Tapping bond markets

A panel hosted by Company Directors and FIIG Securities recently discussed the latest trends in corporate bonds and how directors should approach them. ***Zilla Efrat*** *reports.*

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Photos: Studio Commercial

AUSTRALIA NEEDS TO FURTHER develop and deepen its corporate bond market to fuel its growth and ensure it is globally competitive.

In an attempt to assist this development, the federal government passed legislation in November allowing retail investors to trade Commonwealth government securities on the Australian Securities Exchange (ASX).

Then, in May, it passed laws that introduced "simple corporate bonds" to attract more retail investors into the market, cut red tape and streamline the process for companies wanting to access this type of funding.

Of particular interest to directors is that the new laws seek to limit the range of people who may be found liable for misleading or deceptive statements and omissions to only those directly involved.

But while corporate bonds provide an effective source of financing, bond issuance in Australia has recently slowed on the back of global economic uncertainty, surging yields and a slumping Australian dollar.

So, given the jitters in global markets, the higher borrowing costs and the many regulatory changes affecting bond markets here and abroad, how should Australian directors approach corporate bonds and what questions should they be asking of management?

These were among the topics discussed at a panel event hosted by the Australian Institute of Company Directors and FIIG Securities in June. An edited version of the discussion follows.

Graham Burdis: *As a source of financing, why have corporate bonds been so well used by the big end of town, but not much beyond that?*

Tony Perkins: Public and private companies with a market capitalisation equivalent to the ASX 200 to 500 are generally unrated. There is no doubt an investment-grade or high-grade bond market exists in Australia and has institutional support. But with the exception of perhaps US private placements or 144A markets, there hasn't been much investor interest in bonds issued by unrated corporates in Australia.

Unlike in other countries, a market hasn't really existed here. But we are seeing it develop and unrated transactions are being done for listed and unlisted companies.

Burdis: *Is it an issue of ratings, first and foremost?*

Perkins: Ratings are becoming increasingly less relevant, but there are two other factors. First, fixed income as an asset class in Australia is very underinvested.

Surveys show Australians allocate the most to equities and the least to fixed income. That's because the knowledge in Australia about fixed income is limited. A lot of what we do at FIIG is about educating investors, for example, to understand that in a portfolio, the risk-adjusted returns are better if you include a portion allocated to fixed income.

Things are, however, changing as investment portfolios get larger and investors look for more diversity, not only in terms of their overall asset allocations, but also across the fixed-income spectrum.

Burdis: *At dinner parties, all the superannuation talk is usually about equities. When I point out equities are potentially the highest-risk investment in a company, people appear surprised.*

Perkins: Here is an interesting example. Once we approached an investor to invest in one of our senior unsecured offerings. He thought it too risky and bought the equity instead. This conversation demonstrates investors' lack of knowledge about the capital structure of a company. This is symptomatic of investors starting from a low knowledge base in corporate debt.

Nancy Zhu: Even some institutional investors don't really understand credit or how to value it. Our secondary market is very small. If you look at US debt trading desks, they are bigger than equity trading desks. So I believe there isn't really a market for people to understand.

Natalie Forsyth-Stock: Yet, there is less risk. So if people don't have the skills to do a credit analysis, how do they do an equity analysis? Is it a familiarity thing? Not too long ago, we didn't have very high retail investor participation in the equities market. Things will change, but perhaps slowly.

Greg Hammond: It has to move away from credit ratings to other forms of credit analysis. Credit rating agencies have their own credibility issues, as we know. But the cost of getting rated for some SMEs is quite high. Sometimes their scale is a real negative to the rating and I don't think rating scales are really understood.

If you are not investment grade, you, by definition, must be junk, which is not how the scales work.

Investors need to be educated that simply because a company is not investment grade does not mean it's a poor investment in a balanced portfolio.

Perkins: The way we work is to present our own credit research to our clients and they make their decisions accordingly.

Lindsay Tanner: I spoke to one group that can now do a credit rating for, I think, $36,000 and in only four weeks.

But from my experience, companies are not only concerned about the cost of the ratings process; they also worry about the unbelievable absorption of management time and effort – and the drama.

The ratings question is one issue in play, but there is also an intermediation problem that includes culture. New Zealand is a good counterfactual. There, they are suspicious about equities, but have a thriving corporate bond market. Yet, they have a comparable culture to Australia with pretty much the same regulatory arrangements. It goes back to New Zealand's bad experiences with equities in the 1980s.

