THE UK MARKET FOR HIGH-YIELD DEBT

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There has been an active market in high-yield bonds ("junk" bonds) in the US for some years. Yet, in spite of apparent attractions to UK issuers, there is no effective market in the UK. This article looks at the role which high-yield debt can play and examines the development of the sterling market.

There has been an active market in the US for high-yield bonds — sometimes referred to as "junk" bonds — for some years. These are sub-investment grade bonds which have a credit rating below Standard and Poor's BBB- rating or below Moody's Baa3 rating. The bonds offer investors the chance of a higher prospective return than less risky investment grade bonds. Most are issued by US companies in the US market and are held by American investors.

Total issuance in the US market was about $60bn in 1996 — a typical issue is about $100m to $150m in size, has an intermediate seniority ranking, and a maturity of about seven years. Spreads over US Treasury bonds — in effect, the additional return offered in exchange for the added risk — ranged from 150 basis points for BB+ rated issues to nearly 500 bp for B- rated issues.

In the UK, as in the rest of Europe, bonds of this type are rare: according to one estimate, total sterling high-yield issuance was £425m in 1995 and £745m in 1996 — all of which were unrated (see Table 1).

However, the UK and other European companies have issued in the US. Such "Yankee" high-yield issuance by European based companies amounted to about $3bn in 1996 and, since 1993, the market has been used extensively by media, cable communications and telecommunications companies (see Chart 1).

Swapping the proceeds of a US dollar issue into the borrower's domestic currency can be costly, so this recourse to a foreign market suggests strongly that there are deficiencies in the UK market. Certainly most UK companies which have issued in the US agree that a sterling issue in the UK, were it possible, would have been preferable. Indeed, the lack of an effective UK market may be restricting UK firms' access to capital.

The implication — that there may be benefits to be gained from a deeper and more active sterling high-yield market attractive to UK investors — prompts the search for explanations as to why it does not yet exist. This article examines the question from the issuer and investor perspectives, and assesses various factors which have been suggested as potential obstacles to the sterling market's development.

The issuer perspective

High-yield debt is typically of long maturity, unsecured (or less well secured than typical bank loans) with more flexible — generally non-financial — covenants and is repaid in full on maturity, rather than amortised over its life. So it

Table 1 **UK STERLING HIGH YIELD ISSUES 1995–97**

Issuer	Date	Amount	Maturity	Coupon	Initial spread over Gilts
Eco-Bat Technologies	20/06/97	£65 m	2007	9.125%	200 bp
Castle Transmission	14/05/97	£125 m	2007	9.000%	195 bp
CGL Rail	15/10/96	£165 m	2012	9.375%	130 bp
Fitzwilton Finance (UK)	11/09/96	£80 m	2006	9.750%	175 bp
Daily Mail & General Trust	14/03/96	£100 m	2021	10.00%	145 bp
First Hydro Finance	05/01/96	£400 m	2021	9.000%	115 bp
Computacenter	21/11/95	£50 m	2002	10.000%	225 bp
Independent Newspapers	16/06/95	£75 m	2005	9.250%	125 bp
Slough Estates	11/04/95	£100 m	2017	10.000%	160 bp
DeBeers Centenary	06/03/95	£100 m	2020	9.750%	165 bp
Daily Mail & General Trust	25/01/95	£100 m	2005	9.750%	76 bp

Source: Bankers Trust **NB: All issues were unrated**

affords financing of a kind and with a cash-flow profile not readily available from other sources and is likely for that reason to be attractive to a range of issuers. On the basis of US — and limited UK — experience, these include:

- *High-growth (perhaps high- tech) mid-sized companies*: these firms often have limited security to offer and limited or negative current cash flow, so high-yield debt may provide a more ready source of development capital for them than banks.

