CORPORATE DEBT AS A YIELD PLAY

South Africa's corporate bond market is coming to life. A combination of investor appetite for higher-yield instruments and regulatory disincentives for banks to commit to long-term lending is driving companies to raise billions directly.

BY ERIKA VAN DER MERWE

PROPERTY COMPANY Vukile raised R1,2bn in debt this month with hardly a flicker of interest from the media. The significance of its debut on the listed South African bond market was not lost on the investment community, though, with 14 institutional investors clamouring to buy nearly double the value of debt on offer.

Vukile's arrival on the corporate debt scene seems well timed and follows hot on the heels of public debt issuances by peers **Growthpoint**, **Redefine** and **Resilient**.

About a decade old, the illiquid and still-undersized market for corporate debt in SA might finally be showing some sparkle. Within the next five years this may develop a more discernible radiance. More companies see value in dumping bank borrowing in favour of issuing longer-term debt via the JSE-owned platform, and investors are being pushed and pulled towards the asset class by the growing diversity of paper as well as regulatory change.

Individuals can expect to see more of these listed private debt instruments in their retirement and unit trust portfolios, which today are packed with government- and parastatal-issued debt.

Although the South African corporate bond market has grown exponentially in recent years, it remains starved of choice and liquidity. It does not help that the big money – institutional investors – is uncomfortable buying debt rated anything other than investment grade. The consequence is that pension funds, provident funds, life assurers and unit trust funds snap up any new bond issuance with a good credit rating.

"Following the sub-prime and subsequent financial crisis I have some sympathy for this deep conservatism amongst investors," says Konrad Reuss, managing director for South Africa at the ratings agency Standard & Poor's. "But it has meant that debt without an investment grade rating, and even debt with a BBB-rating – the lowest investment-grade rating – has struggled to get access to the market."

This is quite unlike the status quo in the US and Europe where the corporate debt market is vastly diversified, thoroughly understood and highly liquid. As a result, investors there are comfortable holding debt with less than an investment grade rating – so-called high-yield debt or junk bonds. While about two-thirds of companies included in the S&P500 equity index have investment-grade status for their debt, Reuss estimates that the average debt rating in the US is probably in the region of single B, which is firmly in the speculative zone. The European average is BB-, he says.

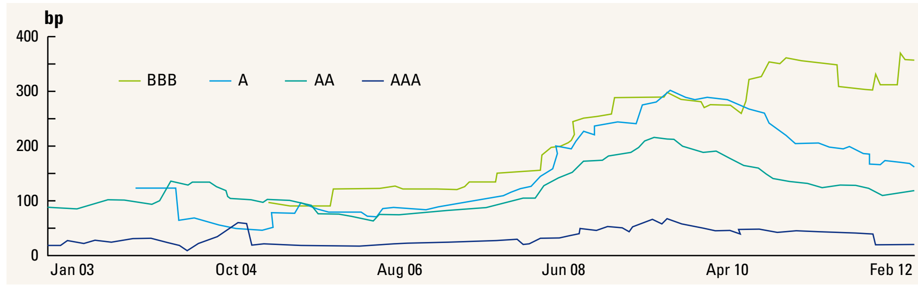
UPS AND DOWNS IN THE MARKET

Panic selling hit these liquid markets hard during the financial crisis. As investors fled, corporate bond yields – the return the buyer receives for owning the bond – shot up. This represents a bear market for bonds as the price paid for the bonds declines when yields increase.

> *"These developments could create a virtuous cycle that propels the South African corporate debt market towards greater liquidity and diversity"*

Although corporate yields are always higher than yields on sovereign debt, reflecting a higher default risk compared with tax-backed government borrowing, this gap opened up dramatically. With secondary trade in South African corporate debt almost non-existent – most investors buy and hold until redemption – the effect was more muted, although higher yields were factored in at the point of issuance.

SA CREDIT SPREAD PER RATING BAND



Source: RMB, Investec Asset Management

The subsequent recovery in sentiment and a search for yield in a low-interest-rate world have driven global debt yields lower and compressed the spread between corporate and sovereign debt yields. In SA this spread over yields on government debt now ranges from 1% to more than 3%, depending on the quality of the company: the more creditworthy the company issuing the debt, the cheaper the rate at which it can do so.

