A successful Eurobond debut

Starting with the Eurobond, Andrew Moorfield of bfinance writes the first of a new series of articles which provide step-by-step guides to key treasury practices.

When looking at how to launch a Eurobond, first we should define our terms. Eurobonds are bonds which are international (cross-border) either in issuance or distribution. They also differ from domestic bonds in that domestic bonds frequently require registration whereas Eurobonds are bearer instruments typically listed in Luxembourg or London. Eurobonds usually have a fixed interest rate and bullet repayment with maturities typically between five and 20 years.

With the arrival of the euro, a significant proportion of Eurobonds are now denominated in euros. This has been accompanied by a dramatic decline in eurodollar issuances. The evolution of the euro-denominated Eurobond market (often called the euro-euro market) has been driven by European investors seeking to widen their pool of fixed income issuers. As a result of pan-European demand and issuance, the euro-euro market is deep and increasingly sophisticated as European investors adopt US-style credit and portfolio analysis tools.

From a treasurer's perspective, the Eurobond market represents a major capital source with pricing competitive with the US market. There is also the additional benefit that a standard basis for issuing a Eurobond avoids the associated Securities and Exchange Commission (SEC) regulatory challenges required by bonds issued to US investors.

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Bank selection

Eurobond mandates represent prestigious fee income for relationship banks. Competition for a major role in a transaction is intense and treasurers will face a bank group that will aggressively use their 'relationship' and 'lending' cards to win a role in the transaction.

Unlike the terms and pricing of bank loans, which are generally kept out of the public domain, a Eurobond transaction is a public transaction. A poorly marketed or priced transaction will negatively impact a corporate's reputation with the fixed income community. Future Eurobond issues are more likely to be expensive for the corporate as investors will require a premium to compensate them for the potential risk of another under-performing transaction.

As a result, it is in the treasurer's long-term interest to ensure the selected Eurobond banks are the strongest banks for their company and the particular transaction. Despite the pressure from large lending banks to win a Eurobond mandate role, the treasurer will need to select banks on an objective basis and not on a 'reward the lenders' basis. A Eurobond bank group (syndicate) is led by a bookrunner (lead bank). The responsibility of the bookrunner ranges from the preparation of the roadshow through to the final execution of the bond sale. In descending order, the syndicate comprises co-managers and then syndicate members. The responsibility of these participants is simply to sell their allocation of bonds.

The choice of bookrunner is challenging. To increase objectivity, it is useful for a treasurer to maintain a set of criteria to rank each financial institution. Such criteria may include:

- **quality and consistency of the capital markets dialogue** – relationship banks that have an understanding of their client's debt profile, funding and corporate strategies should have already commenced a proactive capital markets dialogue with the treasurer. Those banks should have at least addressed issues such as the ideal tenor and currency of the Eurobond (in reference to likely investor demand and the capital structure of the company), identified potential investors and provided an overview of the expected pricing of the Eurobond issue;
- **ability to distribute the Eurobond across Europe** – a successful Eurobond issue requires price tension – this is only created by strong investor demand, which, in turn, requires a bank to have a pan-European salesforce. With the advent of the euro, a number of strong national banks almost immediately claimed to be strong pan-European banks. To assess the credibility of each bank's pan-European distribution, the treasurer must ask a few basic questions, including the size and location of the bank's bonds salesforce and the distribution of previous transactions executed by the bank;
- **fixed income credit coverage** – to stimulate demand, fixed income investors must be able to access fixed income credit research. Treasurers will need evidence of previous credit research completed by the bank's analysts on their industry and competitors. Research should be objective and highlight negative as well as positive issues, provide relative analysis (comparing similarly-rated credits and their pricing histories), and be produced by a team that can demonstrate a fixed income credit research track record; and
- **secondary market trading** – fixed income investors require bonds that are tradeable. Although in the few days following a Eurobond launch the bookrunner will provide liquidity support to an issue, the treasurer must be confident that such support will be ongoing at a level appropriate for the size of issue. As a result, the bank must have an

established secondary trading desk and be able to provide a history of trading bonds issued by corporates similar to the treasurer's company (such as a similar credit rating, industry or geographic spread of operations). Further, banks with an active secondary trading desk can provide a treasurer with more informed and relevant market information than those banks that purely originate bond transactions.

Not only can these criteria assist the treasurer in objectively ranking each financial institution, but they can also be provided to the banks prior to a beauty parade presentation. This will allow banks to tailor their presentation to the treasurer's specific needs and avoid bankers concentrating on inappropriate material during their pitch.