  Such paper is unlikely to be useful to smaller companies and start-ups because the issuance of bonds can be complex and costly. The consensus among issuers and intermediaries in the US is that issues should be at least $50m, although the preferred size would be more than $100m. However, the financial management of middle-market UK firms is becoming increasingly sophisticated and such firms now want to use more flexible financial instruments, such as bonds, which were previously available only to larger corporates.
- *Large management buy-outs*: for similar reasons, high-yield bonds are likely only to be attractive for larger buy-outs — but these are accounting for an increasing proportion of the MBO market.
- *Mergers and Acquisitions*: M&As have been a major application of high-yield debt in the US and could play a similar role in the UK. Gearing in UK mergers and acquisitions tends, however, to be lower than in the US.
- *Project finance and the PFI (Private Finance Initiative)*: projects often show negative cash flows and offer little security in their initial phases. In PFI projects to date, contractors have supplied much of the equity, but there is a limit to how much their balance sheets can bear and a small number have tapped the bond markets. The PFI may eventually become a source of higher yielding bonds.

There is, however, a price to pay by issuers for the advantages of high-yield bonds over more conventional sources of funding: they can be expensive. They are usually unsecured and subordinated to bank debt, so they typically have an interest rate at least 100 bp higher than bank debt for a given issuer. Issuance costs are also relatively high. Investment bank fees are typically 3 to 4.5 per cent, and legal fees and other administrative costs can add another 80bp — so they are not a cheap substitute for bank debt.

Also, US experience suggests that issuance can be an uncertain process. This is partly because, in the US at least, legally binding underwriting is not commonly available. But it is also apparent that investor appetite for paper can change quickly. Several UK issuers in the US market have suddenly found themselves unable to place issues on the terms they expected, having incurred substantial issue costs. Zero coupon bonds are especially susceptible to such problems.

The investor perspective

High-yield debt is essentially a wholesale market instrument, so it is principally aimed at institutional investors. There are very substantial pools of funds which could therefore be invested in such paper in the UK: institutional assets in the UK exceeded £1.3 trillion at the end of 1996 — 20 per cent of which were bonds (including gilts, foreign government bonds and corporate bonds). Chart 2 shows the bond holdings by different classes of financial institutions in the UK.

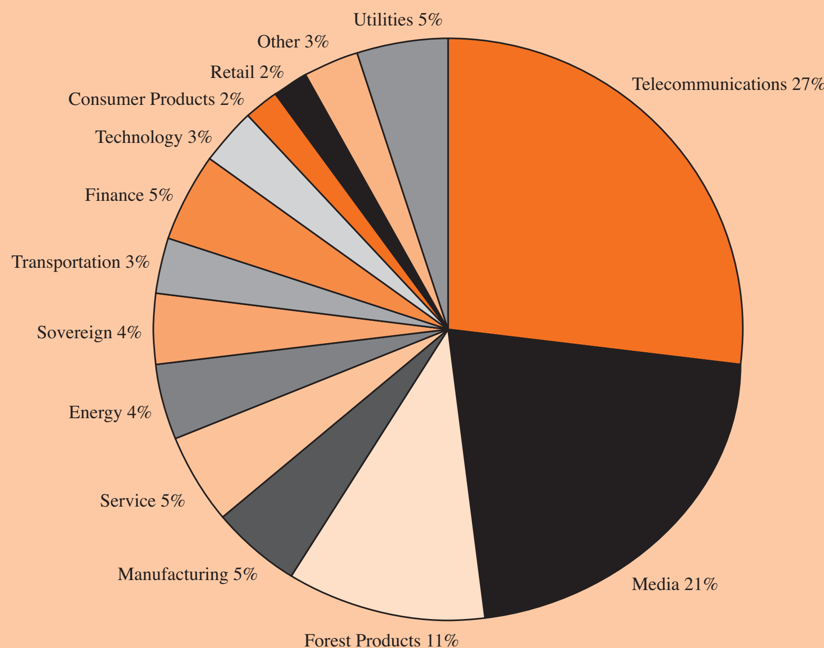
UK investors have so far shown little appetite for high-yield debt. There seem to be two kinds of potential obstacles: investors' ability and willingness to evaluate and then manage them; and restrictions — administrative or statutory — on investment powers.

