Euro bonds – the year of living nervously

Jeremy Froud of Barclays Capital highlights the volatile trends witnessed in euro bonds so far this year in a very nervous market.

As euro market participants begin to drift back from holiday, everyone is very conscious that it is now time to gird themselves for the last round in this year's battle of the markets. Given the market conditions witnessed during the first half of 2000, I am sure that anyone, whether issuer, investor or underwriter, will be able to relate to this analogy.

The year so far has been eventful to say the least and as a result general sentiment is less than positive. Albeit that as this article is being written we are less than two-thirds of the way through the year, there is one word that will become synonymous with 2000 – volatility.

Investors have suffered, wider spreads have led to disappointing performance figures for many, if not all, fund managers. In an effort to provide themselves with a higher level of protection against further underperformance, players in all markets have taken a firmer stance. In short, the pendulum that swings between issuer and investor has moved in the investors' favour.

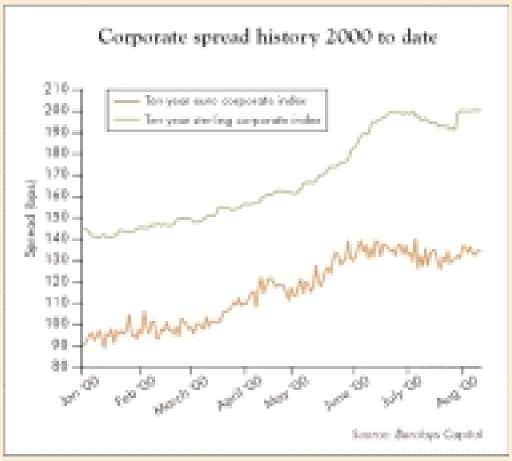
Spreads

The volatility has manifested itself not so much in the yields of the underlying government markets, but more in the performance of spreads. To put this volatility into context, *Figure 1* demonstrates the historic spread performance of corporate spreads in each of the sterling and euro markets since the beginning of the year.

Catalysts

There are several underlying drivers behind this volatility, some of a technical nature and others that are slightly less tangible. Indeed, whether it is a pointer towards a greater degree of sophistication in the credit markets or just bad luck, a wider variety of events than ever before seem to have had a bearing on the performance of markets.

FIGURE 1



In the sterling market, spreads have been dragged wider because of the performance of swap spreads. The healthy state of HM Treasury finances have led to reduced levels of gilt issuance, and indeed the talk is more of buybacks than forthcoming supply. The corresponding perception of a reduction in liquidity has pushed swap spreads wider because it is proving more difficult for traders to build or unwind positions. With many investors cross referencing secondary market bond spreads against both Libor and gilts, wider swap spreads have played a very real part in the underperformance of bond spreads.

Jeremy Froud

A further source of volatility has been caused by a stark realisation that the world has changed, especially in relation to the sheer volume of funding required. Examples are plentiful. Vodafone's merger with Mannesmann, although achieved by a swap of equity, initially required the support of a €30bn bank loan, France Telecom's subsequent purchase of Orange resulted in the launch of another €30bn facility.

Away from the telecoms sector, Unilever used a $22bn bank line to backstop its purchase of Bestfoods. The company very quickly made an appearance in the capital markets, despite the acquisition heralding the end of Unilever's triple A rating. The new rating did not impede the issuance of some $7.5bn of short-term FRNs and there is already an expectation that a further $10bn of issuance from Unilever is in the pipeline.

Indeed, events in the telecom sector have had an effect on sentiment in more ways than one. Expectations of Gilt issuance were further reduced by the UK's recent auction of third generation UMTS licences. This trend should be repeated across the euro zone.

The auction raised substantially more than expected. Theoretically, one could interpret the raising of £22bn for the public coffers as positive. However, the inflow of funds will result in even less gilt issuance, leading to a higher degree of illiquidity, which in turn has continued the pressure on swap spreads.

Investors have reacted adversely to the prospect of bond markets being called upon to fund the cost of the telecoms spending spree. This prospect of substantial future funding led investors to mark telecom spreads significantly wider. In short, if issuers wanted the money, they were going to have to pay for it.

