In volatile times

WITH THE ISSUE OF RATINGS AND RATINGS AGENCIES RARELY OUT OF THE HEADLINES IN RECENT MONTHS, THE ACT USED A BREAKFAST MEETING TO SHINE A SPOTLIGHT ON THE AREA. **JULIET TEWUNGWA** WAS THERE.

What is becoming an annual event in the ACT calendar provided an opportunity to hear the views from three of the main stakeholders: namely ratings agency Moody's, which sponsored the breakfast, a high-yield bond issuer and the investor community. The breakfast was chaired by John Grout, the ACT's policy and technical director.

THE AGENCY PERSPECTIVE Chetan Modi, senior vice president, team leader, European leveraged finance at Moody's Investors Service, noted that high-yield leveraged finance had been on the ascendancy in the past year. Traditionally high-yield has been occupied by telcos and fallen angels following the demise of Lehman and the drying up of bank sources of debt. However, leveraged buy-outs (LBOs) and emerging market businesses have started to play an active role in the high-yield market with the result that speculative-grade has risen to 45% of all rated debt issues (70% in the US).

With banks reluctant to lend in 2009, the high-yield market was open for refinancing. 2009 and 2010 were, in fact, record years for high-yield issuance and levels of default have fallen as markets have stabilised. Default levels in this latest crisis peaked around 12%, considerably lower than the default rate of 16% in 2002 when the dotcom bubble burst.

The record-setting trend seems set to continue: the first half of 2011 (until the market closed in July) saw as much high-yield issuance as for all 2010. The market remains very fickle and it is difficult to say when it will re-open. Investors remain extremely cautious about putting money up, and no big newsworthy transactions are taking place. Risk still remains uppermost in people's minds and it would require good news to bring the market back to life.

Modi warned that the markets remained extremely volatile and were not consistently open to trades. Pricing may be materially higher if and when the markets re-open in the autumn; minimum issue sizes need to be around £200m to attract investors. He advised corporates to plan their refinancing strategy in good time as the pinch-point for refinancing is due in 2014.

THE ISSUER PERSPECTIVE Rick Martin, group director for treasury and investor relations at Virgin Media, presented the issuer's perspective with an outline of Virgin Media's background and its financial strategy of concentrating on strong free cashflow growth as well as shareholder value.

In 2007 the decision was taken to invest more in growth,

IN FUTURE, IT IS HIGHLY LIKELY THE BANKS WILL PULL THE FINANCING CARPET MORE AGGRESSIVELY. BIG COMPANIES WILL PROBABLY ALWAYS BE ABLE TO RELY ON THE BANKS, BUT WHAT ABOUT SMALLER COMPANIES?

undertaking a capital return programme and improving the credit rating of the group. The driver of success, according to Martin, was setting a framework of long-term goals and taking an opportunistic approach within it. This allowed Virgin to hit the capital markets at relatively short notice while still planning ahead.

"Environmental awareness" also played a major part. For example, when central banks are pumping vast amounts of liquidity into the system, corporates should be prepared to take advantage!

He also stressed that corporates should not wait to refinance until they have to.

Remaining flexible on the tools used to refinance was also paramount. The use of convertible bonds, senior unsecured bonds, senior secured bonds and bank loan refinancing all contributed to improving Virgin's credit rating.

Martin emphasised the importance of strong relationships with all the major stakeholders including ratings agencies. Having a clear business strategy and setting out commercial goals as well as capital structure aims are beneficial, as is a willingness to make both private and public commitments, then delivering them.

Regular dialogue with all stakeholders was also recommended rather than waiting to talk to the agencies when, for example, refinancing was required. A positive relationship means no nasty surprises, especially when the company is looking at mergers and acquisitions (M&A) and other capital market activities.

Martin emphasised that a strong relationship with the agencies resulted in organisational discipline, which improves creditworthiness and investor confidence. Investors look through many different lenses and a rating is complementary to other information. If you are able to differentiate your company among other issuers, this helps in tapping different investors. Ratings agencies can also act as sounding boards for the company – talking about different possible outcomes can be extremely helpful.

THE INVESTOR PERSPECTIVE Peter Aspbury, head of European credit research at JP Morgan Asset Management, gave the investor's view of ratings. Ratings provide a framework for dialogue between investors and issuers and an opinion on the credit risk of the borrower, which provides a level of comfort to the investor. Aspbury stressed that the credit agencies did not determine the price of the risk, but provided an important indication of possible risk.

According to Aspbury, investors believe that the actual ratings process is as important as the rating itself when looking to invest. All investors want a decent return for the perceived risk of their investment and an issuer that can commit to and maintain a given credit quality. A clearly articulated balance sheet policy therefore matters more than an absolute rating.

A major area of consideration in making investment decision is covenants. Aspbury said that current market conditions too often dictated non-financial covenant packages. Investors are looking for reasonable covenants with adequate disclosure of non-bond creditor arrangements. In particular, issuers should focus on getting the covenants right first time and avoid creating different classes of bondholders, which is a major bugbear for potential investors.

Ratings agencies also play a part in the covenant debate; the quality of high-yield covenants is indirectly reflected in both ratings and pricing through implied recovery. For example, senior secured bonds merit a substantial discount to leveraged loans on covenants alone.

Other technical considerations for issuers should include a range of maturities and a minimum liquid benchmark size. In addition, there is the question of accessibility; the management team should engage with potential investors as stakeholders.

Aspbury concluded by saying that overall, the health of the European high-yield market depended on it being seen as a fair and transparent market and not too complicated and complex.

UNCERTAIN FUTURE The breakfast concluded with a panel discussion between the chair, Martin, Aspbury and Myriam Durand, managing director of European corporate finance at Moody's.

Durand noted that a number of positive ratings actions had been taken recently, but the future remained uncertain. She questioned whether the banks were going to be there when needed, particularly as a consequence of Basel III. She added that not many big M&A deals were being done at present and while deals were being worked on it was not clear if or when they would be concluded. The question of funding will play an increasingly important role in M&A activity.

Martin stressed that dialogue between the agencies, issuers and investors must continue and that transparency rather than regulation was needed.

Durand agreed and said that agencies were happy if issuers and investors wanted to talk to them and that the sooner companies alerted them to new deals the better. However, it is in the hands of companies how they want to handle the ratings agencies, whether or not to include them in their thought process. A relationship can be built so that the agencies are ready to deal with any bad news.

In future, it is highly likely the banks will pull the financing carpet more aggressively. Big companies will probably always be able to rely on the banks, but what about smaller companies? It is highly likely that they will have to depend on issuing high-yield bonds and so will have to be aware of the rising cost of capital.

The panel were agreed that the high-yield market would be an ongoing source of finance for a range of companies, particularly given the growing disintermediation from the bank markets, although the pace of change is as yet unclear. Companies should be prepared to access the markets opportunistically to manage their refinancing risk and be flexible with covenants to achieve their objectives. Perhaps if those objectives are to be met, the key message is the importance of communication between everyone involved in the ratings and issuing process.

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