6
Real estate	1,191	7
Transport and shipping	438	2
Media and publishing	2,638	11
Metals and ores	866	4
Consultancies/agencies/services	7	1

Source: Capital DATA Bondware

This variety of investment is crucial to the success of the bond markets. In a period when returns from equities look uncertain, many investors are flocking to fixed interest securities. There is always the danger of companies defaulting on their debt – but the market generally prices that in, and the relationship between risk and reward is explicit in the bond market.

Government debt securities markets are often deep, liquid and sophisticated. They provide the basis for a domestic credit market, which is crucial for the efficient allocation and pricing of capital, as well as the management and assessment of the effectiveness of monetary policy. For example, daily turnover in the US Treasury market averages US\$200bn, approximately two-thirds of the global turnover in spot currency transactions involving the US dollar and five times the daily turnover on the New York Stock Exchange. As such, effectively risk-free government securities markets have been crucial in facilitating and pricing private sector transactions.

However, global fiscal rectitude and prolonged economic growth have, with the notable exception of Japan, allowed governments to reduce issuance and in some cases, even to repurchase debt. That's had serious implications for the global bond markets. Scarcity has had the unfortunate combined effect of tightening prices, reducing liquidity and increasing volatility among government securities markets, reducing their benchmark status and viability. So things aren't as clear-cut as they once were.

The recent fragility of global economies, and particularly in equity markets, has driven global interest rates lower. The US Federal Reserve, in particular, has acted with enormous conviction

in providing liquidity to stimulate activity in the world's major economy – particularly in the wake of recent events. But weaker corporate earnings, increasing default rates and serious concerns regarding credit risk have caused risk premiums and spreads (the differential paid by issuers above the zero-risk benchmark, the sovereign borrower in any credit market) to increase.

Fragile equity markets have thus been bad news for sub-investment grade (high risk) issuers, whose bonds often behave rather like the underlying equity: if the company does badly, its shares are worth less and it's more likely to miss an interest payment. But weaker equities markets have been good news for high-quality issuers and investors alike. High quality issuers have strengthened their balance sheets at relatively low cost – their debt is cheap to service compared to equity, and attractive. Falling interest rates may entail lower yields for investors, but also imply capital gains as bond prices increase as equities fall. These advantages are particularly apparent in the UK.

The UK bond market, populated by dynamic, sophisticated and acquisitive corporate issuers, is well-placed to experience further growth and to achieve greater maturity and depth. Gross issuance in the sterling non-gilt bond market has averaged 30 per cent growth per annum since 1995, and with the contraction in the gilt market, the markets are now approximately the same size.

With UK GDP around 15 per cent of the size of both the US and Euro zones and with the sterling corporate bond market only about three per cent and ten per cent the size of its US and Euro counterparts there is clear scope for further growth in private sector debt issuance.

But for the moment, two-thirds of the liabilities of non-financial companies take the form of shares. Bank loans account for around a further quarter of their liabilities, with bonds accounting for only six or seven per cent. Furthermore,

about 90 per cent of current issuance is on behalf of financial institutions, with supranational bodies such as the European Investment Bank particularly active. Any expansion of the domestic issuer base will, therefore, need to be underpinned by the greater attractiveness and ease of bond-financing.

Optimistic signs this is happening include the large volume of non-sterling issuance which is already swapped back

into sterling and the City's central role in the global capital markets which provides both the skills and capital to give life to the nascent domestic bond market.

## WHERE NEXT...

[www.moneyextra.com/glossary/gl00084.htm](http://www.moneyextra.com/glossary/gl00084.htm)

The very basics of bonds

[www.thisismoney.com/tools/bonds.shtml](http://www.thisismoney.com/tools/bonds.shtml)

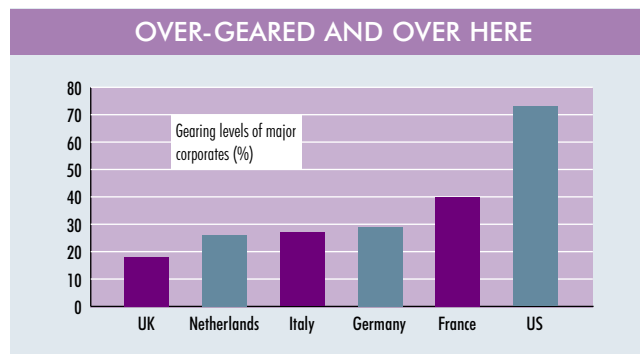
A guide for the investor

# BOND ISSUANCE MADE EASY (UP TO A POINT...)

You don't have to be a major multinational to access the bond markets. But doing a deal to issue debt can be complex and time-consuming. You have been warned.

