Q+A

MARK PATON, CHIEF EXECUTIVE OFFICER, FIIG

BLAZING A TRAIL IN DOMESTIC HIGH YIELD

Since late 2012, **FIIG** has arranged a steady flow of bond deals for unrated, middle-market companies. The firm's CEO, **Mark Paton**, describes the investor base for these transactions, his hopes for the development of this market in Australia, and the reputational risk of bringing unrated – and, occasionally, unlisted – issuers to the capital markets.

It seems that FIIG has identified a market for high-yield deals which are otherwise not being completed. Why is this, and what kinds of investors do these deals tend to attract?
In fact, a large number of firms are tapping into self-directed investors. These investors tend to be high net worth individuals who are taking their wealth out of managed funds.

This is a sophisticated buyer base in terms of the investors' appetite for a range of investments, the fact that they are well educated and experienced, and also that they pass sophisticated investor tests. They tend to hold a wide range of investments within their portfolio allocations – not just to debt instruments but also equities, currencies and commodities, and across borders. And they are not retail investors – they don't need to invest via a prospectus regime.

FIIG has had a relationship with this type of client for the 15-plus years we have been around, often initially by distributing smaller parcels of corporate bonds we have acquired in the wholesale secondary market. But FIIG certainly isn't the only firm that sees the appetite of this investor base. There are many boutique funds and capital-raising firms doing things in the equity market and around private placements of various types of transactions.

In terms of corporate bond issuance – for pure debt purposes, by unrated, middle-market companies – I think FIIG is close to unique. We have found a sweet spot of investors who are looking for yield and who are aware of the risks involved in investing in the debt side of balance sheets.

We believe this is the start of the development of a middle-market corporate bond business which will evolve in all sorts of ways over the coming years.

Why has this market emerged at this point in time specifically?
Our investors are generally looking for income, with a large proportion of them either nearing or already in retirement. In a low-yield environment getting this income poses a challenge.

There is also confidence around investing in the balance sheets of the companies we have brought to market. All but one, so far, has been publicly listed and many of the bond investors already hold the same companies' equity. Provided the bond and its terms are effectively structured, the appetite for middle-market company risk via equity leads on to investors being quite happy also to hold debt.

On the supply side, regulatory changes and the capital-allocation rules being imposed on banks in Australia are making longer-term bank lending to unrated-type risk much more difficult economically for lenders, after cost of capital. Corporates want – and I think they should have – their banks as their main source of funding. But they also need diversity in their sources of finance, and they are certainly open to looking at more cost-efficient and tailored ways of borrowing.

Do you see any interest from institutional investors in the kind of unrated issuance FIIG has brought to market?
We have a good, commercially beneficial and two-way relationship with the institutional side of the market. We distribute a lot of paper for them – especially rated paper we acquire for our investor base.

We also have very strong hopes and desires that institutional investors will participate more actively in the unrated market. We have seen some good participation so far with a number of institutional investors being involved in the past three or four issues we have arranged. The number of participants and the size of their involvement is growing. The feedback from this sector about our activities is very positive and most are watching with interest.

Most institutional investors I speak to say they have a proportion of their fixed-income or equity funds available for unrated issuance – the number tends to be about 3 per cent. And they are looking for yield too, of course. That's not big enough scale for it to have a large impact yet, but we hope that as liquidity in the unrated market grows institutional participation will be normalised.

What about offshore investors? Do you market transactions into Asia – and is the potential pool of liquidity there required for this market?
I think it has to be, eventually. So far, FIIG's investor base has been more than adequate to fill the supply we have seen.

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We have more than 35 transactions in our pipeline. We take a steady approach to introducing them to our investor base – which is growing every day.

But as momentum builds I am sure we will want to tap into external distribution, both on- and offshore. The former is probably first on the list: we are looking to add distribution through such channels as private banks, stockbroking firms and other houses with a concentration of sophisticated investors with whom they have a trusted relationship.

We have conversations ongoing with a number of organisations which have relationships with private-client investors in Asia, too. Some of these client bases are expat-concentrated, where obviously there is a natural desire to hold Australian dollars. But a lot of the high net worth market in Asia is developing interest in the currency – often they are invested in AUD property and debt already.

As a deal arranger, what sort of due diligence does FIIG have to do on potential issuers, given the potential reputational risk around transactions from unrated – and sometimes unlisted – companies?

This is a very important factor in our strategy, given that 90 per cent of what we do is – and will continue to be – brokerage. Our reputation for research, investor education and opening up fixed-income markets to new investors is weighted around that core product offering.

We are very cognisant of the need for quality issuers with security around the income streams they need to generate to service and repay bond holders. In the unrated debt market we know the performance of the issuer through the life of the bond will have our name attached to it – particularly in the early stages of the development of this market, though perhaps less so down the track.

Our commitment to credit assessment at point of origination and our subsequent credit analysis – we have an independent research department which covers all the issuance we arrange – are important. The intention is to keep investors informed about developments in the credit quality of the issuer – good or bad.

What about the investor side? Presumably you know FIIG’s client base well, but when you look at intermediated distribution how do you make sure the investors who end up holding bonds are as sophisticated as they ought to be?

For starters, I do not believe that everything is fair game once an investor qualifies as sophisticated. I approach the importance of representing an investment to a potential investor with exactly the same standards whether they are wholesale-qualifying or not. Our brand risk is just as much at stake in either case.

It comes back to the need for ongoing research and monitoring of the underlying entity. We have a duty of care, to ensure the investors coming into these transactions are fully informed, well-educated and ideally have been though our investor education protocols. They also need to have a track record of diverse and sophisticated investments. They are not coming into these issues as the first things in fixed income they have ever bought.

If we are talking to another firm looking to add these assets to their platform, we look for the same protocols and level of understanding in those protocols.

The issuers FIIG brings to market also have bank relationships, of course. Why do you think the banks have not been more active in taking these companies to the capital markets?

It’s a very interesting question and one I’ve talked to many senior bankers about. There is a combination of factors, not least of which is that if a corporate has a stable and economically productive relationship with its banks there is not much pressure to change it. A good long-term relationship with a bank is gold, and neither side wants to damage it. The desire for diversity comes in when a firm is growing, needs longer tenor or doesn’t feel it is getting the best deal from a single supplier.

Another theory I’ve heard is that banks have a potential conflict of interest around the fact that, on the type of deals we arrange, they would be both the senior-secured lender to the issuer and responsible for distributing its second-ranking bonds through their wealth-management channels – without any type of ‘span breaker’. This would give them two positions to represent if they ever had to act as the senior lender.

The more paper issued in the market the better, so far as we are concerned. The main goal is to grow the corporate bond market for our clients. We don’t need to be manufacturing all the paper and indeed we would be perfectly content if we weren’t manufacturing 99 per cent of it, provided there was a consistently liquid and functional market. •