Retail therapy

Executive summary

- With interest rates at record lows, the equity markets riven by uncertainty and volatility, and a greatly subdued risk appetite, interest in corporate bonds as a retail investment vehicle has grown dramatically across Europe. But in the UK issuers of corporate bonds may be missing out on a massive untapped retail investor market. The retail market could provide a large pool of capital, represents an investor base that holds bonds to maturity, and holds out the prospect of lower costs of capital funding over a period of time. The picture is almost too good to be true yet the retail sector in the UK is largely ignored.

The size of the retail corporate bond market in the UK may be in the region of £20bn, according to the Association of Private Client Investment Managers and Stockbrokers (APCIMS). This figure amounts to around 5% of the £400bn or so of funds invested on behalf of their clients by APCIMS member firms. In a recent survey 39% of APCIMS member firms thought that investment in corporate bonds would grow over the next 12 months compared with only 25% who foresaw an increased uptake of gilts.

Some member firms have reported that demand for corporate bonds has quintupled since 2008. In some cases corporate bonds already represent 100% of a client's portfolio, while 30% is not unusual. Despite the ease of access to bond funds, investors often prefer individual bond ownership. Indeed, the FTSE/APCIMS private investor indices used by private client and wealth management firms as their benchmark are currently weighted at 37.5% in bonds for the model income portfolio.

One APCIMS member firm received more than 100 enquiries in just one day in May this year about investments in corporate bonds. But it could not meet the demand in full since insufficient bonds were available in denomination sizes suitable for the retail investors concerned. The Unilever issue in the spring of 2009 in lots of £2,000 was five times oversubscribed.

In the absence of widespread direct consumer access to the market, bond funds have grown. Ratios of as much as 80% of new money from clients going into bond funds have been reported by the APCIMS membership.

This is helpful but there are drawbacks in comparison with buying issues directly: yields are lower and there are management fees to pay. Most importantly, participants in a bond fund cannot fix either the term of their involvement or where they sit on the yield curve. On the risk side it is argued that the consumer is better protected in bond funds, but it is hard to maintain a case against direct retail participation when blue-chip companies are issuing A-rated paper over, say, five years and, in the case of APCIMS, consumers are in the main advised by expert intermediaries.

Certainly the risk element does not seem to have been a barrier to retail-scale issues in other EU member states, notably Germany. Large German corporates, especially household names, commonly issue in small denominations. Retail demand is widespread and German distributing banks are willing to buy bonds back from small investors at a discount and resell them, thus ensuring secondary market liquidity. APCIMS believes the British market could and should be developed in the same way.

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THE CORPORATE BOND MARKET HAS BECOME ONE OF THE BEST WAYS FOR CORPORATES TO RAISE CAPITAL IN THE CURRENT ENVIRONMENT. IT IS ALSO THE INVESTMENT CATEGORY OF CHOICE FOR SMALL INVESTORS LOOKING FOR SAFE HAVENS AND RELIABLE YIELDS IN A LOW-RISK INVESTMENT.

FINDING IT HARD TO RAISE CORPORATE FINANCE? **DIRK PATERSON** AND **JOHN BARRASS** SET OUT THE ATTRACTIONS OF TARGETING CORPORATE BONDS AT INDIVIDUAL RETAIL INVESTORS.

PROSPECTUS DIRECTIVE AND SIZE OF ISSUES With the UK corporate bond environment biased against the retail investor at present only the tip of the demand iceberg can be seen. The chief contributor to this bias is the Prospectus Directive. The perceived difficulty and cost of producing a full prospectus for amounts below €50,000 has led many lead managers to conclude that targeting the retail market with small denominations is not worthwhile.

On the other hand the retail market, although keen to purchase, is seldom able to participate in the larger dominations. Indeed, Financial Services Authority (FSA) rules requiring professional advisers to ensure that investments are suitable for their clients' individual circumstances may prohibit advice being given in many cases to retail investors to buy at the €50,000 level. The rules may even compel firms to advise clients not to buy if doing so would commit too high a proportion of their funds or fail to fit the overall risk profile of their investment portfolio.

The rules are stacked against development of the retail market in corporate bonds in the UK. Yet with the pent-up demand, the benefits of retail access surely outweigh these costs. The cost of producing a prospectus for smaller denominations varies, but figures of £500,000 to £2m have been quoted for a one-off output. However, if prospectus preparation becomes routine for large company issues, not only does the unit production cost fall in the long run but returns on the investment may be much greater than issuers currently imagine.

Different APCIMS member firms give different figures for the lot size they would be prepared to take pretty well immediately from an issue, but £110m has been suggested. For issuers this would be an attractive scale that would allow a decent return on the outlay. It would also provide competition to the oligopoly of banks, which currently control issue management and distribution into the wholesale market. Issuers would then have an opportunity to drive down the costs associated with intermediary arrangements to get their bonds to market. That would be no bad thing for companies or investors.

