

KEEPING UP WITH THE TRENDS

IF YOU ARE CONSIDERING ISSUING A BOND, OBTAINING INDEPENDENT ADVICE AND GETTING TO GRIPS WITH COMPANY/ISSUER-SPECIFIC CURVES IS A MUST IF YOU WANT TO KEEP FUNDING COSTS DOWN, SAYS **BRIAN MOOYAART**.

In an increasingly competitive funding environment, treasurers are under growing pressure to execute their capital markets operations on accurate terms, with investment banks they can trust with their name. However, globally capable investment banks are becoming fewer, more placement capable and more powerful. So an independent ability to identify the precise terms of a funding operation has become critical.

Broadly, treasurers are likely to find themselves in one of three situations when it comes to executing a funding operation.

In many cases, it may be the first time the treasurer is considering a bond issue, rather than some form of loan financing. There is no precedent for the company to go on and the treasurer will have to research peer group performance in the public bond markets. Input from this will show a great deal of variance. The treasurer in that situation will always wonder whether his or her investment bank will not take one of the less favourable peer group comparators and rationalise this *post facto*.

A second group of treasurers will have tackled one or more issues and will have asked themselves whether the illiquid price of their existing transaction(s) provides them with a fair value benchmark for their next funding operation.

The answer is, invariably, that it does not. Nevertheless, the bankers will certainly refer to the company's paper in the secondary market, often ignoring the fact that its illiquidity impairs any judgement on terms and conditions for a next funding operation. Once again, the treasurer may be faced with a banking pricing rationale that uses an impaired fair value input.

Finally, there is a substantial group of companies whose treasurers have entered the public bond markets on many occasions. This group is increasingly aware that the comparatively small but powerful circle of banks they deal with may not have brought the cost of their funding programmes down or enlarged the placement of their company's paper as much as they had been led to expect. Their borrowing programme is much more substantial and the fine-tuning of a new bond issue correspondingly critical.

If funding costs are to be achieved, an independent source of input is critical in all three the above scenarios. Whereas the banks will be expert in all the variety of financial instruments, they will not

have the treasurer's expertise of his or her own company. The increased trend towards company roadshows with investors underscores this difference. Yet, when it comes to pricing a bond issue, these two areas of expertise are often confused. If a treasurer is to hold his or her own they should aim to equip themselves with a reliable stream of independent data on company performance in the capital markets. It is here that company/issuer-specific reference yield curves can be vital.

TERMS OF A PROSPECTIVE BOND ISSUE. As a treasurer casts their eye across the capital markets in the run-up to a new funding operation, secondary market prices are often one of the inputs. Are such prices real? Can you really deal in any volume at such prices? How wide are the deal-able bid/offer spreads? The answer is frequently that such prices are only partially realistic, as illiquidity and sharp price fluctuations frequently distort the input from this source.

In addition, if you see a peer's secondary prices improve against your own company, that does not mean the impact on new issue performance is *pro rata*. It can also mean that a particular bank is positioning itself for a mandate. The input into the decision-making process from the secondary market is therefore far from ideal.

Another input is to see where members of the peer group are issuing in the primary market. However, the new issue market is far from transparent and it is therefore hard to know whether the peer group primary spreads observed are correct.

Furthermore, what actually happens to that spread when the lead manager is out of the deal can confuse matters further. If a peer comes in at a spread that is markedly better against your own company that does not mean your company's new issue terms have regressed. It nearly always means the peer got the market wrong and you should ignore the hype. Peer group issuance also has considerable shortcomings as a contributor to the funding decision-making process.

Nevertheless, the investment banking contacts with the treasurer constantly draw their input from both the secondary market and peer group issuance. Clearly, the partial picture this provides cannot accurately drive a treasurer's spread strategy.

COMPANY/ISSUER SPECIFIC REFERENCE CURVES; THE MARKED TO MARKET TERMS OF PROSPECTIVE NEW ISSUES.

