US IPO prospects fade, but high-yield booms

The US equity rally of early May is over, and with renewed concern about the US economy creeping back into the market, the outlook for equity issuance is suddenly less clear. Issuers looking to tap the market may have to think twice about timing, and only the most solid deals will get done.

Unlike the flat equity market, the US high-yield market is booming, driven by cut-throat competition among underwriters, positive technicals and seasonal factors. More than 22 deals surfaced in a single week in early June and plenty more were queueing up to get in ahead of the 4 July holiday. With investors' risk tolerance increasing, more speculative credits are on the way.

The Dow Jones Industrial Average broke below the 11,000 support level at the end of May. Against this background, US equity fund managers expressed mixed views on the market, some thinking it was time to search for bargains while others said they were waiting for the markets to settle before doing any buying.

So which deals will get done in the current market? "The market clearly has a value and growth-at-a-reasonable-price orientation, and both investors and issuers have got to be willing to find common ground on valuation and pricing to affect successful transactions," said one commentator.

Technology IPOs, most bankers agree, will only be successful for a top class of issuers. The sector must not only overcome investor scepticism but also broad technology stock weakness since last year. Old economy stocks are coming back. Energy deals, broadly speaking, represent the closest to a sure thing the market has right now. Most issuance from the sector is still expected to go well.

Coal companies, oil groups and energy-related businesses, such as gas pipeline companies, appear to be the best bet. While these companies may not be able to replicate their recent record profit performance, the outlook is good for continued profits going forward.

On the high-yield front, a number of factors are leading to the aggressive bout of issuance, but one recurring theme is that the always super-competitive environment for mandates is turning even more aggressive. With the halfway point of 2001 rapidly approaching, league table trades are becoming extremely prominent.

Mandates are being won by razor-thin margins, while relationships are being discounted. Some bankers said the competition for mandates has become a virtual free-for-all, more so than they have ever seen. In some cases, dealers have all but shut off communication with rival firms.

In terms of league table trades, the largest commercial banks have been the most aggressive. But a host of other factors in addition to the league table competition is driving issuance. The technical bid remains strong thanks to robust flows into high-yield mutual funds. By mid-June, the market had seen eight consecutive weeks of inflows. Year to date, over US$5bn has been added to high-yield funds.

Seasonal factors are also coming into play as dealers are looking to launch deals ahead of the 4 July holiday in the US. While a window of a few weeks is expected to open after the holiday, August is traditionally a slow period. Also, the second half of last year was extremely choppy and bankers do not want to risk running into a repeat of that with a backlog of deals.

While a short-term hiccup is possible as a result of the supply, bankers and investors believe the market may finally be bottoming. "There might be a short-term reaction but, intermediate to longer term, the environment is very positive for non-telecom high-yield bonds," noted Art Penn, head of global leveraged finance at UBS Warburg.

Europe edges towards 'fair value' trading

The introduction of FAS 133 look-alike International Accounting Standard 39 has come an unwelcome step closer for European derivatives users. The European Parliament has adopted a directive to modernise European Union accounting rules by introducing 'fair value' accounting.

The European Commission welcomed the directive's adoption. "The directive amends the EU's accounting directives to take account of developments in markets (such as widespread use of so-called derivatives), business and international accounting standards. It will make it easier for European companies raising capital world-wide to comply with the financial reporting requirements of international capital markets and thus compete on equal terms with non-European competitors," the Commission said.

The Commission also pointed out that the new standards will not have to be applied by European states to all types of transaction, however. "A member state can, for example, permit or require fair value only for listed companies. The directive requires that all companies disclose information on derivative financial instruments such as options, swaps, and futures in the notes on the accounts. However, small companies can be excluded from this disclosure," the Commission statement said.

Although banks are included in the scope of the directive, the Commission stressed that it was not intended to be seen as the introduction of full fair value accounting. "[This is] a concept raising concerns with the banking industry, which is presently being discussed at international level and which will be assessed on its own merits by the Commission." Compulsory adoption of International Accounting Standards is currently pencilled in for 2005.