BENEFITS OF THE RETAIL MARKET A further impact of expanding the UK retail market for corporate bonds could be on the cost of capital, which would very likely be reduced.

While some recent studies, such as McKinsey's, suggest that the cost of debt has not increased as a result of the financial crisis, yields have still been high by the standards of the last few years and spreads between gilts and corporate bonds have grown. But this may be due more to changes in the supply of government debt and the effects of quantitative easing than to the fact that investment-grade corporate bonds are necessarily riskier than hitherto. In these circumstances accessing the retail market for bonds with the concomitant increase in liquidity and demand could have the effect of lowering yields and thus reducing the long-term cost of capital to the issuer. Certainly the popularity of low-denomination issues in a number of continental countries suggests that going down this route is not to an issuer's detriment and may well be to their advantage.

TIME TO TAKE A DEEP BREATH The financial crisis and ensuing economic downturn have yielded obvious challenges and problems but they also afford many opportunities. The corporate bond market has become one of the best ways for corporates to raise capital in the current environment. It is also the investment category of choice for small investors looking for safe havens and reliable yields in a low-risk investment. The corporate bond market is ideally suited to their needs and the UK retail market, which is both large and unquestionably available. It is now down to the issuers to take a deep breath and access it.

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A smoother legal path

JOHN RUSSELL, **SRIKANT CHAKRAVARTI** AND **EMMA GREEN** OUTLINE THE LEGAL IMPLICATIONS FOR UK INCORPORATED AND LISTED COMPANIES ISSUING RETAIL DENOMINATION SECURITIES.

The EU's Prospectus Directive sets out the requirements for the content and approval of prospectuses that have to be published before securities can be offered to the public within the European Economic Area (EEA: the EU countries together with Iceland, Liechtenstein, Norway and Switzerland). The directive applies equally to securities trading on a regulated market in the EEA.

Issuers of non-equity securities in the EEA can choose whether to issue securities to the wholesale or retail market. Securities with denominations of €50,000 (or the equivalent in other currencies) or higher are wholesale securities, and those with denominations of less than €50,000 are retail securities.

When the Prospectus Directive was implemented in July 2005, companies may have been advised not to issue retail securities for the following reasons:

- It was said that there was no significant retail bond market in the UK and that retail investors had no interest in sterling issues.
- Offers of retail securities were considered attractive only in certain European jurisdictions, such as Germany, Spain, Italy and Belgium. That would mean any prospectus would first have to be passported into the relevant jurisdictions (that is, approved by the home member state for use in the host member state). In 2005, there were many uncertainties around passporting. In particular, there were specific local requirements in each jurisdiction, including differing translation requirements. Passporting also gave rise to the possibility that an issuer could be subject to the civil and criminal liability regimes for breaches of the Prospectus Directive in each jurisdiction into which the prospectus was passported. In comparison, issuers of wholesale securities could only be sued in the EEA state where the prospectus was originally approved.
- There was also a risk of liability for the issuer where an intermediary used the issuer's prospectus (but without their consent) for one or more secondary issues of the retail securities in a jurisdiction where the prospectus had not been passported or was no longer current.
- A prospectus had to be approved and published if retail securities were to be offered to the public in the EEA. That in turn would require compliance with more onerous disclosure requirements of the Prospectus Directive. Such extra requirements include the production of a summary section, which in most EEA states would have to be translated into the local language.

BARRIERS DISMANTLED Four years on and the issue of retail securities may be more attractive. Many of the concerns listed above have either been addressed or are no longer applicable:

- There is now a strong demand for retail securities in the UK (see main article), creating an opportunity to issue them at a lower cost than wholesale securities.
- UK companies with shares listed on the London Stock Exchange already comply with the more onerous requirements of the Prospectus Directive. As they now meet IFRS accounting and disclosure requirements, the preparation of a prospectus for a retail securities offer is a relatively straightforward business.
- To take advantage of the increased demand for retail securities in the UK, one approach could be to make offers in sterling and specify in the prospectus that the offer is available only to investors within the UK. This would avoid the need to passport the prospectus into any other EEA states and eliminate any resulting risks. However, following guidance from CESR (Committee of European Securities Regulators), passporting requirements have more or less been harmonised across the EEA (with a few exceptions, such as Germany and Italy). As a result the risk of liability outside the UK arising from differing interpretations of the Prospectus Directive has been reduced.
- The risk of the issuer incurring liability for sales made by an intermediary not acting in association with the issuer has been greatly reduced as a result of CESR's clarification that no such liability should arise.

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