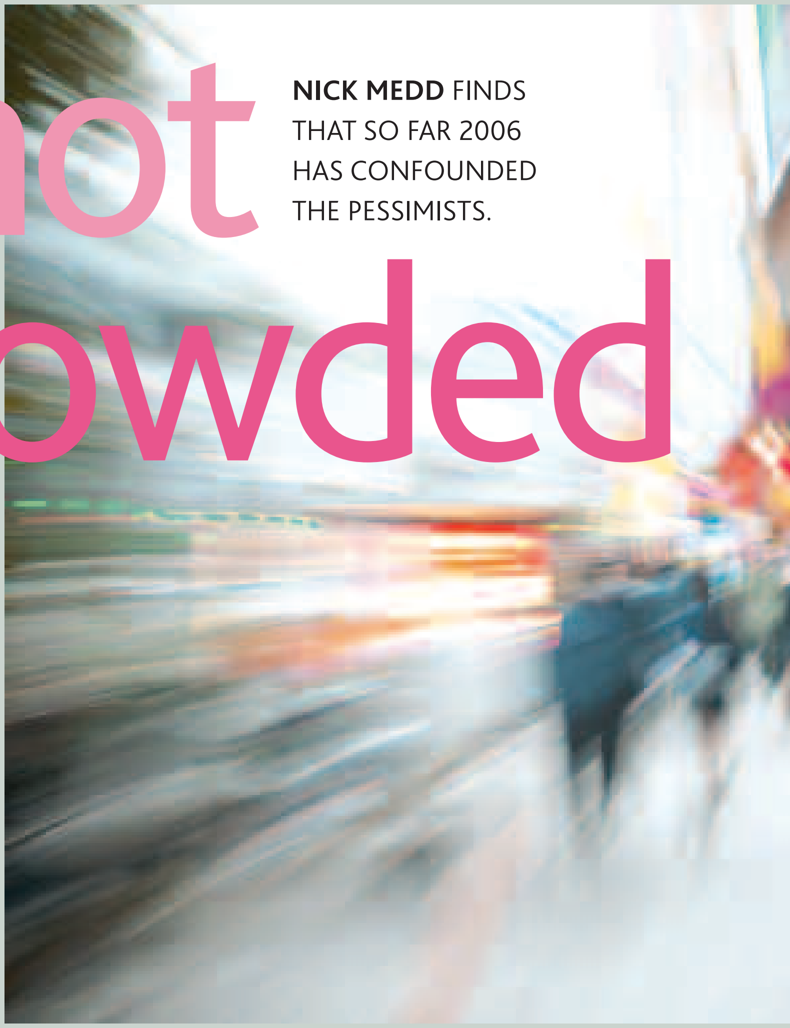
Busy, not overcrowded



NICK MEDD FINDS THAT SO FAR 2006 HAS CONFOUNDED THE PESSIMISTS.

Executive summary

- Corporate credit spreads have tightened this year to date.
- Corporate borrowers looking to stay with fixed bond yields need to give careful consideration to hedging.
- Innovative funding solutions are required to avoid overburdening the European markets.
- Capacity constraints can no longer be a credible rationale for ignoring a US private placement.

Hindsight is such a wonderful thing. At the end of 2005, market expectations were that 2006 would see a substantially greater supply of corporate bonds against a backdrop of increased redemptions, more expenditure on share buybacks and a merger and acquisition-driven new issue pipeline that could only push corporate credit spreads wider – the only debate being the extent of the widening. Hybrid issuance by corporates looked set to become part of the mainstream, with some market participants predicting as many as 25 new corporate hybrid issues in the course of 2006.

The reality has been rather different. While European investment-grade corporate issuance in the year to date has risen to around $21bn (50.4% higher than in the equivalent period in 2005), the development of corporate credit spreads has been the exact opposite of expectations. The five-year iTraxx Europe Credit Default Swap index has, in fact, tightened by 8bps since January (see *Figure 1*).