Evaluation and realisation

For most UK institutional investors, the key portfolio decision is between high returns and capital growth, for which they look to equities, and certainty of returns, for which they typically rely on investment-grade debt. As a result, UK fund managers generally have little expertise in assessing the credit of corporate bonds.

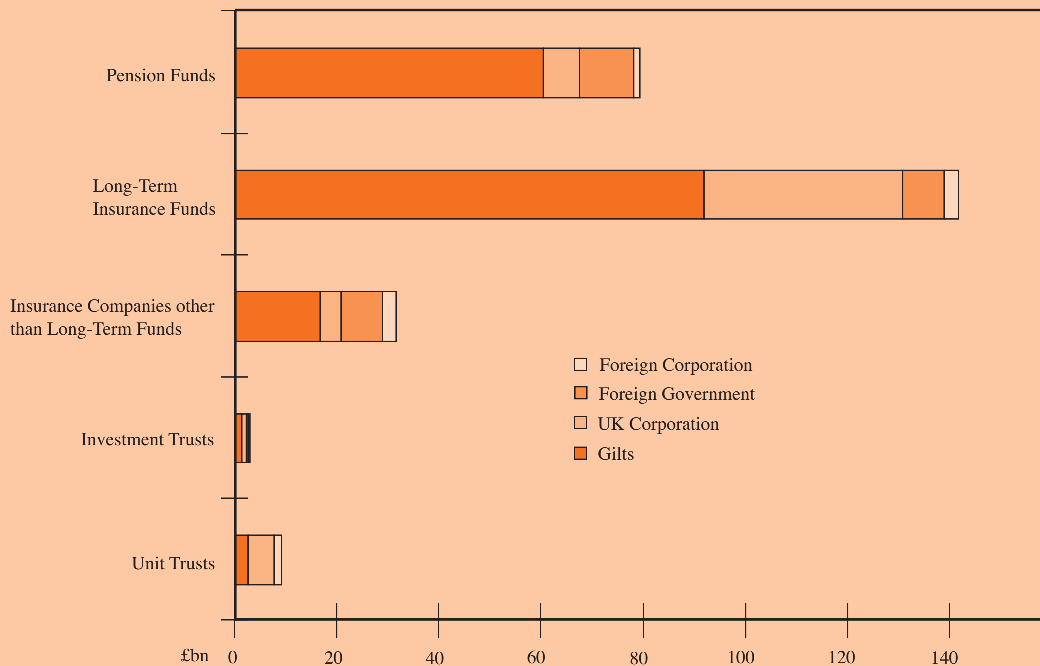
The decision to invest in equities will be underpinned by extensive research into company performance and prospects, but there is little perceived need, and therefore no established expertise, to undertake a detailed evaluation of the likelihood and cost of issuer default. The lack of a significant high-yield debt market in the UK is itself a deterrent to investment in it, as it limits the scope for benefiting from credit assessment expertise.

Chart 1 1996 NEW ISSUE ACTIVITY IN THE YANKEE HIGH-YIELD BOND MARKET



Source: SBC Warburg

Chart 2 **BOND HOLDINGS BY DIFFERENT INSTITUTIONS**



Source: Financial Statistics

UK investors' attitudes are, in part at least, a product of the market environment here, but they could change if the incentive were sufficient.

Prudent investment in high-yield debt requires a careful review of the debt-servicing capacity of the issuer, a thorough understanding of the ranking, the likely treatment of the debt in an insolvency and an assessment of the recovery potential in the event of issuer default. This is because a significant factor in obtaining attractive *ex-post* returns is not just the high coupon payments but also the investors' ability to recover value in workouts. This can call for expertise rarely required of either the equity investor or (because default is a remote event) the holder of investment grade debt. An active post-default secondary market can, at least to some extent, substitute for workout expertise, as it provides a mechanism whereby defaulted debt can be transferred to those willing and able to engage in the workout process. But there is still a need for expert participation, if the exit route provided by such a secondary market is to exist at all and to give assurance that it will reliably deliver fair value.

