30-YEAR BONDS ERUPT

THE LAUNCH OF THREE 30-YEAR BONDS IN THE FIXED RATE EURO CORPORATE BOND MARKET IN JANUARY IS A GOOD SIGN FOR THE FUTURE, SAYS **CRISPIN SOUTHGATE** OF MERRILL LYNCH.

Something quite remarkable happened in the fixed rate euro corporate bond market in January. Within the space of a few days, three separate BBB-rated companies all launched 30-year bonds. They were responding to investor demand: these issues were not pushed into a reluctant market. They put the vivid colour of low investment grade credit into part of the corporate maturity spectrum that had until then been an empty black. It has been a long time coming, but the long end has finally arrived.

Olivetti (€400m), France Telecom (€1bn) and Deutsche Telekom (€500m) all issued bonds maturing in 2033. They joined the major corporate indices such as Merrill Lynch's ER00 at the end of January 2003 and took the Euro Corporate Long end of 25+ years from nothing in December to €1.9bn par value. Two of the issues were later tapped: France Telecom (€500m) and Olivetti (€400m). Further 2033 issues by RWE (single A, €750m) and Electricité de France (AA, €850m) will take the index total to €4.4bn at the end of February.

STERLING HISTORY. The sterling long end corporate bond market has a reasonably long history. There were no 25+ year corporate bonds in the euro index on 1 January 2003. Like the volcanic Surtsey this very long end has suddenly grown from nothing.

The sterling 15+ year corporate index is bigger than the >15 year gilt index. The euro >15 year corporate index, by extreme contrast, is about 1% of the size of the >15 year sovereign index.

Only 4% of the euro corporate index is more than 10 years. Nearly all the bonds are in the 10 to 15 year sector (see *Figure 1* overleaf).

Compare that to the sterling corporate fixed rate market in *Figure 2*. More than half of this market is over 10 years and 43% more than 15 years. But notice also how small is the proportion of BBB bonds – and that is at current ratings: few were BBB when they were issued.

Why should the development and current state of the long end of the sterling corporate market have any relevance to the euro and these new issues? The investors in sterling are largely life companies and pension funds investing in assets aimed at meeting long duration life annuity and pension obligations in the private sector. After state provision, this second tier of funded retirement income provision is highly developed in the UK. But not so in most of Euroland, as *Figure 3* shows.

CHANGING FACE OF EUROLAND. Consider Germany as an example of how Euroland is changing, though. The substantial holdings of liquid fixed bonds held in many German corporate treasury portfolios are partly there for the purpose of backing pension provisions. But the German column in *Figure 3* takes no account of this quasi funding of pension obligations: these assets are not held in legally separated *pensionfonds* or *stiftungen*, so they do not count as funding and do not appear in the chart.

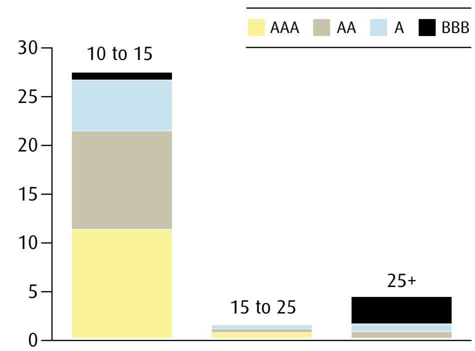
These treasury assets cannot be netted off against pension liabilities under IAS 19, in either its current or likely revised form, or under FAS 87 in US GAAP. But these accounting standards expose the interest rate mismatch risk of these companies, whether or not such quasi funding is recognised. Liabilities discounted at long AA corporate bond rates move corporate net worth in a way that is unmatched in either accounting or economics, by changes in the market value of the shorter dated assets held in the treasury.

Pension asset/liability mismatch risk will become for European treasurers a headache unsoothed by what many investors now regard as the sleight of hand of smoothed accounting. If the International Accounting Standards Board succeeds in its current stated intention, the smoothing approach inherited from FAS 87 will be thrown out in a revised IAS 19 that should be ready by 2006. The solution is the same as so many life companies have learned, many of them the hard way: hold longer duration assets in the first place.

POINTS TO NOTE FOR ISSUERS AND INVESTORS. We are in the early days of the life of the euro corporate long end. But both issuers and investors can draw useful lessons from the experience so far.

