Yankee bonds – a British invasion?

Alex Dell'Anno of Merrill Lynch looks at the reasons why the US market continues to be such an attractive source of capital for UK treasurers.

Which tobacco company with a dominant market share and well-known domestic brand names completed the first tobacco bond issue in the US in 1999? Philip Morris? RJR? Guess again. The answer is Imperial Tobacco. Despite the 1999 issue being Imperial Tobacco's inaugural bond financing in any market, the company successfully raised $600m of ten-year financing, which was used to repay a portion of its outstanding bank facility. The company chose the Yankee market to do its first deal. Why? The answer lies in a number of factors, all of which continue to make the US market an attractive source of capital for UK treasurers.

Size matters

The competitive advantage of the US corporate bond market vs competing sources of debt capital is the market's sheer size and the unmatched liquidity it provides to US and non-US borrowers alike. The outstanding amount of investment-grade corporate bonds at year-end 1998 was estimated to be approximately $3.47trn. This represents 24% of all public and private outstanding US$-denominated debt (*Source: Federal Reserve*). The level of corporate bond issuance has increased to record levels over the past three years, fuelled by steady US economic growth, low interest rates and an active M&A environment.

This liquidity allows borrowers to complete larger size transactions, a fact underscored by Cable & Wireless Communications' $1.8bn Yankee bond completed in March 1998. The objective of the financing was to refinance the higher coupon debt of the underlying companies that were included in the merger to form CWC in 1997 and also to refinance a portion of its £2.9bn bank facility with long-term debt. The Yankee offering complemented a £500m two-tranche transaction that was executed a week before the US deal. As a result, CWC was able to restructure its balance sheet efficiently in a short period of time.

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The US market's depth also allows for issuance in longer maturities. Over 59% of US corporate bond issuance in 1998 had maturities of ten years or longer, a far larger percentage than most competing markets. Issuers can also access 20- or 30-year funds, something that is typically not available in Europe (with the exception of the sterling market). For corporate issuers looking to extend the maturity profile of their debt portfolio well beyond their bank facilities and thus reduce refinancing risk, this is a major attraction.

One factor that is often overlooked is US investors' willingness to accept a 'standard' covenant package for investment-grade borrowers in the public market that does not include any 'financial' covenants (maintenance of minimum net worth, interest coverage covenants or restrictions on indebtedness). The ability of a non-US borrower successfully to complete a Yankee offering with an attractive covenant package is an excellent way to demonstrate to other creditors that the firm has access to competing sources of capital under favourable terms.

Alex Dell'Anno

Are you experienced?

Having to manage the large pools of money that are invested daily in the US corporate bond market, both US credit analysts and fund managers have developed a strong set of credit skills that allows them to establish relative value between different names and to price those credits accordingly. As a result, US investors are willing to commit the resources to do this credit work as long as they get paid for it. The bottom line is that they are willing to take credit risks in return for higher yield. It is the one distinct element of the US that has enabled a variety of companies (both investment- and non-investment grade) to raise capital, creating opportunities that may not exist for them in other markets.

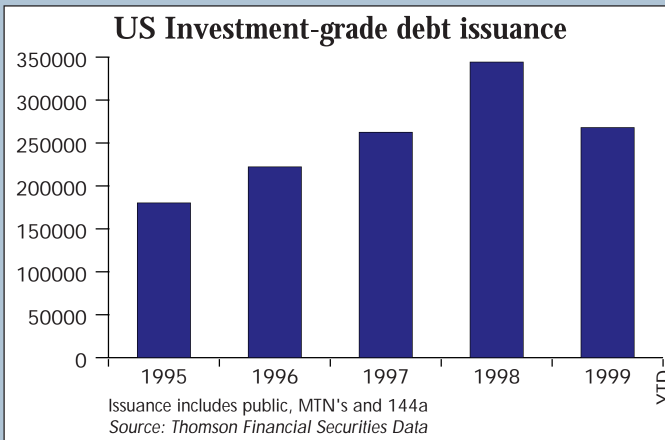
Imperial Tobacco is a good example of US investors' willingness to listen to new credit stories. The US market had never seen a non-US tobacco company issue before. Analysts here generally have a negative view of US tobacco companies because of the litigation exposures these companies currently face as well as the prospect of a state settlement.