**THEY CALL IT LEVERAGE** in the US. Here, "gearing" is still a nicer turn of phrase. But it doesn't matter what you call it. It's still indebtedness. In the choppy economic waters we're currently facing, US companies have found themselves like US consumers: over-borrowed and feeling the pinch. The good news is that with gearing in the UK and Euro-zone modest by comparison (see chart), UK FDs and treasurers have more flexibility in their financing options.

Source: Barclays Capital

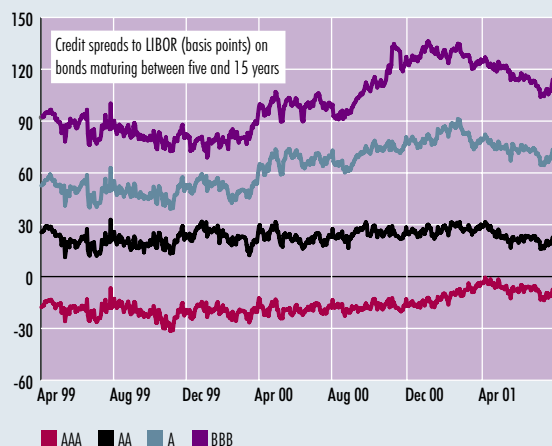


The most familiar sources of finance for UK companies are equity and bank lending. Together, they fulfil approximately 90 per cent of UK companies' financing requirements. Bank lending is flexible and especially well-suited to smaller companies. But the banks' appetite for risk is falling, especially in the wake of the latest Basle proposals (which required banks to hold larger reserves of capital against loans) and concerns on trends in corporate creditworthiness.

As a consequence, bank lending is becoming less available beyond the short-term. It's also expensive. Other financing options include convertibles and warrants (with elements of both equity and debt), asset-backed finance (leasing is a good example of this) and project finance.

So with fragile global equity markets and less attractive and less available bank lending, debt issuance is growing in popularity. This trend has been reinforced by the introduction of the euro (consolidat-

## BLUE CHIPS BORROW BELOW LIBOR



Source: Barclays Capital

ing government and corporate bond markets) and the disintermediation of financing away from banks and towards the capital markets. Nowadays, if you want to borrow money, you can go straight to the source.

And while the bond market is still usually the preserve of larger companies with massive capital requirements, smaller businesses are getting in on the act. Often this will be through securitisation products. Football clubs have led the way here. Leeds United has issued a £60m bond backed by gate receipts, and Ipswich Town is to bolster its reserves (so to speak) with a £25m bond issued through Lazards (see page 29). And who can forget the famous Bowie Bond, backed by the receipts from sales of the singer's back catalogue.

But debt is often the least understood financing option and certainly the least utilised in the UK. "Debt is a crucial funding technique, but companies are often

nervous about the complex issuing process and the costs involved, as well as the rapid pace of change in the seemingly labyrinthine debt markets," says Martin Wooller, an ex-central banker with 25 years of investment management experience. He's dealt in corporate bonds at Bank of America, Rothschilds and Fidelity. Now he advises medium-sized companies, especially debutant issuers, on the bond markets. "Of course, debt issuance isn't appropriate for every company. But for many, it's cost-effective, flexible and can have additional benefits such as promotion of the company's name and increased profile within the investment community."

Unlike the traditional players in the global bond markets, a smaller company may be confined to the domestic credit market and be restricted to shorter maturities on their bonds, smaller issues and higher interest rates. They may also be unable to justify a formal credit rating.

Negotiating these options, especially for the first time, can be a daunting prospect. All of your major relationship banks, debt market experts and specialist advisers will be eager to become involved,

## "COMPANIES ARE OFTEN NERVOUS ABOUT THE COMPLEX ISSUING PROCESS AND THE COSTS INVOLVED WITH ISSUING DEBT"

offer advice and generate fees. Many companies bring in independent consultants before they appoint a lead manager to help manage all these players. But even before that happens, you'll have had to make some crucial decisions.

Getting a formal credit rating is probably the first big hurdle. Independent advice is going to speed up this process by giving you a shortcut into the language and perspectives of the rating agencies.

In the early nineties, around 1,100 issuers were rated world-wide. That number has now trebled. Access to public debt markets now depends on an external, independent rating. The two major global

credit rating agencies are Standard and Poors (S&P) and Moody's Investor Service. The agencies attribute long-term, dynamic and anticipatory ratings from AAA (S&P) or Aaa (Moody's) for the highest-quality issuers, through BBB/Baa for a lesser investment grade issuer. Ratings below BBB/Baa fall within the high-yield or "junk" sector and involve a greater risk of non-payment of interest and principal.

