RETAIL RUSH

COMPANIES THAT WANT TO DIVERSIFY THEIR FUNDING SOURCES USING ORB SHOULD GET IN QUICK, SAY DAVID CLEARY AND EMMA WHEATLEY

London Stock Exchange's (LSE) retail bond market was launched in February 2010 and offers corporates and financial institutions the chance to diversify their funding sources. There are numerous products and instruments described as bonds, such as the recent non-transferable or tradable fixed-rate offers by the likes of John Lewis and Hotel Chocolat. But here we focus on tradable securities listed on LSE's Order Book for Retail Bonds (ORB).

The UK had a retail bond market in the 1970s, but this all but disappeared as government privatisations prompted investors to focus on equity. As a result of this gap, the new retail bond market is much less established than the equivalent markets in Europe, the US and Asia, and to date the majority of deals have been vanilla fixed rate, with a few inflation-linked transactions. Nevertheless, the market is of growing importance for both corporations and financial institutions, and initial expressions of interest are increasingly resulting in live mandates and potential transactions.

RETAIL BONDS: KEY FEATURES

FEATURE	INSTITUTIONAL BONDS	RETAIL BONDS	DEPOSIT ACCOUNTS
Denominations	Minimum £100,000 with £1,000 increments (no maximum)	£100 with typical minimum investments of £2,000	N/A although sometimes issuer imposed, for example £500 minimum
Bookbuilding period	Launched and priced in the same day	Typically a 5-10 day bookbuilding period	No limit – until target size reached
Pricing	Priced in the hours after bookbuilding period	Priced before bookbuilding	Priced before bookbuilding
Pricing convention	Priced (floored) to nearest eighth of a per cent	Priced at par with coupon rounded to nearest 0.1%	At issuing bank's discretion
Settlement	Settle via Euroclear/ Clearstream	Euroclear/Clearstream/ CREST	N/A
Documentation	Standard euro medium-term note/ standalone prospectus	Additional disclosure to comply with the Prospectus Directive	Standard retail deposit terms and conditions
Listing	LSE regulated market	LSE regulated market and LSE ORBs	N/A
Trading	OTC	OTC and via ORB	N/A
Distribution	Bookrunner: one or more banks	Bookrunner: one or more banks plus authorised distributors	Via the issuing bank's website/branch network (if applicable)
Tenor	Typically 5-15 years	Typically 5.5-10 years	Typically 1-5 years
SIPP/ISA eligibility	If years to maturity is greater than five years at purchase	If years to maturity is greater than five years at purchase	N/A
FSCS guarantee	N/A	N/A	Up to £85,000 (sole account)
Investor tax payment	Gross	Gross	Net

Activity

A number of factors are driving activity in the retail bond market. Diversification of funding sources is one – borrowers are keen to reduce their reliance on the bank market and explore other sources of debt finance. Another factor is the desire by fairly irregular borrowers to flatten their debt maturity profiles. Such issuers may wish to avoid having large debt maturity peaks every four or five years – and, at the same time, certain institutional investors are becoming increasingly unwilling to undertake credit work for an issuer that is only going to come to the market every few years.

A solution in such cases is for the issuer to undertake smaller and more regular transactions, as opposed to issuing a benchmarked-sized bond every five years or so. The retail bond market is well positioned to support this model because it is more receptive to smaller deal sizes than the institutional market. As a result, the trend is for issuers to plan for repeat issuance of £50m-£100m bonds every 12-18 months. Corporate borrowers, in particular, are looking at this as a market that will meet their term debt needs both today and in the future.

Tenors in the retail bond market typically range from five-and-a-half to eight years, although the longest tenor we have seen is 10 years. Deal size varies depending on the size of the issuer and complexity or structure of the transaction.

The largest deal the market has seen to date was a £283m inflation-linked issue from National Grid, capturing investor demand last summer after the withdrawal of a successful National Savings and Investments inflation product. Following the success of the National Grid trade, Tesco Bank issued an inflation-linked transaction in December 2011 (with Lloyds Bank acting as bookrunner), which raised £60m in the space of a fortnight. Tesco Bank went on to raise £200m with a fixed-rate retail bond in May.

