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ALEXANDRA GROPP AND **DOMINIC KERR** LOOK AT WHY DIM SUM BONDS HAVE WHETTED THE APPETITE OF BORROWERS AND INVESTORS, AND EXPLAIN HOW THE MARKET OPERATES.

The offshore renminbi bond market, or the dim sum market as it has become widely known, has been growing rapidly since 2007 – the year the Chinese authorities first gave their blessing to banks in the country raising funding in this market. First banks in mainland China and Hong Kong accessed the market, followed by local/regional corporates.

Dim sum bonds have been on the radar of Western corporate treasurers for a little over a year now, ever since US fast food giant McDonalds tapped this market in August 2010. McDonalds has since been followed by a number of other US and Western European corporates, with Unilever the first European corporate to issue a dim sum bond, a CNH300m deal in March of this year. (CNH is the same currency – renminbi – as CNY, but is traded offshore at a different rate from mainland-traded CNY.)

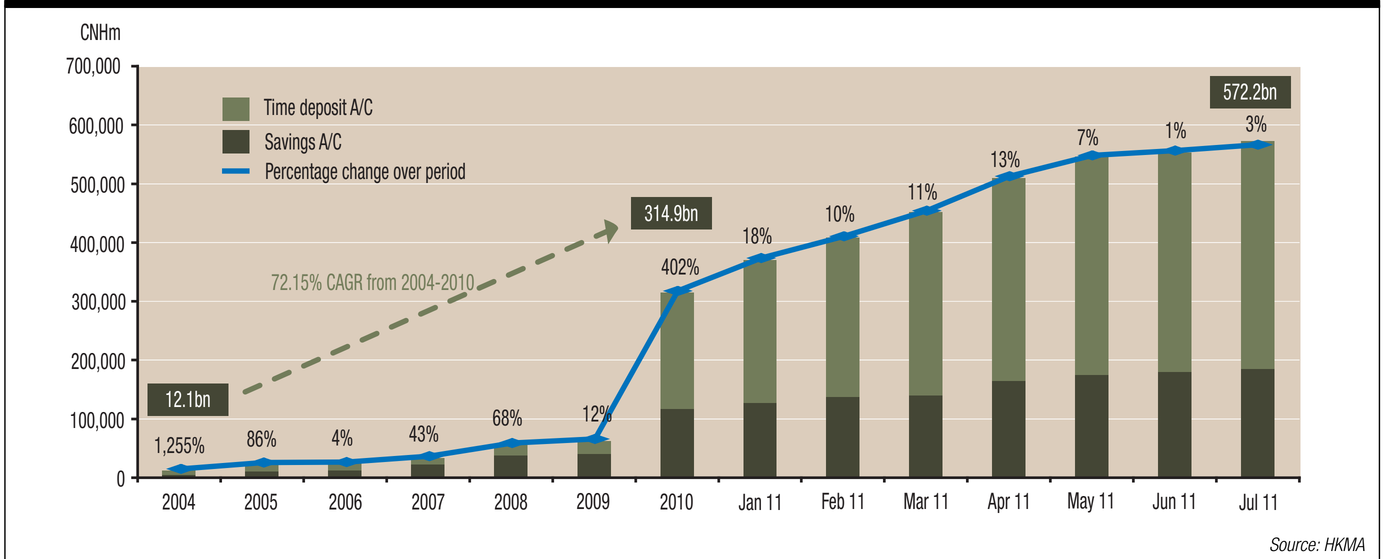
With the number of Western corporate issues now in double figures, and a sizeable pipeline of similar borrowers eyeing up this market, it's a good time to take stock of what has been achieved and to analyse why these borrowers have been attracted by the new marketplace.

