Stores of capital

TO DATE, BOND ISSUES TARGETED AT RETAIL INVESTORS HAVE BEEN THE PROVINCE OF FINANCIAL INSTITUTIONS. **ADRIAN BELL**, **MORTON LLEWELLYN** AND **HENRIETTA PODD** ARGUE THAT CORPORATES SHOULD ALSO CONSIDER ISSUING THEM DIRECT.

Over the last five years a shift has taken place in the savings market in the UK as retail investors have started to switch out of equities and deposits into bonds. This has created an exciting new opportunity for corporate borrowers: a third source of finance, potentially more competitive and better suited to their term funding requirements, which can augment traditional bank lending and wholesale bonds/private placements.

Retail-targeted bonds have been widely available in most developed capital markets, in Europe, North America and Asia. The initiative launched by the London Stock Exchange last year for a retail bond market in the UK, the Orderbook for Retail Bonds (ORB), means that for the first time in a generation this opportunity is now available to UK borrowers through a transparent and regulated market.

Yet the market has been dominated by financial institutions, with only one non-financial borrower so far – Places for People, a social housing business. All have met with considerable success, so why have not more corporates attempted to come to the market?

INVESTOR DEMAND FOR UK RETAIL BONDS Traditionally, direct bond investments have been largely restricted to high net worth individuals. Over the last five years this has begun to change, under pressure from low short-term interest rates, a desire to diversify out of the banks and concern over the volatility and performance of equities. This has been accompanied by a shift towards more tax-efficient savings instruments such as ISAs (individual savings accounts) and SIPPs (self-invested personal pensions). While this has led to record inflows into bond funds, feedback from stockbrokers and wealth managers suggests many retail investors would prefer direct investment in bonds as it would give them a higher level of certainty on income and capital repayment at maturity.

UK retail savings market

Investment	Value	Source
NS&I	£99bn	NS&I 2011
Term deposits	£275bn	BoE April 2011
Bond funds	£107bn	IMA 2011
Stock ISAs	£178bn	ONS Jan 2011
Cash ISAs	£172bn	ONS Jan 2011
SIPPs	£75bn	Moret

THE NEW ISSUE STRUCTURE AND MARKET PLACE However, the market and systems for wholesale investors are suited neither to trading in retail amounts nor to providing the transparency on prices required of a retail investment. The underwriting/distribution mechanism is focused on the requirements of institutional investors.

ORB is a platform for making firm transparent prices in retail sizes that is designed to overcome these difficulties. Over 90 corporate bonds are now quoted on ORB, and more are joining every month.

This structure allows the retail distributors direct access to new offerings. And because of the pent-up demand for bonds from retail investors, borrowers should generally be able to obtain beneficial terms on pricing, while the smaller size and tenor of the issues may be better suited to their requirements.

THE ATTRACTIONS OF A RETAIL ISSUE TO BORROWERS

- **No requirement for ratings** Retail investors do not need ratings but will seek to understand the business model and the product. Retail bonds are particularly attractive for businesses that have a well-recognised brand, a straightforward business model, an identifiable product or a defined share of the market.
- **Longer maturities** Retail investors are particularly keen on maturities of between five and 10 years (to be ISA-eligible, an

investment must have a maturity greater than five years), which is ideal for the requirements of most corporate borrowers.

- **Size and certainty** Bonds can be launched for as little as £20m, while sums between £50m and £150m are the market norm. This provides significant flexibility compared with the institutional market.

In addition, corporates can develop a repeat borrowing programme – akin to the euro medium-term note (EMTN) used by larger borrowers in the wholesale market. This will enable them to develop a following among investors and distributors, thus creating greater certainly about raising repeat funds from the market at different maturities and at modest additional cost.

THE ISSUANCE PROCESS

- **Documentation and disclosure** Much has been made of the difficulties of issuing retail eligible bonds in light of European directives such as the Prospectus and Transparency Directives. The approach taken for this new market has been to limit distribution to the UK and certain other territories and jurisdictions, and distribute only through appropriately qualified and regulated intermediaries. Using this approach, issuers and lawyers are now happy to reduce the minimum denominations on bonds to sizes suited to retail buyers, with minimal additional disclosure on the documentation.

