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Bondholder engagement is already happening. Like it or not!

4-12-2015

For many companies, establishing an ongoing dialogue with their investors has historically been related to equity holdings. Pia Gowland, Head of Fixed Income Advisory at Sodali, explains why establishing a fluent communication with fixed income investors has been progressively important and describes the challenges of communicating with such investors.

Companies around the globe have increasingly been accessing the bonds markets as an important source of financing, especially non-financial organisations. As recently published by the OECD[1], from an annual average of USD 730 billion before the 2008 financial crisis, non-financial companies have raised USD 1.6 trillion in 2013. This increase also translates in the number of such companies that use primary bond markets: from about 1,250 before the crisis to over 2,500 today. Factors influencing this rise include the decrease in bank lending and the historic low levels of bond interest rates.

The need of many public companies having to communicate its story not only to its shareholders but also to its fixed income investors is therefore an increasing trend.

The role of bondholders in corporate governance has grown. There is a recent tendency of aggressive interpretation of established bond covenants. "This kind of bondholder activism is typically carried out by hedge funds who engage specialists to identify actual or potential covenant defaults, file a default notice even upon a minor covenant violation and then negotiate a consent payment or more favourable bond terms"[2]. Such engagement proves that certain bondholders are not limiting their interaction with companies in times of crisis when a debt restructuring is required, but are actively engaged in corporate governance. The need of companies to effectively enforce bondholders' rights should therefore be a priority.

In addition, empirical evidence has proved that firms with **strong corporate governance benefit from higher credit ratings** to firms with weak governance practices,[3] and this translates into lower debt financing costs.

The initiative for dialogue coming from fixed income ESG teams is also growing. Following Sodali's recent discussions with traditional long-term investors managing approximately 2 trillion US dollars, the increased number of ESG focused teams and how they favour bond issuers who perform better on ESG disclosure and climate change resilience is evident, with a few exceptions. Fixed income fund managers now frequently integrate ESG teams input to assess the long term attractiveness of a company's debt, understand the company's ESG challenges and discuss non-financial practices that could impact the short and long-term bondholder returns. This shift in strategy provides additional understanding of the subtleties of the operating context and risks; hence, investors are better placed to make informed investment decisions and where necessary, seek change that will protect and enhance the value of investments. Investors holding minimal equity position will now frequently review the sizeable value of debt and if significant, this will result in a request for dialogue to discuss ESG related issues.

It is on the best interest of companies to engage with existing fixed income investors as well since such could be targeted for future issuances. If investors are satisfied with the solvency of the company and there is an ongoing dialogue between bond issuers and their fixed income investors, the need of the company of having to market each bond individually decreases and the cost of debt could also be lowered. This is particularly important for companies that issue new debt on a regular basis.

[1] [2]Serdar Celik et al, "Corporate Bonds, Bondholders and Corporate Governance", OECD Corporate Governance Working Papers No.16, 2015

[3] Collins et al, "The Effects of Corporate Governance on Firms' Credit Ratings", University of Wisconsin, University of Iowa and MIT, 2006 revised

In certain situations, as long as organisations that have issued public debt can comply with their interest and principal repayment commitments, they may decide to have a distant relationship with their bondholders. However, **once a company starts to face financial difficulties and needs the proactive participation of its fixed income investors**, this distant relationship needs to change quickly. Arguably, one of the toughest challenges for the company and their legal and financial advisors is to negotiate with the different kind of creditors. In particular with bondholders who need to be handled carefully during the restructuring in order for them to act favourably towards the company and guarantee the financial viability of the organisation when in crisis. The working group is required to communicate and negotiate with bondholders that could be spread worldwide.

Bondholder intelligence can serve both strategic and operational purposes in such distressed situations, but also in non-distressed liability management transactions or consent solicitations.

Retail and institutional investors might have different needs and requirements. Bondholder research will aid in the development of a core strategy for the transaction, helping the working group to understand the requirements of the investor population.

A bondholder identification can also assist the legal team to construct documents which are responsive to the circumstances of the investor base. The domicile of the bondholders and the capacity in which they hold their bonds affects the type of offer that an issuer can make. If required, the legal team can get the operation approved by the relevant regulatory entity from where the investors are located, as long as they know where the bondholders reside.

Financial advisors can communicate with investors in advance of the launch of a transaction if they know who they are and where to reach them. They can check potential participation in the proposed transaction and make sure, prior to its official launch, that it will obtain the threshold needed for the approval of an initiative or reach the desired target. An identification of bondholders will also aid the prompt delivery of the offer into all of the correct hands at the earliest possible moment. Furthermore, a bondholder report will help the issuer and its advisors to match incoming tenders or votes with actual investors. This will permit follow-up with investors who have not yet responded.

Identifying and communicating with bondholders to comply with regulatory obligations is also required for bond issuers located in certain jurisdictions. These obligations may include reporting the identity and location of investors to local tax authorities or may be required to deregister and suspend reporting obligations to the local securities regulators. Such process is common practice for companies aiming to de-register with the U.S. SEC, for example

Challenges of identifying and communicating with fixed income investors

Do bond issuers know who their bondholders are? In general, they do not. Publicly available bondholder information only provides a small portion of bondholders' identities and it is often outdated. The Trustee, that represents the interests of all bondholders, is not able to provide bond issuers with a bondholders list either. Even if a company has a list of investors who initially bought their securities, the majority of the trading takes place during the first few days after the issue.

The challenges of identifying investors are numerous. There is no regulatory requirement for fixed income investors to disclose their identities or holding amounts. In addition, the "gap" that separates bond issuers with their beneficial investors can be broad. The chain of ownership starts with custodian banks holding the bonds and could be followed by several intermediaries before reaching the ultimate beneficial owner of the bonds

Market trends and investor sentiment suggests Companies should proactively engage bond holders with a 'long-term engagement' philosophy. An Agent that specialises in identifying and communicating with bondholders can be crucial. A more continuous dialogue and relationship between debt IR and fixed income investors can help companies to better manage their risks and opportunities, understand the key performance indicators investor measure and allay investors' concerns during unexpected situations they may face in the future.