Investor relations for bonds

THE RELATIONSHIP BETWEEN COMPANIES AND INVESTORS IN THEIR CORPORATE BONDS IS RECEIVING INCREASING ATTENTION. BOND INVESTORS OBSERVE EUROPEAN COMPANIES' BOND INVESTOR RELATIONS EFFORTS, AND OFTEN FIND THEM WANTING. SO HOW CAN YOU RAISE YOUR GAME? **NORMAN CUMMING** EXAMINES HOW TO DEVELOP A LONG-TERM RELATIONSHIP.

A high proportion of companies' funding now comes from the corporate bond market. At the same time corporate bonds can be volatile in price, both across time, and in the pricing of one bond relative to another. As a result many companies now face potential variation in their cost of capital from the bond markets, making the relationship with investors in that market a logical focus of attention.

Investor Relations (IR) focused on equity investors, is a well-established activity in most large companies. What is good bond IR? The objectives are clear. The company should look to have proactive contact with bond investors. It should not rely solely on sellside investment banks or on the ratings agencies to be the interface. Nor should the company talk to bond investors only at the time of a deal roadshow, giving the impression that it cares only when it wants to take their money. IR should provide significant bond investors with access to senior management. It should ensure that messages to bond investors and equity investors are consistent. The goal is to bring bond investors 'into the loop' – moving them from the position of obscure second cousin to an appreciated member of the company family.

THE BOND MARKETS Corporate bonds traditionally were a small part of the capital structure of most companies, particularly on this side of the Atlantic. There were exceptions of course – financial institutions and utilities have long been users of the bond market. However, what was a relatively small market just a few years ago has shown dramatic recent growth. Growth has been fastest at lower credit quality levels, with many industrial and service companies that were not previously issuers coming to the market. (*See Figure 1*).

The market has grown for reasons of both demand and supply. On the demand side, investor perspectives have changed. Investors have turned away from equities, as unrealistic return expectations prevalent around the year 2000 have been demolished. The other element is the 'maturing' of the liabilities of many of the big investing institutions. Across Europe, pension funds and insurance companies face an increasingly definite pattern of future liabilities, best matched by assets with the cash flow characteristics of corporate bonds.

Executive summary

- The bond market has shown dramatic recent growth, particularly at lower credit quality levels. This has been driven by a number of factors including a move away from equities, lower bond market transaction costs and a change in bank behaviour.
- Bond IR aims to treat bond investors as important members of the corporate family, although balancing their information requirements with those of other investors can be a challenge.
- Bond investors have different objectives to equity investors – they care more about avoiding losers than picking winners.
- Current benign market conditions could allow the development of institutional standards as urged by the Group of 26.

The change in demand is evident in market prices. Just five years ago, the FT All Share index was trading on a prospective price/earnings ratio of nearly 20 – an equity earnings yield of just 5%. A representative sterling corporate bond yield was close to 8%. *Table 1* shows that this pattern has reversed. Earning yields have gone up, while bond yields have come down. These admittedly crude measures of the cost of capital are pulling corporate treasurers to use the bond markets.

As demand has increased so too has supply. One reason is that a virtuous circle of bond market liquidity has been created. As transaction costs become lower in bond markets, it becomes more tempting for companies to go there for their funding, further improving liquidity. One central element has been the creation of the euro. Previously, a company with activities across Europe had assets and revenues in multiple currencies. The creation of the euro brought these under one currency roof – thus making it feasible to match assets with a debt issue in a single currency.

METRICS AND YIELDS Corporate treasurers are more familiar than most senior managers with the metrics used in the bond market. In assessing credit quality, investors and analysts use some familiar financial ratios. The measures used differ from analyst to analyst and from company to company. However, most look in one way or another either at the extent to which the company's cash flow supports debt, or at the extent to which it covers the annual interest bill. Thus the critical ratios are measures like debt to EBITDA, and EBITDA to interest.

The yields that investors require from corporate bonds vary with the credit quality that they assign to those bonds. Clearly, there is a relationship between the formal credit ratings assigned to bond issues by the rating agencies and the yield at which bonds trade. Lower rated bonds carry greater credit risk, and as a result trade on higher yield spreads relative to government bonds. Spreads typically rise as credit quality declines. However, bonds of a given rating category do not trade on the same spreads. Even excluding extremes, the middle 80% of sterling corporate BBB (triple B) bonds trade on spreads over governments that range between 70 and 180 basis points. (See *Figure 2*). Ratings are not the sole measure of credit quality as far as bond investors are concerned – they price bonds of the same formal credit rating very differently.