GOOD, BUT NOT GLORIOUS Several factors account for this turn of events. First, corporate funding requirements, although way in advance of a very quiet 2005, turned out to be lower than expected. Many 2006 redemptions had been prefunded in 2005 and numerous corporates were still in deleveraging mode as the year began, repaying bonds from cashflow or disposal proceeds.

Second, the markets (globally, not just in Europe) have yet to see a rush to the market to finance mergers and acquisitions (M&A). To the frustration of debt-side bankers, M&A activity takes a while to happen. It takes a further period for regulatory approvals and the like to be given. And it then takes a further period to convert bridging loans to bond take-out.

M&A has picked up and this will filter through more to the bond markets in the second half of 2006. Telefonica's €4bn funding exercise in January to part-refinance its £17bn acquisition of mobile telco operator O2 represents one of the few set-piece M&A refinancings that we have seen to date.

YIELD ENVIRONMENT With major government bond yields at or near their highs of recent years, corporate borrowers looking to stay fixed need to give careful consideration to hedging. Yields have risen rapidly in a short period of time and while a retreat from these levels is clearly possible, the risks are finely balanced. With these markets currently lacking clear direction, locking in at least a proportion of anticipated funding may well be a sensible approach. In relation to hedging government bond yields, several European corporates have already secured "hedge accounting" under IAS 39 *Financial Instruments: Recognition and Measurement* for transactions that are deemed "highly probable" to take place later on this year.

Higher government bond yields are a double-edged sword. From the investor perspective, current yields represent a clear buying opportunity in terms of corporate bonds. In dollars in particular, borrowers are able to rationalise the relative flatness of the maturity curve, as well as low credit spreads, in taking advantage of positive market conditions to issue, especially at 30 years.

SHARING THE LOAD A healthy US dollar market has provided another outlet for European corporates in 2006 yield to date – and has been largely free of leveraged buyout-driven requests from

investors for change of control language. This is in contrast to a European market which has tightened change of control language via 180-day look-backs on control-based rating changes.

The US dollar market has absorbed $12.6bn of issuance by European investment-grade corporates in 2006 to date compared with $3.5bn in the same period in 2005.

Vodafone is one European corporate to have taken advantage of US dollar market conditions, issuing a total of $1.8bn in March, comprising a five-year floating-rate note issue alongside the more traditional five and 10-year combination. Deutsche Telekom and Diageo are two other European names that have accessed the US dollar market in scale in 2006 and others are expected ahead of any similar covenant trends in this market.

INNOVATORS REAP THE REWARDS Corporates and their debt advisors have also been looking towards innovative funding solutions to avoid overburdening the European markets. Staying on the theme of US dollars, new ground in the Eurodollar market was successfully broken by Siemens, which raised a $1bn dual-tranche six-year floating-rate note and 10-year fixed issue in a market historically focused on maturity terms of five years and fewer. Asian demand was a key driver of momentum for this transaction, which represented 35% of the 10-year order book.

Bryan Pascoe, Global Head of Syndicate at HSBC, says: "We recognised specifically the potential for Asian investors to drive a longer-dated fixed-rate tranche than is normal in the Eurodollar market and having a fantastic brand name such as Siemens, we were able to bring them the credit quality and the product they wanted."

The Asian bid has also been key to the success of new issues from Porsche (hybrid) and Glencore (senior). In these instances it is the retail bid in Asia that has been critical to their success. "We were looking to diversify our investor base away from traditional European and US institutions and this trade fitted our needs perfectly," said Andrea Laschetti of Glencore.

And what are the chances of 25 corporate hybrid issues emanating from European names? With Porsche, Solvay and Lottomatica the only three names to have brought deals to market so far in 2006, the dizzy heights of 25 deals seem a remote possibility. With M&A activity picking up, we will see several more deals from continental European borrowers in 2006. UK corporates have yet to test the water with the hybrid product. "Conceptual" resistance from UK corporates will surely break down once the first UK deals are printed.

