A to Z of capital markets

The second extract from the second edition of the ACT companion to treasury management provides a selection of definitions relating to the capital markets.

ACT companion to treasury management is intended for anyone whose work touches on treasury management and who may need to check the interpretation of a word or phrase, including treasurers, finance professionals, business advisors and students. The second edition is an entirely new work, where even definitions of phrases covered in the first edition have been re-written by the new authors.

Bond markets

Bonds are negotiable debt instruments, generally with a maturity of a least one or two years. Bonds can be classified in several ways:

- straight or hybrid (eg bonds convertible into equity);
- domestic or international (the Euromarket being the dominant international market);
- fixed interest rate or floating (floating rate notes or FRNs being the mainstream example of the latter);
- public or private (the definition/significance of the latter is described in the entry for private placement*); and
- registered or bearer (see the entry for bearer instruments*).

Bonds are distinguishable from loans, in simple terms, by being 'securities', ie negotiable, whilst loans are not. They are distinguishable from 'notes' or 'bills' in most contexts by their longer maturity, although terminology can vary from market to market.

There are several types of bond worthy of more detailed comment:

- Eurobond. The essential feature of a eurobond is that it is international (cross-border) in its issuance and/or distribution. It is not necessarily limited to the European market (the 'Euromarket') and its name is slightly misleading in this respect. However, throughout the four decades of the market's history, Europe has been its main forum.
- Medium term note (MTN). These are debt instruments packaged by intermediaries in order to be easy for issuers and investors. They have maturities of between one and fifteen years and can be issued in tranches according to the borrower's needs. In the US market they may be in public ('registered') form or issued as private placements.
- Euro-medium term notes (EMTNs) have maturities up to five years. They tend to be in smaller denominations than their US cousins and to have a London or Luxemburg listing. They are cleared (on a seven day settlement basis) through EuroClear or Cedel and are usually in bearer form (see also custodian*).
- Floating rate notes (FRNs). Unlike MTNs, these have a variable rate of interest. It is calculated usually by reference to an interbank offered rate: London's rate (Libor) is the most frequently used and an FRN's return to the investor is commonly a low spread above a semi-annual reading of a closely defined calculation of Libor. FRNs are issued by medium ranking corporate names all the way up to sovereign governments and supranational institutions. Maturities also stretch from the short end to (for excellent credit risks) updated or perpetual issues.
- Deep discount bonds. As the name implies, these are issued at a price well below par. The motivation(s) for issuers and investors will invariably be taxation and/or cash flow. Treasurers need to assess both aspects in terms of their own jurisdiction and corporate forecasts.
- Zero coupon bonds. The ultimate deep discount bond! The rolled-up interest is inserted into the amount of principal to be redeemed at maturity. No interest is paid until redemption, and the redemption value is calculated actuarially to reflect ambient interest rates and any premium or discount resulting from the instrument's marketability. Treasurers need to establish the tax implications – for themselves and, for broader understanding, for the documentation (eg as regards borrowing limits); and to calculate the reinvestment rate, ie the prospective return on the funds retained until the bond's maturity.
- Junk bonds. These are issued by companies with low credit ratings, and the paper offers correspondingly high coupons. Most treasurers will feel justifiable indignation at the pejorative label which has remained

Global bond

A global bond is a single, temporary certificate representing the whole of a new issue of securities.

The purpose may be one or a combination of:

- controlling the initial distribution;
- allowing time for the printing of many certificates and/or electronic recording of multiple holdings; and
- complying with regulations restricting early trading (eg with a 'lock-up' period).

The global bond is often a bearer certificate and therefore represents in principle a security risk to the issuer. In practice it is so well supervised and is so unmarketable that the issuer need hardly be concerned. The task of holding, exchanging and cancelling the global bond is usually done by the paying agent (ie normally a bank) for the issue.

attached to a category that covers the majority in the potential corporate issuer universe. The largest pools of issuers and investors are in the USA, where the term 'junk bonds' covers all corporate debt below investment grade, ie below 'Baa' in Moody's ranking or 'BBB' in Standard & Poor's. The most common reasons for issuance are (a) takeovers and (b) buy-outs/buy-ins. The market tends to be cyclical, and the severe downturn at the end of the 1980s claimed the lives of two major investment banks.