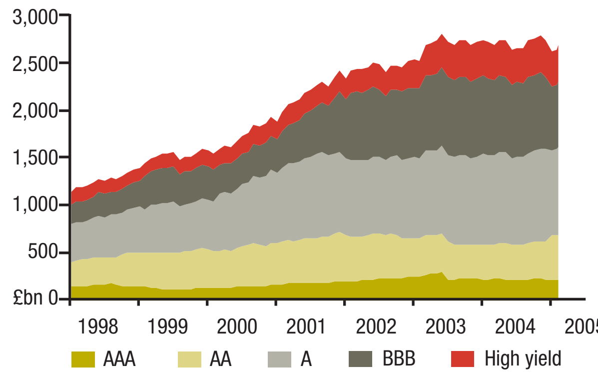
The extent of this differential pricing varies over time. For example, the credit market was very stressed around the end of 2002. Corporate bond spreads were very wide, and so were the differences in spread between bonds of the same rating category. Bond investors' perception of individual companies mattered a great deal – in fact, even investment grade companies that were poorly regarded by investors found it practically impossible to issue in late 2002. The situation changed rapidly over the next twelve months. Spreads came down, and within rating categories spreads became unusually compressed. For now, this remains the case: but while this is a welcome environment for corporate treasurers, it would be unwise to bet on it persisting. The normal condition of the bond market is more discriminating, and users should be prepared.

Table 1. Changing Incentives

	Dec 1999	Feb 2005
FT All-Share	3,240	2,512
Prospective P/E ratio	19.5	13.1
Earnings yield	5.1%	7.6%
Bond yield	7.9%	5.5%

Source: Makinson Cowell

Figure 1. Size and Rating Distribution of Global Corporate Bond Market



Source: Merrill Lynch, Feb 2005

BOND INVESTORS Who are the influential corporate bond investors? Very often, they work in investing institutions alongside colleagues who invest in equities. Corporate bond and equity investors' concerns differ in important respects. The primary driver for equity investors is the gain that they expect. Investors in high grade bonds cannot expect to make a great deal of money. Their main concern is being repaid, and their fear is that they will not be. For equity investors the glass is half full; for bond investors it is half empty. Where equity investors look for earnings and for growth in the companies that they follow, their bond counterparts are much more interested in cash flows and in stability. (See *Table 2*).

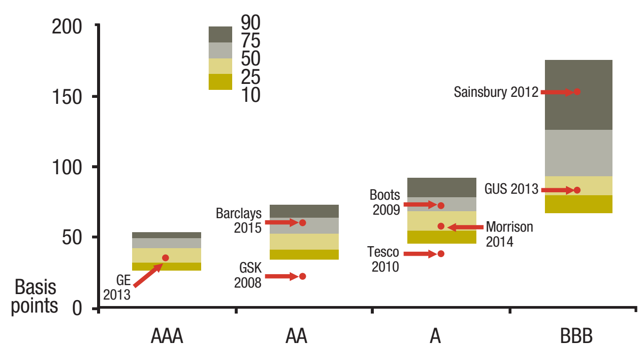
As in the equity world, corporate bond investors in institutions manage portfolios that are measured against indices, and against their peers. Most face the same near term pressures to perform as equity managers. However, the performance risk that these investors face is highly asymmetric. Good bond selection gives modest profits. Owning a bond that defaults, or is downgraded either by ratings agencies or in the eyes of investors, may cost a great deal. Successful corporate bond investors focus on avoiding downside risk. They care not about picking winners, but about avoiding losers.

Institutional bond investors claim to be independent in their decision making. They are sceptical about the advice they get from ratings agencies and sellside investment banks. They see themselves as a sophisticated audience. In their relationships with companies, they are aware of what they regard as second class status vis-a-vis equity investors. Bond investors observe European companies' bond investor relations efforts, and often find them wanting.

