ECNs: another route to short-term finance

Extendible commercial notes (ECNs) offer an alternative to commercial paper with supporting credit facilities. Paul Richardson of Reed Elsevier explains how.

Reed Elsevier is a publisher and provider of scientific, professional and business information. It has expanded rapidly in the US in recent years and the US market now accounts for more than 50% of its sales worldwide. Major US acquisitions in the past five years have included: LEXIS-NEXIS, Shepards, Matthew Bender, MDL Information Systems and the Chilton Business Group. Expenditure on these five acquisitions alone exceeded $4bn.

To fund these acquisitions, Reed Elsevier Inc (Reed Elsevier plc's principal US operating subsidiary) has accessed the US public term debt markets, the Eurobond market, the US commercial paper market and now the extendible commercial note (ECN) market. Reed Elsevier Inc currently has approximately $700 million outstanding on the commercial paper programme and uses it for funding the daily working capital requirements of the US businesses as well as for acquisition financing. The company began accessing the ECN market in July 1999 using the borrowing proceeds to repay maturing commercial paper.

The US commercial paper market

The US commercial paper market is the largest short-term debt market in the world with $1.2trn outstanding (versus $50bn in 1970). The growth of the commercial paper market has been fuelled largely by the advent of money market mutual funds, which serve as an enormous fount of liquidity in the US. The US commercial paper market, rather than the banking system, is now the principal source of short-term liquidity to high credit quality US borrowers such as Reed Elsevier Inc.

The credit rating agencies require commercial paper issuers to maintain committed bank credit facilities in an amount that covers the issuer's commercial paper borrowings and other short-term borrowings (net of cash and liquid investments). Without them the credit rating agencies will not issue a rating for the issuer's paper. The purpose of the bank facility is to ensure that the issuer has access to sufficient funds to repay its commercial paper maturities in the event that the issuer finds itself unable to roll over the maturing commercial paper.

Over the past two years, facility fees have increased significantly as the number of banks in the market has fallen following bank consolidation and the withdrawal of the involvement of Japanese banks. This can be seen as part of a longer-term trend. Banks are placing increasing emphasis on the cost of capital used to support large committed facilities to their corporate customers (measured on both a regulatory capital and internal economic capital basis). They are also placing increasing emphasis on monitoring the return they derive from all types of business with each corporate. Understandably, banks believe that the amount of discretionary, revenue-generating treasury business awarded by corporate customers should be sufficient to recover the bank's balance sheet cost attached to such committed facilities.

Paul Richardson

Drawbacks of commercial paper

From an issuer perspective, one significant problem with commercial paper is that the required bank facility amount is generally equal to the issuer's peak commercial paper borrowings during any 12-month period. The result is a potential for bank lines to be larger than an issuer's actual outstanding commercial paper at any given point in time. Therefore, the issuer is often paying for liquidity insurance in excess of that which is actually needed on a given day.

From an investor perspective, the credit facility is not contractually tied to the commercial paper notes and the issuer is not required to use the facility to repay commercial paper. Therefore, should an issuer experience a liquidity crisis, bank back-up lines do not necessarily ensure that the commercial paper investor will be paid.

From a bank perspective, the current Basle capital adequacy regulations do not take into account the high credit quality of certain issuers (and, therefore, the low likelihood of drawdowns). This results in capital allocation requirements that do not differentiate by credit quality of the issuer and which make the providing of such facilities expensive. Consequently, many banks have a reduced appetite for extending such credit.

ECNs avoid these drawbacks and allow commercial paper investors to provide liquidity insurance directly to issuers, a role traditionally filled by banks via bank back-up facilities.

ECN product description

ECNs were developed by Goldman Sachs in response to issuer requests for

TABLE 1

Prevailing assigned rating * S&P	Moody's	% of Libor	Min fixed spread	Example Libor = 5.00%	
A-1+	P-1	110%	25	5.50%	(L + 50)
A-1	P-1	115%	50	5.75%	(L + 75)
A-2	P-2	130%	150	6.50%	(L + 150)
A-3	P-3	150%	250	7.50%	(L + 250)
<A-3	<P-3	175%	400	9.00%	(L + 400)

