Retail therapy

CHARLOTTE WEIR AND **HENRIETTA PODD** EXPLAIN WHY NATIONAL GRID WENT TO THE RETAIL BOND MARKET – AND IN THE PROCESS PULLED OFF THE UK'S BIGGEST RETAIL BOND TO DATE, WITH A £282M SINGLE-TRANCHE ISSUE LINKED TO THE RATE OF INFLATION.

The UK retail bond market has received a fair amount of publicity this year, but nothing illustrates its depth or sustainability so much as successful issues from seasoned borrowers. National Grid's recent RPI-linked retail bond offering has developed a new facet to this market and shown what is achievable.

On 1 September, Barclays and Evolution announced a roadshow for a potential new 10-year bond issue linked to the retail price index (RPI) for National Grid, targeted exclusively at retail investors in the UK and Channel Islands. There was no target deal size but National Grid was hoping to issue something in line with other retail issues, perhaps £150m. Three weeks later the book closed with £260m in orders, and the deal has been tapped twice since.

Andrew Kluth, head of capital markets treasury at National Grid, said: "National Grid regards its recent index-linked retail bond as a genuinely exciting development in its debt funding operations. We remain committed to this market and intend to fully support it in the future."

At £282.5m, it is by far the largest UK retail offering to date and the largest single-tranche RPI-linked corporate bond since before the financial crisis. With over 80 retail distributors involved and an estimated 10,000 investors, the issue demonstrates:

- enormous demand for corporate bonds from retail investors, many of whom want to make their own decisions about risk and asset allocation rather than leaving selection to a bond fund manager;
- the willingness of these investors to buy a medium-term, lightly structured bond in substantial volumes, provided it delivers what they are searching for: namely, a transparent, predictable return and, in this case, protection against inflation;
- the power of a broad distribution network of stockbrokers, private banks and wealth managers, especially when combined with a media campaign of advertising and editorials; and
- the flexibility of the market where the transparency created by the constant trading of numerous small tickets on the stock exchange's trading platform for retail bonds, ORB (Order book for Retail Bonds), and other platforms means the bond can be efficiently tapped.

Until now, treasurers have been reluctant to use the retail route out of concerns that the disclosure requirements are significantly different and more challenging than those in the institutional market.

The success of this deal shows this is no longer a niche market and we can sense a change in perception among the treasury community. This article aims to explain the reasons why we recommended this retail issue to National Grid and how we ensured its success.

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DIVERSIFICATION For National Grid, which has operating businesses in the UK and US, the decision to diversify its investor base was highly logical. As a frequent issuer in the institutional markets National Grid saw an opportunity to attract an investor base that it had not previously targeted directly and who were keen to invest in inflation-linked products. As is the case with most utilities, a substantial proportion of National Grid’s debt is linked to inflation as a way of hedging its exposure to RPI through the regulation of its UK assets.

The UK retail bond market is a truly diverse source of funding for corporate issuers. It is a domestic cash market which can utilise much of the documentation used for wholesale bond issuance. The distribution process is, however, different, reflecting the end investor who, importantly, is likely to make his or her investment decisions on a different set of criteria from those used by institutional investors.

Like their institutional counterparts, retail investors need liquidity and a reliable platform to sell their bonds. In the UK, there are two dedicated retail bond platforms where stockbrokers can find a secondary market for securities. Bondscape was started 10 years ago by Barclays Capital, HSBC and Winterfloods to provide UK retail stockbrokers with an electronic platform to buy and sell bonds. And in January 2010, the London Stock Exchange (LSE) launched ORB, the first regulated exchange for UK retail bond investors. It currently has six registered market makers, including Barclays Capital and Evolution Securities. ORB was launched to improve transparency in the bond market for retail investors and prices are available on the LSE’s website.

COST Diversification is valuable but difficult to price. The debut issue as well as any ongoing programme of retail issuance has to fit in with an issuer’s overall financing strategy and be in the context of, and preferably beat, target costs of funding.