The interests of investors in the shares and bonds of a given company are aligned much of the time, but this is not always the case. Events can put them on opposite sides of the table. Sometimes, the event is internal management action. For example, a return of capital to shareholders will meet with their approval; however, it weakens the financial cushion available to bondholders, and they will be less pleased. Differences in view can be particularly acute when interest rates are low – a return of capital that does little to a simple headline measure of interest cover, may have a far more adverse effect on debt ratios important to bond investors.

Sometimes of course, external moves have opposite consequences for shareholders and bondholders. In 2004, Marks & Spencer was

Figure 2. Sterling Corporate Bonds: Yield Spreads



Source: Merrill Lynch, Feb 2005

approached by Philip Green with a view to his acquiring it. Green planned to take M&S private, and to leverage its balance sheet substantially. The share price rose, but holders of existing M&S bonds were not protected. The prospect drove bond prices down far and fast – the price of the company's recently issued ten year bond fell by almost 15% in a day. M&S subsequently fended off Green – but at the 'cost' in part of a substantial return of capital to shareholders, lowering its credit rating and leaving the price of its bonds considerably lower than it would have otherwise been. While bond investors would have lost a great deal from the acquisition, they have been hurt even by the successful defence.

Bond investors are looking to improve their standing with companies. Late in 2003, a group of 26 institutions active on the bond buy side issued a manifesto. The title of the manifesto makes clear its ambition – *Improving market standards in the Sterling and Euro Fixed Income Credit markets*. The manifesto set out standards for issuers that the Group of 26 thought appropriate. The goal was not the impossible one of eliminating market driven credit risk, but of minimising the risk of capricious action by management or external predators that would adversely affect bond holders.

Such initiatives are controversial. For example, the ACT has responded that market standards should evolve through normal commercial negotiation, rather than through prescriptive rules laid down by investor groups. In practice, the issue is in abeyance; bond yields are currently so compressed, and investors so hungry for yield, that bonds will be bought with characteristics that fall far short of the Group of 26's ideal. That said, participants from all sides do have the chance to use current benign conditions to design appropriate institutional standards – the conditions that permit easy action are present. It will be fascinating to see how this debate progresses.

INVESTOR RELATIONS The Group of 26 did conclude that "As bondholders we would like to have stakeholder status in the companies we invest in and develop long-term relationships … better direct communication between investors and issuers can help to reduce the 'uncertainty premium', improve market liquidity and is an important element of best market practice". The idea that the company should look to have proactive contact with bond investors poses some major challenges. One is simply that senior management time is a very scarce resource. Another is that within the resources available for IR, bond investors will compete with equity investors for time and attention. A problem specific to bond IR is that there is no precise record of bond ownership. While the company's share register lists its shareholders, the identity of its bond owners is likely to be less clear.

In many companies, the corporate treasurer is the established point of contact with bond investors. This may well continue to be the best practical arrangement. The important thing is that the bond IR task is handled efficiently and coherently. At minimum, the efforts of the IR team and the finance team need to be coordinated. This may require that members of the finance team become adept in the arts of IR, or that IR specialists go the other way.

Whoever is responsible for bond IR has to balance the need for consistency in the messages sent to all investors, with the specific requirements of bond investors. Bond investors are primarily interested in cash flow (EBITDA and related ratios), not in company earnings. Bond investors would like to know the company's future funding needs, and how they relate to the maturity profile of the existing debts. They may be very interested in covenants, financial headroom, and subordination – issues that rarely cross the radar of their equity colleagues, and in which IR specialists are unlikely to be expert.

There is sizeable variation in companies' cost of bond capital. Much of this variation is not explained by variation in formal credit ratings. Instead, it is determined by the continuous, active judgement of institutional bond investors. This is an increasingly important group for the capital markets. The potential gains for companies who 'raise their game' in looking after these investors seem to be substantial.

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Table 2. Investor Perspectives

	Equities	Bonds
Key driver	Greed	Fear
Key question	How much can I make?	Am I sure I will be repaid?
Ultimate source of value	Growing dividends and capital appreciation	Fixed coupons and redemption
Key indicator	Earnings	Cash flows (EBITDA)
Desired attribute	Growth	Stability
Market metric	P/E,EV/EBITDA,DCF	Yield to maturity, spread over govts/swaps
Assessed against key investors	Equity indices, peers Institutions	Bond indices, peers, cash Institutions, insurance cos.

Source: Makinson Cowell