Trends in debt financing: an investor's view

Emu has opened the European corporate market and forced investors to develop credit bond expertise, say Ian Spreadbury and Alex Veys of Fidelity Investments.

In the first two months of 1999, the euro-euro markets saw about 50% more issuance in the non-bank corporate bond market than in the euro-dollar markets. This could have been euro-euphoria, but in the first four months of 1999, euro-euro issuance was still 15% greater than euro-dollar issuance. This is a significant change from previous years (see *Figure 1*) and occurred during a period when issuance in both euro-sterling and euro-dollars has increased.

The make-up of issuance has changed as well. Between January and April 1997, no euro-related issues were brought to market of more than $1bn equivalent. In the same period in 1998 there was one. However, up to the end of April 1999, there has been more than $20bn worth of these large benchmark issues. In addition, the credit spectrum of issuance has also changed. In the first five months of 1998 about 88% of euro (equivalent) investment grade issuance (BBB or above) was from institutions with AAA and AA ratings. In the same period in 1999, 63% came from institutions with ratings of only A or BBB.

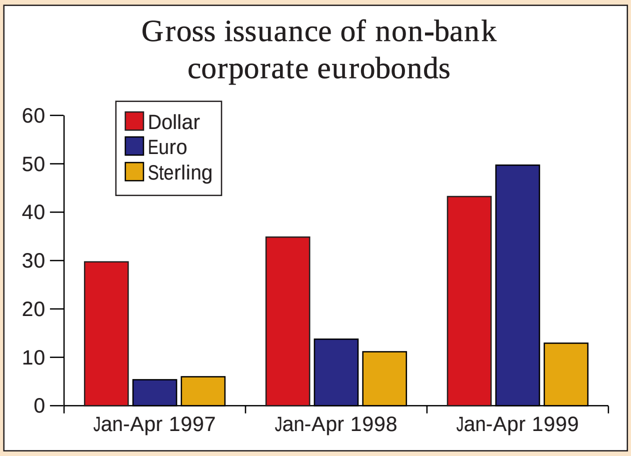
New supply

The supply is a direct result of Emu and the move to a more Anglo-Saxon shareholder ethos. Banks in Europe traditionally have been suppliers of long-term capital to corporates. Pressure from shareholders has made banks more reluctant to be the suppliers of long-term capital and has forced corporates to reduce funding costs by going directly to the capital markets instead. This trend is being fuelled by recent mergers and acquisitions.

New demand

Of course, supply without demand would necessarily lead to a poor market. But demand has increased; again, as a result of Emu. The latter has reduced the number of investment opportunities. Up to 1999, fund managers could play the inter-European FX markets and so-called convergence trades as well. Now there is just one currency. Peripheral markets, rather than yielding 5% more than core Europe, now have a premium of about 30 basis points. Investors must now look elsewhere.

FIGURE 1



Overall interest rate bets are one (unreliable) route. However, fresh corporate supply has opened up a credit route. Investors can, and have, moved down the credit spectrum from government and high-rated bonds to lower investment-grade bonds with higher yield spreads. This is the driver of demand. Unfortunately, to take consistent advantage of this route, companies must build up fully fledged credit teams. This takes time and money, but it is a necessity. Two areas with recent growth are high yield and securitisation.

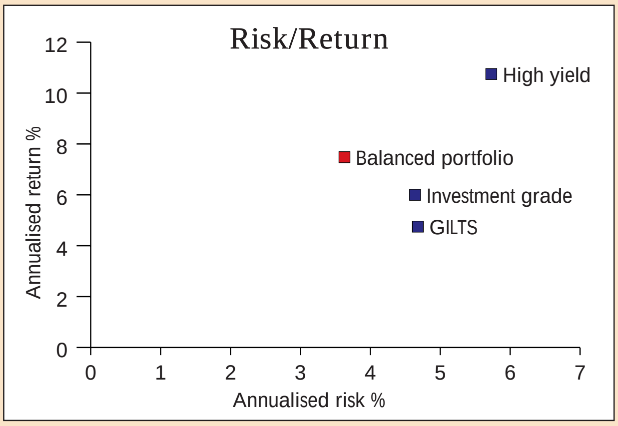
High yield

A significant market in high-yield or sub-investment grade debt has developed in Europe since 1997, with euro-denominated issuance totalling approximately $10bn, or under 1% of the European bond market. However, the market is tiny relative to that of the US where high yield has become established as an asset class in its own right and totals some $500bn, or about 7% of the overall corporate bond market.

