WHERE WILL OPPORTUNITY KNOCK NEXT?

WITH 2003 FAST APPROACHING, WE ASKED THOSE IN THE KNOW WHAT THE FUTURE HOLDS FOR THE EUROPEAN BONDS MARKETS. STERLING ISSUES AND ABS GET THE THUMBS UP BUT ELSEWHERE THE MESSAGE FOR INVESTORS IS UNDOUBTEDLY TO RETAIN CAUTION.

NICK MEDD
Head of Debt Capital Markets
HSBC

WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2003?

The corporate shocks and credit spread volatility of 2002 have left many investors nursing tangible losses and negative feelings towards some industry sectors in particular, and the new issuance process in general. The ongoing threat of military action in Iraq, the possibility of ongoing equity market volatility together with potential weak economic data in Q1 2003 all result in the possibility of volatility in the credit markets.

However, fixed income markets remain very positive as we look forward to 2003. Those borrowers willing and able to cater to investor sensitivities will be able to fund in size and at attractive spreads and absolute yields. Deals that are properly pre-marketed (usually including a physical investor roadshow) from the 'right' borrowers may even find an improved pricing and reception. Finally, those names that are well regarded in the credit markets will be able to broaden their investor base through increased MTN and specific targeted deals.

WHAT PRICING TRENDS DO YOU ANTICIPATE IN 2003?

The extent of credit spread widening in specific industry sectors in 2002 (particularly amongst 'high beta' stocks) has inevitably contaminated spreads in other sectors. Provided that the particular issues in the telco and auto sectors that have given rise to these spread movements in 2002 are addressed in the coming months as expected, overall credit spread volatility in the secondary market should diminish in 2003.

This should create a more benign environment for new issue pricing although in soft economic conditions the potential for new corporate shocks will clearly remain. The equity market will continue to be watched closely as for the jumbo issuers especially, correlation between equity and spread performance will remain. It is forseeable that we will see significant pricing differentiation in 2003 – with those corporates that have deleveraged achieving relatively fine new issue spreads and those that have not being penalised.

Early 2003 is likely to provide good opportunities for borrowers as investors long of cash look to make new investments after a difficult year in 2002 and borrowers take advantage of improved conditions and low rates.

WHAT TRENDS IN CURRENCY, DEAL TYPE AND STRUCTURING DO YOU EXPECT?

Despite mounting speculation regarding euro-convergence, the sterling market has shown no signs of petering out during 2002. It has in fact been a generally more consistent source of capital for borrowers than the euro market in the past twelve months. The increasing capacity of the sterling market has attracted more non-UK borrowers into this market in 2002 than ever before – for the first time ever in 2002 sterling issuance by non-UK corporates has accounted for over 50% of the total from this sector. Growing awareness of the volumes that can be raised in sterling will lead to even greater interest in 2003 – including from sovereign and supranational borrowers, some of which have already begin to test out this market in 2002.

Dual-currency euro and sterling issuance, so prominent in 2001, has been slightly stalled by a lack of overall new issue momentum in the second half of 2002 – nevertheless, this structure has again been used to good effect by a number of corporate borrowers in 2002 and remains an essential method for borrowers who wish to access the broadest range of investors in Europe. We expect dual currency issuance to continue to play a significant role in 2003 giving borrowers volume and broad investor distribution in a single visit to the market.

WHAT TRENDS DO YOU EXPECT IN INVESTOR APPETITE AND, IF 2003 IS GOING TO BE AN INVESTOR DRIVEN MARKET, WHAT COMPROMISES WILL ISSUERS HAVE TO CONSIDER IN ORDER TO GET THEIR DEALS COMPLETED?

It is certainly the case that as 2002 draws to an end, investors remain cautious, dictating which deals they will come off the sidelines for and which they will not (as evidenced by the almost unprecedented number of deals pulled in recent months). However, despite the caution we expect to see the continued trend of strong underlying demand for spread product as the current low yield environment continues.

Investors have not been as focused on covenants or coupon step-up packages in the second half of 2002 as in the previous 18 months. This is partly attributable to the scale of spread movements seen, which have nullified the protection offered by these structures. It remains to be seen whether a continuation of the current weak economic environment will see a revival in demand for these structures from investors.

'AS 2002 DRAWS TO AN END, INVESTORS REMAIN CAUTIOUS, DICTATING WHICH DEALS THEY WILL COME OFF THE SIDELINES FOR AND WHICH THEY WILL NOT'

The shift in favour from equity to debt product will continue into 2003 as investors look for reduced volatility and guaranteed yields. Not all credits will benefit however, as investor experiences in 2002 have left them wary of issuers without strong and transparent credit stories – often regardless of credit rating.

WHAT DEVELOPMENTS DO YOU FORESEE IN ASSET-BACKED, COLLATERALISED AND SECURITISED ISSUANCE?

Next year should see very strong growth in this market as issuers look to strengthen, repair and optimise their balance sheets and investors look to the relative safety of secured debt.

