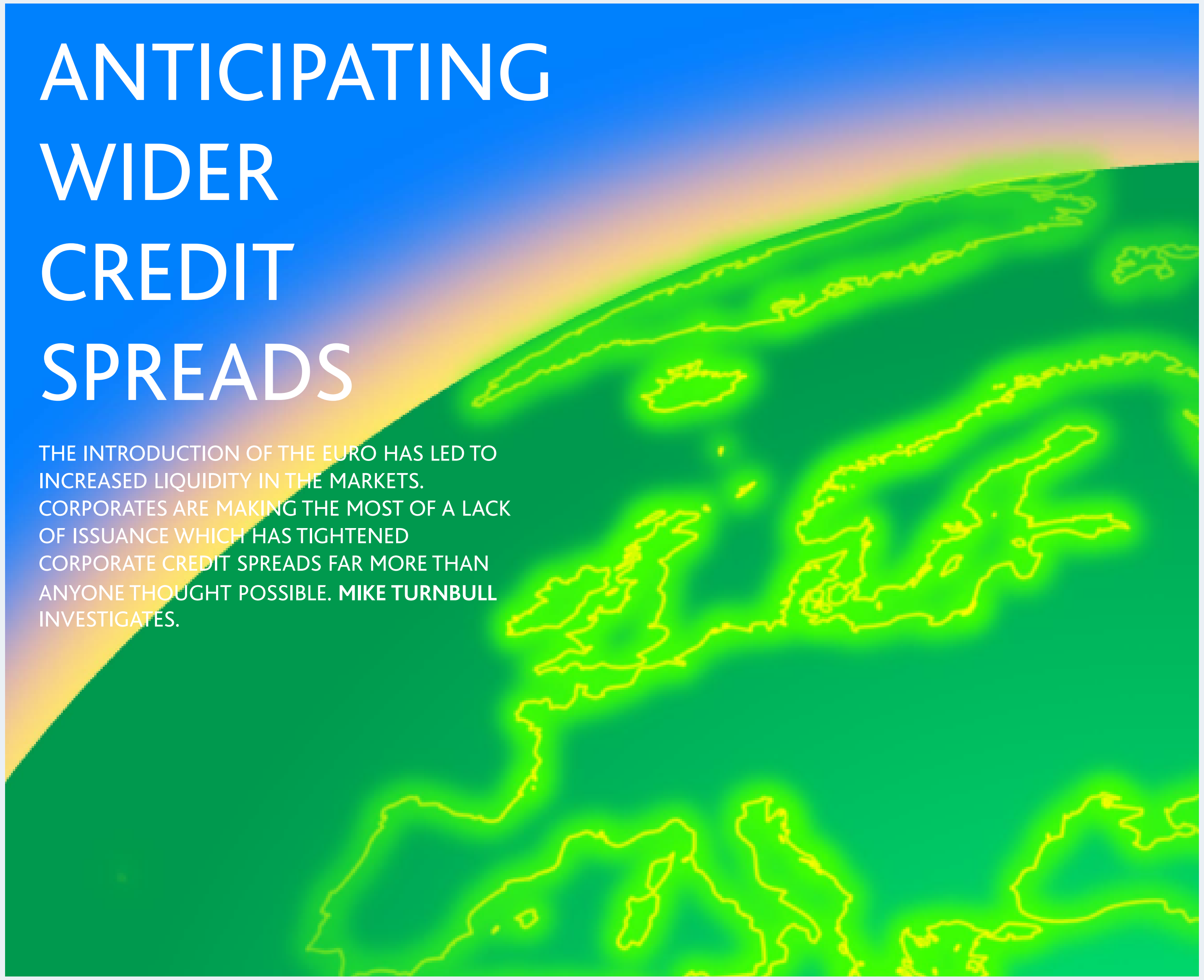
capital markets & funding THE EUROMARKETS

ANTICIPATING WIDER CREDIT SPREADS

THE INTRODUCTION OF THE EURO HAS LED TO INCREASED LIQUIDITY IN THE MARKETS. CORPORATES ARE MAKING THE MOST OF A LACK OF ISSUANCE WHICH HAS TIGHTENED CORPORATE CREDIT SPREADS FAR MORE THAN ANYONE THOUGHT POSSIBLE. **MIKE TURNBULL** INVESTIGATES.



Since the expansion of the European Union (EU), there has been an increase in issuance from Eastern European countries – both in the euro and US dollars. Deals here come to market from corporates that would have found it impossible to execute the same deals prior to the inception of the euro in 1999. The common currency has increased liquidity in the market, making it possible to issue in greater size. It has also enabled lower-rated credits to issue.