Lottomatica's €750m hybrid issue, launched in early May, broke new ground as a benchmark sub-investment-grade deal (TUI issued a €300m B1/B+ hybrid deal in December 2005). Five times oversubscribed at the primary stage and trading 2.5 points (around 40bps) tighter in subsequent secondary trading, there can be little doubt that appetite exists among European investors for sub-investment-grade corporate hybrids.

The hybrid market has continued to develop in terms of structures, with borrowers and their advisors borrowing elements from the financial institution sector and devising new structures to keep the rating agencies happy while satisfying their own requirements. Structuring issues can be ironed out and discontent with elements of structures seen to date should not deter corporate borrowers from exploiting the potential benefits.

US PRIVATE PLACEMENTS WORTH ANOTHER LOOK This market came of age in 2003-2006 with deal sizes well in excess of $500m regularly testing the market, with three transactions in that period of around $1bn in size. Capacity constraints can no longer be a credible rationale for ignoring this market. No longer the preserve of unrated or smaller names, more and more investment-grade corporates are realising the benefits of consistent access and attractive pricing in this market.

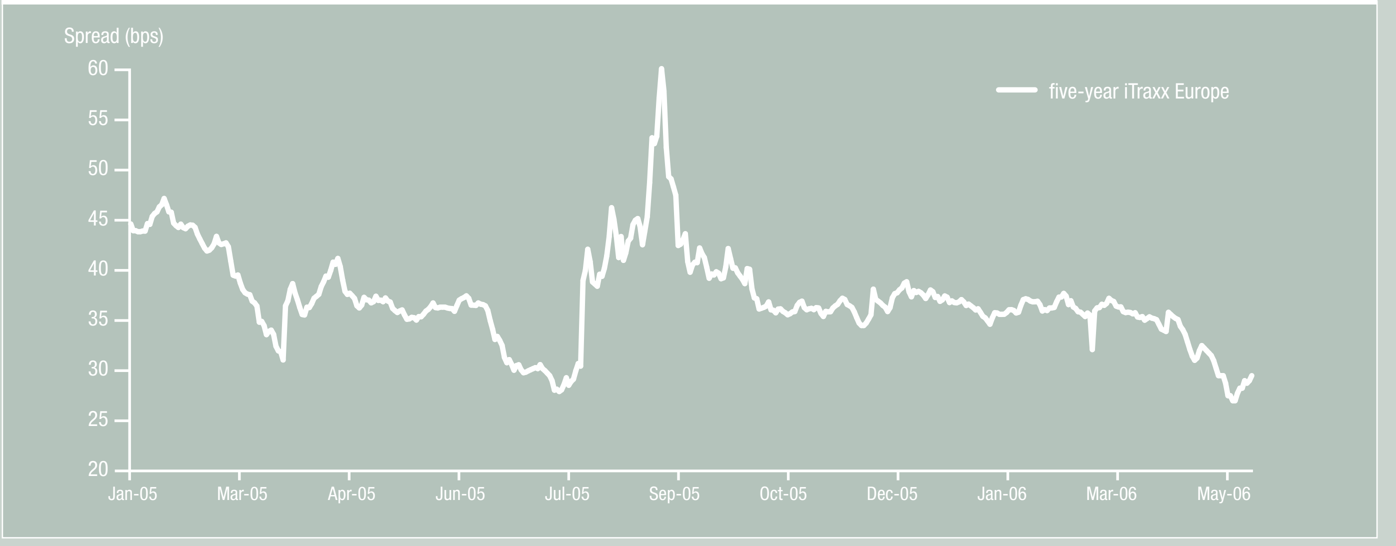
Retailer Kingfisher (rated Baa2/BBB) is the latest UK corporate to take advantage of a very significant pricing arbitrage relative to European public markets, with a three-tranche $466m offering split between seven, 10 and 12 years.

With investors in this market seeking further name diversification and having appetite for more volume, there is a real opportunity here that makes this market worth exploring even by those who have previously dismissed it. Mike Thilmany, Managing Director for Private Placements at HSBC Securities, says: "What Kingfisher has achieved shows the way for other European corporates from the perspective of strong execution, tight pricing and a new investor base".