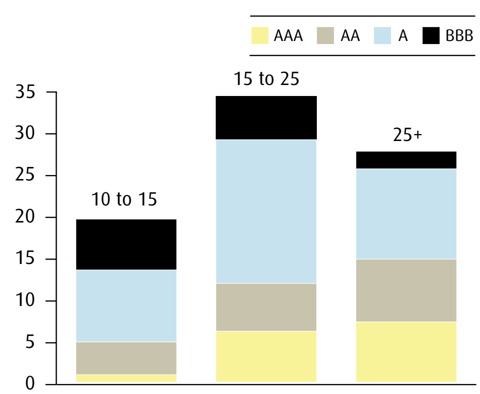
- **Treasurers** need to be prepared to move quickly in the nervous market of 2003: the three initial telecom issuers benefited from being well known, heavily analysed and widely held. They are well aware of the importance of reducing the risks of overleverage to their capital market standing in both equity and debt markets. Above all, a key part of their business represents vital

FIGURE 1
EURO CORPORATES > 10 YEAR (PAR, €BN).



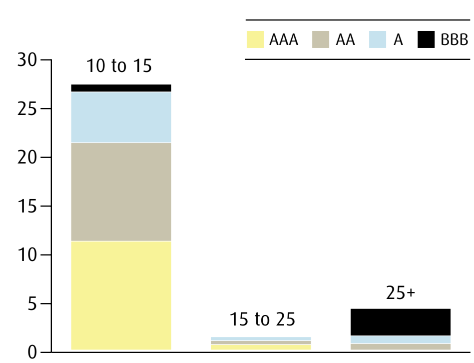
Source: Merrill Lynch Global Index System, ER00 @ 1 February 2003 and later 30-year issues from Bloomberg

FIGURE 2
STERLING CORPORATES > 10 YEAR (PAR, £BN).



Source: Merrill Lynch Global Index System, UC00 @ 1 February 2003

FIGURE 3
PRIVATE SECTOR PENSION ASSETS IN EUROPE 31.12.00 ($BN).



Source: Intersec

infrastructure for the countries in which they operate. These new long BBBs have the lasting attraction of incumbent wireline status as a mitigant to their low rating. The higher-rated utility companies, RWE and EDF, have joined them. Maturity extension is an appropriate goal for core funding of such long-term businesses.

- **For core long investors** (and in euro that now includes many UK pension and life funds), improving the match of long-dated asset and liability flows is a fairly pointless exercise if it falls apart. This could happen in two ways: credit problems in the medium term or issuer call options many years before final maturity. Few BBB issuers have the rating mitigants of these first three telecoms companies. Both BBB and single A issuers should be prepared for the kind of investor caution long familiar in the sterling market: long investors look through the rating for further evidence of sustainable credit quality or demand appropriate protection language where mitigants are absent. Long-dated bonds with 10-year calls are also less attractive to this investor base.
- It was not just **'buy and hold' investors** that took these issues. As 2003 started, there was widespread agreement in the market that telecoms was a sector with good prospects for spread narrowing and one in which to be overweight. These very long duration bonds proved a geared play on any telecoms spread narrowing that benefited the long end. Every basis point of narrowing was magnified to 11bps in price rise. That is why we believe they were eagerly taken up by Italian mutual funds as well as continental European insurers and asset managers looking for total return.
- But such **a high beta strategy** cuts both ways and spreads have been volatile. Because of their duration, these issues can punch well above their market weight in their influence on benchmark index returns. It will be important to have them in the portfolio when they are performing well. But with the many uncertainties facing the markets this year, expect to see the downside of long duration illustrated from time to time – especially when the slope of the credit curve changes (for example, 30-year spreads minus 10-year spreads). Timing is everything, especially in these markets, for investors, as well as issuers.

WHAT THE FUTURE HOLDS. Sterling (*Figure 2*) shows the more likely balance of a developed long end quality spectrum: the longer, the stronger for core buy and hold investors. Euro does not yet have the high quality fixed rate corporates that meet life and pensions liability matching demand at the long end of the sterling market. That job is done mainly by government and supranational issuers. But these three telecoms issues may prove to have been just the catalyst required to accelerate a similar development.

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Crispin Southgate will be speaking on "Basel II - Regulations by Ratings" at the ACT's one-day conference, "Ratings Agencies: Prophets, judges or mere mortals?" held on 20 March. For more information contact Makayla Rahman at mrahman@treasurers.co.uk or phone 020 7213 0703.