The Corporate Bond market is open for business

Bond financing plays an important role in providing capital stability and reducing funding costs for Australian corporates. The market has continued to open up since the global financial crisis and is now accessible to a broader range of issuers including unrated corporates, providing scope for greater growth in the years ahead.

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Australia's largest companies have long turned to the bond market for their debt funding but until recently this option was closed to most corporates. Unlike their overseas peers, Australian companies without a credit rating were forced to rely almost exclusively on bank funding and equity. This created significant risks including short debt duration, debt concentration, high funding costs and difficulty obtaining refinancing during the all too frequent global credit crises.

Over the past two years this situation has improved dramatically with a much wider range of companies gaining access to the bond market including many with no credit rating. Mid-cap corporates that have successfully issued bonds over this period include Plenary Group, 360 Capital Group, Coffey International, G8 Education, Cash Converters, Mackay Sugar Limited, and Silver Chef.

The opening of the bond market is being supported by unmet investor demand including from the self-managed super fund sector, which is seeking fixed-income investment alternatives rather than relying on lower yield term deposits.

Despite the attractions of a bond issue, many corporate finance teams remain cautious that this is a realistic option for their company. In this regard, company directors play an important role in ensuring bond financing is considered in the Board's ongoing assessment of funding alternatives.

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

Ian Macfarlane: *I sit on the board of some large public companies and my observation is that CFOs are conservative when it comes to issuing debt or borrowing money. Their absolute priority is execution certainty. As a result, they are very unwilling to experiment.*

Secondly, CFOs are heavily influenced by investment bankers and they often have a close personal relationship with a particular investment banker, which I also think encourages conservatism because the investment bankers know all about the big end of town. This must be a challenge that you face; the conservatism and protectionist behaviour of CFOs. I've only ever seen it in very big public companies, but it probably goes further down the scale. What are your thoughts?

Mark Paton: The overarching issue is there's a lack of awareness that you can find alternate capital that sits between bank debt and equity capital. So if you're a big public corporation with a credit rating, you're intimately involved in the capital markets and you have the experience and the capacity for bond issuance and you know it works well.

But the vast majority of public and public unlisted companies that don't have a credit rating have never had that experience and they don't have that third leg of capital stability that bond markets bring. The point is, all of those markets don't always work well at the same time; and if you're dependent only on bank debt and equity, and one of those isn't working so well at the time, then you have limited options.

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Whereas if you've got all those legs balanced, then if one's not working, you've at least got two other sources.

Glenn Butterworth: I think it's not only the CFOs but also the boards that are hesitant to go into new territory. For us it makes sense and I think for other companies similar to us it makes sense. That third alternative is something we definitely need.

Morné Swanepoel: Common feedback amongst my peer group is around flexibility and what happens when things go wrong. Many CFOs unfortunately approach things from a perspective of what happens if it goes wrong? They are very risk averse.

Ian Macfarlane: *So this answers the question of why boards should care about company's capital structure. The answer to that is you've got much more flexibility of security.*

Mark Paton: Yes. That's commercial reality – never get yourself in a position where you've only got one option. If you've got three options and one market isn't working particularly well, you've still got two options.

Charles Graham: I think that the capital structure inherently drives the cost of capital for the company and therefore determines what projects make sense and where capital can be deployed in a value-added way.

If boards don't push for capital structures to be optimised, then you're basically going to leave projects, decisions, capital deployment and other issues on the table. At the big end of town, everyone understands they want to have a BBB+ or BBB rating and that there are targets that they should stick within. But at the smaller end of town, it's certainly not that easy to determine what the target should be, let alone access the capital to fill in the gap once you have a target.

Mark Paton: Banks are really good at providing debt, but don't get paid much for the provision of that debt, so they look to structure debt in a pretty conservative way. But you have to recognise, in a cost of capital sense, that's the cheapest cost of capital you can find.

The most expensive cost of capital you can find is at the equity end of the spectrum and long-term bond issuance sits in between the two. Long-term bond issuance isn't supposed to be a replacement for bank debt.

John Ricciotti: It is also about the market we are in, where credit growth is stable due to historically lower levels of M&A and capital investment, so to an extent, companies can rely on their bank facilities to meet current funding needs. But when you start looking at expanding your capital base, that's when you will approach the limits of what your bank will do.

Mark Bayley: In terms of the whole cost of capital debate and with banking very competitive at the moment, from a CFO's point of view, it's a case of being able to get bank funding (for an investment grade borrower) for three years at 150, but also a seven-year bond away at maybe 180. Then the boards will ask why they are paying an extra 30 basis points, because they have forgotten that the GFC happened and assume the banks will always be there and they will just be able to roll it over at a lower cost.