- *If split ratings are assigned to the issuer, the reset rate is set based on the average of the corresponding spreads to Libor for each rating.*
- *If short-term debt ratings are on S&P Credit Watch negative or Moody's Review for possible downgrade (or any other comparable future designation by any successor rating agency to S&P or Moody's), then the next lower category will apply for the reset rate. For example, a P-2 Moody's rating that is on the Review list for possible downgrade will use the rest rate applicable for a P-3 rating.*
- *The applicable 30-day Libor is the rate set 48 hours prior to the beginning of the interest payment period.*

an alternative to bank back-up facilities for commercial paper. ECNs are senior unsecured short-term debt obligations of the issuer having an initial redemption date of up to 90 days from the initial issue date. However, they contain an embedded option that allows the issuer to extend the note on the initial redemption date, taking the maximum maturity of the notes to 390 days. Like commercial paper, ECNs are issued on a discount basis and they carry the same credit rating as the issuer's commercial paper. The issuer is expected to redeem ECNs on the initial redemption date and is motivated to do so by a relatively onerous reset rate should the notes be extended (see *Table 1*). Therefore, an issuer would only choose to extend the notes given an inability to obtain liquidity, for example, at the same time that a commercial paper issuer would need to utilise its bank back-up facilities. As such, the ECN extension feature substitutes for bank back-up facilities.

ECNs are attractive to both issuers and investors. From the issuer's perspective, ECNs are a cost-effective means of obtaining short-term funding without the requirement for expensive bank back-up lines, since the extension feature serves as the liquidity insurance (in much the same way as bank back-up lines do for commercial paper). An issuer would expect to pay the investor a rate of approximately five basis points (bp) above that of commercial paper, yet saves the bank back-up fee. The latter can be anywhere between 7bp and 25bp on an undrawn basis for high credit-quality borrowers depending on the date the facility was negotiated and on factors, such as the amount of ancillary business and overall strength of bank relationships.

Spreads over commercial paper rates are expected to narrow further as the ECN market becomes deeper and more liquid. More significant savings from ECNs can however be derived because the cost of the back-up liquidity (in the form of the extension feature) is incurred only when the borrowing occurs. With traditional commercial paper the issuer pays for the back-up liquidity from banks whether or not commercial paper is issued. The credit rating agencies have confirmed that they do not require bank back-up facilities to support ECNs in issue.

From the investor's perspective, ECNs provide the opportunity to obtain a higher yield than is available with commercial paper in return for minimal additional risk. The investor is paid the additional yield for providing liquidity insurance to the issuer through the ECN extension feature (in the case of commercial paper, the bank is paid for providing this insurance via back-up line fees).

ECN extension feature

If the issuer does not redeem the ECNs on the initial redemption date, the ECNs extend to the stated final maturity date, which is 390 days following the initial issue date. A new interest rate, known as the reset rate, is set based on a predetermined percentage of 30-day Libor and a minimum absolute spread over Libor, both of which are dependent on the issuer's credit rating. In Reed Elsevier Inc's case, the percentage would be 110% of Libor with a 25bp minimum spread over Libor. The rate associated with the extensions will therefore normally be significantly higher than Reed Elsevier Inc's alternative cost of short-term funds.

The investor base

Over 160 investors, representing all major investor types, have purchased ECNs. The investor classification split broadly mirrors that of commercial paper (*Figure 1*).

Documentation requirements

The required ECN documentation is almost identical to that required for the issuer's existing commercial paper programme and most of the documents will mirror the content of the equivalent contracts. The documentation is therefore a relatively painless exercise.

Development of the ECN market

ECN issuance by US companies began in October 1998. At the time of writing, ECN outstandings total more than $3bn, with aggregate issuance to date of over $10.2bn. Over 20 issuers have set up ECN programmes and have issued in the market, with another 25 preparing to access the market in the near future. All of these issuers have commercial paper programmes in place and most have used ECNs as a more cost-effective method of raising short-term finance. Before treasurers automatically resort to increasing the size of their commercial paper programmes with the associated increase in bank facilities I would recommend that they take a look at this efficient and fast-growing market. ■

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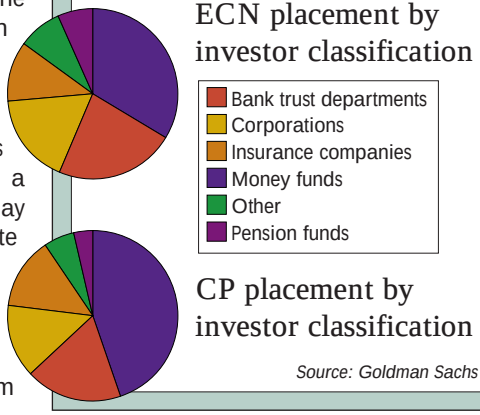
FIGURE 1



Source: Goldman Sachs