In reality of course, the bond investor is in the driving seat – the telecom sector does need the money and given the sums required the bond market is almost certainly the funder of last resort. Indeed, the size of the current need and ongoing requirement for many in the sector will even preclude the ability to play one market off against another, issuers will quite simply have to access all the markets at the same time. The recent offering by Deutsche Telekom simultaneously tapped the dollar, euro, sterling and yen markets and whilst it raised a record breaking $14.5bn, it certainly had to offer some incentive to investors in the form of what appeared to be attractive margins. The transaction will now become the precedent by which future jumbo offerings will be judged and in hindsight, this was an astute transaction as credit spreads have widened sharply in this sector.

Record-breaking though the Deutsche Telekom offering may have been, it pales into insignificance when set against the estimated €300bn required to fund the pan-European cost of the third generation licences and associated infrastructure spend. Having said that, the achievement of raising such a substantial amount of money in one go must never be underestimated. A deal of that quantum proves how markets have evolved but also underlines how they must continue to evolve to keep pace with the requirements of the future.

Event risk

A dominant feature of the corporate bond market in Europe so far this year has been the investors' heightened concern of event risk. As a class, senior unsecured creditors continue to feel threatened by the mantra of shareholder value. In very simple terms, the concept has manifested itself in higher levels of gearing which in turn has led to lower levels of interest cover – an invitation for Standard & Poor's and Moody's to lower their ratings if ever there was one.

> Against a backdrop of nervousness, investor reaction to any unexpected news will be exaggerated

During the year to date, there have been several catalysts to fuel investors' concerns. The migration of cash into new economy stocks away from more traditional investments left many established management teams, through no fault of their own, looking exposed to takeover.

An underperforming equity price may be the catalyst for a bid from a financially motivated predator. Whilst the current management team may profess a strong commitment to maintaining the current ratings as a necessary tool in their ability to finance the expansion of the business going forward, investment grade ratings may not be so high on the new owner's agenda.

The ever increasing availability of finance to mount a leveraged bid has undoubtedly led many slide rules to be run over just as many balance sheets. If analysts failed to identify undervalued assets they went back to the drawing board in search of identifiable, predictable cashflows from the constituent components of the business that would be used to form the foundation of a securitisation. With the cashflows diverted to service the securitisation vehicle, unsecured bond investors are left feeling that their position has deteriorated.

Covenants

In an attempt to seek protection from event risk, investors have looked to covenants as a way of preserving their position. Different markets have traditionally approached covenants from varying perspectives.

The sterling bond market, which tends to be somewhat cyclical in its approach to covenants, has certainly started seeking greater protection. In euros, with the market still continuing to evolve, it is slightly more difficult to spot a trend. During 1999 and for most of 2000 investors have not focused too much on the subject but given recent events there are strong signs that it will be given more consideration. The dollar market, seen by many as the most sophisticated credit market, continues to take a relaxed view to covenants.

Whilst everyone is in agreement that the provision of a tighter covenant package does not make a bad credit any stronger, investors feel that covenants can mitigate some of the unknowns. In the telecom sector, where there is a general expectation of ratings downgrades as the sector is forced to gear up, investors have come to expect some sort of coupon ratchet linked to a change in the long term ratings. For other corporate issuers, investors are keen to seek the right to put their bonds back to the issuer at par upon the occurrence of a pre-determined event triggering a downgrade to below investment grade. Examples of trigger events have been a change of control, a disposal of assets, or indeed a major restructuring of the balance sheet.

The remainder of the year

And so to the future, what will we see for the rest of 2000? Certainly the volatile trend identified above caused by large funding requirements and continued event risk look set to last.

Whilst there is an expectation that conditions will improve, markets will remain prone to bouts of volatility. However, against a backdrop of nervousness, investor reaction to any unexpected news will be exaggerated. As we approach autumn, a considerable amount of nervousness would seem to be priced into the market. Let us hope a lack of surprises will allow markets to end the year on a firmer footing. ■

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