HOW IT ALL WORKS. Company/issuer-specific reference curves are both independent from the secondary market and the advice of the investment banks. Each company has its own reference curve, which is as unique as an individual's fingerprint. Company/issuer-specific reference curves are arrived at by constructing an ultra-liquid basis curve that is continually marked to market and entering a substantial database that shows where previous issuer spreads have stabilised. Company-specific data is a far more reliable standard of a company's fair value in the capital markets.

The company/issuer-specific reference curve is the term structure of a particular issuer at a given time in a given market. A term structure shows its yield-curve, as well as the spread and arbitrage conditions. It is seldom smooth and, therefore identifies opportunities. It also differs between companies and the differences between companies change over time.

Such term structures are the most accurate fair value in the market. They avoid the illiquidity of secondary pricing and the opacity of primary spread formation caused by mandated parties. Instead, they focus on where primary spreads stabilise; by market force and in the public domain.

HOW TO USE IT. The independent input a treasurer receives from their company-specific reference curve can provide a considerable enhancement to company expertise. It is not suggested that such data be taken as a negotiating tool. The current oligopoly of top investment banks mitigates against such use. However, it can be used to ask some pertinent questions.

For example, why is the indicated spread above or below the company's reference curve for that particular day? The company-specific reference curve might favour a different maturity for the funding operation. So why is the investment bank proposing another maturity? A better arbitrage might be available in a different capital market, dollar rather than euro. Why is that market not being proposed?

When the prospective issue gets nearer, a stream of indicative offers comes the treasurer's way. In the run-up to mandating a particular bank, what could be easier than to enter your company-specific reference curve data into a spreadsheet and track the daily receipt of indicative offers from the banks against it? That would soon reveal who the best lead manager should be.

'EACH COMPANY HAS ITS OWN REFERENCE CURVE, WHICH IS AS UNIQUE AS AN INDIVIDUAL'S FINGERPRINT'

WHY IT LOWERS FUNDING COSTS. Consistently issuing at the spreads given by a company-specific reference curve always lowers funding costs. This is because it makes the pricing of your issues and their aftermarket performance reliable and transparent. Investors look for reliability and transparency and reward both with lower spreads over time. Building up a steady history of accurate issuance becomes the company's most cost-effective roadshow.

Often this virtuous circle is entered into in less than a year. Issuing performance will steadily improve compared with the peer group.

FIGURE 1 AN ACCURATE BASIS-CURVE.

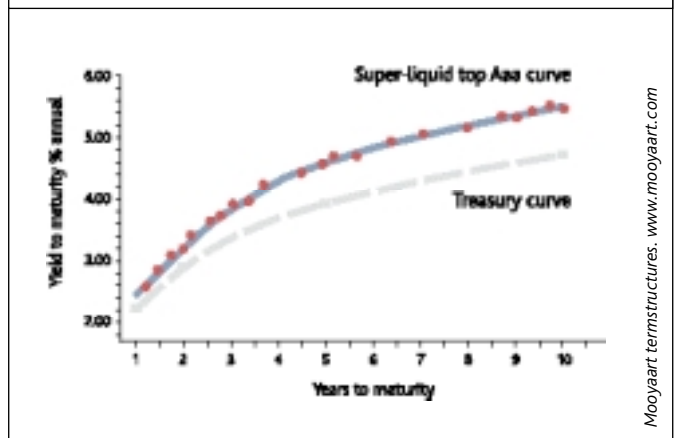
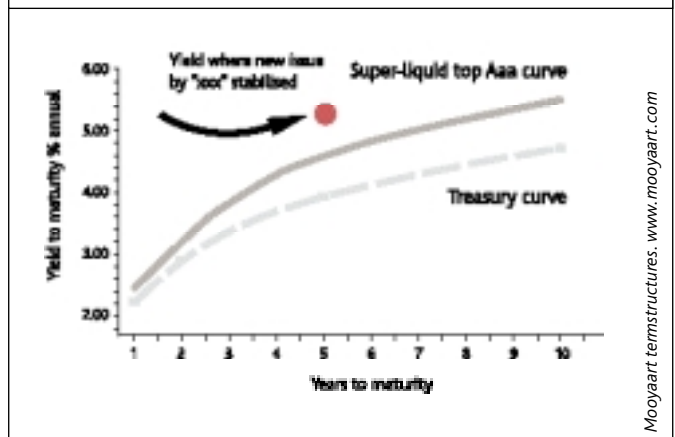


FIGURE 2 YIELD STABILISES WHILE ISSUE IS LIQUID.



