Bondholders – still the poor relations?

12th November, 2009

The Conundrum

When Boards review the lessons of the Credit Crunch, the handling of Debt investors has to be one clear area for improvement. Obvious next steps are:

- Recognizing the importance of stakeholders, other than shareholders,
- Taking a proactive approach to the Debt markets.

The benefits for the corporate are self evident:

- Making a difference to the cost of funds,
- Preserving the ability to issue further Debt.

So why do Boards continue to neglect this critical channel of capital market communication? Most quoted companies will have invested often substantially in establishing channels of communication with their shareholders – otherwise known as Investor Relations. But still today bondholders are treated very differently, which is surprising given the dislocation in the wholesale funding markets and the fact that bank lending is still showing a paltry recovery.

It is indeed much easier to identify shareholders than bondholders which in turn makes it possible to identify and focus on those equity investors who can make the greatest difference to the share price. Also quite obviously shareholders own the company. But bondholders can be critical to the health of the balance sheet. Particularly in the last 18 months, bondholders have also faced a much higher level of risk as issuers across several sectors have looked into the abyss of administration. Moreover, some bondholders also contribute to the capital base by investing in subordinated debt and hybrid capital instruments, and most importantly bondholders facilitate day-to-day business for the corporate. Given this, it is mystifying why the relationship requirements of Debt providers have been – and continue to be - so overlooked.

Indeed, there are two other aspects of the challenge to be borne in mind: firstly that in the current economic climate Debt is often harder to source (and retain) than equity; and secondly, while much
discredited, the rating agencies continue to have a far greater influence over the price of Debt than any individual investment bank analyst has over the share price.

As an aside it is also interesting to note that as a result of the Credit Crunch equity analysts have become much more attuned to the thinking of their Debt counterparts. In our White Paper “IR in turbulent times - the automotive market, 6th May 2009”, a leading sellside equity analyst describes “how all parties (in automotive IR) had had to learn a new vocabulary focussing on the balance sheet, debt, liquidity, funding and covenants.”

Is the status quo enough?

A common corporate response to these challenges is to combine funding and relationship responsibility for Debt investors in the Treasury function. A neat solution but is it enough? While this structure is common it can be very reactive. Nominating the Head of Funding to be the point of contact for Debt investors and to respond to investor queries when they arise arguably provides an adequate service. A proactive Debt communications function has a very different look and feel. Admittedly there is no clear template for the Board in structuring this role; all the lines (including the dotted ones) need to be joined up to avoid information black holes and to ensure consistency of message. A cursory look at the websites of FTSE-100 companies will almost always indicate a tab offering easy access to the IR pages, dominated by share price history and functionality for equity holders. How many websites provide the same ease of service for Debt investors? We would argue very few.

Such an oversight can be short-sighted and costly. Bondholders around the world have suffered substantial losses on what appeared to be safe bets, and so are now demanding clear and effective relationships, communications and disclosures from all issuers. This is a clear and consistent message from the Debt community, which issuers ignore at their peril. At best, investors will not be there for the issuer the next time funding is needed. At worst, investors may buy protection – in the form of Credit Default Swaps (CDS) - and so immediately adversely influence the company’s cost of funds, as bonds are now priced off the CDS spreads. These are real and present dangers for issuers, but ones which can be mitigated by observing some relatively straightforward principles.

A wealth of Debt stakeholders

The concept of Debt stakeholders is probably not high on the Board agenda. The table below makes clear that the Debt community in a broader sense is clearly a significant stakeholder in the business.
Of course there will be some overlap between the Debt and equity communities and some shareholders will also be bondholders. On occasion, analysts may cover both equity and Debt, but they would now be in the minority, as specialist Debt analysts have assumed an increasingly influential position in the markets over recent months, as have prominent journalists with a Debt Capital Markets background, such as Gillian Tett of the FT.

It is worth the Board’s while to dwell briefly on the complexity of the Debt capital markets. Moreover, whilst this article focuses on institutional holders of long and short-term paper, the universe of Debt investors clearly comprises retail bondholders, lenders and standby providers. It is therefore surely in the issuer’s interest to pay due attention to the various subgroups that form the Debt markets. Ignoring the constituent stakeholders presents the following risks:

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bondholder</td>
<td>Sell bonds; refuse next deal; buy protection</td>
</tr>
<tr>
<td>Rating Agency</td>
<td>Downgrade credit rating</td>
</tr>
<tr>
<td>Bond/CDS Trader</td>
<td>Make unfavourable market prices</td>
</tr>
<tr>
<td>Analyst/Media</td>
<td>Build adverse opinion</td>
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</table>
Substantive dangers

We would argue the risks for any issuer who takes a reactive stance in dealing with the Debt market are considerable, as set out on the previous page.