Given the spread volatility in the corporate bond market and the relative stability of ABS and MBS, together with new capital weightings, all signs point to continued out-performance relative to other credit markets.

There may be a divergence of investor interest between asset types and between issuers within various asset classes. In the CDO market, activity is expected to increase but for certain issues such as those backed by investment grade corporates, investors will continue to be particular and carefully scrutinise both managers, structures and pools. Consumer finance will see increased issuance, with more auto ABS expected as corporate spreads widen. Innovative structures for new asset classes may also be tested.

Activity is expected in regulated sectors including transport and utilities. Highly leveraged models will attract interest, further to the major restructuring by Anglian Water this year and the proposed securitisation by Network Rail, the company limited by guarantee which has taken over from Railtrack the operation of the UK's regulated rail business. The timing of any transactions will depend upon a variety of factors, including developments relating to regulatory reviews.

WHAT ARE THE PROSPECTS FOR HIGH-YIELD ISSUANCE?

The past year has seen limited new issuance from this sector (at €2.5bn, less than 50% of that seen in 2001: Fitch), with investors fully occupied dealing with a number of fallen angels (previously solid investment grade rated companies) teetering on the edge of sub-investment grade. For those investors seeking high-yield type margins, buying opportunities have abounded in the secondary market in the telco, auto and other sectors – as investment options, many of these companies retain the benefits of implicit state support (as in the case of telcos) or huge critical mass (as in the case of autos). In addition they have investment grade ratings and the upside of very significant spread performance. In this context the rationale for investment in traditional high yield paper is confined to those who require a high headline coupon.

A normalisation in investment grade credit spreads next year could lead to some revival in high-yield issuance – with the wider interest rate environment already low, and more forecasts starting to factor in further rate cuts to stimulate economic growth next year, a basic rationale for increased high yield issuance could be established. In 2002 to date, some 20 rated EU entities have defaulted on a total US$8.7bn of debt (source: Standard & Poors). Although this is the legacy of a particular period of ill-fated telecoms-related issuance in 1999/2000, the memory will linger with investors for some time to come. For high yield borrowers, the focus next year is once again likely to be the leveraged financed market – as in 2001, when banks have been unable to satisfy demand for senior debt, mezzanine investors have taken up at least some of the slack.

WHAT ARE YOUR PREDICTIONS FOR THE UK GILT MARKETS IN 2003?

HSBC continues to forecast a fall in UK Gilt yields over the next 12 months – with the 10 yr Gilt yield falling by a further 50bps by the end of 2003 and the 30 yr Gilt yield by around a further 20bps. HSBC's gilt view is based on the central expectation of stagnation in the US, Eurozone and UK economies next year and further reductions in interest rates.

There is a possibility that a slowing UK economy and over-ambitious Government tax revenue targets may result in greater than expected new gilt issuance. History shows that while increased volumes of supply do not necessarily result in higher aggregate gilt yields, there are precedents for curve steepening – especially in the UK, where there is most pressure for ultra long-dated gilt issuance. Increased speculation regarding increased gilt issuance during the course of 2003 could therefore lead to a steepening of the curve.

Nick Medd is Head of Debt Capital Markets at HSBC.
nick.d.medd@hsbcgroup.com
www.hsbc.com

PIPPA MASON
Managing Director, Head of UK and Ireland Corporate Debt Capital Markets, Citigroup

WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2003?

2002 has been a challenging year: accounting scandals, US corporate governance, Latin America, Japan, Germany, fears over the global economy and geopolitical uncertainty have contributed to a decline in corporate credit quality and difficult bond market conditions. Safe haven government bonds have reached all time low yields whilst extreme volatility in the credit markets has produced unprecedentedly wide credit spreads. Issuance windows like the one we are currently experiencing are likely to remain a theme for next year unless all these factors miraculously disappear.

Going into 2003 a key factor will be continued volatility due to the Iraq situation. While this is overhanging the market we will continue to have a window-driven bond market. The economic status of Germany and the US will also be driving factors as will the way corporate credit rebounds: improvements are likely to come from a continuation in cost reduction rather than any substantial increase in revenue.

Despite the recent spate of issuance, most investors will end 2002 underinvested in corporate bonds and this, together with new money for 2003, will ensure there is a great deal of cash targeted at new issuance next year. While markets may remain challenging in 2003, we expect ample windows of opportunity for issuers to access the debt markets.

Investors are likely to maintain their risk-averse attitude to bond investments, largely due to the large losses they have incurred during 2002. We expect investors to remain cautious and selective, particularly rewarding corporate issuers for early issuance, avoiding any last-minute liquidity issues. If we get an upturn in the global economy, investors will be encouraged to move from an underweight to a more neutral position in corporate credit. Lack of supply and large cash holdings should help underpin a tightening in credit spreads. However, investors will continue to be wary of the geopolitical backdrop.

With rates remaining near historic lows the opportunity to lock-in across the curve will be there – something that US corporate treasurers tend to view differently to their European counterparts who are often more libor based in their funding decisions. Perhaps we will see some shifts in how companies evaluate this for their respective business models, taking advantage of this opportunity. Indeed, the likes of Vodafone and Unilever issuing in 30-year sterling and 30-year dollars respectively demonstrate that this is starting to happen already to a certain extent.

