Navigating US debt capital markets

INTERNATIONAL BORROWERS FACE GROWING CHALLENGES WHEN TAPPING THE US DEBT CAPITAL MARKETS, INCLUDING MEETING THE COSTLY REQUIREMENTS OF SARBANES-OXLEY, BUT THE US STILL OFFERS ADVANTAGES AS A SOURCE OF DEBT FINANCING. BY **BRYANT OWENS**.

Treasurers exploring debt-raising opportunities in the US debt capital markets must increasingly navigate the challenges posed by changes in interest rates, currency valuations and regulatory oversight. But when exploring global options for obtaining debt financing, the US markets do contain some of the deepest pools of liquidity and can often provide additional opportunities to obtain substantial longer-dated funding.

In terms of total investment-grade debt, euro-denominated

Executive summary

- The US capital markets have some the deepest pools of liquidity. There were 753 issues for $205bn in 2004, up sharply from 372 issues for $163bn in 2003.
- At the end of 2004, the Lehman Corporate Index tightened to 80bps over Treasuries, the tightest spread environment since July 1998. However, a weakening dollar may reduce foreign investors' interest in US dollar assets and cause spreads to rise.
- The larger deals done in 2004 were driven by resurgence in merger and acquisition activity. May Department Stores raised $2bn to acquire Marshall Field's. BellSouth and SBC also tapped the market three times in late 2004 to raise $10bn to fund acquisitions.
- One of the biggest challenges facing issuers in the US is compliance with Sarbanes-Oxley. Its stringent requirements have prompted some issuers to consider de-listing shares from the New York Stock Exchange and others to call for a global approach to oversight and regulation.
- European companies issuing in the US are not exempt from Sarbanes-Oxley's requirements which, among other things, call for the inclusion of internal control reports in annual reports that include a management assessment of the controls and an auditor's report on the assessment.
- A less expensive and more manageable way for European companies to issue securities in the US is via a US Securities and Exchange Rule 144(a) offering. These securities are exempt from registration with the SEC. However, shelf registrations are better for issuers who enter the market on a regular basis as the documentation required for each issue after the first one is reduced.

issuance in Europe last year was greater than dollar-denominated issuance in the US, evidencing a continuing trend in the evolution of the global capital markets. According to Thomson Financial, the first nine months of last year saw euro-denominated debt issuance of €637bn (approximately $860bn), versus $580bn of dollar-denominated debt issuance into the US market.

A different picture emerges if the focus is narrowed to exclude financial institutions. Issuance of all corporate bonds in the US market towards the end of 2004 stood at 753 issues for $205bn, up sharply from 372 issues for $163bn in 2003.

Despite recent US rate hikes and a weakening US dollar, international borrowers have not abandoned the US markets and, in fact, now account for an increasing share of new deals coming to market. Yankee issuance accounted for about 17% of the $580bn of total investment-grade issuance through to late 2004, up 14% compared to 2003 issuance levels. In the Euromarkets, in comparison, US issuers accounted for about 9% of the €637bn in investment-grade debt new issuance heading into late 2004, up only 7% from the previous year.

The preferred market is also an attractive funding source for global issuers. Preferred transactions are largely issued through the US retail market, providing a diversified group of investors to large, frequent issuers. Although market issuance declined in total volume terms in 2004, the preferred market provided significant capital for several major global financial institutions. Specific issuers in 2004 included ABN AMRO, which completed the largest retail transaction in history at $1.8bn, and Royal Bank of Scotland, which priced a $925m transaction.

AN EVER-CHANGING ISSUANCE ENVIRONMENT. Heading into 2005, an interesting new issuance environment arises. US debt market fundamentals are solid due to a combination of historically low corporate default rates, balance sheets flush with cash, and strong technicals. These factors should continue to support extremely tight corporate spreads in the near term. At year-end 2004, the Lehman Corporate Index tightened to 80bps over Treasuries, the tightest spread environment since July 1998.

Over the longer term, however, this issuer-friendly spread environment may not last. Foreign investor demand for US assets has contributed greatly to the tightening spread environment over the past two years. The weakening US dollar may reduce foreign investors' incentives to purchase US dollar assets.

After steady trading for much of the year, the US stock market experienced a post-presidential election rally that drove indices higher. This modest resurgence, in turn, led to projections that institutional investors would shift asset allocations from fixed income towards equities in 2005.

Throughout 2004, there was strong technical support for secondary spreads due to lower levels of supply relative to investor demand. However, this reduction in supply may lead to reduced fund allocations to the investment-grade sector in 2005. US issuance in 2005 is expected to be 10% lower than in 2004.

The trend of tightening spreads could potentially be reversed if issuance levels continue to decline in the US markets this year. This is because a healthy new issue calendar can have an overall positive effect on the spreads, generating price discovery, focus on the sector and liquidity.