A useful means to select a bookrunner is to speak to a number of fixed income investors. Banks will usually provide a treasurer with likely fixed income investors and the treasurer should meet with these investors (without the banks present). Given that fixed income investors are constantly in the Eurobond market, they will identify their favoured (and less favoured) fixed income banks. As the investors are the ultimate customers of the treasurer, this advice should be carefully heeded.

Funding benchmark

In communicating to a bank group, the treasurer will need to make clear the purpose of the funding raised by the Eurobond (for example, refinance debt or finance an acquisition). This will allow the treasurer to set a benchmark to determine the levels at which the all-in cost of a Eurobond is economic for the company.

The benchmark is usually determined by the purpose of the funding. For example, if the Eurobond is to refinance maturing floating rate debt, the benchmark is the company's current floating rate spread over Libor. If the Eurobond is to refinance long term fixed debt, then the benchmark is the fixed rate of that historical debt. The cost of the Eurobond is calculated as:

- **re-offer rate** – fixed rate at which the bond is offered to investors. This is usually a reference rate, say, the US treasury rate, plus a margin);

A typical five-year £100m Eurobond funding cost

Funding benchmark (5-year Bund rate)	5.50%
Margin (60 basis points per annum)	0.60%
Re-offer rate	6.10%
Underwriting fee (35 basis points)	0.07% (35 basis points amortised over 5 years)
Swap costs (1 basis point per annum)	0.01%
TOTAL Eurobond funding cost	***6.18%***

Assuming that printing, accounting, legal and other expenses amount to £200,000, an additional 2 basis points (amortised over five years) needs to be added to the all-in Eurobond funding cost (6.184%).

- **plus underwriting fee** – single upfront fee paid to the bank group, generally between 25 and 35 basis points. This is sometimes agreed as an annual fee amortised over the life of the bond through the swap rate; and
- **plus swap costs** – interest rate differential over Libor which substitutes for the reference rate if the fixed rate debt is swapped into floating rate debt, or the basis cost if the debt is swapped into another currency.

Other general costs will include trustee fees, accounting & legal fees, printing costs and roadshow expenses.

Roadshow

Throughout a roadshow, the bookrunners will reference an ever-changing range of prices called 'price talk'. The aim of price talk is to create a level of price certainty to allow the bookrunner to determine potential demand. The final price is only agreed just prior to the launch and is usually within the price talk parameters.

Very few bookrunners will set price talk at a level that is disadvantageous to a treasurer. This is more than altruism – bookrunners are aware that a poorly performing deal (one in which the price is set either too low or too high) will reflect badly on them in the market. This means that the bookrunner's interest is closely aligned with that of the treasurer.

Relative to a US transaction, the roadshow for a Eurobond is a less legalistic event. The SEC imposes stringent conditions in respect to capital market transactions – from a treasurer's perspective, the difference between a Eurobond and a US bond (Yankee bond) is most obvious in the pre-marketing of bonds to investors. For example, under SEC rules all marketing documentation must be contained within a registered prospectus. This means that hard copies of roadshow materials cannot be left with US investors. In contrast, Eurobond premarketing rules are considerably more relaxed and roadshow materials can be freely dispersed to investors. The SEC rules will not govern a Eurobond if that bond is not sold to US investors. A roadshow is the opportunity for a treasurer to 'sell' the company to potential investors. The usual formats include:

- **one-on-one meetings** – usually the most effective meetings, but extremely time-intensive. These should only be used for large or strategically important investors;
- **group presentations** – useful way to communicate to a mass audience, but allow time for private questions following the meeting (as with bankers, fixed income investors will want to ask their questions in a more private forum);
- **Bloomberg roadshows** – these are now an accepted means of communicating to a mass audience with the convenience for the investor that the show can be watched in their own time (and reviewed at their own pace);
- **investor conference calls** – such calls can be challenging for a treasurer as the treasurer is often alone in a room with a conference phone and is unable to read the reactions of investors. However, they are considered a standard communication tool by investors and can reach a wide audience (normally just prior to a bond launch); and
- **internet presentations** – accompanying a Bloomberg roadshow, a roadshow on the treasurer's company internet site further widens the 'reach' of the investors – and is a useful tool to direct fixed income investors who wish to understand more of the company and the transaction.

Although the roadshow materials are prepared by the bookrunner, the treasurer should provide a 'guiding hand' through identifying the key credit characteristics of the transaction. For example, issues that need to be addressed include:

- credit rating of the issuer. Is the issuer committed to that rating? How can that commitment be illustrated (ie, ratings history)?
- likely event risks (positive and negative) that could effect the issuer;
- purpose of the issue; and
- the issuer's funding strategy (in particular, if the Eurobond is a 'one-off' it will attract less interest than a frequent issuer whose bonds will have the benefit of greater liquidity).

