

An attractive option

Corporate bonds as a complement to equity financing

The collapse of the US mortgage market in 2008 started a financial crisis where banks tightened the lending terms and restricted access to credit. German mid-sized (Mittelstand) companies were especially affected by this development. In Germany, despite the avoidance of a credit crunch and normalising bank lending, the issuance of corporate bonds increased significantly in 2009. This was driven by the credit demand of publicly listed corporations – many of them in the automobile and telecom sector. In the last couple of months, a number of smaller companies have started to follow this lead and have become active in this market.

Driven to a large extent by low government bond yields, institutional investors welcomed these sub-investment grade bonds offering substantially higher coupons. Furthermore, a portion of these bonds were sold in a public offering, hence tapping the hitherto rarely accessed retail market. The inclusion of private investors in an offering has the advantage of addressing a less price sensitive investor base with a longer investment horizon than the investment period of institutional investors usually is.

A minimum of covenants

Compared to other high yield bond markets, especially in the US, publicly offered bonds in Germany have been structured with a minimum of covenants. US-style high yield bonds generally limit, amongst other things, the com-

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pany's ability to borrow, to distribute dividends or to sell and pledge assets. The absence of such covenants gives the issuer a great deal of flexibility not offered in other markets.

However, a public offering requires a prospectus approved by the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) or another competent authority of an EEA member state. The prospectus contains foremost the description of the issuer, a list of risk factors, an overview of the business and the relevant markets, as well as audited historical financial information for the two most recent financial years including interim financial information.

Need for rating opinions

Most of the issuers chose to mandate a rating agency for a rating opinion. Usually institutional investors have caps on the amount to be invested in different classes of bonds, e.g. unrated vs. rated issues and investment grade vs. non-investment grade. Some institutional investors even require a bond and/or an issuer to be rated in order to participate in the offering. The selection of one of the three international rating agencies S&P, Moody's or Fitch seems a safe bet when accessing institutional investors. The



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rating is also an important tool when marketing the offering to retail investors. However, the latter group accepts rating opinions from less well-known agencies. Hence, in order to access a larger investor audience, attaining a rating could be worthwhile.

Marketing to retail investors may involve advertising the offering in financial media, including specialized websites as well as promoting the issuance by way of press releases, interviews and other public relation activities. Retail investors are targeted far more easily if the issuer is widely known with a brand or a recognised household name. A German stock exchange recently launched its retail trading platform for marketing new bond issues and accessing the exchange's registered private investor base besides banks as distributors for their retail customers. Taking advantage of a specialized market segment targeted to private investors will help issuers with less well-known brands in a placement which may lower marketing costs significantly.

With oder without prospectus?

Most of the bonds issued have generally been admitted to the regulated unofficial market (Freiverkehr). The admission does not require a prospectus or any obligation by the issuer, thus bonds placed without a prospectus are equally qualified to trade. A liquid aftermarket, however, does require a market maker willing to take on risk by actively buying and selling securities if no other market participant is active. Since institutional investors require a minimum level of liquidity in order to buy the issuance, the issuer should take note of the mandated syndicate bank's relevant market making track record.

The process involved for a publicly offered corporate bond from preparation to placement takes approximately four months. The most critical part of the transaction is the preparation of the prospectus, a process which requires around three months, including the approval process with the supervisory authority. The rating process takes about six to ten weeks, depending on the complexity of the company, but is carried out in parallel to the prospectus preparation. Pre-sounding with institutional investors takes another one or two weeks – followed by prospectus approval and a subscription period of usually up to two weeks.

Successful recent examples

One of the first issues offered on a stock exchange's retail platform was a EUR 150 million, 7.25%, 2010/15 senior unsecured bond of Dürr Aktiengesellschaft, the German automotive production system supplier. The offer consisted of a public offering in Germany and Austria as well as a European institutional private placement among European institutional investors conducted by Close Brothers Seydler Bank AG. The bond was unrated, although Dürr already had a corporate rating (S&P: B, Moody's: B2). The preparation for the issue started in mid June. Feedback collected by the syndicate bank during a one week pre-marketing roadshow in early September was used to determine the coupon and the final terms. Due to institutional investor indications of interest, the company and the syndicate bank were able to secure a full placement of the bond issue before the offer period even began. Books opened on September 13th and were closed early on the same day with the issuance being three times oversubscribed. Institutional investors accounted for approximately 61% of the order book.

Conclusion

The issuance of a corporate bond is an effective complement to equity finance. The current market environment enables issuers to secure attractive bond terms, especially if retail investors are included in the offering. However, in order to anticipate a successful bond placement earlier in the process, it is advisable to include an institutional investors' tranche.