A long list of factors make it difficult to assess what is really driving the market in Australia. There is a price issue and bid ask spreads. This is a result of our culture, as well as a lack of distribution, a lack of a secondary market and some asymmetrical things. For example, what if you are accustomed to an equities market that seems to be going up in double-digit figures? If a big part of your return is a capital gain, do you go for the preferential tax treatment or the upside of the bond?

On the education front, you are coming from a really low base. Most Australians that are, say, over the age of 40 or 45 have grown up in a world where very few citizens were making these choices. We have come from a highly aggregated wholesale investment world where only a small minority owned financial securities to a world where that has become widespread.

Burdis: *Bonds are also an opportunity for the industry. With superannuation funds growing at the rate they are, we will run out of possible equity investment choices in a short time. The value of super savings is going to exceed the value of the ASX.*

Perkins: I welcome any initiative in Australia that encourages more investors into this asset class. Issuers have been a bit gun shy because of the legislative imposts. But there is new legislation to encourage issuers into retail markets. That's good. Also, the ASX recently started trading in Commonwealth government securities. I am not sure how that will go. With the rare exception of some very large issues, the turnover of ASX-listed interest rate securities is not particularly high.

Burdis: *ASX CEO Elmer Funke Kupper saw the establishment of an exchange for government bonds as the first step towards developing the corporate bond market.*

Perkins: Maybe it is. But the fact is that, globally, bonds don't trade on exchanges. They trade over the counter because of the liquidity provided. We are trying to get the largest pool of liquidity possible because that is good for all investors – retail, institutional and wholesale.

In some cases, institutional investors have steered clear of interest rate securities because they are listed, because they see retail investors trading in what is a very illiquid security. All of a sudden, the price goes down and that's the price institutions have to mark their holdings to. So they are reluctant to invest in them. That's not ideal because it reduces the potential pool of liquidity for the overall market.

Hammond: I remember as a young man visiting Europe, when you walked past the bank, it would have a list of income securities available for sale displayed in its window. These, for example, would be for a range of German industrial companies and you could invest in relatively small amounts.

We don't have that in Australia and it will be a long time before we do under the current regime.

We want investors to be able to invest directly themselves, as opposed to going through their funds. But in Australia, there is a tension between the reforms on the ASX, which are directed at individuals managing their own investments, and the fact that most of the wealth of Australians, outside of their home, is in their super.

While they make choices about asset allocation in their super funds, most don't make choices about how it is invested. They rely on fund managers to do it.

Burdis: *Does the new legislation provide any improvements in practice?*

Hammond: It is clearly an improvement for those able to access it. You have to be an ASX-listed entity or guaranteed by one in the first place. There is also a minimum size for at least your initial issuance that may well be beyond the financing needs of some smaller companies.

The legislation is predicated on you regularly issuing and that is a challenge. A smaller company doesn't need to issue bonds twice or three times a year. In contrast, a company like Woolworths or BHP Billiton has large financing needs and can afford multiple issuances over a year.

I don't think the director liability issue has ever been a problem. It's about price fundamentally. If issuers can raise money at a cost-effective price and investors will buy at that price, the industry will solve all other problems.

Tanner: Large companies have a difficult choice. They would like longer tenor and to diversify their balance sheets. But what if the bank price is cheaper? There may well be rollover risk in three years' time, but how do they know what the world will look like then and whether they will still be there?

Hammond: There's another issue. Whether it's bank funding, the wholesale capital markets in Australia or the 144A market in the US, these are usually less complicated, quicker and less expensive than doing a retail corporate bond issue in Australia.

Companies haven't got all the time in the world to focus on a corporate bond. As a treasurer or financial controller, the idea of something being uncomplicated and quick can be very attractive even if it's a bit more expensive.

Perkins: We already sell investors a $10,000 parcel of bonds. They are not retail but wholesale investors in terms of the corporations law definition, but they are buying parcel sizes that are not large. The borrowing company is issuing a wholesale bond, but the liability provisions imposed on its directors are nothing as onerous as they had been in a retail prospectus up until now.

A company can do a wholesale investor-targeted issue with an information memorandum in six weeks and the costs are small, particularly from a due diligence perspective.