As equity investors have fundamentally different concerns from fixed income investors, a roadshow should not be a rehashed version of an equity presentation. The presentation should last no longer than 30 minutes and the presenter (usually the finance director or treasurer) should ask for critical feedback from the bookrunner.

Swapping the issue proceeds

Unlike the US market, in which fees are aggressively maintained by banks (usually at a level up to twice that of the European market), fees can be negotiated downwards by Eurobond issuers. One means for a bookrunner to discretely reduce a treasurer's underwriting fees is via a subsidised swap if it is agreed to convert the normal fixed rate issue to a floating rate end product for the issuer.

A subsidised swap is simply an off-market swap in the treasurer's favour. If the proceeds were swapped from a fixed interest rate to a floating rate, the swap would normally be executed at the bank's bid rate (the rate at which it will 'buy' a fixed rate obligation). A subsidised swap is a rate better than the bid rate and this level is pre-negotiated with the bank before the Eurobond is launched (for example, a subsidised swap could be a swap at the mid rate plus half a basis point), together with the reference screen from which the swap market bid and offer rates will be taken. Note this is not necessarily the bank's own bid/offer screen.

Clearly, a requirement for a subsidised swap is that the swap is executed with the bookrunner. Prior to the bond launch, two parameters must be agreed (and confirmed in written – usually e-mail – format):

- the reference rate (normally Libor for a floating rate end product or a government bond rate for a fixed rate end product) at the time of the Eurobond sale. The reference rate must be agreed by reference to a specified Reuters or Telerate screen with both the treasurer and the bookrunner agreeing to the rate immediately prior to the execution of the swap; and
- the definition of 'mid' and the level of subsidy must be clearly agreed. If a corporate generally receives an interest rate swap with an average spread (ie, difference between bid and offer) of three basis points, it is reasonable to assume that the mid rate is the bid rate +1.5 basis points. A one basis point subsidy therefore equates to the bid rate +2.5 basis points. This calculation must be agreed with the bank (preferably in writing) prior to the swap execution to achieve a floating rate end product.

Success of a transaction

As a Eurobond transaction is a public transaction, judging its success is relatively straightforward. Following the bond issue, if the bond price tightens (the price of the bond decreases) then that indicates the issuer sold the bond at a premium. If the price widens, then the fixed income investors 'overpaid' for the bond.

If the treasurer will only ever issue one Eurobond, then – all things being equal – it is preferable that the bond price widens in the aftermarket. However, if the treasurer is likely to issue another Eurobond, the bond price should tighten. This allows the fixed income investors to generate an immediate mark-to-market gain on the bond and will make them more amenable to buy future issues from the corporate. This 'halo effect' is an important psychological selling tool in the Eurobond market.

The challenge with generating a halo effect is to ensure the bond price tightening is limited. General market consensus is that a two basis point tightening represents a successful deal. Generally, an investment grade transaction that tightens significantly more than two basis points has either been mispriced or priced in volatile market conditions.

The role of the bookrunner is to ensure that following an issue, the Eurobond trades in a liquid market. This is accomplished by the bookrunner operating a 'short' in which they have oversold the Eurobond. To offset the short, the bookrunner must acquire bonds in the secondary market and thus create a level of demand in the aftermarket. This additional liquidity will allow short-term investors (often called 'flippers') or investors who were under-allocated bonds (and who sell their allocation, rather than buy additional bonds in the after-market) to sell their bonds without the bond price dramatically falling. As a short position can create a trading loss for the bookrunner, the skill of the bookrunner's syndicate desk is to ensure that a sufficient – yet prudent – short position is built prior to a bond launch.

Post deal communication

If the treasurer is likely to be a repeat Eurobond issuer, it is important to maintain an ongoing dialogue with major fixed income investors. An often-heard complaint from fixed income investors is that they 'only hear news from issuers when it is bad news'. Fixed income analysts value an ongoing dialogue and such a dialogue will allow the treasurer to create a halo effect around the company as an issuer.

Establishing a dialogue is relatively straightforward. A treasurer should add fixed investors to the company's press release list, invite investors to bank presentations, and offer an investor conference call if the company undertakes any significant corporate event.

Final recommendations

Although the success of a Eurobond transaction is significantly influenced by market conditions, the role of the treasurer is critical. Factors such as basing the selection of syndicate banks on objective criteria, consistent communication to banks and investors, an informed roadshow and providing an unambiguous benchmark will result in a strong Eurobond execution. A successful first transaction will then set a precedent for future deals. ■

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