US capital markets: big is beautiful… small is beautiful

Despite shifting investor preferences, the US market remains a great source of capital, say authors Mason, McAllister, Albright and McBride of Salomon Smith Barney.

In Q1 2000 European issuers accounted for less than a third of non-domestic issuance into the US market. Of this, only three issues came from investment grade UK borrowers. The relative lack of UK corporate issuers was, to some extent, driven by borrowers taking advantage of and/or setting debut benchmarks in euros, given the strong credit appetite in the new European credit market.

However, the US has been a traditional source of capital for UK companies and those issuers who looked to this market in Q1 2000 met with a very positive reception. Below we review the macro trends in both public and private US markets, highlighting the fact that despite shifting investor preferences, the US market continues to offer an efficient and cost effective alternative for UK treasurers.

Public market trends: jumbo issuance is here to stay

Whenever corporate issuers develop a sizeable capital market financing plan, they must normally review the relative merits of multiple offerings (on a public and/or private basis depending on cost, timing, disclosure and publicity considerations) versus a large one-time financing with several maturities along the yield curve.

Critical to this analysis will be a judgement on the current and future supply/demand relationship prevailing at the time of planned issuance. If a particular offering size falls substantially short of an issuer's overall financing requirements – and the market is aware of this – that initial offering may be adversely affected because of the anticipated future supply. To avoid this situation, issuers may choose to fund a majority, or even the entire amount, at

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one time rather than spreading their financing over a longer period. Bulk financing should result in lower administrative and legal costs and reduces exposure to market movements.

The one clear drawback is that the jumbo approach does mean that the financing is locked in at a single point in time and therefore the timing of the issue is all important (although hedging strategies can mitigate some of these concerns). This method of market issuance is aligned with current investor sentiment, which favours comparatively larger, more liquid issues over small, less liquid tranches. However, it is dangerous to over generalise and market access can be heavily influenced by the specific issuer's credit strength and frequency of issuance.

The recent phenomenal growth in the market for jumbo bonds (defined as bond offerings of $1bn and greater) is a product of both the strategic financing needs of corporate borrowers and the liquidity and performance objectives of institutional investors. It was only a few years ago that issuing in 'size' meant $500m. While much smaller issues are still perfectly feasible, times have changed and the old barriers which limited greater market access have been substantially dismantled.

In 1995 total jumbo issuance volume amounted to $21bn. By 1999 more than $245bn in jumbo offerings were issued, exceeding the total jumbo issuance volume for the three prior years combined – this explosion has meant an average annual volume growth rate of just over 85% since 1995 (*See Figure 1*).

M&A driven activity

Why this surge in jumbo issuance? Firstly, the corporate financing environment over the last few years has been driven by increased M&A activity. As the number and size of acquisitions have grown, so have the general loans, bridge facilities, commercial paper drawdowns, bond issues and equity offerings. Growth in jumbo issuance has followed the overall surge in M&A volume which is anticipated to grow at an even faster pace in Europe than in the US.

Public market investors prefer liquidity

A second major driver has been investor demand for liquidity. Jumbo issues, large and often multi-tranche, allow investors to modify the duration of their portfolios by moving up and down the maturity curve whilst remaining invested in the same credit, much like their investment behaviour in government markets.

This came into sharp focus during the chaotic market conditions that prevailed in the Q3 1998, when investment grade corporate spreads on average widened by 50-75 basis points. At that time, and in periods of extreme market volatility

FIGURE 1

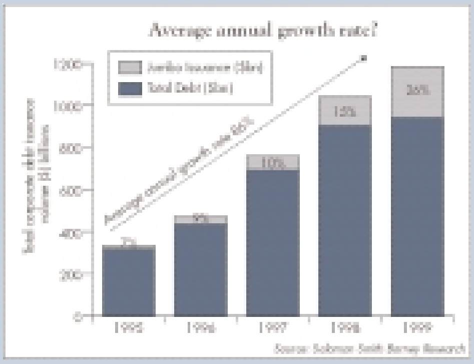
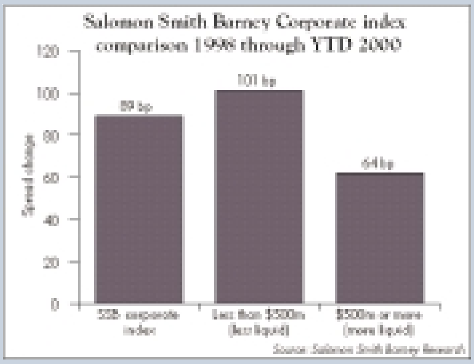


FIGURE 2



since then, investors have gravitated towards large, liquid securities that are actively and widely quoted and which enjoy narrower bid-ask spreads than smaller, less liquid, 'off-the-run' issues. Although corporate spreads (and swap spreads) have widened in general since 1998, tranches greater than $500m have outperformed both the Salomon Smith Barney aggregate corporate index and smaller issues, less than $500m in size (*Figure 2*).