Bulldog issue

Bulldog bonds are issued in the UK domestic market and in sterling but by foreign borrowers. They are thus the British counterpart to (eg, Yankees in the US, Samurais in the Japanese and Matadors in the Spanish markets.

The special features of the UK market for foreign company treasurers (apart from the obvious currency aspect) are:

- long maturities availability – at least for strong credits;
- the powerful but predominantly institutional and selective investor pool;
- the highly variable market appetite: the bulldog market may be closed to corporate issuers for years on end; and
- an informal calendar-smoothing service that operates under Bank of England guidance. This is a successor to the erstwhile queuing system whereby the Bank managed the calendar directly.

The bulldog market has tended to suffuse in recent years into the Euro-sterling one and thus to become simply the 'sterling' market. At the time of writing, the outcome and timing of the UK's single currency decision is unknown. This, together with the usual analysis and opportunism, will be a main concern of treasurers contemplating a sterling bond issue.

Corporate treasurers have been helped by the UK government's policy of keeping the lid on state borrowing levels. Competition for funds is thus less marked than from the government sectors in the German and Italian capital markets, for example.

Commercial paper

Commercial paper stands approximately half way between bank loans and bond issues. It is short term, unsecured indebtedness, packaged by intermediary firms and sold to investors who are then free to trade the paper.

Commercial paper (CP for short) tends to be a volume business, and the major markets are within the US and in the Euromarket where the relevant branch is 'Eurocommercial paper'.

Maturity dates are specified with each issue, and the repayment amount reflects the notional interest over that period because the paper does not bear interest.

Borrowers will typically create a 'programme' under which they can issue repeatedly. Issuers below the highest grades of creditworthiness often arrange for a guarantor in order to improve the marketability of their paper.

For treasurers the decision on CP can be determined largely by the strength (ie creditworthiness) of their company and the scope of their funding needs. Unless these are substantial, there is usually insufficient justification for issuing CP. Once over that threshold the treasurer needs to choose one or more dealers(s) who will take care of much of the administrative work and of the relaying of information and 'intelligence' to and from the investor market.

Convertible debt

A debt convertible bond offers investors the opportunity to switch, at their option, from the variable rate of interest provided initially to a predetermined fixed rate.

The principle behind the debt convertible is that the borrower should enjoy a relatively low interest payment in recognition of the option that the investor holds. Another instrument, the drop lock bond, has a predetermined trigger point (ie no option) at which the variable rate switches to fixed.

Convertible issues in this all-debt form are relatively rare because it is unusual for both borrowers and issuers to perceive at the same time that they will derive benefit from them. Not only is there a problem of matching attractions across the issuer/investor frontier: each side has access to rival instrument opportunities.

For the treasurer these included commercial paper*, note issuance facilities and swaps* and options* (see also bond markets*). ■

Placing power

Placing power is the ability of intermediary firms to sell securities firmly to end investors. Usually the context in which placing power is tested is a new issue or other major capital market* transaction (or bond market* transaction).

'Firmly to end investors' means that not only volume can be placed: the quality of the placement should ensure negligible onward selling, at least in the short term.

Placing power is a quality sought by issuer/vendor clients when choosing a lead manager. The lead manager will in turn seek the same quality in the candidates for joining its syndicate of underwriters. Selling to dealers or brokers (as opposed to end investors) is a symptom of poor placing power. Selling to inappropriate investors is likely to result in 'flowback', ie to a rapid and/or strong flow of selling by those initial takers into the trading market. Investors could be inappropriate for a wide variety of reasons: part of the skill in using placing power is choosing the right target investors for each transaction, taking account of its timing, market rationale and so on.

Factors creating placing power include:

- skilled sales staff;
- good quality research;
- underwriting/syndication strength;
- geographical coverage; and
- investor-client relationships.

Placing power has become more valued in recent years not only because of the increasing number of big transactions (for example because of privatisation) but also because of the spread of American-style underwriting and distribution styles.

The ACT companion to treasury management, edited by Valerie Hawkes and sponsored by Prebon Yamane, will be published this month. It is available for sale at £45 to non-members and £35 to members – please call publications on 0171 213 9728.

Nigel Forrest of Nashbrook Partners contributed the above definitions.

**Indicates terms covered elsewhere in the book.*