Investment powers

The other key aspect from the institutional investor's perspective is their formal capacity to invest in sub-investment grade paper. Many institutional investors in the UK are constrained in this respect. For example, many managers of pension funds lack trustee approval to invest in such assets: trustees tend not to allow investment outside the mainstream of domestic and overseas equities, investment grade bonds and property. There is, however, no statutory obstacle to them doing so.

Many pension fund managers are allowed to invest in the equity of companies whose high-yield debt they would be unable to hold, even though equity is riskier than debt. This suggests that, if trustees were more familiar with the instrument and satisfied that fund managers had the capacity to realise its potential returns, this constraint on investment could be relaxed.

A significant number of unit trusts, unit-linked insurance funds and investment trusts are also constrained from investing in high-yield debt.

In these cases, the restriction originates from their fund description and is presumably the result of the actual or perceived lack of interest among the retail investors at whom the funds are targeted.

Some unit trusts do undertake such investment: in particular, the "UK gilt and fixed interest" sector invests in corporate bonds and some of these may be high-yield. However, many of these funds are marketed as low-risk vehicles and as such they do not invest heavily in high-yield paper.

Life funds seem to be unrestricted in their choice of investments: they are of course subject to solvency tests by the DTI, but these seem neutral between investment grade and other debt securities. Directors usually set broad guidelines as to the maximum that may be invested by a fund in particular credit quality ranges. It appears, though, that these limits are rarely reached.

Structural impediments

A range of structural factors have been cited as obstacles to the development of this market, perhaps because they are respects in which the UK and US environments differ. The most common factors cited include differences in issuance regulations, insolvency procedures and tax regulations.

Regulations on issuance

In the UK, the framework for securities issuance does not differentiate between the treatment of high-yield debt securities and that of other debt securities: any issuer of debt securities must comply with the Banking Act 1987 as well as with the general law on prospectuses, listing and advertising. The Banking Act can restrict issuance if this involves the acceptance of deposits as defined in the Act. But even here the Exempt Transaction Regulations 1997, allow a wide range of corporate debt issues to take place without the issuer contravening the Banking Act.

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Companies proposing to issue debt securities may also have to consider the Bank's guidelines on the lead management of sterling capital market issues. Firms which are incorporated elsewhere in the EEA may lead manage such issues if permitted to do so by their home supervisors, either in their home country or elsewhere in the EEA if this is allowed under the passport. Firms incorporated in the UK or outside the EEA may also lead manage issues in London if they have satisfied the Bank of England as to their competence and experience.

Tax issues

There are significant structural differences between the US and UK tax systems which may affect the servicing costs of debt and equity, and so contribute to the success of the US high-yield market. The fact that in both countries the return on debt (whether interest or discount) is deductible from corporation tax profits, whereas dividends are not, gives debt finance an advantage over equity — encouraging higher gearing. Nonetheless, the UK system, unlike that in the US, partially imputes corporation tax to shareholders and makes an indexation allowance for capital gains on equities. So (until the recent Budget restricted dividend tax credits) the UK system provided more flexibility and created less incentive for issuers to prefer debt over equity finance.

When a UK company does decide to raise debt, its interest costs tend to be lower when borrowing from a UK bank than when issuing domestic debt securities. This is because interest can be paid gross to a bank — avoiding the need to deduct withholding tax from interest payments and remit it to the tax authorities. Since withholding tax does not apply to the discount securities, however, there is an incentive to issue zero coupons instead of interest bearing debt, if there is investor demand for it.

However, despite these differences, the general opinion among issuers and investors seems to be that the UK tax regime has not in practice presented an obstacle to high-yield issuance.

