Communication is the key

Andrew Moorfield of bfinance explains the importance of maintaining constant communication with your MTN banks.

A medium-term note (MTN) programme is one of the most convenient and efficient ways for a treasurer to raise funds in the capital markets. The most frequent issuers tend to be large corporates and financial institutions, as these have the regular financing needs and treasury resources required to get maximum benefit from this funding source. An MTN programme can be regarded as a 'shelf' of debt from which funds are drawn down over a defined period. An MTN issue has a tenor of between three months and 10 years. Funding can be drawn down in the form of notes issued to investors on a regular basis – or otherwise – at any point in the term of the programme. MTN programmes fall into two broad categories:

- **US$ medium-term notes** (US-MTNs) registered with the Securities and Exchange Commission (SEC). US-MTNs are denominated in US dollars and are issued to US investors; and
- **European medium-term notes** (E-MTNs) registered with the appropriate listing exchange (usually London or Luxembourg). E-MTNs can be denominated in any currency and are primarily issued to investors in the euro-zone.

For US-MTNs and E-MTNs, the size of an MTN shelf is usually set at the amount of funding the issuer would typically expect to issue over a two-year period. As a result, there is no market convention as to the 'typical' shelf amount.

One of the main benefits of the programme is that it allows the corporate to take advantage of opportunities when market circumstances combine to make MTN funding less expensive than other sources, which usually appear at short notice. The corporate is able to issue quickly an MTN because their programme is already in place, and all that is required is for an investor to make an offer for the corporate's paper at the right price.

As with other debt instruments, the MTN can be issued in a number of currencies and offers two forms of return for the investor: the coupon and the final principal.

The coupon can be issued on a quarterly, semi-annual or, more rarely, a monthly basis, and will offer levels of income depending on whether it is fixed or floating at a given level against prevailing short-term rates.

Public transactions vs structured transactions

MTN programmes can be launched on the public markets or can be issued privately. Functionally, there is little difference between a private and a public issue except that a public issue can be offered to a wider range of investors. However, a private placement allows the treasurer to negotiate a more structured and specialised deal in comparison with the generally plain vanilla paper issued into the public markets. Investors, particularly those in the sophisticated US market, are more likely to 'buy and hold' and will have specific – if not unique – requirements to which privately-issued MTNs are tailored. For example, an investor (usually a non-bank financial institution or an investment fund) may need to hedge a particular exposure, or invest in an instrument with an embedded return linked to an underlying index or which contains a particular tax angle. Such features will allow the issuer to demand a premium from the investor, resulting in a lower all-in coupon for the treasurer compared with a plain vanilla issue.

As the due diligence issues for such structured MTNs can often be complex, a treasurer will generally need to obtain internal accounting, tax and legal sign-off prior to signing a term sheet, ie the corporate must guarantee this, not the bank. The regular information updating requirements and tax issues in issuing from and into various jurisdictions can be complex and onerous and should not be underestimated.

The challenge for a treasurer is to obtain approval within an appropriate time frame (usually 48 hours). As this can have a severe burden on the resources of the treasury, and other departments within the organisation, only large corporates and financial institutions typically issue into this market, despite the aggressive pricing that a corporate can achieve.

The challenge in approving transactions within 48 hours is driven by fixed income investors. Investors seeking to meet a particular investment requirement generally approach a range of issuers within a rating class. Usually, the first issuer to respond positively will win the transaction. Furthermore, those issuers who make themselves open to structured MTN enquiries, yet fail to respond within a reasonable time frame (or to respond at all), will quickly develop a negative reputation with investors. Despite the fast moving nature of capital markets, a spoiled reputation can take years (or a change of treasurer) to restore.

> In a market with many issuers, it is difficult for the treasurer to differentiate his MTN programme sufficiently to generate the desired level of investor interest

Although public investors are also highly sophisticated, their investment needs are more straightforward than the private market. This is reflected in less aggressive pricing and a greater reliance on credit ratings, rather than embedded structural features. Most investors in the public market evaluate MTNs based on the pricing of notes issued by issuers with similar credit ratings, or in a similar sector. In a market where there are a great number of issuers, this means it can be difficult for the treasurer to differentiate his MTN programme sufficiently to generate the desired level of investor interest.

Pricing opportunities

The pricing opportunities the treasurer is hoping to take advantage of with his MTN programme typically arise for one of two reasons. First, the yield curve for prevailing interest rates may invert to create a cheaper funding environment for a limited period in a given time frame. Second, a favourable move in the interest rate swap curve may arise with similar consequences. This is important if the treasurer issues a fixed rate note and swaps the proceeds back to a floating rate obligation. In either scenario, a company that is running an MTN programme can take advantage of such opportunities very quickly.

