Eurobonds: a view to a killing?

The arrival of the euro means it's all change on the Eurobond market. Keith Phair of The Bank Relationship Consultancy looks at the implications for treasurers.

There has rarely been more interest by corporates in issuing debt in the Eurobond market. The reason for this is mainly due to the advent of the euro and the much-heralded prospect of an integrated market that rivals the US in size and, eventually, diversity of credit appetite. The European market remains fragmented, but the attitudes of investors are changing rapidly and the 'euro Eurobond' market represents a significant opportunity for fund-raising by corporate issuers.

This article looks at the impact on issuers of the changes in market dynamics that have reshaped the Eurobond market over the last five to 10 years, and explains why corporates attracted by the undoubted opportunities in the rapidly developing single European debt capital market must remain wary of banks attempts to 'optimise their income' from client relationships.

European consolidation

Traditionally, companies have expected to do deals in the Euromarkets with cheaper fees and considerably greater price competition than, for example, the US domestic market has offered. However, underwriting practices in today's Euromarket have developed along lines closer to the US, a trend which has been aided by continuing consolidation amongst the European competitors aiming to rival the American 'bulge bracket' firms. As little as five years ago, every major European country had at least three commercial banks which were actively and aggressively pitching their capital markets' capabilities in competition with the specialist investment banks. For many corporate borrowers there might have been 10 or more reasonably credible lead managers who could be played off against one another and be 'pumped' for information. Then, when a mandate was awarded, it was usually executed as a 'bought-deal', under which the lead manager took the full risk of distribution and was often lucky to make anything like the stated management and underwriting fees for the deal. No wonder that corporate treasurers were confident that the process would produce all the free advice they could want about the market, topped off by a finely-priced deal!

Happy days indeed for borrowers... but such memories are fading fast. Almost every aspect of market dynamics has now changed. In many countries, there is now only one 'national champion' commercial bank able to offer a comprehensive level of service As in all other areas of banking and finance, the level of investment required to keep pace with such developments as the Internet-based distribution of bond issues, means that only the best-resourced banks can compete effectively. There are fewer sources of information available to treasurers who want to consider dispassionately a range of alternative markets. Of course, good information was never entirely free or independent, but the current situation pales compared to when there were a larger number of banks operating in every sector of the market.

Keith Phair

These changes create significant problems for corporate issuers. In most cases, companies taking a serious look at the euro Eurobond market for the first time do not have long-standing relationships with many of the major capital markets' banks, and their traditional banks may not always be well-placed to fully penetrate the fragmented euro sector.

Emerging European market

Part of the reason for the current fragmentation is that the euro Eurobond market is barely a year old. As issuers await the emergence of a more coherent market, the legacy of the former national currencies and markets means that institutional investors are reorientating their approach from the domestic to the pan-European at varying speeds.

But with many of the smaller institutions remaining slow to adapt to the new range of opportunities, it is currently difficult for any individual investment bank to gain a comprehensive understanding of investor preferences across Europe. As a result, most of the corporate euro-denominated deals feature two or three joint-lead managers.

Nevertheless, the euro-denominated debt capital market is already blossoming, with the corporate sector reaching one third of the size of its US equivalent in its first year and fundamentally changing the way in which corporates in Europe are funding themselves. For some time, Europe's top tier corporates have been able to fund themselves more cheaply than via banks by accessing the capital markets directly. However, since

the introduction of the euro, increased market depth is having a more devastating effect on corporate lending by banks as BBB-rated international corporates and below also discover that disintermediated funding can be the cheaper, more efficient option. With bank debt accounting for around 75% of corporate liabilities in France and Germany, for example, the scope for growth is substantial.

The euro debt capital market may be increasingly attractive to corporate issuers, but not all of the ways in which it now mirrors the US market are to be welcomed by treasurers. Although the Euromarket has traditionally been a more flexible market to access, recent years have seen the concentration of power move towards the underwriters.

Eliminating risk

The advent of the 'reoffer' mechanism has improved the risk/reward profile for underwriters, to the potential detriment of the issuer. Typically, corporate bond deals today will only be launched after extensive pre-marketing and then only when sufficient demand has been pre-identified (and 'circled') to clear the whole deal at the reoffer price, virtually eliminating the immediate risk for the underwriter and locking-in his fees. And, very importantly, the whole marketing process will usually only begin once a lead manager has been selected, thereby eliminating most of the potential for competitive tension at a stroke. As a syndicate manager recently commented, "Where else can you make these sort of fees for no risk?"