That's the reaction we get sometimes when we say we have investors behind us that can provide longer-term debt. There's a huge amount of investor demand for those types of assets, but the corporates say the banks can finance them.

THOUGHT LEADERSHIP ROUND TABLE

Mark Paton: We have been through the GFC, you've seen credit contract and are starting to see credit expand a little bit, so I think it's a more expansive credit environment. But, the underlying economic reality is that everybody is working harder to make the same or less margin in most industries.

When markets are normalised, companies invariably are mostly focused on trying to find the lowest cost of capital. Invariably it's usually only in times of crisis when people go looking for alternative solutions. That's the challenge to opening up the domestic bond market, and I don't mean just unrated, I mean the whole market. If you want longer tenure and you want more flexibility, the bond markets give you that. Of course, it comes with some additional premium.

Ian Macfarlane: *A big company understands all that. If you are sitting on the board, one of the things you get in every board meeting is a graph showing the maturity structure of borrowings. The whole aim is to make sure that it's not all in one place, you fill in the holes, and you refinance the bits. Ideally you would like everyone to think that way and be prepared to pay a little bit more for the security of not being dependant on having to roll everything over at some particular date. What would you view as best practice in the management of capital structure?*

John Ricciotti: Risk appetite is key to that assessment. Directors should ask: "Do we have a capital structure that supports our strategy i.e. sufficient liquidity and funding for operating and investment requirements. This leads to an assessment of where you are sourcing your capital and the match with the strategy, i.e. are we accessing a range of markets and will the capital support a change in business conditions? There's always that truism that treasurers and CFOs are agnostic around capital. They are agnostic about where they get it from, as long as it's competitive on price and terms.

That doesn't always hold true. If you think your alternatives are narrow, you tend to go down the path where you feel you're going to get best execution i.e. the conservative approach of your main credit provider. I believe that's where seeking advice outside of your main credit provider is going to give you a broader sense of what the alternatives are to manage your capital structure.

Morné Swanepoel: What's your observation on refinance risk at the corporate level of bigger institutions? I think people have very short memories. I remember when quite a few of the more 'substantial' developers were destroyed by an unsuccessful refinance.

John Ricciotti: We call it a fat tail risk, we tend to see it every five to seven years where there is market volatility. We make sure that we have the right conversations with our clients around diversifying capital to minimise the potential impact when the markets are volatile and that's generally a situation where there is a single or small group of credit providers who are not willing to provide any more credit.

That conversation around refinance risk is a very healthy one, because bank pricing and terms can change significantly, and bonds are able to provide an alternative that reduces the risk. The other consideration in the infrastructure markets is that a bond can provide long tenor financing which significantly mitigates refinancing risk.

Morné Swanepoel: Tenure is a key competitive advantage the bond market has over the banks.

Charles Graham: On this topic of capital structure management, I think we've touched on a number of points, which can all be summarised in one critical issue - diversification. Have as many banks participate in the bank syndicate as possible to keep the relationship depth and to diversify.

Ensure you've got diversification of tenure and in product. Make sure you have diversification in all those areas, because it's impossible to predict the future. You are not going to know which markets are going to move and which markets aren't going to move.

Ian Macfarlane: *That must be much easier if you have a 20 billion dollar balance sheet. But you are looking at businesses that are much smaller than that. And how much diversity can you get? Can you do more than have three things? Your own equity, bank finance and one bond? How do you achieve that if you are small?*

Mark Paton: I think you can. The market is now available to middle market corporates to do what very big rated corporations can do. The fact is there will be more options for them and as the rules are changing to make it easier, those companies that want to go down that path, can. Those that wanted to issue over the counter market domestically can do that. Those who are big enough and want to go into foreign capital markets can do that. There are a variety of solutions around.

Phil Harvey: If you look internationally, what we are hearing is that in the European market, the SME sector has started making use of the capital market, partly because European banks themselves are de-leveraging.

Ian Macfarlane: *What are the key differences between bond and bank facilities from a borrower's perspective?*

Glenn Butterworth: The main thing is getting your head around the covenant structure and the fact that your bondholders provide a separation. You can pick up the phone and speak to your bank manager on a daily basis and ask them if you need something. It's going to cost you money, but they're there and you can have an ongoing relationship. Whereas with bondholders, there is that separation, you're locking yourself in for four to seven years, in set regime of covenants. That's probably the biggest thing for us to get our heads around in terms of a company that's trying to grow.

Like I say, it's really just the initial stages of getting your head around how it is going to work and whether it fits with what we are going to do in the next five years and our strategy.