Insolvency

Of potentially greater significance, given the default risk associated with high-yield debt and the importance of recovery rates, is the effect of insolvency law and informal procedures for restructuring the capital base of a company in financial difficulty. It has been argued that UK insolvency law provides a disincentive to high-yield issuance compared with the US, because it gives less power to unsecured creditors to influence the outcome of an insolvency.

Most issues of high-yield debt are unsecured or secured by a second charge over certain of a borrower's assets. In the event of a borrower becoming insolvent, holders of high-yield debt will rank behind preferred creditors (such as tax authorities and employees) and secured creditors (usually banks) for repayment. Secured lenders are afforded greater privileges in Administrative Receivership than in Chapter 11 (respectively the most commonly used frameworks for corporate insolvency in the UK and the US). Receivership allows a secured creditor to appoint a receiver to recover his loans by realising his security. The courts are not involved in the appointment.

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Chapter 11, by contrast, is initiated by an application to the US bankruptcy court by an interested party, such as a creditor, a shareholder or a director of a business in financial trouble. Its objective is to try to find terms to preserve a business that are acceptable to a majority of creditors. Chapter 11 also gives explicit rights to any interested party to be consulted and to appeal to the courts should they believe that their interests are being overridden.

Differences between US and UK insolvency procedures may not, however, be as marked in practice as they would appear on paper. Most receivers make every reasonable effort to preserve the business, and this frequently involves negotiating with different classes of creditor to gather their views about participating in a financial reconstruction.

However, the ranking of different types of creditor is much the same in both countries: security rights, in particular, are respected. But there is a greater difference between the rankings of different creditors' claims in the Anglo-Saxon countries and in continental Europe where obligations to employees are given relatively more weight.

A further practical issue is the liquidity of high-yield debt that is in default. There is an active secondary market in distressed debt in the US which enables holders of defaulted high-yield bonds to realise their value and thereby transfer responsibility for deciding the terms of a capital restructuring to specialist intermediaries.

A market in distressed debt has emerged in the UK in the past five

years, and it has played a role in a number of recent extra-statutory workouts for companies which had encountered financial problems. But some argue that information is typically not as widely available in UK workouts as is in the US, because much of the negotiation takes place between a company's bankers. To the extent that that is true, it will tend to obstruct reliable price formation in the secondary market, and so lower its liquidity.

Outlook for the UK

A number of factors are working to change UK investor attitudes to credit risk, which could provide impetus to the high-yield market here. It is often remarked that low interest rates prompt the search for higher yields. The prospect of a prolonged period of low inflation may increase institutions' appetite for credit exposure as a source of higher returns.

Similarly, EMU may stimulate investor demand: it will remove opportunities to earn returns through exposure to currency risk; and a consolidated Euro market would provide greater scope to diversify credit risk. It might also create greater secondary market liquidity.

Separately, maturing pension funds are widely expected to increase their bond holdings. Also various legislative changes, such as the Pensions Act which came into force in April 1997, contain a number of features that could impact upon the investment strategy of pension funds. Though on balance these tend to favour bond investment generally rather than high-yield instruments in particular, there could nevertheless be benefits to the high-yield market. Similarly, the abolition of repayable tax credits announced in the Budget is likely to favour investment in bonds by pension funds.

Of course, the high-yield market by its very nature brings risks as well as benefits. Issues may, for example, be mis-priced so *ex-ante* spreads do not compensate investors for the default risk they are taking. This could be exacerbated in the early stages of the market by low liquidity. Certainly, issuing houses and investors in this paper would need to develop the credit skills to price and assess this type of security properly.

So there are potential risks to financial intermediaries both in holding high-yield bonds and in underwriting them — either at issue or (by committing to provide liquidity to the market) in the secondary market. If the secondary market does not function efficiently, it may be difficult to value holdings of this kind of paper — or to assess the mark-down which might be associated with a rapid sale.

Nevertheless, high-yield debt would plainly add to the range of financing options available to UK companies and, if such a market can develop here, it would eliminate the hedging costs and other uncertainties created by issuing such paper in the US market — where UK companies inevitably also suffer from poorer name recognition.

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