Of course, the fact that underwriters now 'make their fees' doesn't necessarily mean bad value deals for corporate issuers. There is nothing wrong with the principle of fair reward for fair effort or the exercise of skill. However, it is no accident that most bankers are now focusing their resources on obtaining 'negotiated' deals from corporate relationship clients (often regarded as a tame, if not quite captive, market), rather than pursuing the more transactionally-orientated borrowers, who are big and active enough to be able to demand that their lead managers take more underwriting risk and/or work for lower fees.

These large transactional borrowers have advantages that can never be matched by the less frequent borrowers who are increasingly being encouraged to use the debt capital markets instead of 'low-margin' borrowing from capital-sensitive banks. Assessing the right price and size for a deal by an occasional corporate issuer has always been more of an art than a science, and 'selling the credit story' has always required more time and effort than handling issues for regular and familiar borrowers. There are strong signs, however, that bankers' artistic talents are extending into poetic license or economy with the truth. For example, a recent borrower was prevailed upon to widen the reoffer price on his large five-year deal by 20 basis points (bp) per annum after the initial marketing period, due to 'adverse market sentiment'. Less than 36 hours after launch, the spread on the deal had tightened by 13bp, implying that the borrower had left at least $2 million (over and above the fees) on the table for the market to share. Nice work if you can get it!

Bankers are also becoming much more adept at linking business in other areas to the award of a bond mandate. Acquisition finance in the syndicated loan markets is easy to come by at present because the corporate borrowers are relatively price-insensitive – demand being driven by strategic imperatives, thus helping bankers to hit their high return targets. It also offers bankers the opportunity to lock borrowers into mandating them for the subsequent refinancing in the capital markets. This linking was simply not happening five years ago. Banks are now trying to play a much tougher game with their corporate clients. The trusted 'house bank' is becoming history and the term 'relationship' banking being abused again as banks adopt an increasingly selective policy towards clients.

Banks muscle in

The desire of banks to derive increased levels of fee income from their corporate clients will be familiar to all treasurers. In terms of fund-raising and debt issuance, this means that relationship banks are putting pressure on corporates for a larger slice of the action. However, a large international corporate might have anything between 15 and 30 relationship banks and will find it hard to structure a conventional Eurobond syndicate of more than eight to ten banks, which meets the needs of all parties involved. As a result of these relationship pressures, increasing attention is being paid to reviving the Selling Group concept, which went out of fashion in the cutthroat markets of the mid-80s. With a Selling Group, a broader group of banks are invited to help to distribute the issue, but are not involved in the management and underwriting of the issue. There are also moves afoot to couple this development with the use of a 'pot' system, under which banks that can genuinely place the issue into important 'buy-and-hold' portfolios are rewarded with a commensurate proportion of the selling fees.

Horses for courses

The increased use of the reoffer mechanism is indicative of increasing similarities between Europe and the US practices, but there are still many more players and, theoretically, more choice in the nascent European market. But the fact that these banks are still heavily engaged in marketing activities to establish their pan-European credibility brings its own implications. In order to win mandates that will enhance their market profile, many banks will inevitably be tempted to play to their strengths. If a bank knows that it can sell debt of a specific maturity to a certain sector of the investor base – or needs a certain type or size of deal for reasons of league table positioning – it may consider this a more important factor than the actual needs of the client. It is never wise to judge a bank purely on its track record, but this must be emphasised even more forcefully at this early, fragmented stage of the euro Eurobond market's development. Corporates would be well advised to choose lead managers for individual issues strictly on a 'horses for courses' basis.

It is clear that many corporate treasurers don't always recognise that the game is now being played under new rules. The whole aim of many relationship managers, coverage officers and marketing men is to bind their corporate clients tightly in, introducing them to more specialist services as they go, en route to their goal of fee maximisation. A treasurer might be flattered by the prospect of doing deals with 'Megabank Brothers', dazzled by the intellect of star economists or derivatives salesmen, or may simply be pleased to be invited to Wimbledon or the opera. But all banking discussions should be entered into with caution, as even a casual comment can hand an alert banker a key negotiating point. The sensible treasurer will want to avoid having his pocket picked whilst he is looking the other way. ■

Keith Phair is a senior consultant, Capital Markets with The Bank Relationship Consultancy.