A new world

RICHARD BARTLETT, ROBERT ST JOHN AND **RUSSELL MAYBURY** LOOK AT RAISING FINANCE IN TODAY'S MARKETS.

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In the third of its series of articles, the RBS Debt Capital Markets team reviews themes and trends in financing and corporate capital structure, suggesting some considerations for treasurers and chief financial officers (CFOs) operating in a changing, and challenging, financial environment.

Liquidity has dried up, deals are scarce and the full effects of the credit crunch are yet to be felt. Now is the time to re-examine financing strategies and take advantage of opportunities to optimise funding and improve shareholder return. But first, it's important to have a solid grasp of the background events, not least just how dramatic the decline in issuance has been. According to figures from Dealogic, UK corporate issuance is down 43% year on year, while European corporate issuance is down 73% year on year.

In the second article in this series (*The Treasurer*, January/February, page 36) we referred to some examples of how the credit crunch, sparked by problems in the US sub-prime mortgage market, has led to a repricing of risk and greater difficulty in accessing liquidity. Credit spreads across all major currencies have widened significantly since the record tight levels in the first half of 2007, a trend which looks set to continue over the medium term (one year plus).

That's bad news for firms that bought credit in order to aggregate it in a single instrument and then sell this instrument as a diversified credit at a lower price, thereby exploiting an arbitrage between the price of an individual credit and that of a diversified portfolio. For these investors, the investment decision hinged on the size of the available arbitrage rather than any fundamental view of credit quality. They typically hedged their exposure to individual names through the purchase of credit default swaps (CDS), so the relative yield of a credit compared with its CDS costs became the key pricing benchmark for new issuance. While these investors were marginal, they were important in helping to create price tension with the larger real money funds. These investors have been decimated by the events of the last six months and are no longer a significant influence on the price of new issuance.

THE RETURN OF REAL MONEY Real money investors (buy and hold investors such as pension funds) are now driving transactions, relying on the relative value of companies at any given rating, instead of CDS spreads for pricing. There is a focus on stock picking which is increasingly sector- and name-specific and, with the reopening of the front end of the yield curve, investors are keen on shorter maturities. Effectively, we are now in an "up in quality and down in duration" environment. Recognising this change in investor base is key for the future success of corporate issues.

Despite tough conditions a number of companies have successfully accessed the market. On 5 March, for example, BAT (Baa1/BBB+) successfully launched and priced a £500m 16-year and a €1.25bn (£960m) seven-year dual currency deal. The transaction was benchmarked against outstanding cash instead of artificially wide CDS levels. Such transactions demonstrate that real money investors such as insurance companies and pension funds are willing to buy paper, but at spread levels which reflect a sizeable premium to secondary trading levels.

In contrast to the depressed issuance levels in the euro and sterling markets, the US market has seen a 12% increase in issuance year on year, according to Dealogic, due mainly to the sheer depth of the market and associated surety of execution. In addition, low yields have made dollar coupons attractive. During tough market conditions the US market has often been open for corporate issuers – at a price – when the Eurobond markets have remained closed.

IMPLICATIONS So what are the implications of this change in market dynamics where the real money investor is now king? For a start it's important to note two of the main characteristics of the present market. First, there is a smaller investor base and, second, there is a substantial level of pent-up demand. Treasurers, meanwhile, need to work with the investor base to ensure they fully understand the credit positives that the issuer offers. Naturally, market conditions have given investors increased bargaining power.

And since investors are now more selective than ever, it is vital to recognise their three main areas of concern:

- **Secondary liquidity** Illiquid bonds make it difficult for investors to exit positions;
- **Pricing-attractive credit spreads** Investors are focusing on the relative value of bonds to other cash assets such as AA-rated bank paper (five-year maturities trading in the G+230bp (L+130bp) area as at mid-March); and
- **Bond covenants** Before the credit crunch, the bond market put little pressure on companies over covenants; that has now changed.

