Playing catch-up – UK institutional investment

Mark Hutchinson of the Prudential M&G considers the changes in the asset class of corporate debt and the challenges facing UK institutional investors.

With companies raising more and more debt financing in the bond markets, it is somewhat surprising that the requirements and aims of bond investors are still not understood by issuers. Even with banks changing through mergers and an increased focus on shareholder value, companies know how to deal with their requirements. But it is less clear that this is also true when dealing with investors in the capital markets. Especially for those issuers who are going to do a number of debt issues, a relationship with bond investors is important, so that the two parties can keep each other abreast of strategies and developments. This article will highlight developments and trends currently within UK institutional debt investment.

Bank and bond markets are merging

Historically, companies have considered the pricing and structuring requirements in the banking and bond markets to be totally different. Obvious examples are the pricing at a spread over government securities, not Libor, longer tenors and fewer covenants.

However, the current trend is that these markets, especially in pricing, are converging. In future, both markets will view fund raisings by companies in the same way (see *Figure 1*). Banks and bond investors are both taking the same risk: for example, both rank on a senior unsecured basis.

Those companies that have raised bank finance for non-relationship reasons, such as for an acquisition, know that the pricing of bank loans in these circumstances is different from usual and reflects more the credit rating or leverage of the company. This is illustrated by the increasing use of grid pricing in the syndicated bank market.

With these markets merging, issuers are going to see differences in how bond investors approach investments.

Covenants in bond markets

On the bond side, the increase in corporate bond issuance has meant that bond investors have more experience in analysing companies and comparing the risk profile of a number of companies in a sector. The old days of only debentures being issued with the same capital and income cover ratios, irrespective of the credit quality of the issuer, have gone. Investors in UK public bonds are now asking for covenants, where the proposed pricing does not adequately cover the perceived risk in the outlook for the company's credit rating.

This point is greatly misunderstood by issuers, especially those that have issued bonds in the past without covenants. If you look at *Figure 2* and put on, say, your pension trustee hat, which instrument would you want your pension fund to invest in if, on a Libor basis, the five-year bank funding was at Libor + 50bp and the 10-year bond was at Libor +50bp (the latter is calculated by swapping the fixed-rate coupon of the corporate bond from fixed to floating rate)? Which has the better risk/reward dynamics?

It goes against economic logic that the asset with the shorter maturity, the

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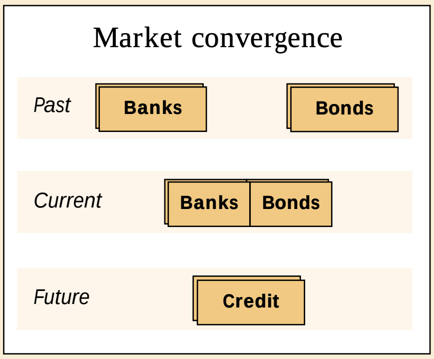
FIGURE 1



stronger covenants and, with the development of the secondary bank loan market, similar transferability, has the higher or same return to the investor. Therefore, it should not be surprising that during the roadshow for a bond the issuer is asked about their bank facilities. If the bond is to be subordinated in maturity and terms, there is no doubt that the pricing should reflect this. If it does not, then the issuer should arbitrage the two markets to gain the best fund raising for their shareholders.

Alternatively, an issuer may consider that, despite better pricing and terms within the bank market, they want to access the capital markets for the longer tenor. Certainly, at present, there are cost advantages to the longer tenor, with the inversion of the sterling yield curve. In addition, to access the fixed-rate market without using bank swap counterparty lines can be beneficial, especially for smaller companies.

Areas of investment for institutional investors

As can be deduced from the above, institutional investors are starting to look much more closely at the credit markets as a whole rather than just the public bond markets. Therefore, where once issuers expected only to see the names of banks, institutional investors could now well be part of the distribution strategy for the arrangers of bank loans. I shall now look at areas where there have been significant recent developments.

Private placement market

When I last wrote for *The Treasurer* magazine in the October 1998 issue, under the headline 'Growth of corporate debt as an asset class', the conclusion was 'the UK, compared to the mature US market, is only in the early stages of building a full public and private corporate bond market'.