While some fund managers argue that narrower yield spreads imply that South African corporate debt is now on the expensive side, others continue to see opportunity. For many fund managers, this spread remains a sought-after performance sweetener and keeps investors willing and ready to participate in new issuances.

In fact, says Simon Howie, who is head of credit for South Africa and frontier markets at Investec Asset Management, participation in the corporate debt market is the key to outperformance within fixed-income fund management. "In the current environment the South African sovereign and parastatal debt market is largely flow driven, in the sense that yields are highly correlated with what big international investors are doing in our market. These flows are difficult to anticipate, which makes it tough to outperform the benchmark through inflation forecasting and active management."

What's more, Howie says, viewed relative to what investors are getting from sovereign debt, credit spreads in the South African corporate debt market are still at historic highs. A decade ago investors could get an average 2% spread while sovereigns were yielding 14%. Today the same average corporate debt spread is available, but sovereign debt now yields between 6% and 8%.

RISK-REWARD INTERPLAY

In financial jargon, it means corporate debt offers a healthy interplay of risk and reward: despite its higher relative default risk, this corner of the debt market compensates the investor commensurately with higher returns.

Francois van Wyk, chief investment officer at Cadiz Asset Management, argues that in a portfolio context the compensation can be more than commensurate. "We have modelled a few scenarios and find that the addition of corporate debt to a fixed-income portfolio made up of sovereign debt gives the virtuous result of better returns and a lower volatility of those returns."

With all this appetite for their debt, why are so few companies testing the waters? The South African bond market has issuances totalling about R1,4-trillion, according to Brian Vambe at Marriott. "Nearly three-quarters of this is sovereign debt, a further 16% is parastatal issues and only a fifth comes from the private sector. Banks have always dominated the private issuance of debt and accounted for more than three-quarters of total private debt in issue by the end of last year. The insurance sector (5%), industrials (5%), telecommunications companies (5%) and the motor industry (4%) make up most of the remainder of private-sector debt issues."

"The oversubscription on new issuances confirms that supply of corporate bonds does not meet prevailing demand. One reason for this is that corporate South Africa has been conservative with its use of cash and therefore has had limited need for capital. Over the past two years we have seen a 20% increase in corporate deposits held with banks," Vambe says.

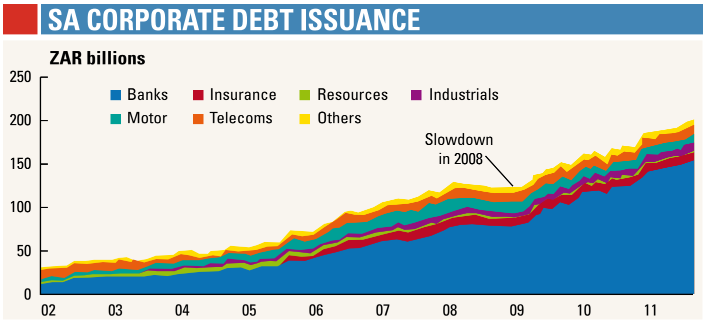
Barry Martin, co-head of debt capital markets at RMB, says this cautious balance sheet management from corporations – rational behaviour given financial and economic uncertainty – has limited new issuances to about R20bn a year, with the typical issuance being in the order of R1bn each.

NOT A DEBT-MARKET CULTURE

He points out, though, that there are also more structural reasons why companies tend to shun the debt market in favour of shorter-term bank loans. "Tapping the debt market typically commits the company to a period of three to six years – and for a large amount. It also doesn't give the company the flexibility to repay the debt early." Compare this with more flexible sources of bank lending, such as trade finance and overdrafts.

"For companies reliant on longer-term funding, and who are comfortable with the bullet profile of corporate debt rather than the amortising nature of bank debt, the corporate bond market remains the natural and most cost-effective source of funding, though," Martin says.