Hammond: On the liability issue, Australia is a considerable outlier in its approach to bonds. If you do a retail prospectus in Europe for bonds, it is about issuer liability. There is no deemed liability for the directors at all. It's also true in the US, where the standards for the issuing company might be higher, but there is no per se deemed liability for directors. What will matter is the extent to which directors were involved in any misleading statements.

Vivian Quinn: From my experience as a CFO and director of several mid-sized to large companies over the past seven years or so, I have seen that directors' liability is probably one of the last decision criteria when selecting funding sources.

Directors will think of many other things first. I can't speak for all directors, but there are so many other factors to consider when making these funding decisions, such as the business strategy, what it is you are funding, the length of the term, the risk and so on.

Directors' liability is important, but I don't think it's the key determinant. The new legislation will reduce the liability of directors, which is great, but there are other elements of the *Corporations Act* 2001 that will continue to catch directors anyway.

Hammond: You are right, but I wouldn't get overly concerned about it. Misleading and deception provisions, whether they are in the *Corporations Act* or in competition law or the state fair trading acts, apply to virtually everything a company does.

The new legislation, however, does do two things. It takes away the deemed liability for vanilla, simple corporate bonds, but these are only a small subset of the fixed-income market. It also changes the defences for liability in relation to the extent that you can rely on others, including the company's management, and that is important. But as we said before, directors' liability is hardly the first thing that drives the decision.

Getting back to the decisions directors have to make. If you get into financial difficulty or your business model changes or the company undertakes a transformative transaction, it is easier to get approval for variations or amendments of the terms of your agreements with your banks than it is with bonds.

The flipside of that is that bonds will have less covenants and restrictions on them. So the range of circumstances for which you might need consent is smaller, but if you do need it, it can be a very painful process.

In Australia, it isn't too bad. Australian institutions – often because they are also invested in your equities – are more willing to look at changes than investors in the US or elsewhere where their only involvement with you may be through the bond.

Forsyth-Stock: These days, people have large syndicates of banks so you are not just dealing with one party. But I suppose, when you have a whole lot of bond holders, you have the same thing.

Hammond: In some bond markets, you don't know who your investors are at any point of time – for example, in the European bond markets.

In the US and Australia, you can get reports from the clearing systems that reveal who holds your bonds. They would often be nominees and trustees, but at least you can ask them to pass the information on. But in the US bond market, you might have 15 to 25 US institutions invested in a typical private placement and that's just like the bank syndicates if you need to go to them for some consent or approval.

Zhu: Last year, we went through a $1.2 billion refinancing and had a debate about which market to go to. Of course, there's not really a retail bond market so you do an institutional placement. But, if you really look at it, there is a big price differential between the bank market and all of those institutional placements. And the bank market also offers much more flexible terms. You can take five-year debt today and refinance it tomorrow without any problems if the market looks set to change.

Hammond: In some ways, treasurers are like investors. They also need to have diversified sources of funding.

Tanner: You may have the refinancing risk in 10 years' time, but how many corporate treasurers see themselves doing the same job 10 years later? Everybody is in favour of the longer term, but should they pay for it now? I am not so sure.

It's human behaviour. Decision-makers may think that, at one level, the company would be much better off if it had a differently structured balance sheet, more diversity and a greater spread of tenor and so on. But then they may also think: "Okay, I have this stroppy group of shareholders and the media on my back, so do I really want to take a slice off the next corporate bond line when I don't have to?" Maybe not.

Hammond: There is a trade off. Think back to before the global financial crisis, to perhaps Australia's shortest ever ASX-listed company, RAMS. It was essentially 100 per cent funded in the short term through the commercial paper market in the US. Things froze and rollover risk was there...

Tanner: People have very short memories, though. Unless you get regular reminders of the bad things that can happen, these are just going to fade in our priorities. People respond to the context and the signals around them. Why are politicians short-term decision-makers? Because they get rewarded for that. Familiarity is the ultimate driver of voter behaviour. That is why some of them behave like reality show contestants. Exactly the same happens in the corporate world.

Quinn: It does, because people are driven by what they are measured on and they will make decisions based on that.

Tanner: It's something we need to keep in mind. So before we criticise individuals for being short term in their decision-making, we have to think through their incentives and disincentives.