CHASING THE CHINESE DREAM The sheer potential of the Chinese marketplace for Western corporates means that any window that opens up for them to gain greater access to financing there merits serious consideration. The appeal of reaching out to China's burgeoning middle class is a particular draw for consumer and retail sector companies, and these have been prominent among the early entrants to the dim sum market. Some of these companies have been growing their businesses in mainland China for many years, and have firmly established brands, material assets and large numbers of employees. What could be more natural than to take advantage of a partial liberalisation of the market to raise CNH offshore, and to take these proceeds onshore into mainland China for deployment in their operations there?

In relation to its dim sum bond, Tesco's chief financial officer, Laurie McIlwee, says: "China is an important market for us and represents a great growth opportunity. This is a new and innovative way of funding our business as it continues to grow and demonstrates our commitment to China."

RAISE OFFSHORE, TAKE ONSHORE Hong Kong has been the laboratory for this stage of China's CNY liberalisation/internationalisation experiment. Dim sum deals are co-ordinated, syndicated and distributed out of Hong Kong, a jurisdiction with which Western corporates are very comfortable. Typically documented under English law (or New York law in the case of US issuers), these deals can be issued either off a Euro Medium Term Note (EMTN) programme or via standalone documentation. The whole process of documenting and issuing a dim sum bond will be very familiar to any treasurer who has done a public bond in any of the G3 currencies (the dollar, the euro and the yen).

Figure 1: CNH deposit base



Source: HKMA

If a roadshow is necessary, this will take place in Hong Kong and Singapore. The dim sum market therefore offers the possibility of raising renminbi without having to go physically to mainland China along with the comfort of "home-town" legal code and familiar documentation, all with English as the lingua franca. As dim sum is an offshore market, by definition none of the investors will be in mainland China.

The actual execution of a dim sum bond is then at least as straightforward as issuing a sterling, euro or dollar bond. It could be argued that as issue sizes are normally smaller than in the G3 currencies, and the investor base more compact, the dim sum issue process can be even quicker and more straightforward.

Most corporates that issue dim sum bonds intend to use the proceeds within mainland China, but there are some exceptions. If a potential borrower were, for example, to have a Hong Kong-based supplier that accepted payment in renminbi, that would be an almost perfect scenario; there would be no need to go through the processes required to take the proceeds onshore into mainland China (as described below).

However, in the great majority of cases the intent is to fund operations or pay suppliers in mainland China. So what are the drivers for going through the onshore approval process?

THE ECONOMIC IMPERATIVE The dim sum bond market enables corporates to capitalise on the very different onshore and offshore borrowing rates for CNY and CNH. Onshore renminbi (ie. CNY) borrowing rates are regulated by the People's Bank of China (PBOC) and are currently set at the following minimum levels:

- one year, 6.56%;
- three years, 6.65%; and
- five years, 6.90%.

The rigidity of this regulated system means that even the best-rated corporates are unable to take full advantage of their credit quality in achieving a superior rate of borrowing compared with their lower-rated peers.

In comparison, the dim sum market has no such regulation and is able to set its own market-driven levels for borrowing. The coupons paid by the majority of Western corporates in this market to date are 1–3%. The saving for those corporate borrowers able and willing to go down the dim sum route and then onshore the proceeds are very significant.

Any corporate that is borrowing (or contemplating borrowing) within mainland China at the regulated onshore rates should therefore be asking itself if the dim sum bond market bears serious consideration as a real alternative. With the fulcrum of investor demand still in the two- to three-year range, this is not a long-term bond market in the traditional sense. However, there is still the opportunity for a superior economic outcome when compared to the pricing of onshore loans.

For borrowers looking for longer-term instruments, the outlook is positive. While for the foreseeable future investor demand will continue to be anchored in the two- to three-year range by private banks and fund managers, the maturity curve is gradually lengthening, with the Chinese Ministry of Finance's own 10-year dim sum deal, and the seven-year tranche for French corporate Air Liquide (see below) two signposts in that direction.