In essence for a company with borrowings, the Board risks a higher cost of funding by neglecting Debt communications. Many Boards will recall the dreadful months of later 2008 when the Debt market turned very ugly; given the interconnected nature of this market and the speed with which distress spreads, we remain surprised that many Boards have not deemed it necessary to provide a dedicated relationship service to the Debt market. Many companies have not subjected their equity IR teams to significant cost cutting recognising the importance of good shareholder relations in times of crisis; given the problems within the Debt markets during the Credit Crunch we are surprised that the Debt providers are not treated with a similar deference.

Personal experience

During his tenure as Head of Debt IR for the Kaupthing Bank Group Brian Donnelly was in a unique position to observe the impact of Debt communications at first hand. It is tempting to conclude that this dedicated Debt function was peculiarly relevant for such a credit-challenged entity, but we would argue that any company with significant borrowings would be wise to provide such a service. Kaupthing supported, indeed helped to evolve, the concept of Debt stakeholder management outlined above and more importantly also saw clear advantages from its pro-active approach. Bondholders remained loyal and positive effects were seen in market-trading levels which could be traced directly to specific programmes and events carried out for Debt practitioners. Kaupthing was known in the markets as being pro-active in the discipline and the team was fully committed to Debt IR, rather than carrying out this function in parallel to other execution roles. Brian Donnelly would argue forcefully that putting a 100+ year-old UK bank into administration, using a law designed as an anti-terrorism measure and thereby bringing down the whole Group, in no way invalidates Debt communications.

Standing up and being counted

Indeed we are now seeing other market participants are demonstrating the need for professional and dedicated Debt communications. For example, both RBS and Lloyds, arguably now amongst the safest credits given the obvious consideration of part-government ownership, have appointed a full-time Head of Debt IR in the last few months. In each case, this was a new role, reporting to the Head of IR, testament to how both banks view their relationships with the Debt markets.

Traditionally fixed income investors have felt that major UK issuers could do more in terms of disclosure and indeed willingness to disclose. A major investor cites a conference call held in the thick of the credit crunch where the Treasurer of a FTSE-100 company “clearly didn’t want to be on the call, nor felt they needed to make a call at all”. Indeed, it behoves Boards to remember the market truism that you source Debt when you don’t need it, because if you wait until you do, it either won’t be there, or the price will have moved dramatically as others may well be in the market.
too. The Credit Crunch is the starkest example of this phenomenon. We would argue that a structured programme of communication with the Debt market is one very simple but effective mechanism that Boards can adopt to best ensure an ongoing ability to borrow. Not least Debt communications keeps all channels open for the moment when the company might indeed decide to go to the market early. The same leading UK Debt investor commented, “Having a dedicated point of contact for the Debt world makes a real difference, and it differentiates issuers. I am more inclined to deal with them and, subject to credit, more likely to recommend them to my Portfolio Manager.”

**Corporates, too**

While the debate on Debt communications tends to revolve around financial institutions for obvious reasons, other sectors are also heavily dependent on the Debt markets. Certainly the cheapness and availability of Debt before the Credit Crunch saddled many companies with what subsequently became a very high burden of Debt to service. There are also companies which are structurally exposed to the Debt markets. One thinks here of the captive finance providers of the car manufacturers. The equity market feared these subsidiaries could expose the industrial parent to banking risk, in particular the lease books of certain luxury manufacturers and of course the enormous securitisation operation represented by GMAC. Several of the OEMs had however been ahead of the banks in establishing Debt IR programmes and the European manufacturers are certainly playing a role in nursing the ABS markets back to some weak approximation of health.

Within the FTSE we are seeing an awakening to the value of Debt communications as more companies appoint dedicated teams or individuals such as BAA. And just recently, the Director of Treasury of a FTSE-100 company laid out as one of his priorities for 2010 the goal of “developing better relationships with my Debt investors, and engaging with them effectively”.

