Maturity extensions

AKIS PSARRIS REFLECTS ON THE LIABILITY MANAGEMENT THEMES THAT HAVE DOMINATED THE EUROPEAN CORPORATE BOND MARKET.

Corporate treasurers often use liability management (LM) transactions to facilitate early debt retirement as well as for the proactive refinancing or restructuring of outstanding liabilities. LM transactions can be designed to help issuers address a variety of economic, liquidity and capital structure objectives. This article focuses on the LM themes that have dominated the European corporate bond market in the last 18 months and the opportunities for issuers going forward.

CAPITALISING ON LOW LONG-TERM BORROWING COSTS Most of the European corporate LM activity since early 2010 has been dominated by proactive extensions of short-term debt maturities as issuers seek to lock into historically attractive long-term funding by taking advantage of record low government bond yields and tight credit spreads. Most issuers have chosen to extend their short-term maturities through either:

- cash tender offers for selected debt securities launched concurrently with a new bond offering; or
- debt exchange offer transactions.

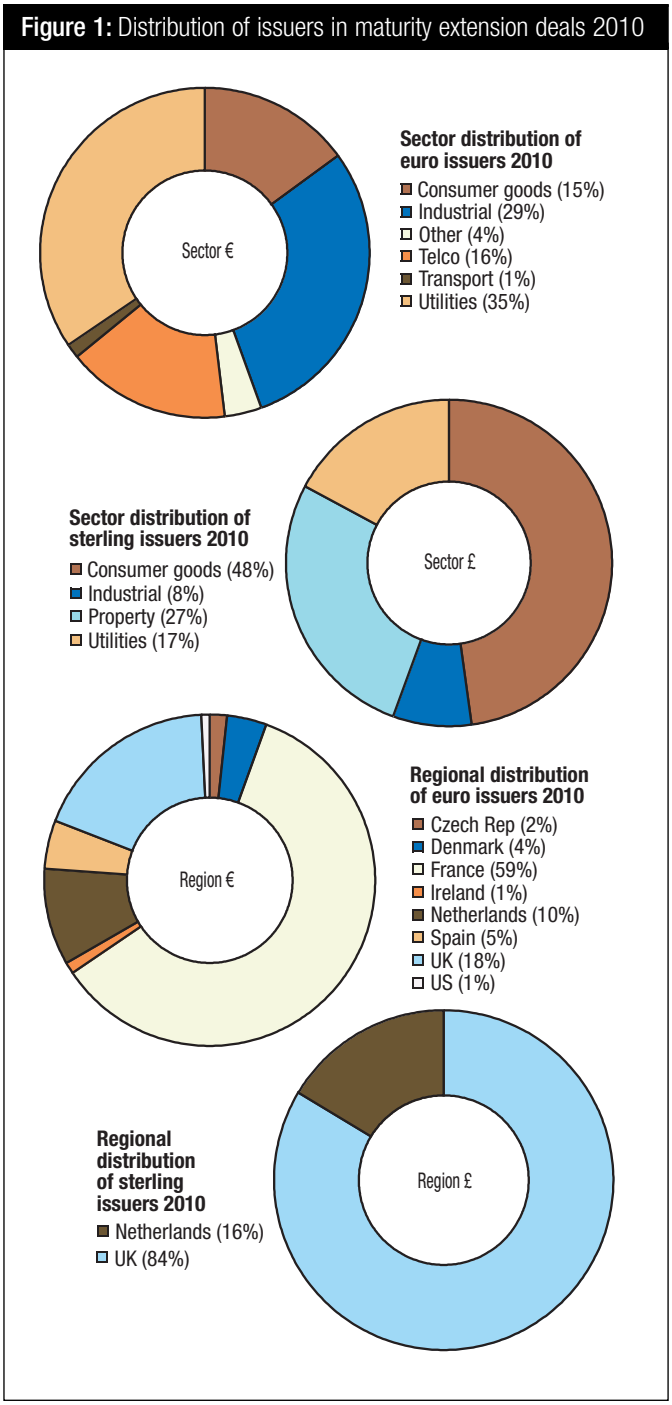
Figure 1 shows the geographic and business sector distribution of issuers executing maturity extension transactions in 2010 in euro and sterling.

QUANTIFYING THE MATURITY EXTENSION BENEFITS Issuers can incorporate economic considerations, as well as views on future borrowing cost, in the decision to extend short-term debt maturities ahead of their scheduled redemption date.

- **Analysing net present value savings** The net present value (NPV) approach uses an after tax discounted cashflow (DCF) model to evaluate the savings attained (or friction costs incurred) in refinancing the outstanding debt with new debt of like maturity. In most cases this analysis will result in slightly negative economic benefits as issuers have to pay a small premium to their matched maturity fair funding levels to entice bondholders to sell the outstanding debt (see the 'Tools to minimise buyback friction costs' section later in this article). For premium bonds, the tax benefit realised with the debt retirement can help reduce NPV costs and in some cases could even result in a small NPV gain.

  One drawback of the NPV analysis is that it assumes the evolution of future borrowing costs is fully reflected in today's borrowing curve. This does not allow issuers to incorporate views on future borrowing costs (interest rates and credit spreads, or – for floating rate borrowers – just credit spreads) in the decision to address maturities early. This drawback has led many issuers to adopt a cost of carry breakeven analysis in the refinancing decision.
- **Breakeven analysis** The breakeven analysis calculates by how much borrowing costs for a given tenor (e.g, a new 10-year note) need to rise at the time the outstanding debt matures for an early refinancing decision to be optimal. For short-dated maturities (one to two years) the breakeven rise in borrowing costs can sometimes be

Figure 1: Distribution of issuers in maturity extension deals 2010



as low as a few basis points. The magnitude of the breakeven rise in borrowing costs is influenced by the necessary buyback premium, any upfront tax benefits, the steepness of the borrowing curve and the tenor of the refinancing instrument used in the calculation. Issuers can rely on breakeven analysis to make a decision on whether an early refinancing is desirable as a hedge against a possible rise in borrowing costs above the calculated breakeven levels.

