Why do the all the top banks advocate Pot?

Anthony Barklam and Michael Turnbull, of MSDW, explain how Pot systems are helping investors and borrowers get the best out of the bond markets.

Pot was not a concept familiar to many in Europe's fixed income markets up until 18 months ago. Pot involves a concept of new issue marketing and execution that has been imported into fast growing European credit markets from its more mature North American cousin.

However, its inclusion into a growing number of new issues in Europe this year has sparked adverse comment and confusion among borrowers and investors alike – unsure whether the benefits outweigh the pitfalls. Here we look at the system, the reasons for its adoption, and find out why the system is being sponsored by those investment banks that could lose the most through its establishment.

In Europe, 25 years of Eurobond underwriting has historically been structured as a real event. Lead managers and co-lead managers were allocated a number of bonds (or millions of nominal currency equivalent) to sell to investors. Issues will always be sold according to name, structure, pricing, and quality/quantity of underwriting banks. However, as the credit markets expanded and became less domestic due to the single currency, the frailty of the retention system has become exposed.

France sets an example

Take France, a key investment area crucial to the success of many corporate issues in euro so far. In 1997, fixed rate French franc issuance flow came to a total of 168 issues, amounting to between three and four a week. The bulk of these issues were non-credit intensive, supranational or high grade sovereign issuers, or at the margin, domestic French corporates well known to the equity departments of the French investing institutions.

This year, there are a much larger number of issues being marketed to a finite number of investors. To date, the same French investors have seen in excess of 2,500 euro-denominated fixed rate issues, at a rate of about 10 per day.

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Now a French investor is marketed regarding corporates and structures from all over Europe. He has 15 times the activity and a finite amount of attention. Quite apart from the prioritisation the investor needs to make on which issues to pursue and which to discard, it is all too tempting for a competitive dynamic to kick in. With five to 10 underwriters, lead managers and co-leads, all with bonds to sell, the investor is in a strong position to auction his interest. And while the fixed price re-offer system has been devised to prevent precisely these off market sales in primary form, all too often investors are being promised bonds by weak co-lead managers in the secondary market at levels within their cost, but below the agreed re-offer. As a result, spread and cost discipline is undermined by underwriters seeking to offload paper. The first two years of the euro-denominated credit market are peppered with examples of deals that have been priced, structured and timed correctly, but then been undermined in the market by unsold co-lead bonds.

Getting the lead manager

Likewise, in the underwriters arena, primary activity has grown in sophistication and diversity enormously. Selection of lead managers is key to a bond's success, both through placement power and credibility. If selected, it is the their duty to ensure the greatest exposure and market leverage for the client.

As investors develop more credit expertise and have funds that can be more sector-specific, the market has become more cut-throat, and other investors more selective. Deals can succeed or die by the weight given to a transaction and the enthusiasm granted

Anthony Barklam

Michael Turnbull

it by the selected lead. As a result, the co-lead manager's role has changed. They are less involved in the pre-marketing and bookbuilding of a transaction.

Lead managers' skill set includes advising clients on their optimal issuance and pricing strategy – a process where disclosure of key information to parties outside the immediate lead management group may not be in the borrower's interest. But there are good reasons why it may be in the borrower's interest to have an established co-lead underwriting group:

Niche placement – European investors are now largely consolidating their dealer contacts, leading to a filtering effect in bond flows to the top investment banks. Information on flows and product are as crucial to the savvy investor as they are to prospective borrowers. Investors who used to have three to four dealers per currency/product now speak on average to about five or six investment banks on a regular basis for mainstream bond business.

The survival of the fittest is indeed in operation in the bond market, with the development of a Euromarket bulge bracket. That does not mean there is no room for select niche players, bringing incremental geographic or sector expertise to supplement core placement. Niche players bringing incremental orders can improve deal tone and widen name recognition to the long term benefit of the borrower.

Liquidity – issues with limited underwriting group sponsorship can signal lesser market liquidity, potentially affecting both primary and secondary pricing and trading.

Borrower relationships – the inclusion of relationship banks into an underwriting group is likely to continue to be a tool for recognition of relationship.

So we have a dilemma – to bring issues into a market where placement is increasingly dominated and driven by the lead managers, where control of the deal is key to its performance, while accepting the importance of incremental placement, liquidity and borrower relationships.

The Pot structure seeks to bridge these difficulties

Pot structures can take on various guises, but the most common, and the easiest to digest by investor and borrower alike, is the 100% Pot structure. This is the Pot in its purest form. With a pre-agreed economic split, the issue's characteristics are dissected, separating economics (percentage underwriting per lead/co-lead) and placement. With two or more leads, the lead managers run an 'open book' between them, revealing all orders to each other and working together as one seamless lead management team.