**Recruitment freezes**

In today’s environment one consideration in establishing a Debt communications programme is resource and headcount. Debt communications is not yet perceived as a necessity in the way that equity IR is for quoted companies. We would argue that for the reasons set out above companies that have a borrowing requirement also have a Debt communications requirement. Our most recent White Paper “Shareholder retention, 7th September 2009” considered how Boards often devote greater effort to acquiring shareholders than retaining them. It is also true of Debt investors – the cost of retention is far outweighed by the cost of acquisition. As such we question why more effort is not expended keeping existing bondholders on board. If an investor has taken a risk by investing their own or client funds in the company’s paper, that investor has identified value. The first step has been taken. To retain the investor, the issuer needs to be aware of the holding, acknowledge it and then develop a relationship built upon communication. Loyalty seldom develops in an information vacuum. While a healthy secondary market is an important aspect of liquidity, if there is too great a turnover in its Debt, the Board has little stability in its investor base and in its cost of funding, and it becomes increasingly difficult to influence supply and demand curves. Architecting the investor
base, another theme from our latest White Paper, also very importantly extends to Debt. Knowing who is holding the corporate Debt and building a base of Debt holders who know and like the company and its management is a crucial part of building a stable capital structure as the basis for strategy implementation. This process goes hand in hand with the process of architecting the shareholder base.

**Who are our bondholders?**

It has to be admitted that the process of discovery is much more challenging with bondholders than shareholders. There is no public register available. We would argue this is a reason to redouble Debt IR efforts, not to give up. Good record keeping and banking relationships provide practical ways of creating and maintaining a database and, by applying the 80/20 rule, a good portion of the investor base can be readily identified and easily updated. In parallel a little bondholder acquisition can also be done, acquainting investors with the corporate and funding story before funds are needed. It is easier to have investors understand the business and credit, and maybe even put lines in place, in advance than to wait for the next deal. One could argue all this is an investment banking function. While the banks clearly have a role to play, there is so much the corporate can do to build its own profile in the markets. We would argue that relying on intermediaries is a wasted opportunity if not a risk. The Board has a responsibility to oversee the health of the balance sheet and capital structure. In this context the Board should be concerned about corporate positioning in the Debt market and ensuring that the company is doing all it can at an early stage to improve the cost of funds.

**Getting out and about**

In the Debt markets it used to be thought that a “non-deal roadshow” was a euphemism, an indication that a deal was coming soon, or that something was wrong. Today sophisticated issuers devote management time to keeping existing investors up-to-date and educating prospective investors who are not yet familiar with the corporate story. Engaging proactively with the Debt markets is part of the process of bondholder retention and acquisition, and feeds into corporate image and reputation.

We would argue that a proactive approach to Debt communications should not be limited to the bondholder community. Analysts, traders and the media are also a key influence on investor sentiment. We have also noted that with institutional funding drying up, many companies, including multinationals, developed a keener interest in retail funding be it through equity holdings, deposits or Debt.

And no discussion of Debt IR would be complete without a reference to the Rating Agencies. Much ink has been spilled here and whatever view one takes on the contribution of the agencies to the mispricing of risk, they remain an important part of the risk discovery process. It absolutely makes sense to engage with the agencies but we also suggest that issuers keep eyes and ears open regarding newcomers to this market. And indeed we expect investors themselves to devote more
time to analysing credit risk. All this places additional pressure on the in house team but equally represents a chance for the issuer to inform the analytical process.

As indicated we see this Debt communications programme as an ongoing process not a one-off exercise. We recommend that the Board focuses on relationship building skills when recruiting for this role. Analytical skills are a given but Debt communications is now where equity IR was 10 years ago or so and there is an entrepreneurial element involved in charting this new field. Equally, Debt communications is also about marketing. Competition for capital and refinancing is intense and will by all forecasts continue to be so over the next 2 to 3 years. The company that can differentiate and articulate its investment case to the Debt community enjoys a head start.

**Conclusion**

It used to be the case that the investment decisions of bond investors would be fairly predictable; not any more. Now, some ignore external credit ratings, some shun certain industries or geographies, and some steer clear of names who have not called bonds on call dates. Boards need to be aware of all these limitations – and of the risks of passivity.

We advocate that Boards take matters into their own hands. If Boards want to retain bondholders, keep the cost of funds down, ensure a steady flow of investors for the future, and engage in a meaningful dialogue with the market, it is possible to do so. An effective Debt communications programme offers companies the opportunity to put forward a differentiated investment case and to develop supportive relationships. Whether building from scratch or working with the existing team, we suggest that Boards should ensure that Debt stakeholders receive professional service focused on timely provision of data, clear articulation of the investment case and cementing of the relationship. We would argue that the Board has an obligation to consider the tool of Debt communications as it seeks to secure the balance sheet and funding in the years to come.