The key aspect of marketing Imperial Tobacco was to explain that the company has no US litigation exposure and more importantly, it operates in a litigation environment that is vastly different

from that in the US. If investors accepted this core argument, the thinking went, they would then focus on the key operating and financial strengths of the company and price the deal in line with BBB-rated credits without assessing a 'tobacco premium'. The strategy worked.

"What impressed us during our marketing campaign was the sophistication of US investors in terms of credit analysis", says Jonathon Riley, Group Treasurer of Imperial Tobacco. "Because it represented our inaugural bond offering, we wanted to make sure that we would be telling our story to a group of investors that would listen and be willing to analyse our credit. From our standpoint, the depth of the US market for BBB-rated credits meant that we would get this kind of audience. That would mean better pricing and greater certainty that we would get our deal done. That is the primary reason why we chose the US for our first deal." In fact, more than 67% of investment-grade corporate bond issuance in the US in 1998 was in the BBB or A rating category.

FIGURE 1



Issuance includes public, MTN's and 144a
Source: Thomson Financial Securities Data

Sell, sell, sell

To take advantage of this credit expertise, issuers will often undertake broad-based marketing campaigns in advance of pricing their issues. The objective is to position one's credit story aggressively with as many high probability buyers as possible. "The one thing that I remember from our offering was the importance of meeting with investors face to face", says Graham Robertson, group treasurer of Cable & Wireless. "Once investors met with the management team and heard our story directly, we got a tremendous response. I don't think that we would have been able to increase our transaction (from $1bn to $1.8bn) if we had not spent the time that we did on the road before the launch. That approach also facilitated our return for an additional $700m eight months later."

Close cousins

While US investors have purchased bonds of corporate and finance borrowers from around the world, the higher comfort level with UK regulatory and accounting practices means that UK issuers tend to get access to a broad universe of potential buyers. As a result, they tend to pay the smallest Yankee premium, ie, spread above comparably rated US credits.

"Outside North America, UK issuers represent our largest source of corporate bond investment with over $2bn outstanding as of July 31", according to Ronald M Bringewatt, CFA, SVP of American General Investment Management. "While adding diversification to our portfolio, we believe that the risks of investing in UK companies are minimal when compared to other non-US investments. Transparency of financial information, a reliable legal and regulatory framework and accessibility to senior management are all key factors that support our continued investment in the UK."

Looking ahead

This year, the US market has been characterised by heavy new issue volume as borrowers attempt to complete any fund raisings well in advance of year-end (one symptom of Y2K). With investors unsure about the direction of interest rates, this supply of new issue has fostered greater volatility in spreads and market liquidity.

> The dominance of the US bond market has been challenged this year by the advent of another major source of appeal, the euro

One theme that has emerged this year is investors' increasing fascination with larger deals. The notion is that in a weaker market environment, larger deals tend to perform better than small offerings as investors can realise a better bid/offer quote when attempting to sell bonds. The extreme evidence of this trend can be seen in 'mega deals' such as Ford ($8.6bn), AT&T ($8bn) and Walmart ($5.5bn). Overall, deal sizes are increasing, with the average for investment-grade corporates going from $309m in 1998 to $433m in 1999 YTD.

An additional development in the Yankee market has been to take advantage of the growth of the credit markets in Europe. Both BSkyB's $600m Yankee offering in February and the similarly sized Imperial Tobacco deal were structured to allow for sales to European accounts. Though US investor demand drove the size and pricing of these deals, European institutional and retail demand accounted for approximately 20% of the respective order books.

The dominance of the US bond market has been challenged this year by the advent of the euro. Beyond any pricing considerations, the proximity of the euro market and the less onerous disclosure requirements for European offerings is a major source of appeal.

While the evolution of the euro market has presented treasurers with another source of capital, the US market will likely remain an important alternative for UK corporates. For companies with US dollar funding requirements, this will certainly be the case. But even for those issuers with non-dollar requirements, the market's size and sophistication will mean that the US will continue to be worth a look when analysing financing alternatives. ■

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