

# A burst of energy

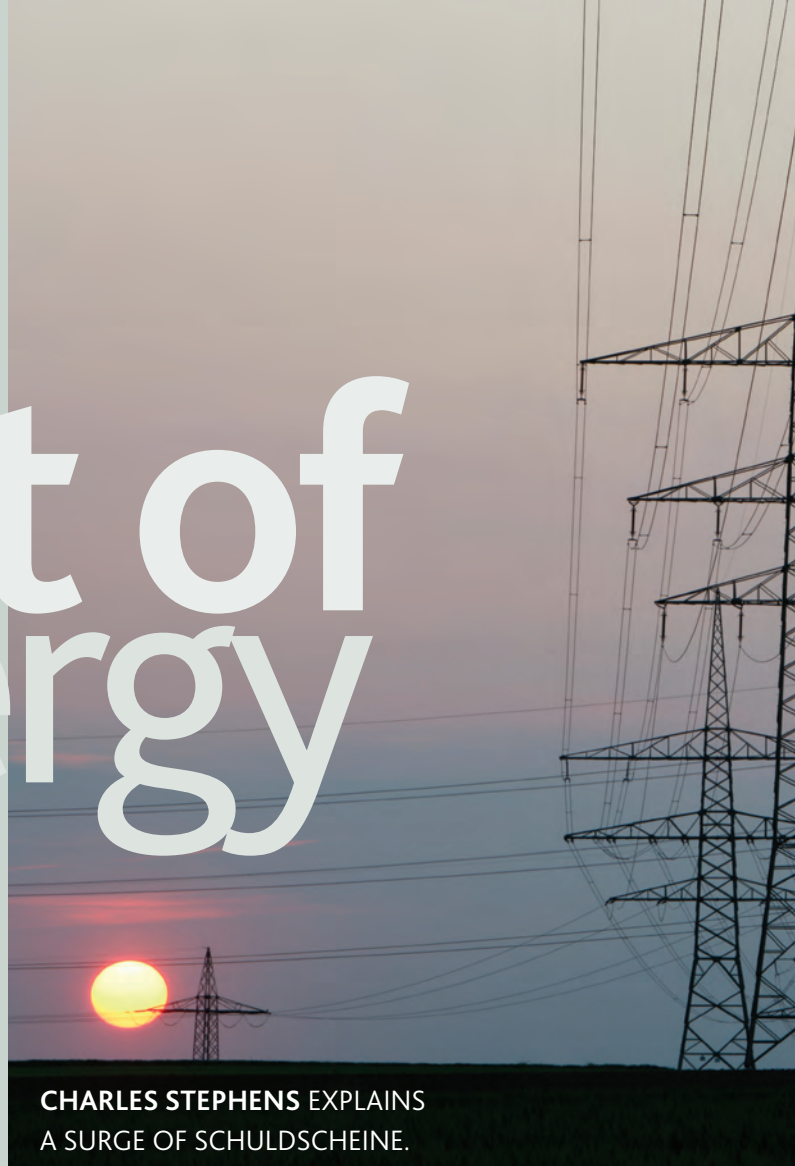
## Executive summary

■ There has been a flurry of new deals launched over recent months in the schuldschein (German loan instrument) market, with investors in the enviable position of being able to pick and choose. The preference for German deals is clearly being asserted. However, for non-German borrowers that meet investors' criteria for credit ratings and pricing, schuldscheine can make a useful contribution to funding diversification.

Schuldscheindarlehen (often shortened to "schuldscheine" and usually translated as "certificates of indebtedness"), are loan instruments, used for many years in the German-speaking world. They are bilateral loans, privately placed, unlisted, unregistered, usually governed by German law and embedded in the legal framework of the German civil code. The largest category of schuldschein issuers is German public authorities, but the market is also tapped by corporate borrowers and financial institutions. This year, the schuldschein market has seen a surge of corporate activity, and presented funding opportunities for a wider range of borrowers. National Grid plc has recently completed a €150m transaction, which provides a useful case study of the issues arising for a UK company in this market.