At the end of last year, a credit roundtable of 50 of the most significant bond investors in the US published a detailed covenant wish-list on the issues that they would like to see investment-grade borrowers addressing. Although it's unlikely that all the issues in the document will find their way into covenants that are given by issuers, it is certainly having an influence.

Furthermore, it will be interesting to see if there is a similar move by European investors. European investors are familiar with the document not least because of the commonality of many large investors across the US and European bond markets (such as Pimco, Wamco, Blackrock). There is a particular interest in change of control, with investors concentrating on both the content and the language of such covenants. This looks certain to be a key feature of the market over the next 12 months.

Key covenants examined were:

- Change of control;
- Negative pledge;
- Coupon step-ups (including sub-investment grade step-ups); and
- Reporting obligations.

Box 1: The market is open

ALTHOUGH TIMES ARE UNDENIABLY MORE CHALLENGING THAN THIS TIME LAST YEAR, DEALS ARE STILL POSSIBLE. BELOW WE LOOK AT SOME RECENT TRANSACTIONS:

■ **BAT** (Baa1/BBB+) successfully launched and priced a £500m 16-year and a €1.25bn (£960m) seven-year dual-currency deal on 5 March. The issue generated an order book of £800m and €2.5bn (£2bn), which allowed both tranches to be increased in size and priced at the tight end of guidance. Cash-rich real money investors made up a large part of the order book with hedge funds taking only 3% of the euro tranche, allowing the transaction to be marketed against the cash curve rather than artificially wide CDS levels.

■ **Philips** (A3/A-) launched a $2.75bn five-, 10- and 30-year dollar tranche, pricing at T+220bp, T+220bp and T+240bp respectively, on 11 March. The transaction had a strong order book and demonstrates the strength of the underlying liquidity in the dollar market.

■ **Bunzl** (unrated) priced a five-year private placement transaction into the US market on 11 March, taking advantage of five-year US Treasury yields, which had hit a five-year low. The $100m (£49m) transaction is the third time Bunzl has issued into the US PP market and the transaction demonstrates the speed with which an existing issuer can tap the market for new money: no PP memorandum was required, the existing note purchase agreement template was used. The company was able to leverage off its results announcement to update investors on recent developments.

■ **BMW** (A1/A+) successfully launched and priced a CHF 700m (£340m) three-year and seven-year issue on 29 January. This dual-tranche offering was a blow-out transaction in the CHF market for the German car manufacturer BMW and is the largest CHF transaction launched by this issuer to date. Moreover, this is one of the largest corporate issues that has been launched in this market in recent years.

The three-year tranche was targeted at asset managers and banks, while the seven-year tranche was targeted at the current sweet spot among institutional investors in the CHF market and consisted mainly of insurance companies.

Footnote: RBS acted as joint bookrunner in the BAT and Philips transactions and agent in the Bunzl transaction. ABN AMRO acted as joint bookrunner in the BMW transaction.

Of these, investors are concentrating on the detail of the change of control covenant in particular and this condition looks certain to be a key feature of bonds over the next 12 months.

DISTRIBUTION IN 2008 With these substantial changes in market conditions, CFOs and treasurers are recognising the need to depart from the processes and methodologies used prior to August 2007.

Interestingly, changing market conditions have resulted in a huge reduction in the traditional deal roadshow, designed to generate investor support for a specific deal with a predetermined time frame. In today's climate, issuers simply can't afford to take the risk that the market will be open for them at any particular time. Instead many issuers are now engaging in roadshows that are not deal-specific, with the aim of keeping bond investors well informed so that when the time is right, action can be taken swiftly to price and execute a transaction.