Burdis: *Do directors have to make a conscious effort to ensure their organisations include the corporate bond market in their mix, especially if the treasurer and CFO are thinking in the short term?*

Perkins: The Australian Institute of Company Directors, to a certain degree, has blossomed off the back of notions of good governance. I would have thought that when it comes to the financial profile of the company, good governance is not having all your eggs in one basket in terms of one or two banks.

It is all about mitigating your rollover risk and ensuring you have the best relations you can with all your financiers. There are many factors and I don't think the average director would sit here and say it's all about price.

Directors understand the importance of real prudential governance. They like the fact they are diversifying away from their banks.

In some instances, their banks are also encouraging them to do this because the banks don't want to be the ones with the singular burden of providing solvency to the company.

Forsyth-Stock: From a directors' perspective, often the personal incentive is their reputations. It's about the longevity of the companies they have been involved with.

Hammond: But how do companies reward their CFOs and treasurers? If the reward is based on the lowest cost of funds, then you need to change your KPIs.

Tanner: It is also about being "easily measurable". Diversity of funding is not an easy, simple thing to create a measurement for, whereas simple, bottom-line "here's what we're paying for X dollars of debt" is pretty easy to measure.

Perkins: Think about compliance with occupational health and safety (OHS) laws. There is personal liability for directors for OHS, but again, OHS doesn't increase your bottom line. In fact, it reduces it because it's costly. But we still do it. Why? Because it's proven to be good risk management and that is what directors want.

Hammond: A lot of companies are refinancing their bank debt before it is scheduled and has matured. Sure, it helps to stagger and also, it is something you can do now. You don't know whether it will be as easily done in 12 months' time.

One of the challenges with bonds, I think, is the extent to which you can redeem them early. Bond investors don't like this.

In the past three to five years, we have seen more corporates buying back their bonds early. But have these programs been successful in managing the rollover risk associated with the bond?

Perkins: From an investor's

perspective, there are pluses and minuses with early buy-backs. If it is a fixed-rate bond, depending on which way interest rates have gone, investors can lose out.

Investors don't like that. If they are compensated with some kind of premium that was incorporated into the terms of the bond when it was originally framed, then I don't think investors can complain irrespective of how interest rates go.

We have seen a number of transactions since the global financial crisis where the bonds were sold on the assumption they would be called and they weren't, because the issuer couldn't manage the liquidity obligation of buying back the bonds.

Justifiably, investors take a very negative view of this. If investors feel the bonds are being bought back from them in an uneconomical way – unless they purchased them on those terms – they could crucify the issuer.

I believe the oldest bond market in the world is the Dutch market, where interest rates are at 500-year lows. The Australian bond market is at 100-year lows. It is argued that real rates of interest could go negative in Australia. They are negative in the US and Europe. So they are a great deal for borrowers. But is buying a fixed-rate instrument a good deal for investors?

Investors in Australia are still

buying fixed-rate bonds, but they aren't buying government bonds because there is little return.

They are buying corporate bonds because there is a credit spread that gives them something to live on.

We are not particularly active in floating-rate bonds, but you could see investors buying them if they thought interest rates were going to go up.

It seems the issuance of convertibles and hybrids has diminished. Is that because of change in the ratings agencies' approach to assigning "equity credit" to hybrids?

Hammond: It's due to two factors. One is the changed approach of the ratings agencies. The other is that the big issuers of many of those instruments have been regulated – the financial institutions, insurers and so on.

There's been some uncertainty over how the change in Basel III rules work. That's beginning to come to an end. We've seen a couple of Basel III-compliant deals come through and there are more in the pipeline.

Basel III-compliant instruments are different to the hybrids we saw in the past and the market will take time to work out how they should be priced and where they fit into a portfolio.

They are designed to have so-called loss absorbency features so that if a financial institution becomes non-viable, investors can be forced into ordinary shares or written off.

Perkins: It's no accident that it is the retail investors who have been buying these types of instruments. They are the ones probably least able to understand the complexities of these transactions and the least able to understand that while it may be a fantastic company issuing the security, investors are being paid fixed-income returns for equity-style risks.

With the new Basel III regulations, the risks of these securities have grown. I will be interested to see how much more compensation investors will be getting.

Institutional investors don't like these instruments. They don't see the compensation as being just and they worry that if retail investors are heavily involved, there might be some irrational pricing.