Retail investors pay less attention to spread to gilts or LIBOR (although discretionary fund managers will use these benchmarks to ensure the bonds offer fair value in the context of the wider market), and more to absolute yield (both running yield and yield to redemption). They will compare a new issue to other bonds in the market and a variety of different assets including term deposits, structured products and equity. In addition, they are less concerned about official credit rating and more about the business model, competitive position and management. Familiarity and name recognition are also great advantages.

These factors have made retail bonds a more stable source of funding over the past few months when the wholesale markets all but closed down.

It is fair to say that coupon level is very important for retail investors, particularly in relation to fixed rate investment. While retail investors have reduced their return expectations since the beginning of the year, recent falls in rates have made fixed rate issuance a challenge, particularly for strong investment-grade companies, and retail investors are currently looking for at least a 4% coupon from a corporate bond. The yield targets for inflation-linked products are lower, at around 1–1.5%.

STRUCTURE From market feedback, it had been clear to us for many months that investors have been more focused on inflation and looking for appropriate products to invest in. There are a few inflation-linked bonds in retail denominations but they are not traded on ORB and are old, illiquid and standing at prices substantially above par, due to accrued inflation and falling yields. So retail investors who had used up their NS&I limit and wanted a longer-term product they could hold in a self-invested personal pension (SIPP) or individual savings account (ISA) have only really been able to buy RPI-linked gilts.

Retail buying of RPI-linked gilts has been strong for over a year, and a trend had become clear: retail investors are prepared to buy longer inflation-linked bonds than conventional ones. They chased yield along the curve as real yields turned negative. This supported our recommendation to National Grid: issue a medium-dated, gilt-style, RPI-linked bond targeted at retail investors. Whereas demand for fixed rate products was greatest at five and a half to seven years, for a linker aimed at providing capital protection National Grid could issue a longer-dated product more suited to its asset base.

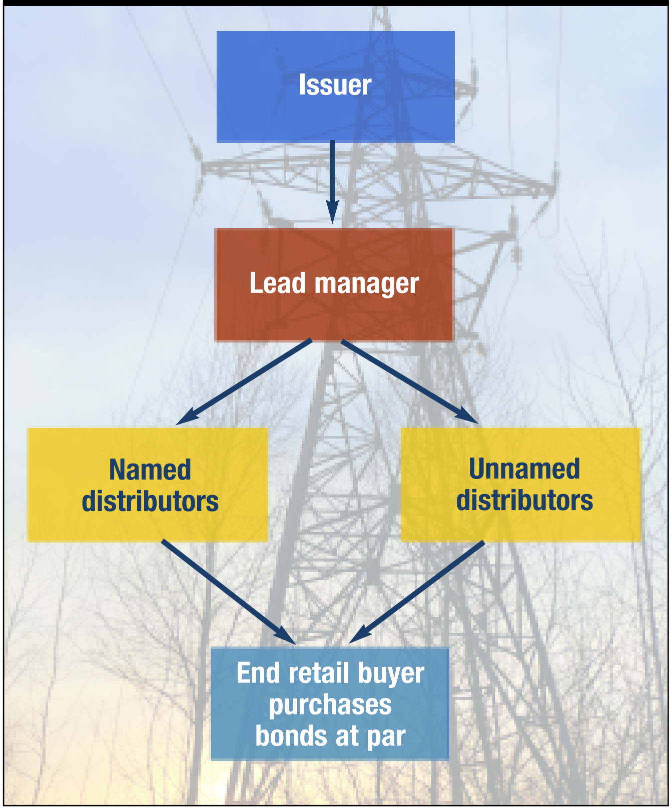
There were two other key features of the structure. Given the greater complexity of the issue, we suggested that there should be a par floor at redemption – ie. whatever happened to inflation, National Grid could say that investors would always get their money back (absent a default). Also, the issuing entity should be National Grid (the holding company and equity-issuing entity with which retail investors were already familiar) rather than the regulated operating companies.