Ian Spreadbury

Alex Veys

FIGURE 2



Clearly there is scope for further growth in the European market so let us look at some of the key issues for investors:

Risk There is a feeling among many investors that high-yield bonds are highly speculative, an image the sector has been struggling to shake off since the collapse of the US junk bond market ten years ago. One measure of risk is the expected level of default which, based on the Moody's study (January 1999) averages 3.27% for non-investment grade bonds (1970–98).

Allowing for an average recovery rate of around 50%, the expected loss rates for the high-yield sector are probably less than 2%. Current yield spreads over treasuries are 600 basis points (bp). Thus, while the default data are based predominantly on US data which may not fully represent the experience in Europe, investors seem to be getting more than adequate compensation for the risk of default.

Figure 2 looks at risk versus return for both high-yield and investment-grade bonds using the classic measure (standard deviation of returns) against US data for high yield. Interestingly, since the correlation with investment-grade bonds is quite low it is possible to construct a balanced portfolio with lower risk/higher return characteristics than a mainstream investment-grade portfolio.

Structure European high-yield market prices tend not to differentiate according to the way bonds are structured. While US high-yield issues tend to be subordinated operating company debt(contractually subordinated) European high-yield issues are often structurally subordinated (issued out of a holding company), since in some European jurisdictions contractual subordination is not recognised. From an investor's viewpoint this deficiency needs to be recompensed and there are signs that investors are pushing for structural improvements in new issues, particularly in the UK where contractual subordination is legally recognised.

Securitisation

The sterling market has seen a number of deals in the past couple of years over several sectors, including utilities and property. Examples include: Punch Taverns, Roadchef, Mutual Securitisation (NPI) and Broadgate. This form of finance is available to issuers holding an asset (or block of fairly homogeneous assets) with fairly stable cash flows. Bonds are secured on the cash flows and are often issued in several tranches ranging from AAA to BBB in credit quality. Deals tend to be complex in structure and fairly illiquid. Issuers usually obtain ratings from two agencies to give investors enough comfort on the structure.

Securitised bonds tend to trade at least 50bp cheap for their rating relative to conventional bonds, largely as a result of their complexity, illiquidity and restricted information flows. They can be partly addressed by issuers/issuing houses to help reduce yield premium.

Illiquidity in these deals in many cases is the result of having only one issuing house meaningfully involved in issuing, marketing and providing research on the bond. There are signs that this is changing but issuers should ensure that more than one house is actively involved in the primary issue and in secondary market making.

Regarding information flows, these structures tend to be highly leveraged and regular detailed cash flow information (at least quarterly) is vital to enable investors to monitor credits effectively. In many cases issuers are reluctant to make this information available, posting it instead to rating agencies and trustees, neither of whom will make it available to investors. Indeed, investors need to be careful that to avoid insider dealing problems any potentially price-sensitive information received is made generally available to the market.

Development of the market

As a market develops there are bound to be conflicts between issuers, market makers and investors. Two of the most important are the possible implementation of withholding tax (WHT) in the euro markets (covered in the press) and the propensity of issuers to 'tap' existing issues (sell further amounts of a particular bond into the market).

From an issuer's perspective taps would seem to make sense. An issue has gone well, there is demand for the bond and it would seem prudent to tap the issue. This process could be seen to create bigger, more liquid, issues and puts the issuer back in the news.

From an investor's perspective, however, there is often little time between a bond announcement and its pricing. Investors have to work fast to do the necessary credit research before buying. Tapping the issue shortly after initial issuance (less than six months) impacts these investors in a number of ways:

- it changes the supply-demand equation. Initial investors took the amount of supply into account when deciding how much of the issue to buy;
- slower (less able?) investors have the luxury of waiting to see how an issue trades before participating; and
- taps are issued behind the market, further benefiting slower houses.

These factors remove performance from total return investors and give it to the slower houses. Faster houses become less keen to participate in primary issues while they wait to see what happens. Demand for initial issues falls, funding costs for the issuer increase and the market becomes less liquid.

New possibilities

There is no doubt that the euro-area markets are healthy and growing as a result of the introduction of Emu. This has opened up issuing possibilities for such products as securitised and high-yield debt; at the same time investors have developed their expertise in credit bonds. Nevertheless, the market is young and there is as much responsibility with the issuers as the brokers and investors to develop the market into a true competitor to the US. ■

Alex Veys and Ian Spreadbury work in the fixed income department of Fidelity Investments.