SA CORPORATE DEBT ISSUANCE



Source: Renaissance Capital

For the rest, banks remain the primary port of call, Reuss says. "Historically, South African companies have had strong and long-standing relationships with their banks while operating in a closed market owing to exchange controls."

This is one explanation for why a corporate debt culture never developed in SA. Another, Reuss says, is the regulatory underpin of institutional investment, which has influenced demand for paper. "Regulation governing the eligibility of assets in the pension and life insurance industry has always favoured equity over debt. Typically, then, companies have gone to the JSE when they needed capital."

The local market conditions encourage some corporations to avoid the domestic listed market for debt. Those who need funding for offshore expansion or who know their below-investment grade debt would find no interest locally and choose to issue their debt in dollars or euros outside SA. Trade in these bonds, which includes paper from the likes of Sappi, SABMiller, Consol and Edcon, and which is on an over-the-counter (OTC) basis, is far more liquid than in SA. With greater liquidity comes more pricing volatility – and opportunity for investors to profit from their views on changes in credit spreads.

Another option is for companies to issue debt locally and place it directly with investors, bypassing the listings process. Mei-Chi Liou, portfolio manager at Futuregrowth Asset Management, says the firm's credit team now sees greater value in this portion of the local market compared with listed debt. "We are able to negotiate better terms, rates and conditions in the unlisted space, which is more difficult to do in the listed market. These covenants give the credit team better control over risk and therefore offer our clients greater protection."

Barry Martin ... Structural reasons why companies tend to shun the debt market.

A new and different wave of regulations could tilt incentives for both demand and supply more strongly towards corporate debt in SA. "With the phasing in of the Basel III regulatory regime, which requires banks to have higher capital and longer-term debt on their balance sheets, the likely consequence is increased costs of bank loans," Liou says. Faced with pricier bank debt, she argues, many more corporations could soon tap the listed bond market for their borrowing requirements. "Changes in Regulation 28 of the Pension Fund Act have also increased the investment allowance for these types of assets, especially unlisted corporate debt."

GOOD TIME TO TEST MARKET

Property companies' recent enthusiasm for corporate debt listings is a clear response to this looming development, given the weight of funding costs in their business models. Others could soon follow, wisely choosing the good times to test the market for a rating.

Banks will be joining the expected dash to raise debt. "Up until now, banks have used rolling short-term debt to fund much of their capital needs. The new Basel rules will probably require banks to hold funding that more closely matches the duration of their assets, which I estimate to be in the region of seven years," says Jean Pierre Verster, analyst at 36One Asset Management. "In order to extend the term of their funding profile, they will have to increase their bond issuance."

These developments could create a virtuous cycle that propels the South African corporate debt market towards greater liquidity and diversity: more companies coming to the debt market create the depth that attracts new issuers as well as new investors, including foreign investors who have been glaringly absent from this tightly held market.

"A huge amount of cash went into emerging-market debt over the past few years, with the realisation that these regions are not as risky [as previously thought]," Howie says. "Over the next five years we will definitely see greater interest in South African debt."

WHAT'S IN IT FOR ME, THEN?

With its hefty issue sizes, the bulk of the corporate debt market was not designed for direct involvement by the retail investor. Indirectly, though, it has gained importance for the individual.

Credo Capital, which manages offshore portfolios on behalf of its private client base, is a keen investor in dollar- and pound-denominated South African debt. Referring to the global OTC market in corporate debt, Rupert Silver, head of Credo Capital's fixed-income desk, says corporate debt has been "very popular since 2009 and we don't think this will change much. With equity markets broadly flat over 10 years and with cash giving next to nothing, the relatively high yields available on trusted corporations seem very attractive to many private investors, who aren't in the main worried about the ups and downs in the market so long as they continue to 'clip coupons'." Clipping coupons refers to the constant income that is earned from the coupon payments made on corporate bonds.

For the typical South African investor whose financial market exposure is through pension funds or unit trusts, the argument is similarly valid. Investec's Howie says: "With it becoming a bigger feature in income and bond funds, I am definitely seeing increased awareness from retail investors that corporate debt can form part of a low-risk, conservative portfolio." IM