READY FOR TAKE-OFF

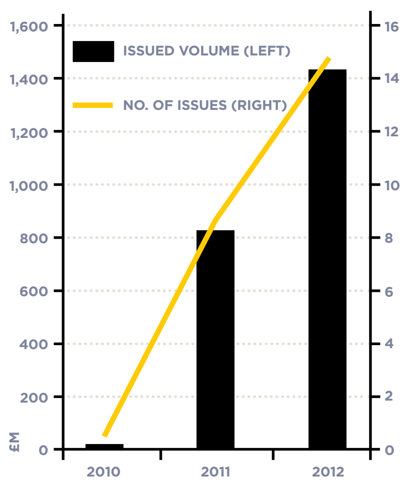
IN 2012, THE AMOUNT RAISED ON THE UK RETAIL BOND MARKET NEARLY DOUBLED YEAR-ON-YEAR. BUT MORE GROWTH WILL FOLLOW, PREDICT HENRIETTA PODD AND MORTON LLEWELLYN

Last year was another period of growth for the retail bond market as it further developed as a source of debt capital for companies looking to borrow in smaller amounts than those demanded by the wholesale markets. Parameters for preferred issue sizes, structures, pricing and credit profiles have emerged as the market becomes more mature and investors have an increasing amount of choice.

Overview of 2012

The retail bond market got off to a slow start in 2012, with just repeat issues from property manager Places for People and lenders Provident Financial and Tesco Bank. Consequently, demand for bonds exceeded supply. But the market then experienced an unprecedented run of new issuers after July, which more than satisfied investor demand. Increased confidence from borrowers is reflected in the fact that the amount raised nearly doubled year-on-year – from £870m in 2011 to £1.5bn in 2012.

RETAIL BOND ISSUES



The 5% barrier

As demand for inflation-linked issuance has subsided, investors and their advisers have looked for higher-yield, fixed-rate offerings. The London Stock Exchange (LSE) was able to raise £300m at 4.75%, but all other retail issues have had a coupon at, or in excess of, 5%. Although an attractive investment-grade credit rating or strong name recognition will help borrowers to break through this barrier, 5% remains a material hurdle for investors on a primary issue.

Although borrowers can beat a 5% rate in the wholesale or US private placement market, the retail bond market has several advantages worth considering. It offers funding diversification and provides considerable value to those companies that may not have easy access to the wholesale market, perhaps because of the small amount they wish to raise, their lack of credit rating or the nature of the sector in which they operate. For example, as the wholesale market is still overweight in financials, the retail market has offered attractive terms to issuers in this sector. Of the £1.5bn raised on the retail bond market in 2012, nearly two-thirds was claimed by the financial services sector.

Looking to the future, it is important for the development of the retail bond market that higher-rated issuers start to price in the low 4% region, or close to their wholesale pricing levels, thereby encouraging a broader range of issuers to the market.

Mid-cap issuers from the property sector

The retail market also offers value to other mid-cap sectors where borrowers may be willing to pay the higher yields demanded by investors in return for longer tenors and greater flexibility than that offered by the banks. To date, this opportunity has been seized exclusively by property companies, which typically borrow on a secured basis from banks and other long-term debt providers. The trend started in July 2012 with a successful issue by the property real estate investment trust Primary Health Properties for £75m at 5.375% for seven years. The bond was issued by the group holding company and is unsecured and unguaranteed – so it ranks behind secured debt and is subordinated to operating companies' debt and creditors. A similar structure (although with varying covenants and corporate structures) was used by four more property company issuers – CLS (5.5% – seven years), Workspace (6% – seven years), St Modwen (6.25% – seven years) and Unite (6.125% – eight years).

Private companies

A potential development in the retail bond market is issuance for private companies. With the demand for yield, and for a better position in the capital structure, the market lends itself well to private companies in the form of senior secured debt.