A comparison could be drawn to conditions in Q1 2000. The inversion at the long end of the Treasury curve does not look like abating in the foreseeable future as 30-year US Treasury supply dwindles and more buybacks further reduce liquidity. US agencies have become widely accepted as a proxy for US Government securities, but recent questions over the continued implicit government support have undermined the idea of 'surrogate' Treasury bonds.

Migration toward size has also been prompted by 'indexation', where large issues have become 'must own' securities for 'total-rate-of-return' investors, and requisite use of major indices has led some investors to re-weight their portfolios. Issuers such as Vodafone AirTouch have answered the wishes of bond buyers seeking liquid benchmark maturities for well-known names. Furthermore, as investors increasingly carry out more in-depth credit work, by necessity they limit themselves to the number of names which they can meaningfully study. Consequently, investors often see focus on larger issues as a more efficient use of their time, especially those accounts who are restricted to buying maximum percentages of any given issue.

How big can you go?

Further evidence that the market is moving towards larger, more liquid issuance comes from data showing that over the past five years, average size on corporate issues has grown from $160m to $245m. Jumbo bond tranches follow a similar pattern, showing an average growth in tranche size of 10% annually (rising from $645m per tranche in 1995 to $905m per tranche in 1999), suggesting that size is a critical factor to be considered by issuers in the competition for investor attention and capital commitment.

Stay Yankee or go Global?

Another significant aspect of the decision for corporate issuers when looking at how to gain access to public investors in the US is whether to use the 'Yankee' or 'Global' format. In 1999, Global bonds comprised over 50% of investment grade corporate jumbo issuance, well above the 1998 level of 38%.

Global bonds are most effective when an issuer's offering and marketing methods are geared towards attracting not only US investors but international investors as well, generally requiring a roadshow which addresses both the US and Europe and in some cases Asia. A broader audience should create more competition for the paper, leading to oversubscription and price tension between US and international investors.

Vodafone AirTouch case study

$1,750,000,000 7.625% bonds due 2005
$2,750,000,000 7.75% bonds due 2010
$750,000,000 7.875% bonds due 2030

In early February, Vodafone AirTouch Plc (A2/A-) successfully completed its three tranche $5.25 bn debut Global transaction via joint bookrunners Goldman Sachs and Salomon Smith Barney. This was the largest ever US dollar global bond offering by a non-US corporate borrower. Despite occurring in the middle of the takeover negotiations of Mannesman, a five-day, eight-city global road show generated an order book of $8.5bn with over 200 domestic and international accounts participating.

The size and quality of the order book allowed both upsizing and tranche size adjustment to meet both investor demand and the company's maturity preferences with no deterioration in pricing. Proceeds were used to repay commercial paper and bank debt incurred in association with the AirTouch acquisition which was completed in 1999.

What did Vodafone Airtouch achieve? They established a strategic investor base in the US and Europe optimising distribution, cost and future flexibility. By issuing in five, ten and 30-year maturities via a global bond they established a US dollar credit curve and a liquid benchmark financing which trades efficiently in the secondary market, giving investors the opportunity to play the curve without switching out of the Vodafone AirTouch credit.

The ability to document the notes in a 144a format with registration rights (ie, to be SEC registered within nine months, once the Mannesman accounts become available) allowed the company the flexibility to proceed with ongoing financing on the most cost effective basis during an active M&A situation, and in the process set a new dimension in market access for non-US borrowers. ■