The theme dominating corporate European debt capital markets at the moment is that of tender offers and exchange offers. We have recently seen at least 10 tender or exchange offers by European companies alone in the past two months – KPN, Stora Enso, RWE, Vivendi Universal and Lafarge to name but a few. There are a number of reasons why so many of these active 'liability management' transactions are being undertaken.

Exchange offers are a way to lock into the attractive issuance terms in the market at the moment, without bearing the negative carry from overfunding a future redemption. Given the dearth of supply of corporate paper, and low interest rate yields, these offers are now taking place at spreads that many believe will be unachievable in the near future. For example, in July this year, RWE (rated A1/A+) announced a simultaneous tender and exchange for €2-2.5bn of its 2007 and 2008 Eurobonds. The new 10-year Eurobond will be issued at mid-swaps +35bps. In comparison, RWE issued a 10-year Eurobond in April 2002 at mid-swaps +75bps.

Exchange offers provide companies with a way of managing their debt profiles by smoothing out a spike in the redemption profile, or extending the average maturity of debt, and potentially increasing or decreasing leverage as required.

Tender offers allow a company to return cash to bondholders, thereby supporting the bonds that remain in the market. Many companies now find they have excess cash on their balance sheets and paying down debt early can be an efficient use of money. It reduces interest expense and puts the company in a healthy position to issue debt at a later date when it is needed. The perceived lack of mergers and acquisition (M&A) activity adds to the belief that spare cash will not be needed in the near term. Examples include Vivendi Universal's tender for €2.5bn of its outstanding high-yield bonds. Simultaneously, Vivendi Universal sought a consent solicitation to rid itself of the relatively restrictive high-yield covenants (consent solicitations are another example of liability management tools that corporates can use to give themselves covenant flexibility when they need it).

Tender offers and exchange offers also have softer benefits for issuers. They enable a company to get in front of investors with positive news and maintain a profile in the capital markets; they also provide an opportunity to sell the company's story. For a company with public debt nearing maturity and with either spare cash, or the need to enhance its debt maturity profile, liability management is an issue well worth considering.

Many corporates are currently at their target level of leverage and have achieved a satisfactory maturity profile. However, it still makes economic sense to proactively take advantage of current bond market conditions and reduce uncertainty around future funding.

The most likely reason for any company's credit spreads widening is that the market as a whole moves wider. There are several products in the market – for example, the market standard 'i-Traxx' indices – which allow a company to protect itself against the risk of the market widening. This is essentially an index of credit spreads on bonds. It can easily be bought and sold, as it is based on a pan-European portfolio of 125 names. Because this index moves with general movements in the credit markets, it can be used to protect the issuer against any movements in general credit spreads.

Spread locks are derivative instruments that can be used to lock into today's credit spreads into the future. Corporate treasuries have been heavy users of interest rate locks, to eliminate interest rate risk on fixed rate bond issues. For a company expecting to issue in the future, with concerns that spreads may widen, this offers (in effect) an opportunity to issue a bond without the cost of negative carry.

Bond warrants are instruments that essentially make money for the corporate if its credit spread widens. Buyers of these warrants have the right (at some future time) to force the corporate to issue a bond at today's credit spread. If spreads widen, the corporate will keep the upfront premium it was paid to enter into the trade. If spreads tighten, the corporate will be forced to issue a bond at today's levels.

In the absence of any major exogenous shocks, much the same is predicted in forthcoming quarters. The pipeline of corporate bonds in Europe and the US still feels light. Interest rates are expected to continue to rise. Morgan Stanley Research sees US interest rates standing at 2%, the European rates at 2.25% and the UK rates at 4.75% in December 2004.

The international market

The biggest influence in the debt capital market globally this year was always bound to be rising interest rates. The US Fed has raised its rate by just 25bps to 1.25% since the beginning of the year, while the Bank of England has hiked interest rates by 25bps on three separate occasions this year to 4.5%. The European Central Bank (ECB) has stood firm, thus far, at 2%. Given that the intentions of the central banks have been very well flagged for some time, there has been little change in the flow of issuance in response to any of the banks announcements. Other macro factors – rising oil prices, China's slowdown, currency volatility (and US dollar weakness) have failed to make a significant impact on securities issuance.

