Opportunities in global credit markets

Kate Mingay of Goldman Sachs reviews US debt markets in the context of funding opportunities for corporate issuers internationally.

Conditions in the global corporate debt markets over the first quarter of 2001 have been extremely resilient in the face of equity market volatility and weakening credit fundamentals, while issuance in the US and euro markets has risen dramatically over the fourth quarter 2000 and is running at a higher rate than in the first quarter 2000.

If there is one theme that stands out during this period, it is the continuing evolution of the euro market. This has been seen in both the capacity shown for global telecom and automobile issuers and the increasing scope of the markets for BBB-rated issuers.

This evolution is allowing European markets to rival their US counterparts on corporate financing opportunities for an increasingly wider range of issuers. The real choice between markets – or the opportunity to use them simultaneously – is widening, while the approach to each market becomes more standardised, as European markets adopt a number of US-style practices.

The widening choice is benefiting European corporate issuers, as the drive to diversify debt financing away from the banking market continues. However, the focus on the euro market presents the risk of overshadowing what has been an outstanding first quarter in the US markets. The highlights are as follows:

New issue volumes – record issuance of $184.5bn for the first quarter of 2001. Investment grade issuance rose by 79% after the fourth quarter of 2000 and 19% over the first quarter in 2000. Contributing factors include strong technical demand factors as funds have been allocated out of equities into fixed income and supply fuelled by issuers taking advantage of the lower rate environment.

Average deal size continues to grow – $448m in the first quarter of 2001, with nearly 50% of a the volume accounted for by transactions of $1bn-plus comapred to $337m in the first quarter of 2000. Ongoing focus on liquidity continues to contribute to larger transactions.

Resurgence of lower rated issuers – BBB-rated issuance increased in the first quarter of 2001 by more than100% compared with the first quarter of 2000. While investors remain concerned about credit, falling interest rates have led yield hungry investors to return to the high yield and BBB sectors.

Maturity – as rates have continued their trend lower, investors have been looking for opportunities to pick up yield, contributing to a tremendous increase of 10-year and 30-year securities, which is in sharp contrast to the market trend towards shorter maturities in 2000 and the current lack of depth in euros beyond seven years.

Pricing – the first quarter of 2001 saw spreads tighten by an average of 31bps after an average widening of 64bps for 2000 (see *Figure 1*). However, while the pricing advantage is very real for fixed rate borrowers (see *Figure 2*), declining swap spreads have affected the Libor cost. Many European borrowers, when analysing the costs of markets on a Libor basis, believe the euro market will provide better pricing. This perception seems particularly the case for BBB-rated issuers (see *Figure 3*). However, such analysis is oversimplified. The index of BBB issuers in Europe is more heavily weighted towards BBB+ ratings, with the US more broadly spread, making the average spread tighter for Europe. The markets continue to display significant

FIGURE 1

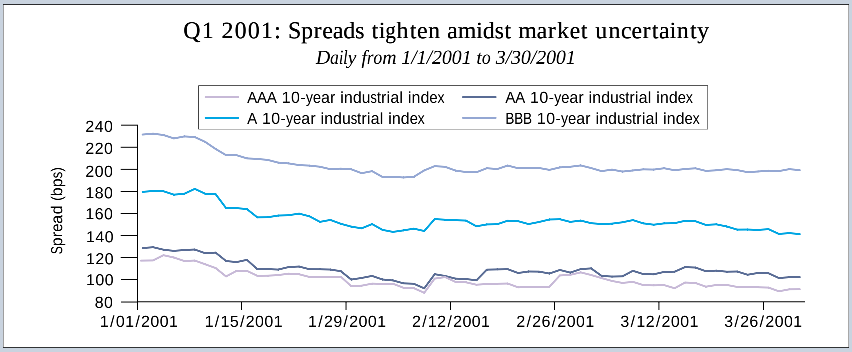
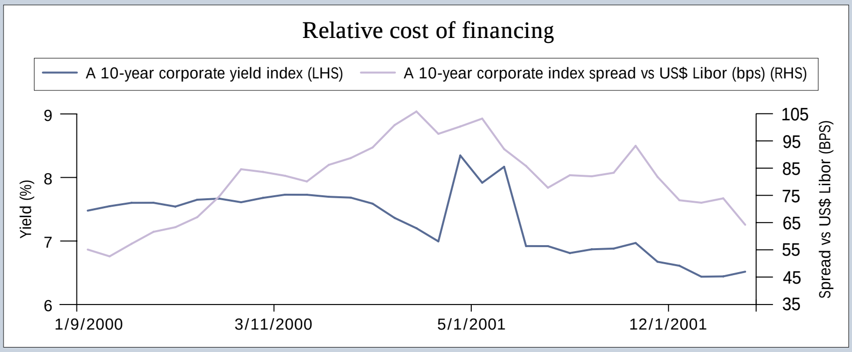


FIGURE 2



spread differentials across sectors (see *Figure 4*).

Not only are fund managers' sector views increasingly differentiated, but the range of pricing between individual issues for a given rating is widening in this environment as the market analyses exposure to the economic cycle, stability with credit ratings, event risk and the strength of the management case. Views on sectors and even individual firms in both markets vary significantly. As a result, with conditions strong in the US and euro markets, ultimately the market of best advantage will largely be a function of company and sector specifics. However, with the evolution of the euro market, more issuers than ever are now able to exercise a choice.