**WIDER AND DEEPER** Traditionally, the investor base for schuldscheine has consisted primarily of German and Austrian insurance companies, regional Landesbanks, savings banks and co-operative banks. The focus of these lenders has generally tended to be on domestic corporate credits, typically for transactions up to €200m

**THIS YEAR, THE SCHULDSCHHEIN MARKET HAS SEEN A SURGE OF CORPORATE ACTIVITY, AND PRESENTED FUNDING OPPORTUNITIES FOR A WIDER RANGE OF BORROWERS.**



**CHARLES STEPHENS EXPLAINS  
A SURGE OF SCHULDSCHHEIN.**

in size. In the early months of this year, however, schuldschein investors showed appetite for much larger transactions for blue chip German household names. BMW, Siemens and E.ON successfully completed deals of €1.3bn, €1.1 bn and €650m respectively.

These well-known users of the debt markets turned their attention to schuldscheine principally because of poor conditions at the time in the public bond markets. Widening bond spreads, high volatility and high new issue premiums gave borrowers strong incentives to look for funding alternatives. Schuldschein pricing, although wider than in the mainstream syndicated loan market, began to look competitive versus bond pricing. At the same time, new fixed income investors were drawn into the schuldschein market by the well-rated credits now on offer; by a shortage of new bond issuance; and by the volatility of mark-to-market valuations on bond portfolios.

The rationale for major German companies to issue schuldscheine applied equally to non-German companies, provided that investors could be found. In fact, a sub-sector of the investor base proved willing to look at foreign corporate credits offering relative value. This opportunity was embraced with notable enthusiasm by French corporate borrowers including France Telecom, Renault and Schneider.

**THE ISSUES** In April this year, when National Grid mandated Bayerische Landesbank and Commerzbank to arrange a schuldschein transaction, the market had already demonstrated appetite for non-German credits. However, there had been no recent comparable transaction from a UK corporate. The challenges therefore were to tailor schuldschein documentation to the company's requirements and to present the deal to investors in such a way as to be sure of a successful outcome. National Grid was keen to put schuldschein investors on a level footing with its bond and MTN holders, and their



**CREDIT RATINGS, NAME RECOGNITION AND PRICING WILL BE KEY COMPONENTS OF SUCCESS. FOR A BORROWER THAT MEETS INVESTORS' CRITERIA, SCHULDSCHNEINE CAN MAKE A USEFUL CONTRIBUTION TO FUNDING DIVERSIFICATION, PROVIDED THAT THE TRANSACTION STRATEGY TAKES ACCOUNT OF THE MARKET'S CHARACTERISTICS.**

respectively. The arranging banks made available "fact sheets" on the borrower in German, and investors also had access to rating agency reports on National Grid. The draft schuldschein loan agreement was available on request.

An investor call was scheduled a few days after launch, for a presentation by the company, accompanied by slides. Notwithstanding that National Grid is a regular user of other debt markets, the view taken was that potential first-time lenders should be offered the courtesy of a chance to hear from the company at first hand and to be able to ask questions if appropriate. In particular, it was important that investors should have a clear explanation of the group, which for regulatory reasons includes numerous borrowing entities with different credit ratings.

Corporate schuldscheine typically have a long marketing period. In National Grid's case, the order book was kept open for nearly six weeks, giving investors every opportunity to complete their approval processes. For the company, this necessitated some focus on the clear market clause and agreement was reached with the arranging banks for non-competing transactions to take place in the meantime.

The outcome for National Grid was an order book well in excess of the €100m minimum specified at launch, and a final deal size of €150m. Investors were attracted by the regulated nature of the company's businesses, its Baa1/BBB+/BBB+ ratings, and the realistic pricing on offer. There are 11 lenders in the transaction, varying in size from €1m upwards. Approximately two-thirds of the orders were for the floating rate tranche. The final pricing of the transaction, 100 basis points over mid-swaps/Euribor, was in line with the company's objectives.

From June onwards, the schuldschein market has seen a flurry of new deals launched. Investors are in a position to pick and choose, and the preference for German deals is clearly being asserted. At the time of writing, we expect some of the deals in progress to get done, but that others may struggle. Credit ratings, name recognition and pricing will be key components of success.


For a borrower that meets investors' criteria, schuldscheine can make a useful contribution to funding diversification, provided that the transaction strategy takes account of the market's characteristics.

schuldschein agreement therefore incorporates some of their MTN terms and conditions, for example, in relation to early redemption and events of default. Documentation was produced simultaneously in German and English, with the German version being binding.