RECENT US ISSUANCE THEMES. In contrast to 2003, the larger deals done in 2004 were driven by resurgence in merger and

acquisition activity, including a $2.2bn issue by May Department Stores to acquire venerated retailer Marshall Field's. BellSouth and SBC Communications collectively tapped the market three times in late 2004, raising $10bn to fund the acquisition of AT&T Wireless by their Cingular joint venture.

California-based utility company Pacific Gas & Electric Co. issued $6.7bn in multiple tranches to emerge from bankruptcy – the largest non-financial transaction in 2004. Other notable multi-tranche transactions included Telecom Italia's $3.5bn issue for corporate purposes and Australian-based Westfield Capital Corp's $2.6bn issue linked to a restructuring and interest-rate play. Notable single-tranche transactions included a $650m offering from WPP Group, a London-based advertising agency, and a $500m offering from Tate & Lyle.

The trend towards companies using debt to fund share repurchases is also gaining momentum. Over the past couple of years, corporate issuers have been keenly focused on developing excess liquidity and building cash balances. As the economy has gradually improved over the past year, companies have increasingly been taking advantage of historically low interest rates and tight credit spreads to return value to shareholders.

Limited Brands, for example, announced a $2bn stock repurchase and a $500m one-time dividend funded through existing cash balances, a $500m term loan and a $500m senior note issuance. Separately, TXU Corp. executed a $3.5bn debt issuance to repurchase stock.

Greater debt issuance by the European subsidiaries of US multi-national companies may be encouraged by the newly enacted US Homeland Investment Act.

This allows multi-nationals to repatriate overseas earnings at a 5.25% tax rate – significantly lower than the current 35% corporate tax rate. Its provisions thus create a powerful incentive for companies to dividend retained earnings back to their US parents. Where companies have high levels of retained earnings but not enough cash to make the payout, the dividend could be financed through debt issuance.

Government estimates peg the amount of potential repatriated funds at about $135bn, but analyst estimates run significantly higher. Estimates of the potential effect of the Homeland Investment Act on new issuance range from $50 to $100 billion for 2005.

DESPITE RECENT US RATE HIKES AND A WEAKENING US DOLLAR, INTERNATIONAL BORROWERS HAVE NOT ABANDONED THE US MARKETS AND, IN FACT, NOW ACCOUNT FOR AN INCREASING SHARE OF NEW DEALS COMING TO MARKET.

However, for treasurers interested in debt issuance in the US market new regulatory developments must be a major consideration. In the wake of a series of financial and accounting scandals that heightened public awareness regarding inappropriate corporate activity, US regulators have enacted tougher laws that affect all companies issuing public debt in the US.

Most notably, the Sarbanes-Oxley Act of 2002 (see *No Shelter from the Storm,* page 16, *The Treasurer,* October 2004) instituted significant corporate governance and disclosure reforms. For European corporations, the new regulations have triggered a spate of complaints about the costs of complying with the new rules, prompting some issuers to consider de-listing shares from the New York Stock Exchange and others to call for a global approach to oversight and regulation. While the new regulation requirements must be recognised, several avenues still remain for tapping the US debt markets.

One of the most straightforward methods for European companies to issue securities in the US is via a US Securities and Exchange Rule 144(a) offering. Securities sold under Rule 144(a) are exempt from registration with the SEC, but may only be purchased by 'qualified institutional buyers', a class of sophisticated investors such as pension funds, insurance companies and other institutional investors, as well as registered high net-worth individuals.

Non-US investors also can purchase 144(a) securities if the transaction is eligible under Regulation S. The benefits of the 144(a) process include that it is less expensive and more manageable for issuers who anticipate accessing the US market infrequently.

For issuers who wish to issue on a more regular basis, shelf registrations are typically established. Although a shelf registration may initially be more expensive and time-intensive to establish, the necessary documentation for each issue taken off the shelf is reduced significantly. These shelf offerings are usually sold to 144(a) investors in the US, but some non-US issuers can and do register their programs with the SEC for broader distribution. An SEC registration requires US Generally Accepted Accounting Practice (GAAP) financials to be included in the offering document, while 144(a) transactions can utilise non-US GAAP financials.