The commercial paper (CP) market

Recent volatility has caused uncertainty among investors and A-2/P-2 spreads to widen, particularly in the US CP market. Market access for most issuers rated A-1/P-1 or better, including asset backed issuers, is largely unaffected, although the automobile, telecom and utility sectors have experienced some difficulties. This has therefore been an issue for Tier 2-rated firms.

Borrowers rated A-2/P-2 have traditionally found ample funding opportunities in the US CP market. More recently, investors in the euro market have also become more willing to consider purchasing lower-rated assets as the introduction of the euro has helped to developed credit awareness among investors.

Outstandings in the A-2/P-2 sector peaked at almost $150bn US CP and European CP (ECP) in November 2000. Issuance of A-2/P-2 notes has tended to represent about 10% of the US CP market and 5% of the ECP market.

Contrary to expectations, the end of 2000 saw a dramatic widening in credit spreads for A-2/P-2-rated issuers, combined with a sharp reduction in liquidity. At the start of 2001, A-2/P-2 credit spreads did not tighten but remained wide.

In addition to the usual seasonal factors, there were several reasons for the dramatic spread widening observed at the end of 2000. By the fourth quarter, economic data showed unmistakable signs that the US was slowing. As usual during such times, investors began to re-examine their lists of acceptable credits and to shorten maturities.

Perhaps more significantly, 2000 also represented a deteriorating credit environment. Several issuers, including Conseco, Finova and Xerox, experienced difficulties and, towards the end of the year, Armstrong World Industries defaulted on $50m of US CP. Following that default, it became apparent that the poorer economic environment and the weakness in the equity markets were impacting upon several industry sectors. Many telecom and automobile manufacturing companies, which already had significant levels of debt outstanding, but which had previously been highly rated, were faced with potential downgrading.

Some of the biggest short-term borrowers in the market, such as Lucent, DaimlerChrysler and AT&T, were affected. There was also the threat that several Californian utilities may default on their debt as the State of California struggled to resolve a regulatory crisis.

By the end of the calendar year, spreads for A-2/P-2 paper, which had started the year at dollar Libor +10bp to +15bp, widened out to dollar Libor +120bp to +150bp, almost double those of the previous year. In addition, the US CP A-2/P-2 market contracted in size from peak outstandings of more than $140bn to $100bn. Issuers in the A-2/P-2 category, with access to US and ECP programmes, have witnessed a big price differential between the two markets because European pricing has not risen substantially.

As a result, they have been able to take advantage of the European market's appetite for A-2/P-2 names and issued at levels in the Libor 10bp to 20bp category when levels in the US were an average at Libor A-2/P-2 +50bp.

While the European market does not have the depth of the US market (the European sector has outstandings of 20% of that of the US market), its strength over the first quarter has been marked and has made the ability to tap either market a real advantage.

Spreads have stabilised in the US in recent weeks at the Libor +40bp level. In addition, the continuing ability of the market to fund large strategic transactions was demonstrated last month by Abbott Laboratories and Kellogg to fund their Knoll Pharmaceutical and Keebler Foods acquisitions respectively. Abbott, rated A-1+/P-1, raised $5bn in one day and Kellogg rated A-2/P-2, raised $4.7bn in five days following a two-week period of pre-marketing. ■

FIGURE 3

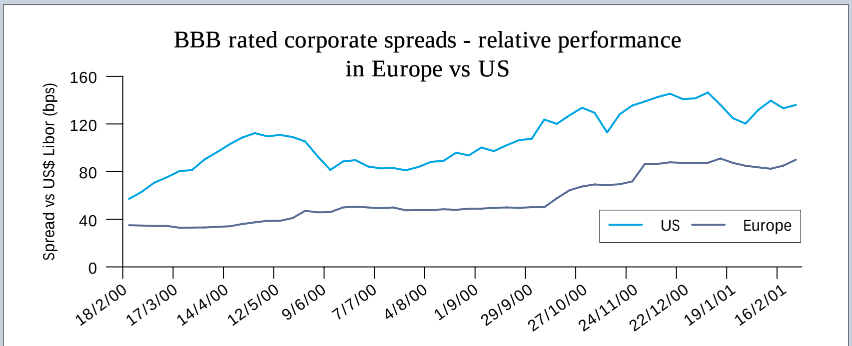
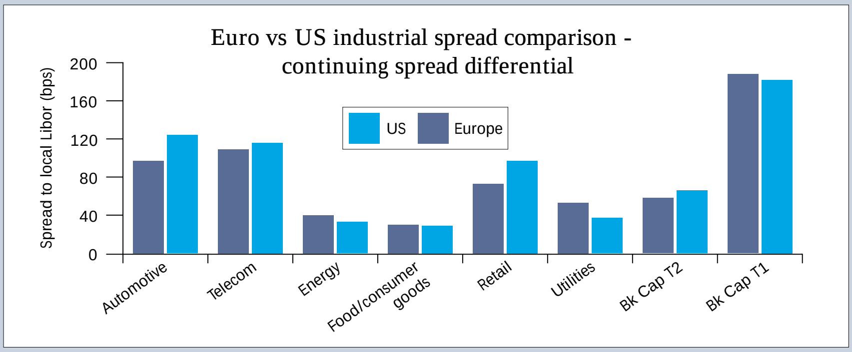


FIGURE 4



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