A particular issue to be addressed was UK withholding tax. Schuldschein investors expect to receive interest and principal free and clear of deductions, with a gross-up commitment from the borrower if needed. National Grid, for its part, wanted the right to redeem the transaction early if gross-up payments are required, which is the company's position also on issuance under the MTN programme. To minimise the possibility that gross-up payments will be needed, a "Qualifying Lender" test has additionally been imposed, taken from syndicated loan market practice. In essence, this test requires investors either to be a UK bank or to be domiciled in a location – such as Germany – where they have the benefit of zero withholding tax under a double taxation treaty with the UK. Investors falling outside the Qualifying Lender definition may of course have the possibility of qualifying if they can lend through a branch or subsidiary in a suitable location. Since schuldscheine are loans and fall outside the Eurobond withholding tax exemption – being unlisted and not in bearer form – disclosure of lenders' identities is required by HM Revenue & Customs. The onus of certifying their domiciles correctly has been placed on the investors themselves (via the Agent Bank), rather than on National Grid.

**ATTRACTING INVESTORS** The deal was launched in June. Investors were presented with a term-sheet for a five year transaction – the most active area of interest – which they could commit to in either fixed or floating rate format. Price guidance was given on the basis of a spread (90-105 basis points) over mid-swaps or Euribor

Charles Stephens, Corporate Finance,  
Commerzbank Corporates & Markets  
[charles.stephens@commerzbank.com](mailto:charles.stephens@commerzbank.com)  
[www.commerzbank.com](http://www.commerzbank.com)

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# Schuldscheine: investor diversification at the right price

National Grid has approximately £19bn of long-term debt. Currently the company is investing in all areas of its international electricity transmission and gas transmission and distribution businesses to maintain and expand the networks. In order to finance this investment, along with its maturing debt, National Grid's treasury are focused on raising up to £3bn of debt between January 2008 and March 2009. The public bond markets have so far supplied over £1bn of the requirement. Due to a number of reasons, however, including the current new issue premia seen in the public bond market, National Grid was interested in exploring other opportunities to provide competitive funding for the group. A schuldschein transaction was one option that National Grid had previously considered but not utilised due to the additional documentation required. Current market conditions and the expectation of more favourable pricing compared to public markets, as well as the benefits of investor diversification, have made this option more attractive.

All documentation was prepared prior to the announcement of the transaction. With the key terms based on our EMTN programme, only the specifics of the unlisted loan document needed to be agreed. Investors were offered both fixed and floating tranche options with one of the lead banks appointed as paying and syndicate agent. Beyond the required documentation, it was necessary to liaise with HM Revenue & Customs to obtain the appropriate clearances in order to make interest payments free of withholding tax. This co-ordination and documentation took somewhat longer than initially envisaged.

There were a number of risks involved in proceeding with the transaction. The most significant being the four to six week

marketing period that is needed in order for investors to complete their credit work. With price guidance going out at the start of the process, there was a risk that by the time the transaction closed the pricing could look very out of line with the volatile public market. In order to give the deal its best chance, we knew we should avoid transacting a benchmark euro deal during that time period. For an opportunistic issuer like National Grid, a decision to stay out of that market for several weeks, was not taken lightly. Another risk was the uncertainty relating to investor perceptions of a UK company as opposed to a German issuer with whom they would be more familiar. Another UK issuer had only recently pulled back from a schuldschein transaction when it appeared not to be achieving their objectives.

In the end the transaction proceeded smoothly following the launch on 20 June 2008. National Grid raised €150m with pricing at the end of July of mid-swaps +100, which compared favourably to a benchmark euro issue at that time. The outcome was particularly pleasing against the backdrop of an exceptionally large number of schuldschein deals which came to market this summer.

Overall, this was a successful transaction for National Grid, providing an alternative funding mechanism with preferential pricing and diversification of the investor base. While the structure and initial preparation for this transaction was perhaps more than we had initially anticipated, we were very satisfied with the outcome in terms of size and price and it is a market we hope to return to again.

Alison Stevens, senior capital markets manager, National Grid  
[alison.stevens@ngrid.com](mailto:alison.stevens@ngrid.com)