OTHER DRIVERS The dim sum bond market is an initiative that the Chinese authorities are keen to promote. There will be cases where obtaining their approval to onshore funds will be much harder to get (eg. residential or commercial property development/purchase, consumer finance). However, where the borrower's goal is to inject funds that will promote real economic activity, economic expansion, jobs growth and technology development, our experience is that a very constructive attitude will be taken towards applications to onshore dim sum proceeds.

In every case we would recommend that all the necessary approvals to onshore are obtained prior to the execution of a bond

issue. This avoids the risk of having renminbi funds "trapped" in Hong Kong and incurring a cost of carry on deposit; it also ensures that positive relations are maintained with the Chinese authorities. The commitment to the mainland China market reflected by issuing a dim sum bond and taking bonds onshore is a big positive for long-term investors in this jurisdiction.

The investor diversification achieved in issuing a dim sum bond gives borrowers profile in a region where there is a very substantial amount of capital available for investment. We have already seen several Western corporate borrowers take volumes from the market in a single deal that are equivalent to dollar or euro benchmarks in size – ie. $500m.

For borrowers with assets and revenues in mainland China, raising a dim sum bond is likely to be the most economic natural hedge available. Corporate treasurers should realise that the optimal solution for mainland China funding is freely available to them via this market.

IT'S A STRATEGIC PLAY, NOT AN ARBITRAGE MARKET It is important to make the point that at this stage of its development the dim sum market is not an arbitrage market in the way that the markets for Swiss francs and Australian or Canadian dollars are sometimes viewed. While liquidity in the renminbi swap market is improving, especially in the one- to three-year range, it is still relatively poor and the "wrong way round" axe out of renminbi means that raising a dim sum bond and trying to swap the proceeds back to euros, dollars or sterling will typically not result in a positive economic outcome. The decision to issue a dim sum bond is therefore a strategic one, although given the tenors available in the current market (typically one to three years) it is a decision which is more comparable with the loan market.

Figure 2: Order book distribution

Source: HSBC and SCB

INCREASING APPETITE FOR DIM SUM CNH bond issues from multinational corporates are still a relatively small part of the dim sum bond market but they have significantly raised its profile and played an important part in increasing and diversifying the CNH investor base. The growing volume of the CNH deposit base and the anticipated appreciation of CNH continue to fuel the strong demand for dim sum bonds. As of the end of July, the CNH deposit base in Hong Kong stood at CNH554bn, compared with approximately CNH145bn bonds outstanding. This imbalance has acted to lower offshore deposit rates, consistently in the 1-2% region.

Given the wider market volatility in recent months, price discovery and transaction timing were paramount for the success of the recent transactions. Liquidity in the secondary market is still developing due to the nascent nature of this market. In particular, the smaller-sized transactions from highly rated borrowers are tightly held and not traded frequently. This has driven secondary market prices higher and yields to levels that cannot serve as meaningful pricing benchmarks for new primary issuances. Direct feedback from investors on pricing therefore remains key.

Tesco initiated another wave of debut CNH bond issues from multinational corporates in late August with a three-year CNH725m transaction. Its household name and credit strength attracted strong investor interest. BP followed shortly thereafter with its successful debut CNH700m transaction.

And the day after the BP transaction priced, Air Liquide issued CNH2.6bn across five and seven-year tranches, a record for a non-Asian CNH issuer. Air Liquide had undertaken an investor roadshow in August to gauge interest and then waited for more stable market conditions before launching the transaction. Although most investors continue to prefer shorter maturities from three to five years, longer tenors are possible, as demonstrated by Air Liquide's privately placed seven-year tranche.

Investors based in Hong Kong and Singapore continue to drive the demand for CNH transactions but we have seen solid demand from European investors and expect it to grow further as more accounts put the necessary infrastructure in place. All CNH bond offerings so far have been sold under Regulation S, which restricts marketing activities to accounts outside the US. US investors with funds based offshore have been involved in some transactions but when decision-makers are based in the US, the time difference continues to be a challenge for transactions where order books open and close intraday during Asian business hours.