Rating decision reprices corporate bonds

Moody's landmark decision to change its policy to allow its sovereign ceilings to be pierced caused a flurry of activity in the secondary bond market among the 38 issuers which saw their long-term foreign currency bonds subsequently placed on review for upgrade. The move is expected to reprice the corporate sector of the emerging markets.

The ratings under review for upgrade include the foreign currency bonds and notes of energy companies, banks and telecoms companies mainly in Latin America (28 of the 38 under review) but also in Asia (three issuers) and EEMEA (seven issuers). Additional entities may be added to the list over the next few months.

Moody's said the ability of a borrower to exceed the ceiling of its country of domicile will hinge on three factors: the creditworthiness of the issuer (including external support mechanisms); the probability that there would not be a generalised moratorium in the event of default by the government in question on its own foreign currency obligations; and the special circumstances of the borrower in terms of access to foreign exchange.

The decision came as something of a surprise as Moody's, which had long viewed S&P's corporate rating policy as too aggressive, will now be taking the most assertive position in the rating of corporates relative to the sovereign ceiling. S&P typically allows companies in countries with official or de facto hard currency pegs to achieve ratings above the sovereign ceiling. Moody's will now expand that policy to countries with floating exchange rates.

The news caught the imagination of the emerging markets trading fraternity. Latin corporates saw some decent buying, with issuers on the Moody's list tightening in by anything from 10bp to 20bp. Moody's move also sparked some repositioning in the Mexican peso, but the benefit is seen as short term. IFR

Hedge funds drive risk tool boom

'What-if' position scenario analysis is booming, driven by hedge fund use of equity derivatives. Banks and web-based equity derivatives platforms have been falling over themselves to provide risk managers with better risk measurement services. But real-time trading platforms and historical analysis are not the only risk management tools desired by hedge funds, pension funds and asset managers.

Dubbed virtual portfolios, risk measurement services that include a 'what-if' scenario along with the more traditional kind of risk analysis are gaining in importance. The hypothetical feature allows for a more customised and flexible approach to the management of risk and answers situational hedging questions about a portfolio.

Managers who incorporate the use of the client risk reporting enhancement would have a better handle on whether a particular position will better correlate a fund to an index, for example. IFR

Japan's FSA extends derivatives clampdown

Japanese financial authorities suspended Tokyo-Mitsubishi Securities from bond and equity trading as a result of improper activity in the reverse convertibles market. It was the first suspension of a Japanese bank in connection with the sale of these instruments. The instruments became legal following the liberalisation of the Japanese OTC equity derivatives market, but have recently been racking up losses for investors.

In early June, the Financial Services Agency (FSA) ordered the wholesale securities arm of Mitsubishi Tokyo Financial Group to suspend most equity transactions on its own account for two weeks. The FSA also advised the brokerage to pay back ¥365m ($3m) to investors.

Separately, the Ministry of Finance also suspended the firm's brokerage from participating in Japanese government bond auctions, also for two weeks. The official moves followed a period of high activity in the reverse convertibles market that was only dampened by the recent stock market downturn.

This, in turn, led to the discovery by many investors of the dangers of investing in these instruments, and provoked the FSA investigation. The deals in question were bull market instruments which had embedded short puts. If prices went up, investors received an enhanced return in cash. If the market went below the strike price, they received stock, rather than cash.

Most of the deals ended up in the hands of retail investors. The situation was exacerbated by the increasing complexity of the deals. Many had digitally-enhanced coupons, where the mainly retail investors that bought them were due a bonus coupon if the stock held above a given price, but if it went under the trigger the buyers lost the bonus coupon.

Such structures required deft handling by the banks issuing them. To hedge their positions, banks had to sell the underlying stock the closer the market went to the barrier, and there was an obvious temptation to try to hold the stock below the barrier.

"The fine line is, how much do you sell and with what timing?" said one trader. "If you do it properly you are probably OK, but if you do it too aggressively then it can be deemed, in the worst case, market manipulation to push the market down to avoid paying the bonus coupon to your investors." IFR

These extracts are from IFR (International Financing Review).
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