There can be no doubt that the UK is now past the early stages but still not at the mature state of the US markets. On the fixed rate private placement side, this is due to lack of depth with only two or three participants in the unsecured investment grade part of the market. The US market is still the main source of investors for issuers, but around 20 have accessed UK institutional investors either on a bilateral basis or in creating a sterling tranche within a US private placement fund raising.

With the lack of investment grade issuers of single A minus and below in the sterling public bonds markets, the private placement market is very attractive for those institutional investors who want a broader exposure to credit, without going right down the risk curve to high yield credits.

With respect to terms and conditions in this market, the market has developed to mirror those achieved by issuers in the US. Pricing will be dependent on the public market in the UK, so there may be occasions where US dollars raised from US investors, which are swapped back to sterling, will be cheaper funding for a UK company than accessing sterling from a UK investor. Judging by the experience of the last two years, this will be a function of the different swap markets on a particular day.

In summary, the UK private placement market is established, but to get regular issuance of the £100m size per deal, the market needs to have more participants than the existing two or three, either from other institutional investors or perhaps even pension funds, who want more diversified credits in a corporate bond portfolio.

Leveraged bank loans

The attraction for institutional investors is the risk/reward trade off in lending at the senior secured level with its high recovery rates under UK bankruptcy rules. It is estimated that in the US 42% of funds raised in the leveraged bank loan market (defined as non-investment grade with minimum credit spread of Libor + 150bp) is provided by institutional investors. In Europe, other than US institutional investors who have a London office, it was only in 1999 that the first UK institutional investor participated in this market. There are many hurdles facing non-banks – tax and documentation being the principal two. However, with the support of the Loan Market Association, there can be no doubt that, again, borrowers will see more non-banks within the syndicated market for LBO and MBO finance, as the arrangers see the advantage of wider distribution of these type of loans.

Public bonds

With the introduction of the euro, there are a greater number of issuers who are raising funds in the euro and sterling corporate bond markets. With investors less able to gain extra yield by investing in different government credits across Europe, they are now looking to the corporate bond market. This trend will continue.

FIGURE 2

Terms and conditions of funding for investment grade corporate

	Bank loans	Public bonds
Maturity	5-7 years	7-10 years plus
Financial covenants:		
1. Interest cover / **2. Gearing**	Minimum one of them	Sometimes none
Other covenants (eg negative pledge, change of control)	Definitely	If exist, weak
Pricing of credit spread	Grid pricing or fixed	Fixed
Transferability	Yes	Fully transferable

While many areas of the public bond market are growing, one deserves comment: asset securitisation. Securitisations of residential and commercial mortgages, credit cards and, in the UK, operational cashflow have all grown significantly and investors are getting much more experienced and comfortable with these structured investments.

The challenge for institutional investors is to get the depth of staffing comparable with their US competitors, so certain people can specialise in particular sectors or type of investments. Currently, if there is any difference amongst corporate bond teams, it is just between the investment and non-investment grade. As bond issuance continues to grow this will change, which will be of benefit to issuers, investors and intermediaries.

Looking ahead

There have been significant developments in corporate debt markets in the last two years, and there is no doubt that the next two will be no different; but what the catalysts will be is harder to predict. However, certain trends are in place: convergence of the bank and bond markets; bank mergers and acquisitions; greater corporate bond issuance, especially in euros; and larger corporate bond teams amongst investors.

Certain events are also on the horizon: review of the minimum funding requirement (MFR) for pension funds in UK; introduction of new BIS rules for banks; and Paul Myners' review of pension fund and institutional investment.

Whatever happens in the next couple of years, issuers are going to have to keep up to date with the requirements of not only their banks but also non-bank investors. While there will be opportunities for issuers to arbitrage between different markets, this will lessen over time, as both bank and non-bank investors will come to look at the underlying credit of the issuer in similar ways. Pricing will be based not only on the credit but also the terms of the instrument being issued, and how it compares with other debt obligations of the issuer in other markets. ■

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