All the recent bonds were listed at a stock exchange in either Hong Kong, London or Luxembourg and had at least one credit rating, which is preferred by some key investors in the CNH market and supports best possible execution, especially for larger transactions. Although not necessarily required for household names, some form of investor marketing can be very beneficial as a lot of the Asian investors do not look at European credits on a regular basis. For less well-known names we believe it is essential that investors are given the time and information required to complete their credit work.

With regard to the final BP order book, Gary Admans, its head of capital markets, said: "The CNH bond market offers a good opportunity to gradually add diversification to our investor base and fund our businesses in China at an attractive rate. We were very pleased to see strong interest from accounts in Hong Kong, Singapore and Europe. Pricing the transaction at 1.7%, the tight end of final guidance, was a success considering the volatility in the global markets."

REMITTANCE APPROVAL PROCESS The CNH bond market offers companies a very attractive opportunity to fund their mainland operations. While CNH bonds can be used to finance trade settlement or be swapped to other currencies, to date all but one multinational corporate have used the proceeds to fund their mainland operations in China. Remitting the issuance proceeds to mainland China requires approval from the Chinese regulators, so obtaining these approvals is a very important part of the transaction and often the most time-consuming.

The remittance approval process is independent from the CNH bond issuance in Hong Kong, which in itself does not require any approvals from the Chinese regulators. It is recommended to start the bond documentation and the remittance approval processes in parallel to ensure the market can be tapped as soon as all necessary approvals have been received.

Funds can be remitted to mainland China by way of a loan or an equity capital injection from the offshore parent or a related company. So far most companies have chosen to remit issuance proceeds to mainland China via a shareholder loan, which requires the approvals from two regulatory bodies, PBOC and the State Administration of Foreign Exchange (SAFE). Such a loan has the advantage that its terms can be tailored to match the debt service on the CNH bond. An equity capital injection does not allow the same flexibility given that cashflows from mainland operations can be extracted only in the form of dividends, which makes the management of payment of interest and principal on the CNH bond more complex. Equity injections require the approval from Ministry of Commerce.

One disadvantage of a shareholder loan is that its amount – and therefore the money that can be remitted to mainland China – is restricted. The available limit, also called "gap" or "foreign debt quota", is defined as the approved total investment of the receiving entity minus its registered capital. This restriction applies to all shareholder loans and is not specific to the funds raised in the CNH bond market.

This might change, however. In early August, China's regulatory authorities indicated that the remittance of CNH bond proceeds via renminbi-denominated shareholder loans might no longer be subject to the foreign currency debt quota. This could significantly reduce the restrictions on the amount of funds that can be remitted to mainland China. In our view, this would contradict the policy-makers' hitherto firm grip on the amount of CNH bond proceeds that can flow to mainland China. We expect this to be clarified in a new set of guidelines for the remittance approval process which we believe will be issued in the near future.

DIM SUM IS HERE TO STAY China's regulatory authorities are committed to developing the offshore CNH market as part of the internationalisation of the renminbi. Regulations and conditions for the remittance of CNH bond funds to mainland China will continue to develop. Banks with a strong local presence, a detailed understanding of the processes and strong relationships with the local regulators are best placed to guide issuers through the sometimes complex challenges of seeking all necessary approvals for bringing funds onshore.

Fabienne Lecorvaisier, group chief financial officer for Air Liquide, says of the overall process: "One of the more challenging aspects of completing the transaction turned out to be securing the regulatory approvals from PBOC and SAFE for the remittance of the proceeds onshore. The Chinese regulators are understandably careful to make sure the funds are not simply hot money but represent investments which are important to the economy. There were numerous other applicants also competing for approvals from the regulators, which can cause something of a delay in the process."

Note: The Chinese authorities published revised guidelines for foreign currency remittance as this article went to press.

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