Lower funding costs and better placement will widen access to new markets. More choice will give the treasurer more flexibility and control over the timing of issuance. Funding operations will consistently be done at the correct spread, where supply and demand for a given issue are in equilibrium. As treasurer, you are more informed as to the choice of position on the curve that optimises the spread/arbitrage combination and the timing of issuance and hence corporate funding strategy is improved compared to the peer group.

As a result of repeatedly accurate and economic issuance the treasurer builds investor loyalty to the company's performance in the markets and hence its brand as an issuer. The treasurer can benchmark the chosen lead manager's performance over time and obtain a better grip over the company's profile in the capital markets.

Furthermore, where transparent inputs are used, the treasurer will easily and conveniently communicate the rationale of his or her funding strategy to members of the Board.

HOW REFERENCE CURVES ARE CONSTRUCTED. A benchmark curve based on 25 of the most liquid and highly rated issues in each capital market is the critical point of departure. The cumulative criteria these liquid and highly rated issues are subject to are:

- Aaa/AAA rated issuers only;
- issues have to be of benchmark size;

FIGURE 3
SPREAD STABILISES WHILE ISSUE IS LIQUID.

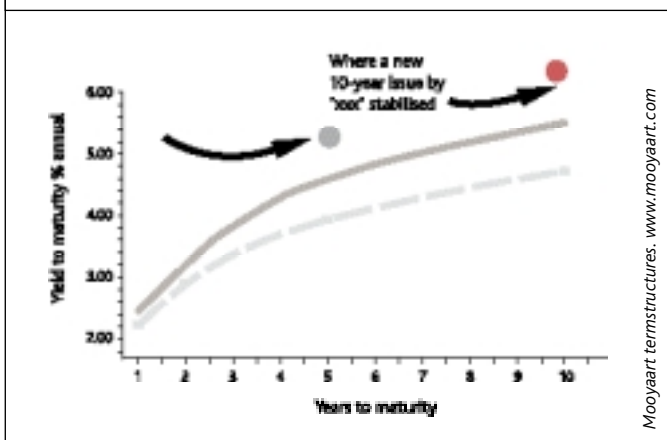


FIGURE 4
ISSUER REFERENCE CURVE FOR A NEW ISSUE.

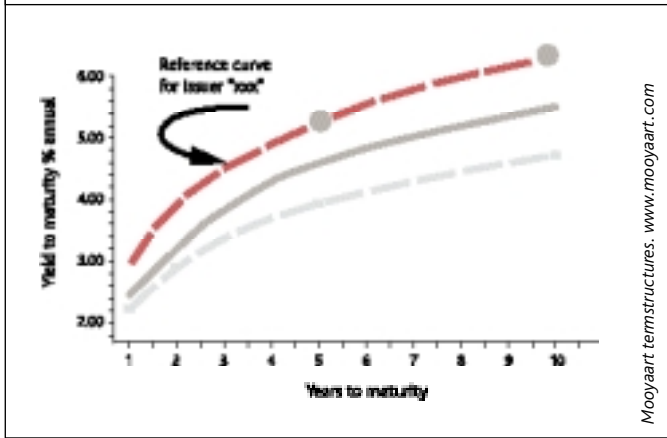


FIGURE 5
INDIVIDUAL ISSUER SPREADS OVER THE BASIS-CURVE.