Obstacles

Despite the success stories, potential issuers should bear in mind that the retail bond market is not without its obstacles, particularly for companies that have not issued bonds previously. The level of disclosure required can be off-putting for unlisted issuers, although for listed companies this is less of a hurdle. The legal documentation and processes can appear quite daunting for debut issuers, but as the market develops, legal firms are increasing expertise in this area and the documentation is becoming increasingly standardised.

Pricing is another consideration for potential issuers. All of the fixed-rate retail bonds issued to date have had a coupon in excess of 5%. As investors can get a return of 4.25-4.5% from high street bank deposit products, retail bond issuers need to offer a higher coupon to make up for the fact that retail bonds are not guaranteed by the Financial Services Compensation Scheme. The 5% floor is not set in stone, however, and we believe that as bank deposit rates continue to fall, high-quality retail issuers will be able to issue at 5% or lower, opening the market to companies and financial institutions for which the pricing is currently felt to be too high.

Name recognition, or lack of it, was previously seen as an obstacle, but this is becoming less of a concern as investors become comfortable with single-name risk.

What to expect

Corporates that are looking to access the retail bond market should expect the entire process to take a minimum of 10 weeks. Timing is arguably less of a concern than in the institutional market, which can close for periods as a result of economic and financial news flow.

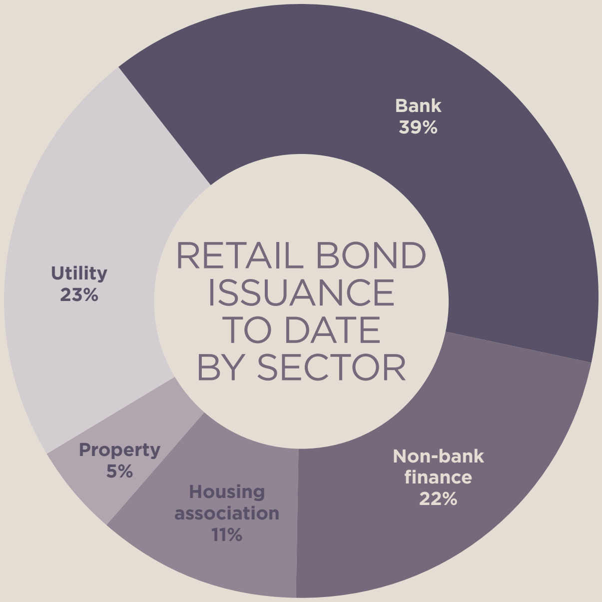
In contrast, the retail bond market is typically open and receptive all year round, with only brief closures in July and December. Peak investor interest is at the start and end of the tax year. Nevertheless, competing supply is a concern and issuing is not recommended when more than two issuers are in the market. The way to get round this is to use bookrunners that are active in the market to ensure that the pipeline is managed correctly.

Companies that enter the retail bond market should also ensure they put in place an appropriate financing structure and one that facilitates repeat issuance. We advise clients to look at their capital structure, both in terms of what they want today and what they want in, say, five years' time, and to ensure they are not adding any unnecessary complexity.

While the interest in this topic is very positive, potential retail bond issuers should look beyond the current rush into the market and think carefully about the reputational risks they may incur with retail investors holding their paper. It is important that issuers focus on choosing bookrunners that will stand behind the trade, make a secondary market as appropriate and continue to support them going forward. Reputational risk is also a concern for the bookrunner.

Future prospects

To date, banks and non-bank financial institutions have largely dominated retail bond issuance, but we see UK corporates, both rated and unrated, as the next opportunity for growth in this market over the coming year. There is a strong pipeline for the rest of 2012 and we are anticipating a significant amount of activity in the months ahead.



SOURCE: LONDON STOCK EXCHANGE, LLOYDS BANK
NOTES: BROKER DISTRIBUTED ISSUANCE FROM FEBRUARY 2010, EXCLUDING RBS


David Cleary is a senior director, corporate debt capital markets, Lloyds Bank Wholesale Banking & Markets. Email: david.cleary@lloydsbanking.com


Emma Wheatley is an associate, capital markets, Lloyds Bank Wholesale Banking & Markets. Email: emma.wheatley@lloydsbanking.com

LLOYDS BANK