In December, the private education group Alpha Plus Holdings* was the first company without listed debt or equity to successfully close a deal in the market, raising £48.5m at 5.75% for seven years secured on a portfolio of freehold schools. This was a first in many ways – a private group, a senior secured issue, smallest issuer to date and a smaller distribution group than evident on larger issues. Private companies have a special story to tell: they need to assure the market that they will operate

*CANACCORD GENUITY WAS SOLE BOOKRUNNER IN THE ALPHA PLUS HOLDINGS BOND ISSUE

ANNOUNCEMENT DATE	BORROWER	SECTOR	MATURITY	LENGTH (YEARS)	COUPON (%)	RATING	ACTUAL ISSUE SIZE (£'M)
12-Jan-12	Places for People	Property	2022	10.0	1.00% RPI Linked	AA-	40.0
14-Mar-12	Provident Financial	Financial	2017	5.5	7.000	BBB	120.0
16-May-12	Tesco Bank	Financial	2020	8.5	5.000	None	200.0
21-Jun-12	Severn Trent	Utility	2022	10.0	1.3% RPI Linked	Baa1/BBB-	75.0
03-Jul-12	PHP	Property	2019	7.0	5.375	None	75.0
12-Jul-12	ICAP	Financial	2018	6.0	5.500	Baa2/BBB+ (Fitch)	125.0
22-Aug-12	CLS	Property	2019	7.3	5.500	None	65.0
30-Aug-12	ICG	Financial	2020	8.0	6.250	BBB-	80.0
07-Sep-12	Beazley	Financial	2019	7.0	5.375	None	75.0
19-Sep-12	Workspace	Property	2019	7.0	6.000	None	57.5
16-Oct-12	LSE	Financial	2021	9.0	4.750	Baa2/A-	300.0
17-Oct-12	St Modwen	Property	2019	7.0	6.250	None	80.0
21-Nov-12	Unite	Property	2020	7.5	6.125	None	90.0
22-Nov-12	Tullett Prebon	Financial	2019	6.5	5.250	BBB	80.0
26-Nov-12	Alpha Plus	Education	2019	7.0	5.750	None	48.5

with the same standards of transparency and disclosure as a company with listed equity, explain the different approach private equity may have to ownership (for example, using shareholder debt to fund the business) and demonstrate commitment to the business.

Developing the investor base

Although the market is polarised around financials and property companies, there remains a recurring request from investors for different issuers, ie industrial, transport, utilities, retail, leisure and service companies. But these are sectors that generally have access to a lower cost of debt. Consequently, the retail investor base needs to be more cost-competitive in this area. Credit evaluation and the benefits of diversification will help to achieve this. Public credit ratings can help, but as retail investors do not necessarily need these, then the alternative publication of well-informed credit commentary will greatly assist in assessing new issues and secondary market relative value. The publication of such reports is currently underdeveloped, and we expect further improvements in this area throughout 2013.

In addition, the investor base has floundered when asked to absorb more than one deal (perhaps two) at a time, and this remains a major challenge. A year ago, we highlighted that a number of the larger retail brokers struggled to handle more than one or two issues at the same time and this remains the case – having a clear run at the market, when investors can focus on credit issues and then relative value, remains preferable to competing with a congested pipeline where the focus becomes yield. In the run-up to the year end, the market found it hard to absorb the issues being marketed and struggled to evaluate the different credits. As supply exceeded demand, secondary bond pricing underperformed. This is not ideal in an innovative market, as retail investors, new to this product class, will be disappointed if their investments fall in value, even if temporary.

Conclusion

The year 2012 was another significant year in the growth and development of the retail bond market. It remains eager to receive returns in excess of 5% for investment-grade credits, limiting rated issuers to financials, while mid-cap corporates have entered the space in the form of property companies issuing junior debt at yields increasingly above 5.5%. For the market to break away from this polarised status, the yield requirement of investors for high-quality rated issuers needs to fall comfortably below 5%, so a space will open up for regular industrial corporates making senior-ranking issues, reflecting a greater appreciation of relative credit value and the benefits of diversification. This will be an emerging theme of 2013.

ABOUT THE UK RETAIL BOND MARKET

UK retail bond issues are those that are listed on the LSE and traded on its retail bond platform the Order book for Retail Bonds (ORB). They must have at least one market-maker that establishes a public, two-way price. They also have a maximum denomination of £10,000, thereby permitting retail involvement. The ORB was set up by the LSE in February 2010 to meet strong demand from retail brokers and wealth managers for bond issues in modest denominations.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