FIGURE 3

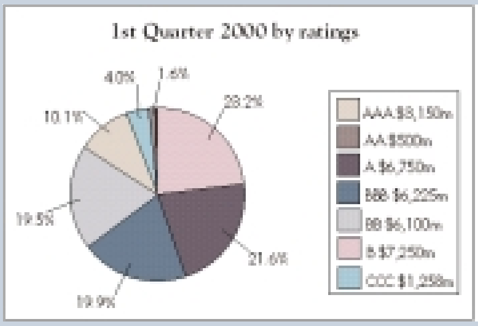
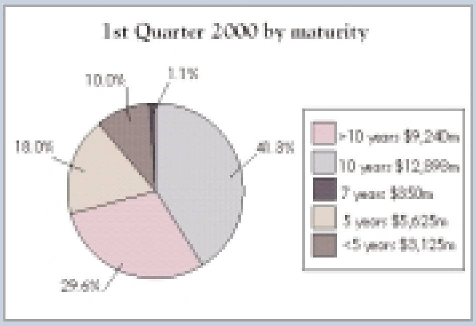


FIGURE 4



This should result in better pricing for the issuer.

International interest in global issues has fluctuated significantly over the years and is heavily dependant on the specific issuer and the market. Currently and for the past year international demand can be expected to average around 15-25% for any one tranche. However, this percentage is expected to rise in the near-term to higher levels as international investors (particularly European) continue to develop a deeper appreciation for credit products and as greater fund flows facilitate larger investments.

Alternatively, there may be strategic reasons why a treasurer might opt to come to the Yankee market as opposed to going Global. These include size and strategic placement. For example, a $200-300m issue would not benefit from a Global format as it could not provide the liquidity implicit in the Global platform. In addition very long dated issues, 30 years and greater, are highly sought after by US investors but have a very limited audience outside.

Private market – great execution enhanced by public market trends

The US private placement market has become more attractive for many issuers for whom a public transaction in today's environment just doesn't suit. This cannot be attributed to any single driving factor. Investor preferences in public markets both in Europe and the US include liquidity and a desire for well-known names. Issuer preferences have led to a lack of domestic supply as US issuers turn to Europe and the Euro for FAS133 reasons.

In addition, rising concerns regarding Treasury technicals and event risk have driven spreads wider. In contrast, the private market investor typically takes more of a 'buy and hold' approach, often buying bonds for longer duration portfolios and so is less susceptible to the foibles of the daily market.

In a world of $5bn+ public transactions the private market has seen comparatively low supply, although as public market volatility persists an increasing number of issuers may look to private placements to fill their funding needs. Although supply has been weak, demand has been strong not only from dedicated private accounts such as insurance companies and pension funds, but also from buyers who would normally focus on public issues. Due to the difficult conditions in Q1 2000 and early closing of books for Y2K, many investors are behind on their investment programmes and are more receptive to new product, especially for transactions longer than 10 years.

With an experienced, credit-focused, US investor base issuers may admittedly face more covenant requirements than they would for a public issue in the US and certainly a Eurobond. For BBB quality borrowers private market investors generally look for covenants which seek to ensure that the company remains investment grade, but can allow temporary flexibility during acquisitions. The key is a well-brokered dialogue between investor and issuer that produces covenants structured to balance the competing interests and ensure best execution: ie sufficient comfort for the investor and maximum flexibility for the issuer in the future.

> Some of the best things can still come in small packages!

Despite this there are still many appealing aspects to a US private placement. Maturities are similar to the public arena (anywhere from three to 30 years) with capacity for issue sizes of up to $500m or more and over 18-24 months possibly $2-2.5bn in aggregate.

Issuance can be on an unrated basis – an increasingly challenging prospect in the Euromarkets given the growing supply of new, rated names - and bullet or amortising structures can be incorporated at little or no extra cost. Execution can be swift (four to six weeks in many cases) and targeted marketing to select sophisticated buyers makes it that much easier to market the story and structure to investors.

All these factors, combined with the discretion and confidentiality on offer, make the US private market an increasingly attractive option for certain borrowers at the current time.

All shapes and sizes

The US public market has experienced considerable volatility in Q1 2000. Despite this borrowers have had good execution opportunities.

The US can successfully accommodate large size, liquid transactions but has not lost its appetite for smaller, targeted issues be they on a public or private basis. The advent of electronic distribution mechanisms has also begun to impact the public market side in particular, although from a practical point of view there is still a long way to go before issuers and investors embrace the mechanism fully – a topic which merits its own discussion.

Despite anticipated continued volatility in the credit markets on a short-term basis, looking forward big is certainly beautiful but the some of the best things can still come in small packages! ■

The authors are Pippa Mason, Malcolm McAllister, Ray Albright and Myles McBride of Salomon Smith Barney. The views expressed are the authors' own and are not necessarily shared by Salomon Smith Barney.