Many companies will get a rating from both the major agencies. Agency analysis – both quantitative and qualitative – is rigorous, detailed and conservative, especially now that corporate defaults are on the rise. S&P reports that 75 issuers with outstanding debt of \$75bn have fallen from investment grade to speculative grade in the last 18 months (just look at the telecoms sector). And borrowers in newly vulnerable sectors such as airlines will push the default numbers even higher.

The rating process need not be onerous, however, and you might gain insights into your business as a side benefit. The time scale for a rating may be from as little as two weeks to as much as several months, with three months a reasonable average for a new issuer. Fees should be around \$50,000 for an initial rating plus three basis points (0.03 per cent) of the principal amount of the rated issue.

Once you've got the rating you can get to work on the details of your prospective debt issue. There are four key variables: how much you want to borrow, in what currency, how long for (the maturity) and at what interest rate.

The size of the issue will depend on your financing requirements and your ability to attract investors. Size and regularity of funding requirement will influence your choice between a single transaction and the establishment of a medium term note (MTN) programme, for example, which lets you issue tranches of debt on an ongoing basis.

Currency considerations will depend partly on interest rate differentials. You might issue a euro denominated bond, for

## EIGHT STEPS TO BOND MARKET HEAVEN

**Step 1:** Determine that finance is required and that debt issuance is an appropriate financing option.

**Step 2:** Perhaps in conjunction with an independent adviser, establish approximate parameters: the size of issue, its currency, maturity and interest rate, and cost of financing your objectives.

**Step 3:** Seek a formal rating from one or more of the recognised rating agencies.

**Step 4:** At the same time, appoint lead manager.

**Step 5:** Negotiate and agree a structure for the bond, including size of issue (and continuing issuance programme), currency (and associated swaps), maturity, interest rate structure (fixed, floating, index-linked and any swaps) and overall financing costs.

**Step 6:** Start marketing your issue and price it to satisfy your needs, the instincts of the lead manager, your underwriters and potential investors.

**Step 7:** Cultivate a dynamic, liquid secondary market.

**Step 8:** Develop an issuance programme, strengthening the balance sheet and building the investor base.

### WHERE NEXT...

[www.gtnews.com/articles4/2481.html](http://www.gtnews.com/articles4/2481.html)

Private placements financing medium-sized German firms

[www.pensions-age.com/August%2001/suppintro1.htm](http://www.pensions-age.com/August%2001/suppintro1.htm)

Looking at the growth of non-gilt bonds

[www.iii.co.uk/bonds/?type=understand&subtype=glossary](http://www.iii.co.uk/bonds/?type=understand&subtype=glossary)

Guide to bond terminology

example, because EURIBOR is lower than LIBOR. But you have to look at the costs of converting the proceeds into sterling.

And the foreign markets can be harder to access. "While the US corporate debt market is deep and liquid, it is also very name-specific, exacts a foreign issuer premium and involves more demanding legal and documentation requirements than elsewhere," warns Martin Wooller.

Maturities extend from flexible, short-term commercial paper, with maturities from seven days to one year (these can be used to finance an acquisition through its early stages, for example), through medi-

um-term syndicated loans, private placements and public bond issues. The longest maturities extend to 40 years on some Yankee bonds (issued in the US market by overseas companies). There are even some perpetual bonds with no maturity date. If the maturity of issuance is related to its intended purpose then Yankees might, for example, be issued by companies with operations in the US seeking long-term funding as a balance sheet hedge. Standard medium-term debt maturities are generally two, three, five, seven or ten years.

When you're considering interest rates, you have access to a range of options, including fixed, floating and index-linked debt, all further complicated by the possibility of swapping one form of debt for another to reduce the total cost of finance.

"It is important to think beyond the first issue and to establish a track record," says Morris Grossfeld, who was responsible for public debt, private placements and commercial paper at Forte during the nineties. "The first issue needs to be a success so that subsequent issues can also be successful."

That depends on your company and your advisers making good decisions in relation to the above variables. But you'll have to add in some skilful marketing of the issue in the primary market and pay careful attention to the bond's continuing performance, name recognition (it's a bit like protecting a brand) and liquidity in the secondary market.

For many UK companies the domestic market offers several alternatives to a trip to the global bond market. Private placements, although less liquid and often involving demanding documentation (see the Ipswich Town case study, over), may prove ideal if you need long-term finance. Issues are typically between £20m and £100m and are often used by companies with BBB or sub-investment grade ratings.

"The bond markets are global and the associated resources, opportunities and options are huge," says Martin Wooller. "This is especially true for UK issuers, with the proximity of the City of London. But they must be clear about their ongoing financing objectives. If so, a good bond deal should result in a flexible and cost-effective source of finance."