■ **Accounting considerations** Accounting considerations can influence both the decision to refinance early and the method used

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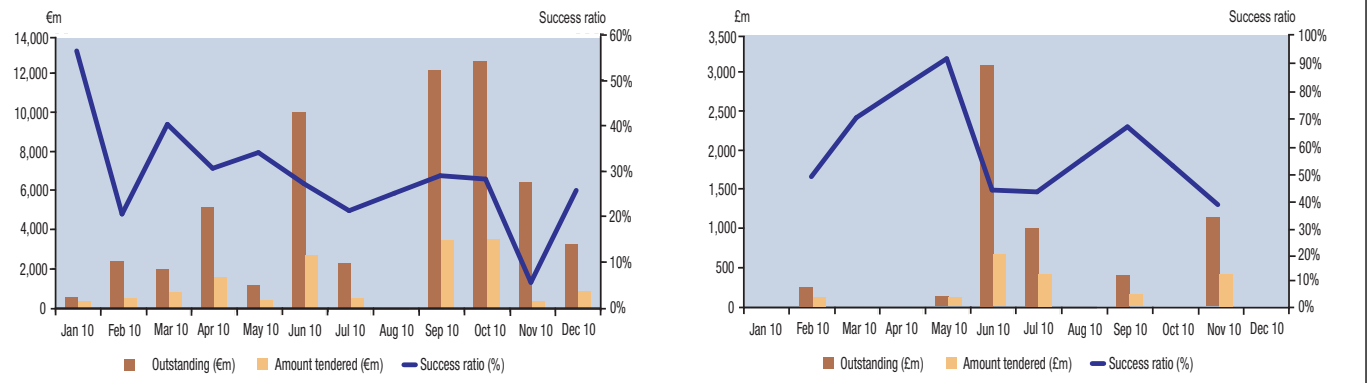
Figure 2: Repurchase amount targeted versus amount outstanding in selected euro and sterling buyback transactions



to effect the refinancing. A refinancing of outstanding debt with a tender offer and new issue approach will result in an upfront loss or gain for the issuer depending on the price paid to retire the bond relative to its basis (which is usually close to par).

■ **Debt exchange approach** Issuers uncomfortable with realising accounting losses (or gains) upfront may be able to spread the accounting loss/gain over the life of the refinancing instrument by utilising a debt exchange approach if a cashflow test, as described in IAS 39, is satisfied. One drawback of this approach is that if the tax treatment of the loss follows the accounting treatment, then any tax benefits from the extinguishment of the outstanding debt will also be realised over the life of the new debt instrument. In addition, since the accounting charge is spread over the life of the new debt instrument, the issuer will realise lower ongoing interest expense savings relative to a tender offer/new issue approach which expenses the charge upfront.

■ **Swap considerations** An early refinancing of outstanding debt may require the unwinding of interest rate and/or cross-currency swaps attached to the existing debt. The economic and accounting impact of such unwinds needs to be factored into the refinancing decision.

TOOLS TO MINIMISE BUYBACK FRICTION COSTS Buyback costs can increase significantly if an issuer seeks to retire a significant percentage of its outstanding bonds. Issuers have been able to minimise buyback costs by structuring debt repurchases to target several short-term maturities with a combined face value significantly higher than their buyback target. By targeting just the "float" of the outstanding bonds as opposed to marginal sellers, some investment-grade borrowers have been able to retire significant amounts of debt at premiums as low as 5-10bp through offer-side levels.

Certain issuers have also used fixed-price or fixed-spread Dutch auction tender offers to discover a market-clearing price for the repurchase amount sought. Dutch auctions minimise the buyback premium by introducing competition among bondholders but need careful structuring to realise their full potential. In a Dutch auction tender offer approach, the issuer invites investors to submit an offer to sell their securities at a specified price level. Investors can submit:

■ non-competitive offers at a minimum price set in advance by the issuer; or

■ competitive offers at a higher price than the minimum price.

The minimum price is typically set at market levels or at a small premium to market. After the expiration of the auction the issuer selects at its discretion a clearing price that maximises the objective of the buyback (which could include trade-offs between NPV savings, interest expense reduction, or volume repurchased). All investors' offers to sell at a price lower than or equal to the clearing price are accepted at the clearing price. Offers submitted at the clearing price are subject to proration at the issuer's discretion. The mechanics of this structure encourage investors to submit offers at the minimum price to maximise the chance that their offers are accepted and potentially realise price upside should the issuer set a clearing price higher than the minimum price.

Figure 2 shows the repurchase amount targeted versus the amount outstanding in selected euro and sterling buyback transactions. For euro-denominated notes, issuers chose to target a higher face value of debt in the second half of 2010 to reach their buyback targets as tender offer success rates progressively declined due to investor reluctance to sell short-term corporate bond assets in a record low interest rate environment.

MATURITY EXTENSION OPPORTUNITIES IN 2011 Market conditions remain favourable for maturity extension transactions. Interest rates are low by historical standards in all major funding currencies, while the supply of corporate bonds has declined year on year, creating competition among investors for assets in the primary market. Issuers can monitor market conditions and utilise the tools that are discussed in this article to analyse potential maturity extension opportunities.

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