Watching credit for covenants

The UK finally seems to be catching up with the US in relation to credit analysis in the bond markets. Investors are becoming more sophisticated in this area and are increasingly conducting their own in-house credit work.

Recent credit events have led investors to revalue the importance of this type of research so that they can fully understand the covenant implications of current and future bond issues.

In particular, water, property and telecom companies, through their restructuring and refinancing strategies in search of shareholder value, at the expense of credit quality, have driven this change in investor attitudes.

The water and telecom companies, which started life as AAA or AA credits, have moved into a position of increased financial uncertainty which has led to downgrades in credit with further falls not ruled out.

Credit deterioration

Much of the problem has arisen because the bond market has been relatively buoyant in a deteriorating credit environment. Bonds continued to be sold with weak covenant packages as credit ratings deteriorated.

Recent events involving Hyder, Kelda, MEPC and BPT have highlighted the risk of credit deterioration for unsecured lenders, of either the securitisation of cash flows through a Kelda-style mutualisation or the replacement of publicly listed share capital with more highly geared private equity.

The repercussions are being felt throughout the UK bond market in all except the highest investment grade sectors.

Covenant protection

Whereas some investors had simply relied on a corporate's unsecured credit rating or even its reputation, they are now demanding increased credit protection through covenants. Some recent sterling issues for industrial and commercial borrowers have been delayed so that the covenant package could be renegotiated. In the telecoms sector the covenant debate has been almost universal. US, UK and European investors are demanding some recognition of the risks they run in this sector. Whether they are being reasonably compensated is another matter.

While we are in an environment of major corporate restructuring, investors will constantly refer back to the small print of bond issues. As a consequence, borrowers should expect demands for credit event protection for the foreseeable future. ■

TIM METZGEN
Global Markets
RBC Dominion Securities

INTERNATIONAL BONDS

These are a selection of bonds announced recently. The details, updated to the middle of last month, were supplied by *IFR Securities Data, London* and other sources.

Issuer	Launch rating M	Launch rating S&P	Amount (m)	Coupon (%)	Price	Maturity	Launch Spread (bp)	Fees (%)	Bookrunner
Integrated Accommodation Services	Aaa	AAA	GBP405	6.48	100	Mar/29	180	0.625	Deutsche Bank
Punch Taverns	Aaa	AAA	GBP350	(e)		Oct/04	35		Schroder Salomon Smith Barney
	Aaa	AAA	GPB300	6.82		Jan/16	180		
	A2	A	GBP450	(f)		Jun/05	110		
	Baa2	BBB	GBP165	(g)		Jun/05	265		
	Baa2	BBB	GBP150	8.374		Feb/28	400		
	Ba2	BB	GBP69	(h)		Oct/04	575		
Thames Water	A2	A	EUR100	(i)	100.065	9 Feb/02	(j)		Credit Agricole Indosuez
TI Group	A3	BBB+	GBP150	7.875	99.231	Jul/10	(k)	0.40	HSBC UBS Warburg
	A3	BBB+	EUR300	6.375	99.456	18 Jul/05	(l)	0.32	Deutsche Bank Schroder Salomon Smith Barney
Travelex	B2	BB-	GBP75	10.5	100	31 Jul/10	(m)		Barclays Capital

(a) 611bp over gilts. (b) Not disclosed. (c) 551bp over US Treasuries. (d) 885bp over the January 2000 bond. (e) Libor + 35bp to June 2005 and thereafter stepping up to 115bp. (f) Libor + 110bp to June 2005 and thereafter stepping up to 330bp. (g) Libor + 265bp to June 2005 and thereafter stepping up to 795bp. (h) Libor + 575bp to June 2005 and thereafter stepping up to 1.725bp. (i) 11bp over three-month Libor. (j) 6.5bp. (k) 260bp over gilts. (l) 131.5bp over 5% 2005 BTAN. (m) 528bp over gilts.

Launch ratings are from Moody's (M) or Standard & Poor's (S&P). NR = Not Rated. R = fixed re-offer price. Launch spread is over comparable government bond.