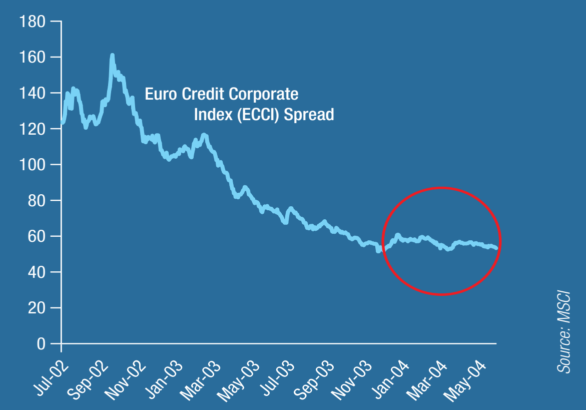
New issuance of debt by corporates has been extremely quiet. International corporate issuance in the first half of 2004 was around 36% down on the same period last year. One reason is that there simply isn't the need for cash. In both the equity and debt markets, we have seen many companies with enough spare cash to return sizeable amounts to shareholders and bondholders, in the form of stock and bond buybacks, and special dividends. This surfeit of cash is due to last year's 'pre-funding' activity in the fixed income markets. The good news for issuers intending to tap the debt markets soon is that the supply/demand imbalance caused by a lack of corporate issuance is keeping corporate spreads at attractive levels; opportunistic capital raising is being greeted favourably by investors still hungry for yield.

Corporate risk spreads are still at the same tight levels that they were at the beginning of this year. The MSCI Euro Corporate Credit Index has been range trading in a remarkably tight band – between 50 to 60bps versus Bunds since January.

This year has seen a continuation in the pick-up of activity in the equity markets. Pent up demand from nearly three years of volatile and bearish market conditions has unleashed a flood of new IPOs into the market, as well as opportunistic block trade executions. An expected corollary of this would be that the investor money pouring into equities might direct some of the demand away from the fixed income markets. However, equity investors are being very discerning about the deals that they choose to invest in and there has been particular price sensitivity to new issues. Even so, a large number of the IPOs executed this year are trading below issue price.

As underlying interest rate yields pick up, the credit markets offer a better return to investors than they have done for some time, whilst corporate credit quality continues to improve. As of mid-June 2004 according to Standard & Poor's, 290 entities either had a positive outlook or were on CreditWatch with positive implications, compared to 243 reported in March 2004. This is due to issuers' improving balance sheets and capital structures, and streamlining operations, the result of which has been enhanced profitability.

Figure 1. Euro corporate credit spreads (spreads to Bunds in bps)



'DESPITE THE EQUITY MARKET RISING FROM THE LOWS OF MARCH 2003, THERE IS STILL A REQUIREMENT FOR EXTRA FUNDING OF PENSIONS IN BOTH EUROPE AND THE US'

Infrastructure funding projects, especially in the transport sector, are likely to continue raising large sums – for example, the ISPA-TAV (Italian rail finance) and Metronet. The £6.7bn raised by Network Rail in multi-tranche offerings since the end of March can be added to this list. There are still a large number of these deals under consideration across Europe. Despite the large amounts being raised, there is little chance of other corporates being crowded out of the market, given that the infrastructure projects are concentrated almost exclusively in the AAA category.

One of the best performing sectors over the past year has been the high-yield market, where we have seen falling yields and extreme spread compression of the credit rating spectrum. European high- yield bond new issuance has increased from 15 deals in the first half of 2003 to 36 deals in the second half of 2004, an increase of 173% in US dollar volume terms. This level of activity is expected to be sustained at least until the final quarter of 2004, as investors' demand for high yields push spreads down.

In the light of an expected hike in interest rates, there is increasing appetite from investors for defensive plays (that is instruments that do not lose value if interest rates rise, such as floating rate notes). For example, in just one week in June, Cadbury Schweppes, Daimler Chrysler, Tui and Vivendi Universal priced €2.5bn of euro floating rate notes (FRN) between them. The longer-dated FRN market has opened up with Edison's €500m seven-year (BBB-rated) and a benchmark 10-year FRN announced by GECC (AAA-rated) in July. Given the rate hike expectations in the market, the levels of investor appetite and momentum and the impressive pricing being achieved look set to persist. These factors make such instruments an appealing option for corporates.

Impetus for issuance may also come from the need to fund scheme deficits. Despite the equity market rising from the lows of March 2003, there is still a significant requirement for extra funding of pensions in both Europe and the US. Following the £400m, 10-year fixed rate bond issued by Marks & Spencer in March this year, explicitly for the purpose of pension funding, more corporates may take advantage of the favourable issuance conditions and follow this route.

If we accept the current lack of corporate supply is due to pre-funding and over-funding last year, when corporate bond yields seemed to be on a permanent downward trajectory, and funding for one-to-two years was some time towards the end of this year, corporates who intend to maintain their leverage ratios will need to access the corporate bond markets again. This may go some way to redress the supply/demand imbalance.

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