When corporate treasurers mandate two houses to raise a cash amount for them, they should expect both to be equally responsible for the whole, not just the 40%–45% of their own underwriting. The Pot system ensures this. By looking at the transaction as a whole rather than a number of separate allotments, the borrower ensures a distancing of the placement of bonds and the economics attached to them.

This transparency also extends to the co-lead managers, who know they will be named as participants in the deal with a nominal percentage underwriting amount. But with no physical bonds allocated to them they know they will be paid their fee whether they bring orders to the deal or not.

The structure enables discipline of placement and spread between all parties. While being involved and encouraged to bring in orders to the deal, co-leads are not under pressure to sell bonds, so investing accounts are unlikely to place orders at levels wider than the agreed spread.

By being involved as a co-lead, the underwriters have the ability to satisfy their niche, additional orders to the limit of their size, to the benefit of the transaction, the borrower rewards relationships with payment for underwriting, and investors know the issue will be sponsored in the secondary market by a broad range of banks.

To further ensure strict placement discipline, co-leads give the names of any investors they have to the leads, so the book held by the lead managers is a true and fair reflection of the size and quality of orders. Depending on the level of subscription, the joint lead managers may agree to underallocate certain investors, particularly those that may be of a more short term nature (see *Example 1*).

Criticisms of the structure

Criticism of the Pot structure comes from two main sources:

- those investment banks which may stand exposed as underperformers as leads or co-leads. By running an open book, lesser performers are exposed. Participants are no longer only able to use a cheaper price than other underwriters as the incentive to sell their bonds; and
- niche players with proprietary investing accounts – the issue of protecting

EXAMPLE 1

€1bn AA-rated issuer.
5 year issue. Fees: 0.30% Total.

2 lead managers: 40% each, 80% Total
5 co-leads: 4% each

As a retention, old Eurobond-style issue, the co-leads have €200m to place. Co-leads will effect a return on their underwriting by selling bonds at any price above their all-in (about 5bp wide to re-offer).

As a Pot issue in this example, co-leads are each paid an underwriting fee (€40m x 0.30% = €120,000) and invited to place orders into the lead managers' book at re-offer only.

Effectively, the lead managers assume the responsibility of selling the entire deal, and are paid 80% economics for 100% potential liability. ■

> The inclusion of relationship banks into an underwriting group is likely to continue to be a tool for recognition of relationship

one's own niche franchise is one with which one can sympathise. Investors may also wish in certain circumstances to maintain anonymity. This may be overcome by limited orders being accepted with adequate qualification as 'Account X'. The reality, however, is that knowledge of the name of an account should not be enough in itself to threaten a franchise. Investors, as much as borrowers, choose to do business with banks for a variety of reasons – simply knowing the name of an investor and the size of their investment is no more threatening to the investment franchise of a bank as them knowing a borrower has borrowed €1bn in the market to the capital markets franchise.

Why Pot ?

This links us neatly into the issue of why the leading global investment banks promote the Pot as a structure. Morgan Stanley Dean Witter's (MSDW) pan-European placement franchise is one of the key drivers of its success as a fixed income house. This success, and its major competitors' success, is based on premier execution for borrowers and investors.

The most successful bond underwriters are those with the broadest placement, the greatest depth of product, the most credible research and the confidence of both borrower and investor. There will always be a role for specialised placement in the euro markets.

> The Pot gives the corporate treasurer an extra tool with which to exercise discipline in bond execution, in a market that increasingly requires it

However, with the huge volumes, both in absolute amounts and number of deals, the complexity and diversity of credit product, a deal's success cannot be subject to the performance of the weakest link.

The ability to execute and sell complex credit stories is one that separates the haves from the have-nots in the underwriting world. Smooth execution should not be affected by moving to the lowest common denominator. Investors need the confidence that issues will not be offered wider than where they are prepared to buy. Spread stability is key to their continuing sponsorship.

As a primary lead manager in the euro-currency market, MSDW would rather reveal to our joint-bookrunning competitor banks the investors we bring into a transaction and in return receive the same, for even though in the majority of cases we end up giving more than we receive, we have the comfort of knowing how the deal as a whole is performing, and are so in the best position to ensure the most robust advice to bond issuers.

To advise a borrower with only half the available placement information in this market is not only difficult but an unwise move. We have faith that, while with full transparency our investing relationships will remain unaffected, the price and execution benefits for borrowers will be enhanced.

A valuable tool

As bonds become more integral to the financing tools of the corporate treasurer, less of a price-only driven commodity; and bond investor relationships grow in importance to a level more commonly seen in the equity market, primary new issue performance and wholesale market sponsorship and approval are key to the diversification and maturity of a corporate investor base. The Pot gives the corporate treasurer an extra tool with which to exercise discipline in bond execution, in a market that increasingly requires it. ■

Anthony Barklam is Executive Director, Head of Corporate Debt Syndicate; Michael Turnbull is Executive Director, Head of UK Corporate Coverage at Morgan Stanley Dean Witter.

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