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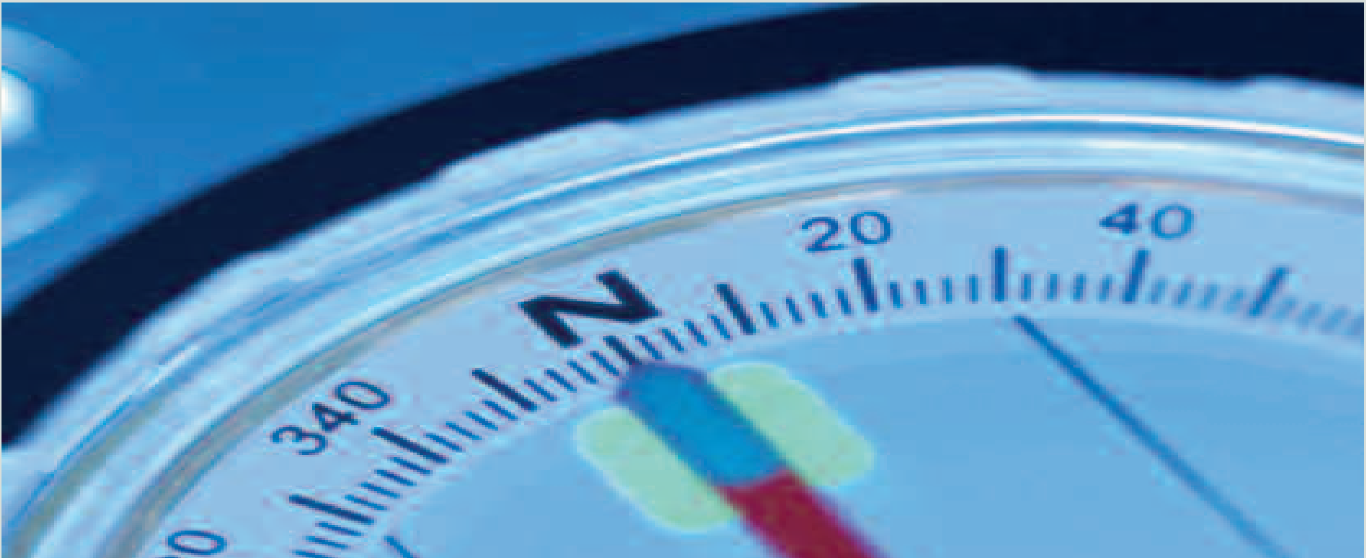

Sarbanes-Oxley – what it means for issuers

The Act is a comprehensive package of corporate governance and accounting reforms that, since enactment in 2002, have spawned a number of new laws regulating corporate governance matters, insider transactions, public disclosure requirements and auditing practices.

European companies issuing securities in the US are not exempt from the Sarbanes-Oxley Act as the law's provisions apply to all issuers that have securities registered under the Securities Exchange Act of 1934. The law also applies to companies required to file reports under section 15(d) of the Exchange Act, or those that have filed a registration statement under the Securities Act of 1933 that has not yet become effective and that has not been withdrawn.

The Sarbanes-Oxley Act does not apply to Rule 144(a) issuers unless a 144(a) offering was followed by a registered exchange offer and the issuer is still required to file reports with the SEC. Also, the Sarbanes-Oxley Act does not apply to non-US issuers that submit information to the SEC pursuant to Rule 12g3-2(b) under the Exchange Act, such as issuers whose securities are represented by Level I American Depositary Receipts (ADRs).

The Sarbanes-Oxley Act saw the creation of a new accounting oversight board to regulate public accounting firms. Issuers with securities listed on a US securities exchange or NASDAQ are required to have fully independent audit committees.

Members of the audit committee may not accept any consulting, advisory or other compensatory fee from the issuer and may not be affiliated persons of the issuer or any of the issuer's subsidiaries. Failure to have an independent audit committee and non-compliance with the provisions could result in de-listing or a refusal to list any of the issuers' securities on US exchanges and NASDAQ.

Companies also must disclose, in 'plain English' and 'on a rapid and current basis' material changes in their financial condition and the results of their operations.

Sarbanes-Oxley requires issuers to maintain internal disclosure controls and procedures for financial reporting. Annual reports must contain an internal control report, including an assessment by management of the effectiveness of the company's internal controls. The issuer's outside auditor must attest to, and report on, the internal controls assessment made by the issuer's management. These rules apply to non-US issuers as well as US issuers.

Companies are no longer permitted to use their independent auditors for certain non-audit services, such as financial information systems design and implementation. They need pre-approval of their audit committee, or a designated member of the audit committee, for other permitted non-audit services including tax services.

Additional responsibilities were imposed on audit committees including having primary oversight of the independent auditors and requiring disclosure of whether the audit committee includes a "financial expert," as defined by the SEC.

The Act provides for two new CEO and CFO certifications. CEOs and CFOs are required to forfeit bonuses and stock gains if the company restates its financials as a result of misconduct.

Directors and executive officers are prohibited from purchasing or selling any equity securities during any blackout period imposed under a company's retirement plans. A company also may not make any personal loans to its directors and executive officers, other than loans pursuant to Regulation O and certain consumer loans.

Certain reports regarding changes in ownership of equity securities, including option grants, restricted stock awards and gifts, must be filed within two business days following the date of the transaction. An issuer must also disclose in each periodic report whether or not it has adopted a code of ethics for senior financial officers and other principal accounting officers.

And finally, the law has created, and in some cases increased, criminal and civil penalties for fraud, securities law violations and the destruction, alteration or falsification of records.

For example, if an issuer restates its financial statements due to material non-compliance with the financial reporting requirements as a result of misconduct, the issuer's CEO and CFO must reimburse the issuer for any bonus or other incentive-based or equity-based compensation. This also could include profits realised from sales of the issuer's securities during the 12-month period following the first public issuance or filing with the SEC of the non-compliant financial statements.