It is therefore possible to make retail issues, such as for Tesco Bank or Provident Financial, using the same template on documentation as the wholesale market, with only minor amendments.

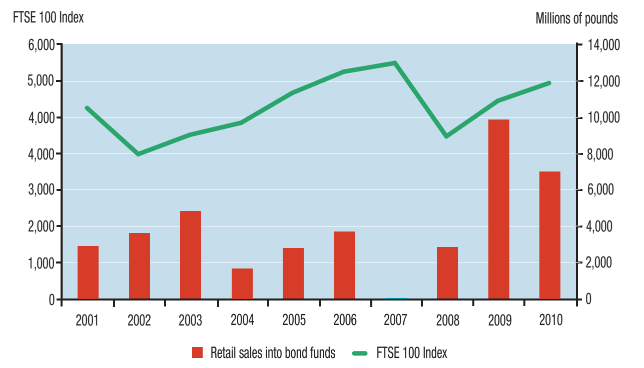
- **Documentation for first-time bond issuers** Most potential issuers will have publicly traded equity and will be reporting in compliance with existing stock exchange requirements, so producing a bond prospectus should be relatively simple. It should, however, be recognised that the preparation of a bond prospectus will cost more than that for a US private placement or a bank loan, but this ultimately needs to be evaluated in the context of the benefits that can be achieved, namely diversification of funds, currency, long tenor, non-amortising and bond-style covenants.
- **Other costs** The other objection often raised about retail issues concerns overall cost. With retail documentation broadly identical to wholesale documentation, legal and accountancy costs will be broadly similar. This means that the only material difference in costs arises on advertising and PR, which are discretionary.

ALTERNATIVE ROUTES TO ACCESS RETAIL DEMAND Some corporate issuers have accessed retail demand through privately placed debt. Names such Hotel Chocolat, Ecotricity, and King of Shaves have raised small amounts (under £15m). These fund raisings are often referred to as retail bonds, but as they are neither transferable nor listed on a regulated exchange they should not be confused with the retail bonds referred to in this article.

John Lewis raised a more meaningful amount of £50m through a loan-like product, the John Lewis Partnership Bond. Although the offer was limited to partners and account holders it illustrates the strong demand available from the retail investor base as well as the ability to capture the value of brand loyalty.

Why do companies choose this route? The product may be less attractive for many investors as it provides no liquidity and lacks the same degree of regulatory protection as associated with a prospectus. In addition it means the debt cannot qualify for either SIPPs or ISAs. The argument is often advanced that the

Retail sales into bond funds versus FTSE 100 index since 2000



documentation is simpler, but for anyone who issues other public securities this is now unlikely to be true.

OPPORTUNITIES FOR UK ISSUERS In summary a UK retail bond issue listed on ORB will enable a company to raise relatively small amounts of debt in tranches of between £50m and £150m, for long tenors of between five and 10 years, on cost-competitive fixed-rate terms, and with bond-style covenants. A compliant prospectus will be required but the cost of this, if spread over the life of an issue, is negligible.

Any UK company that wants to raise long-term debt capital and to diversify its sources of funding should consider the UK retail bond market. Highly rated companies with access to low-cost debt may have lower-cost alternatives available, so the relative terms should be considered, as well as potential customer loyalty benefits. For smaller and lower-rated companies the key assessment is whether the credit profile is acceptable to the investor base – ultimately a matter that bookrunners/arrangers should advise on.

FISHING THE POOL The UK has a deep pool of retail investor capital to be deployed and the infrastructure to support the growth of the market. The critical question is whether it is a market that UK corporates and borrowers want to engage with or one they prefer to ignore because they are sufficiently comfortable that other sources of debt capital will remain more attractive and reliable.

Adrian Bell is head of debt advice and origination at Evolution Securities.
adrian.bell@evosecurities.com

Morton Llewellyn
morton.llewellyn@evosecurities.com

Henrietta Podd
henrietta.podd@evosecurities.com

Evolution