DIFFERENT LIABILITY MANAGEMENT APPROACHES DELIVER DIFFERENT OUTCOMES With "liability management" (in the context of bond buybacks, exchange offers and amendments to terms and conditions) now a well-established concept in the European bond markets, variation in approach (and outcome!) remains the order of the day.

In terms of first-half corporate activity to date, we have seen the full range of liability management techniques. These range from the separate tender offer and new issue approach by Swedish conglomerate Investor AB, to the exchange offer process used by UK

Figure 1. Corporate Credit Spreads Narrow



packaging company Rexam and the straight tender offers from Volkswagen and Cadbury Schweppes.

Variation in approach is partly explained by variation in goals. Investor AB wanted to refinance and term-out and had strict economic parameters for both the buyback and the new issue element of the exercise. In this instance the borrower determined that better execution could be obtained on each element by splitting them into two separate (but contemporaneous exercises). In contrast Rexam's exchange offer route enabled favourable accounting treatment of the premium paid on the buyback element due to being inclusive of a cash element to the tender – deferral of premium hit to the profit and loss account under international accounting standards (IAS).

Straight tender offers such as those from Volkswagen and Cadbury Schweppes do not offer the opportunity to take advantage of IAS in the same way, but in these and other cases buying back bonds represented a good use of surplus cash and an opportunity to deal with refinancing issues.

In the field of liability management, a clear understanding of each borrower's objectives and priorities is necessary to interpret the approach that a particular borrower has undertaken, and to judge the degree of success represented by the outcome. It is clear that the use of the consent solicitation mechanism by which a borrower can sweep up investors that elect not to participate, for whatever reason, and achieve a complete outcome, is on the increase. Often accompanied by an early tender premium to encourage early and high take-up of a proposal, this can make a lot of sense when the ambition is to remove or amend the terms of an entire bond. Arguably, trying to achieve a consent solicitation will usually entail a larger premium than a simple 'any and all' offer to buy back bonds. This is due to the need to achieve a given hurdle rate (usually the extraordinary resolution percentage).

Market acceptance of, and familiarity with, liability management techniques continues to grow. It is fair to say that the sterling market remains more patchy in this regard. Some major sterling investors remain keen to try and ensure that any amendments to existing bonds (including negotiated buybacks) are dealt with under the auspices of the Association of British Insurers (ABI).

While the ABI certainly provides a forum for negotiation with investors, the suspicion remains that negotiating with what is effectively a panel of the major sterling investors can only result in a higher premium being paid than if an offer to buy back is publicly presented to the market as a whole. Where complete assent is required (for example, to effect a covenant change), avoiding consultation with the ABI may be more of a challenge.

Liability management remains a developing area. With more moving parts than a new bond issue, consideration needs to be given not only to economic issues, but also to reputation/profile issues, associated derivatives and hedging applications. This market offers flexibility and opportunity to corporate borrowers – and also requires careful management.

MARKETS RECEPTIVE TO NEW ISSUANCE AND DEVELOPMENTS

2006 has been positive for corporate borrowers so far. Markets have in general been receptive to new issuance and developments in terms of market and product diversification have opened up new avenues.

The only obvious cloud on the horizon, in European markets at least, has clearly been leveraged buyout risk (which has generally affected corporate credit spreads on a temporary and name-specific basis) and the consequent demands from European investors for change of control covenants. It remains to be seen whether this will become a standard clause in European bond documentation. A number of deals (including transactions for BAT, Cargill and Investor AB) have seen very successful execution without such a clause.

In most cases, corporate bonds that have offered change of control have seen relatively easy execution and good secondary market performance and liquidity. It could prove to be the case that borrowers unwilling to offer change of control find execution tougher in the future if the majority are offering it.

Corporate treasurers in Europe don't in general regard change of control as a huge ask. Their main concern is that they are not giving up more than their peers and that this could lead to clamour from investors for additional covenant protection.

As for corporate spread development in the remainder of 2006, the risks are clearly balanced towards widening from current tights. But why repeat the mistakes of the past and make a prediction?

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