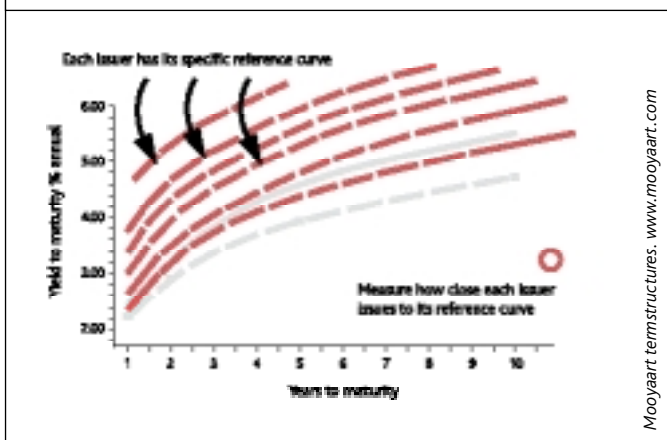
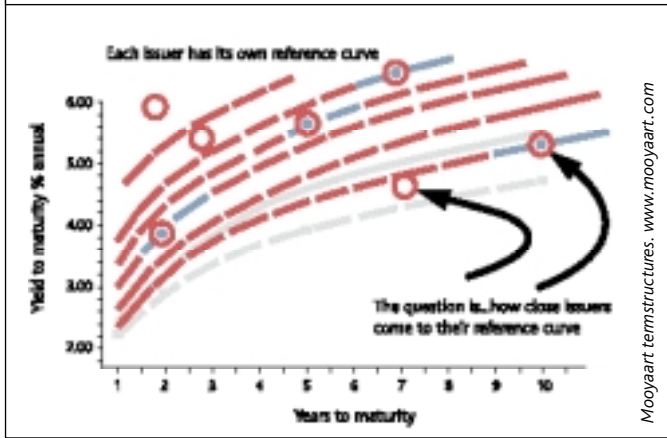


FIGURE 6
HOW CLOSE IS EACH ISSUE TO ITS REFERENCE CURVE.



- the coupon has to be in line with the current market;
- the issue has to be highly liquid;
- bid-offer spreads have to be the tightest in the market;
- the issue should have been led by an investment bank that is among the top 10 in volume;
- the lead manager must also be in the top 10 of our accuracy-rating league-tables; and
- the lead manager must have executed a minimum of three deals in three years for the issuer.

The few issues that make it through this cumulative screening process are clearly the best of the best. They are highly reactive to any change, including any psychological change in market tone. An accurate basis curve can then be drawn through these particular issues (Figure 1). With the basis curve established, we now measure where a given new issue comes (Figures 2 & 3). After syndicate break and after the lead managers are unable to influence the price, the spread over the basis curve will stabilise while the issue is still liquid. This is the critical moment at which we measure the spread and monitor its stability until it goes illiquid (Figure 4).

We now have the spread of that issuer in that maturity and in that market. We do the same with the issuing terms of close to 3,000 issuers. Progressively, it gives us all the individual issuer spreads over the basis curve. That, in turn, gives us the basis point relationships

between each issuer in each capital market (Figure 5). As general spread levels change, so that change is reflected in the basis curve. That curve, in turn, reflects those changes throughout the ratings categories and sectors of almost 3,000 issuers.

The basis curve marks itself and all spreads connected to it, to market. As the spreads of newly launched issues change over the basis curve, so those changes are at once reflected among all these 3,000 issuers. The new spread marks itself to market over the basis curve, which then marks all spreads connected to it, to market.

Therefore, if general spread levels increase, the basis curve will widen. If new issue spreads increase over the basis-curve, all issuer spreads will widen. The result is that general spreads are constantly marked to market. It also means that company/issuer-specific spreads are constantly marked to market.

The data is automatically back-tested and verified on every movement in general spreads, as well as on every new issue that appears. With a substantial and constantly expanding database, we are able to define the spread at issue of each borrower as it comes to the market (see Figure 6).

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