At the moment, we are also seeing a lot of demand for inflation-indexed securities. That's because if governments are printing indefinite amounts of money, then economic wisdom tells investors inflation should be just around the corner. So while real yields are low and could go lower, investors are looking to buy some protection against inflation going up.

Tanner: The spreads between corporate bonds in Australia and some of these markets are so huge that, despite the currency risk factor, it is perhaps surprising there hasn't been greater international investor interest.

Perkins: Historically, we've seen borrowers going offshore with their corporate bond issues – to the US private placement, 144A and other markets – and that was largely driven by price.

But in the past few months, we've seen corporates such as BHP Billiton, Qantas, Lend Lease and Downer – with credit ratings ranging from A+ to BBB- – come to the Australian market. That tells me the price must be more competitive here. It's also no accident that it's companies with a BBB or similar credit ratings doing this because these are the bonds investors want.

Zhu: Yes, because of their yields and because the yields of A-rated bonds are not that attractive at present.

When fixed-income investors are chasing yield, they want B-credit corporate bonds.

B-grade issues used to account for less than 25 per cent of all bond issues. Now they are edging up. The demand is really there. Lend Lease and other issuers are more than 200 per cent oversubscribed.

Hammond: Global regulatory changes in the derivatives market are also driving this trend. The changes are increasing the availability and costs of bonds and currency swaps.

A lot of those arrangements are now going to be subject to collateral requirements and many issuers don't want to go into arrangements that lock them into having to provide collateral in the future.

That makes Australian dollar instruments more attractive and the Australian market is the most logical market to find these, although not the only one.

Tanner: We should discuss the shift in Australian savings from the banks into superannuation.

It is unavoidable that more of the heavy lifting in lending to corporate Australia is going to have to be done by the superannuation sector.

At least one of the banks has already publicly acknowledged this. So the question for the big institutional investors is how that is going to occur.

Hammond: We talked about syndicates earlier. We are now seeing super funds being participants in syndicated bank financing from day one and behaving more like banks than fixed-income investors.

Tanner: Remember that the money they deal with is not at call or short term. The fundamental point here is ultimately about tenor and the super funds are a better match for the markets we are talking about.

Hammond: But we keep assessing the performance of super funds quarterly. They may have long-term funding, but they have short-term incentives.

Zhu: The super funds say they can't increase their fixed-income allocation because of legislation that allows members to change funds. They need to keep a certain liquidity to allow for this.

Hammond: I reckon that's a bit of an excuse if you look at the volume of churn that happens.

Burdis: *It is also how choices are made in the super funds. Members ask to be put into equities, but they don't ask to be put into fixed income. That's the mandate the funds have.*

Tanner: This works on two levels. One is the funds have to keep an amount of liquidity to make provisions for payouts. The other is cosmetic, to ensure they don't increase the incentives for members to bail out. Members could say: "Hang on. You earned 1.2 per cent. This other fund earned 6.7 per cent, so see you later." But I find it disturbing when the funds talk about things like 100-year rolling averages. They completely miss the point. This is not about averages and aggregates. It's about each individual member and if you are on the wrong end of a cycle as a super fund member that is massively overweight in equities, you don't care about the 100-year rolling average. Ultimately, you are not dealing here with totally pooled money. It doesn't matter what the aggregate amount is because at the end of the day, that money is hypothecated to one individual and his or her circumstances.

Hammond: A debate in the funds management industry is whether we should have separate balanced funds for different age groups. A balanced fund for members starting their working careers would be very different from one for those in their 50s.

Perkins: They say you should have fixed-income allocation the same as your age – so if you are 50, its half fixed income and if you are 80, its 80 per cent.

Hammond: This thing about diversity is that it's not just diversity between fixed income and equities. It's also within that portion of fixed income that you have got diversity, just as within equities, and in theory that should be driving investors to say I want more choice in the fixed-income products I can have.

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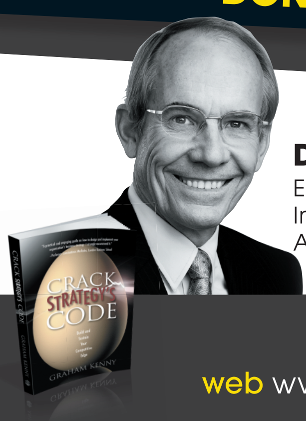

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