■ WHAT PRICING TRENDS DO YOU ANTICIPATE IN 2003?

As investors continue to focus on issues such as leverage, liquidity and refinancing risk, credits with plenty of liquidity and strong ratings (preferably mid single A or better) will get best market access as will those companies with lower ratings in more 'defensive' sectors, with strong credit stories. These trends are likely to lead to further spread dispersion within rating categories, as investors sideline credits in cyclical industries and companies with any negative taints. We expect some of the more difficult credits to get relatively better execution in private placement markets.

■ WHAT TRENDS IN CURRENCY, DEAL TYPE AND STRUCTURING DO YOU EXPECT?

We expect fairly similar issuance proportions in euro, US dollars and sterling as in 2002, although perhaps more on the US dollar side as that market suffered particularly in volume terms earlier this year. It is difficult to predict as we would expect issuers to go to the markets offering best relative value, and investors across all markets have a lot of cash on the sidelines.

We expect an increase in private placement issuance for the reasons previously cited. We can also see grounds for continued use of the 'Global' bond platform and the multi-currency, multi-tranche approach for larger funding needs, in order to obtain the most diverse investor base with the tightest pricing.

Key for next year will be the continued theme of corporate restructurings and liquidity with liability management playing an increasingly significant role. This year many household names had liquidity problems and had to undergo restructurings to continue in business, while others faired less well. This will likely continue.

Last but not least, documentation. This might be the big bugbear in 2003. It is an important focus for both issuers and investors. In particular, the debate on bond market negative pledge clauses with respect to the inclusion of bank debt will continue, particularly for the weaker credits and first time issuers. The precedent argument for repeat issuers may be difficult to assume, or at least there could be a pricing consideration – especially if we continue in an investor-driven market.

■ WHAT TRENDS DO YOU EXPECT IN INVESTOR APPETITE AND, IF 2003 IS GOING TO BE AN INVESTOR DRIVEN MARKET, WHAT COMPROMISES WILL ISSUERS HAVE TO CONSIDER IN ORDER TO GET THEIR DEALS COMPLETED?

Focus will be on relative value and liquidity more than ever before – a commensurate return for the risk being taken. This may lead to further spread dispersion within rating categories as mentioned before.

In view of this, the expected volatility and the potential for an investor driven market, issuers should keep an eye on setting realistic, achievable goals and being flexible to maximise the opportunities as they present themselves. They should take on board investor concerns accordingly in the context of the financing they are looking to achieve.

■ WHAT DEVELOPMENTS DO YOU FORESEE IN ASSET-BACKED, COLLATERALISED AND SECURITISED ISSUANCE?

We see the mortgage-backed, loan-backed market used by financial institutions set to continue as a core part of the market. In addition, we believe that the corporate-focused asset-backed market has a lot of scope for further expansion. This may take the form of more whole business securitisations, property securitisations, receivable-backed issues, and other asset-supported financings. Issuers are looking to utilise their assets to improve funding costs.

For corporates, the activity to date has been focused on certain industries, such as telecom companies where securitisation has been used effectively by KPN, BT/Telereal and Telecom Italia to name a few, in the form of receivables-based financing and real-estate based financing. 'Whole business securitisations', where the entire business is funded through asset-backed securities, should have continuing use in utility-based businesses as per the two transactions completed in the UK water sector (Welsh Water and Anglian Water). Whilst the auto ABS market is yet to be tested, this could well prove to be an important development to look out for in 2003.

■ WHAT ARE THE PROSPECTS FOR HIGH-YIELD ISSUANCE?

An important factor during 2002 has been the large number of investment grade issuers that have been downgraded to the high-yield world, absorbing a large part of the investor allocations for this sector. In 2003, as part of this phenomenon, we may see demands for restructuring of covenants for these names to more standard, and more restrictive high-yield constraints. However, we expect high yield issuance to improve in 2003 as corporate and leveraged buy-out financings increase while the previously dominant telecom, media and technology sectors remain moribund. Corporate issuance is likely to increase as European banks continue to be more circumspect about lending to weaker credits and to companies where the available ancillary business does not justify large bank loan participations. High-yield use for LBO financing is well established and likely to rise as European corporate restructuring continues and beleaguered conglomerates are forced to dispose of assets.

■ WHAT ARE YOUR PREDICTIONS FOR THE UK GILT MARKETS IN 2003?

Gilts, like other government bond markets, have suffered recently. If, as we expect, fears about the global economy diminish – with or without central bank easing – then all government bond markets are likely to suffer further, and gilts will not escape, so yields are set to go higher. However the pensions situation, and the fact that investors will seek safe haven instruments in times of continued volatility and credit deterioration, will to some extent offset this as the demand side of the equation is underpinned.

Pippa Mason is Managing Director, Head of UK and Ireland Corporate Debt Capital Markets, Citigroup.
pippa.mason@citigroup.com
www.citigroup.com