Final coupon guidance was influenced by a number of factors including benchmark gilt yields, spreads on National Grid’s other sterling bonds, other RPI-linked corporate bonds and products such as RPI-linked deposits.

ACCESS Since the introduction of the Prospectus Directive, many borrowers have felt that the hurdle set by regulators when it comes to accessing retail investors is simply too high. The introduction of ORB has heralded a more pragmatic approach by all parties involved.

As with a wholesale issue (minimum denominations 100,000), the retail bond’s basic document is either a euro medium-term note (EMTN) programme or a standalone prospectus. To issue smaller denominations, some additional features are needed; most importantly, the issuer needs to review the risk factors and any descriptions of the company’s operations and financial statements with the target audience in mind. In addition all bonds admitted to

Figure 1: Distribution model for retail bonds



ORB must settle through the CREST system. For frequent issuers with an EMTN programme these changes can be incorporated into the base prospectus either at an annual update or via a supplement. Issuers of smaller denomination bonds must also comply with the EU's Transparency Obligations Directive, requiring regular financial reporting in a specified format and timetable. Fortunately, most EU issuers with listed equity already comply with the directive.

So there are platforms for electronic trading and price transparency, and lawyers have addressed many of the concerns in terms of appropriate disclosure. At the same time, Barclays and Evolution have responded to feedback from retail brokers and wealth managers for a flow of new issues distributed across their network.

The distribution of the bonds in the retail process varies from the institutional model. As Figure 1 illustrates, the core of the distribution is a small group of "named distributors", which appear in the marketing material and documentation and are responsible for marketing on behalf of the issuer and utilising their retail network to reach the widest possible group of investors. National Grid invited eight distributors to its named group.

Bonds are also made available by the lead managers through "unnamed" distributors, which encompass the rest of the stockbroking, private bank and wealth management community. A total of 82 participated in National Grid's bond and we estimate that they, supported by the PR campaign, could have reached one million retail investors.

For distributors to fulfil their role effectively they need marketing support and a commitment to secondary market liquidity; these are characteristics which National Grid understands reduce the cost of funds and ensure constant access to the markets.

To meet the information needs of retail investors, the issuer prepares a summary document which sets out the key terms of the transaction in easy-to-comprehend language which needs to be clear, fair and not misleading.

For a company issuing into the retail market for the first time, a well-orchestrated roadshow and PR strategy is critical. National Grid therefore committed considerable time and resource to do a roadshow across the retail network, manage a comprehensive PR campaign of editorial and advertising, produce user-friendly marketing materials and encourage liquidity by requiring Barclays and Evolution to provide secondary market prices on the ORB and Bondscape platforms.

RIGHT PRODUCT, RIGHT NAME, RIGHT TIME In February this year, Barclays and Evolution opened the fixed rate retail market with a seven-and-a-half-year fixed rate bond for Tesco Bank. It seemed the right name for the new market. Similarly, it was important that the first corporate linker should be issued by a well-known name and one where the strategic reason for issuing this type of bond was very clear. National Grid was an obvious candidate as a non-bank issuer and a network utility with a simple story – transmission/distribution, gas/electricity, US/UK – and the investment case as far as the credit was clear. This meant that we could direct most of the marketing efforts to explaining the index-linked instrument.

Timing, of course, is everything but lucky timing is even better. A few days into our roadshow it was announced that NS&I was withdrawing its inflation-linked certificates.

CONTINUING INTEREST Retail investors who want certainty of income are caught on the horns of a dilemma between low interest rates and inflation. There is still strong demand for fixed rate corporate bonds especially from credits willing to pay slightly higher coupon levels. For higher-grade credits, either maturities can be stretched to justify a 4%+ coupon on a fixed rate bond or the RPI-linked option remains available. As the market develops, we expect to see a wider range of credits from FTSE 100s to midmarket corporates and more variations in structure on offer. However, in all cases investors will demand the transparency and liquidity that can only be provided by a professionally managed and regulated bond market.

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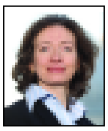

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