Proactive stance

Key to a successful MTN programme is a proactive stance by the issuer. There is a danger the treasurer might be disappointed by the pricing on the first issue of his MTN programme and may subsequently let the facility gather dust. By neglect, a treasurer may miss out on these opportunities. Therefore, it is crucial for the treasurer to maintain a constant dialogue with the lead banks in his MTN group.

The unpalatable truth is that the treasurer may need to fight for attention in order to persuade his banks to work hard to find the right investors in what can be an extremely overcrowded marketplace, both in terms of supply and demand.

The overpopulated MTN market has created an informal etiquette for the treasurer in maintaining close relations with his MTN banks. For example, it is considered appropriate to launch the first note in the programme via the lead arranger. The treasurer must also decide whether he will only use the banks in his MTN issuing group or whether he will accept 'reverse enquiries' – for example, an investor put forward by a bank from outside the issuing group.

Etiquette dictates that the issuer should observe a blackout period (a period of not accepting reverse enquiries) of at least three months to allow the issuing group time to establish a dialogue with investors about the programme. At the end of the blackout period, the issuer should inform the issuing group that it is accepting or considering a reverse enquiry.

If the treasurer posts price levels on his MTN programme, he should do so at realistic levels for the issuer's industry and credit rating. If the treasurer does not want to use his MTN programme, he should not set unrealistically tight targets. Rather, the treasurer should inform MTN banks that his funding needs do not currently require the use of the MTN programme.

If a treasurer receives an enquiry that meets his price levels and funding requirements – and in the absence of any material event – in good faith he must accept that enquiry. To not accept will damage the issuer's reputation with the MTN banks and, given the relatively small community of MTN banks, this unfavourable reputation will spread rapidly. Likewise, if a treasurer adjusts his pricing levels, then this should be communicated quickly to all his MTN banks – generally via a group email.

Bank selection

When choosing the lead arranger and selling group for your MTN programme, it is important to remember that the lead bank will carry the majority of the responsibility and should be chosen with the utmost care. Therefore, the lead arranger should be assessed first on grounds of its track record in the MTN market. It is often helpful to speak to clients – on the investing side as well as the issuing side – to assess their track record.

The treasurer should already have a frequent dialogue with the candidate banks, thereby having established their understanding of the capital markets and – equally importantly – the company's own funding needs. The treasurer should not be tempted simply to reward relationship banks for past favours with a slice of the action on his MTN programme. Instead, he should ask himself: 'Can this bank deliver my targeted investors at the price I want?' By appointing a bank with little MTN experience or capability for purely relationship reasons, the issuer risks its own credibility and that of the programme.

An MTN programme should also not be crowded with banks – six to eight banks will allow the treasurer to retain a competitive environment, while allowing the banks sufficient opportunity to compete for the treasurer's MTN business.

Prior to selecting banks, the treasurer must determine the purpose of his programme, which could include:

- **opportunistic issues taking advantage of pricing windows (and usually involving structured transactions).** Such transactions require banks with sufficient swap lines (as structured transactions inevitably involve an embedded swap) and a deep pool of sophisticated investors. Selected banks must be able to demonstrate to the treasurer a detailed knowledge of structured transactions and have a track record of completed deals for companies in similar industries and similar credit categories; and
- **regular source of funding (often in the public markets).** Such funding programmes need banks with a broad range of fixed income investors enabling the issuer to achieve 'geographic reach'. Evidence of a strong secondary trading ability would also tend to indicate the bank has an active two-way relationship with fixed income investors. Such a relationship may grant the bank a greater degree of market intelligence than that of institutions which are less active in secondary trading.

In allowing each bank access to compete for MTN activity, treasurers should ensure that each bank's geographic strengths are complementary. For example, if all MTN banks have a sales strength in a limited pool of countries, this denies the treasurer the opportunity to issue to a more diverse range of potentially attractive investors. Finally, treasurers must review their panel regularly – usually every 12 months – with clear guidelines for inclusion and exclusion. This not only encourages existing MTN banks to remain focused, but it also allows other relationship banks to access the MTN panel.

Balancing act

The MTN market is crowded with issuers and is one in which a treasurer's banks are reliant on their relationships with fixed income investors. Treasurers must recognise the balancing act that is required by their relationship banks as they seek to meet the needs of both treasurers and their fixed income investors. To assist their banks in marketing their company as a potential issuer, treasurers need to ensure they maintain a consistent dialogue with their banks. Examples include being transparent on reverse enquiries, providing all MTN banks with equal access to changes in funding circumstances and updating pricing levels. Most importantly, treasurers should honour transactions that meet their target pricing and amounts. If they cease to require funding from their MTN programme, they should explicitly communicate that message to their banks, rather than set unrealistic funding levels.

Treasurers doing this should reap the benefits of a flexible and competitively priced source of debt. ■

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