Successful sales techniques in 2008 have included the following:

- Issuers maintain communication with investors away from deals.
- Deals are executed on an intra-day basis to reduce the risk of failure to complete. That means corporates have to maintain a close dialogue with their lead manager so they can understand the best time to go to market.
- Treasurers and CFOs carrying out investor roadshow updates rather than deal-specific roadshows to reduce execution risk.
- It is vital to move faster than has previously been the case. Issuers might have to be looking at the market on a daily basis for a period of up to six or eight weeks to find the right opportunity. In times of increased volatility, the windows in which to issue bonds are more limited due to greater nervousness and attention to news flow. It is increasingly difficult to gain investors' attention.
- Corporates should ideally engage with their lead managers to swiftly identify issuance windows when markets are benign and spread movements minimised. A large amount of issuance is likely to happen in these windows with investors competing for time and attention in a limited space. There are examples of companies taking two to three hours to consider opportunistic issues following successful early morning trades by competitors, only to find that by the time they had decided to launch in the afternoon, the issuance window had closed.
- Corporates that are capable of remaining flexible to type and tenor of debt will be able to achieve lower new issuance premiums. In previous years there has been a dependence on shorter-dated debt such as the commercial paper market due to the cheaper cost of funding. This pricing differential no longer exists, presenting opportunities for issuers to better align their funding structure with their asset base.

Despite the challenging economic conditions and the recent fundamental market change it should be emphasised that the market is still open. As the examples in *Box 1* demonstrates, it should be possible to raise substantial capital in dollar, sterling and euros. Corporates will have to modify their stance to achieve the execution and best outcome but with the right approach it is perfectly possible to execute successful transactions.

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Box 2: A range of alternatives

In today's environment it is worthwhile understanding the full range of alternative markets and sources of funds available, some of which treasurers may not have considered seriously before. The alternative markets include private placement, puttable callable reset bonds and local markets such as Swiss Francs.

■ **Private placement** The US private placement (PP) market saw $39bn (£19bn) of issuance last year, with approximately 55% originating from non-US issuers. UK corporates accounted for 24% of this non-US issuance. Transactions sizes range from $50m (£25m) to $1.2bn (£590m) with the sweet spot of investor demand occurring in the seven- to 12-year maturity range. Investors are generally real money US insurance companies with a buy and hold mentality. Credit ratings are not required to access the market – investors will form their own view of the issuer's implied rating. In volatile conditions the PP market has consistently remained open, with transactions being priced throughout the recent market turbulence. Issuers currently reliant on the bank market may wish to look to PP as a first step towards funding diversity, which is particularly important given the current banking liquidity squeeze.

■ **Puttable callable reset bonds (PCRB)** The PCRB is a structure in which the issuer raises long-term finance but is prepared to be terminated early (on the initial date). To achieve this, a bond is issued with a long maturity date but the issue may be put back to the issuer early or repriced in the initial date depending on interest rate movements. Investors will only hold the bond to the exercise date.

■ **Local markets** It is worth considering local markets which have historically been dominated by supranational and financial names. There are two main reasons why corporates should consider accessing local markets:
Relative value: Local markets such as Swiss Francs (see below) offer good arbitrage pricing. Recent corporate bond issues in the market have been able to price flat or through their respective CDS; and
Diversification: Investors are complementary to those in the Eurobond market, providing issuers with the opportunity to diversify their underlying investor base. Issuing in a local market also demonstrates an ability to access alternative sources of funding to the Eurobond market.

One example of a local market is the Swiss franc (CHF) market. The combination of weak euro credit markets coupled with changes to the composition of the SBI index in Switzerland have led to strong demand from Swiss investors for new corporate names. The index has historically been dominated by AAA names but now that the lowest acceptable rating in this index is BBB, there has been a shift in asset allocation in the CHF market by Institutional investors.

Demand from investors for Swiss francs has outstripped supply and consequently attractive pricing at levels flat or through CDS have been achieved by a number of corporate names.

There has been a growth in issuance size, with some corporates issuing multiple tranches offering a combined issuance size of CHF 600m+ (£290m). The market also allows issuers to come back to tap such issues and build up the outstanding issue size at attractive levels.