Ian Macfarlane: *Moving on to more practical issues. What are the key considerations for directors when assessing the suitability of bond issue for their company?*

Phil Harvey: The directors' main obligation is to consider what's in the best interest of the company, so when you look at the funding mix, it's a very important component of that. This also drives a range of considerations such as flexibility in terms of your funding plan and what's the appropriate mix of debt or other forms of capital, including the mix of bank and bond funding and whether or not you are dependent on a single source of funding, and where's the appropriate place to source that capital.

Then there is the question of which market is appropriate? Are we talking about the US, are we talking about domestic wholesale, or are we talking about the retail market in Australia or other markets offshore? Do these markets provide the kind of funding which is unavailable from the banks? Flexible covenant packages are a consideration as is whether or not you can move to a position where you are on an unsecured platform that gives a company an additional amount of flexibility.

Ian Macfarlane: *Mark, from your experience, what are the key obstacles you have to overcome, or if there's a board, the CFO has had to overcome, in order to make the decision to issue a bond?*

Mark Paton: I think on the internal side first and foremost it's about identifying the real need. What are your short-term funding needs, working capital needs, your capital structure, and what are your long term funding needs? If you have long term funding needs then that's what the bond markets suit. Secondly, I think where the company is in its corporate activity is important. Is it a stable time for the company?

Generally speaking, bond markets price the best when you've got a good stable credit story to tell. It doesn't mean you can't issue when there's an M&A or some sort of recovery going on, but generally speaking there's no upside for bondholders. They are fairly conservative investors, so they want to see a conservative track record and a history trail behind it, which makes the most efficient outcome for the issuer.

The external issues are about what sort of industry are you in; does it suit that sort of market, what's happening in the markets at the time when you are issuing? If there are other industries issues going on and you want to come in to the market from an industry that's favourable and it's got good economic outlook and credentials, that makes for a stronger demand from investors for that type of risk profile.

Glenn Butterworth: Moving into an untested market that's not familiar in Australia from board perspective, for the CFO it's about making sure you are aware of how it works and how it's going to work for the company. So it's a bit of an education internally. Then, obviously, it's about how it is likely to be perceived by the investors.

Ian Macfarlane: *Phil, what's the process for issuing a bond?*

Phil Harvey: First it is to pick advisers and your third party service providers who are going to be involved in the transaction. That's usually a board decision. The second step is really around the documentation and building the architecture that allows you access to market. And to a certain extent, that's no different to any other transaction. The experts on the arranger's side will know what the investors are looking for.

In terms of timing, this can be accelerated or relaxed, depending on the company's time frame. You want to give yourself a certain amount of time that allows consideration of the issues involved, but at the same time if a window of opportunity opens up, people can move very quickly to take advantage of market opportunities.

The only other thing I really wanted to touch on was with respect to the disclosure regime and some of the liability issues for boards, which is very important when they are considering going into the capital markets, it is very different to what they have to consider when they are going into a bank market.

Mark Paton: You also want to make sure you've got an arranger/adviser who's got a track record, who can bring your company to market, who understands your business. So an organisation that can understand the middle market corporate, understand the risk profile of it, tell its credit story, construct a solution so that it does stand the test of time for how the instrument is going to work in the market, and then can actually deliver the capital behind it.

Ian Macfarlane: *How do you manage relationships with bond investors after it has issued?*

Glenn Butterworth: From our perspective it's quite easy, we release information on a continuous disclosure basis, so we've got information in the market. In terms of the relationship with the bondholders, a lot of that is done through the arrangers, so people who actually provide the information, spell it out to the investors, and keep the ongoing communication going.

Obviously, subject to keeping the bond investors informed it opens up the opportunity to go back to those investors in the future. Similarly to equity holders, the more we get out there in front of them, update them on what's happening, the more they can assess the credit risk and how we've performed against what we said we were going to do.

Ian Macfarlane: *What are the key needs of debt investors?*

Mark Bayley: In terms of the investor environment at the moment, it's searching and chasing the yield dragon. From a bond investor's point of view, we want good covenant protection but we don't want to restrict the company from its normal course of business. We want those covenants to protect us from downside risk, we'd prefer the company not to make a leveraged acquisition or get taken over by private equity.

But equally we want management to run the business without having to worry about covenants and bond documentation, because that's wasting resources. Management are better off running companies than focusing on financial covenants.

Ian Macfarlane: *Well it's been very good to hear these views both from businesses that access these markets to raise funds and from financial institutions that distribute bonds to the broader investment community. I'm encouraged by what I've heard today and can see the opening of the bond market providing more opportunities for both issuers and investors, which is a welcome change for the continued development of our capital markets.*