The Impact of an Emerging European Corporate Bond Market on Corporate Governance

Exploratoty roundtable on Corporate Governance, Innovation and Value Creation
Istanbul, Turkey, 1 February 2012

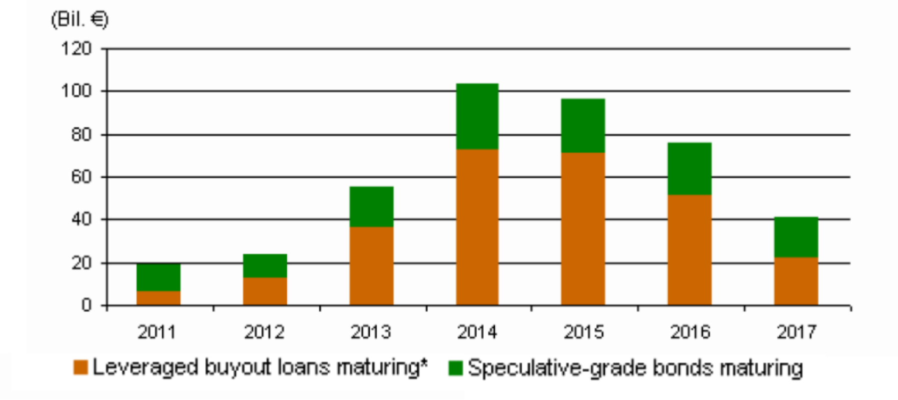
I. THE EUROPEAN CORPORATE FUNDING MARKET

II. IMPACT ON CORPORATE GOVERNANCE

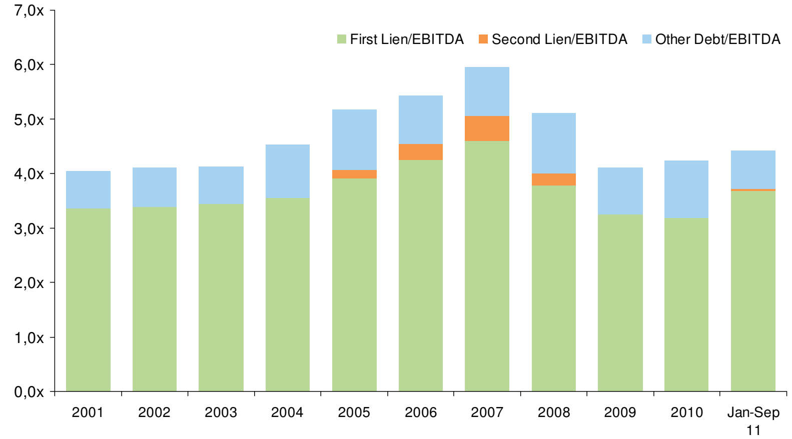
III. CONCLUSION

DEMAND FOR CAPITAL WILL CONTINUE TO BE SIGNIFICANT

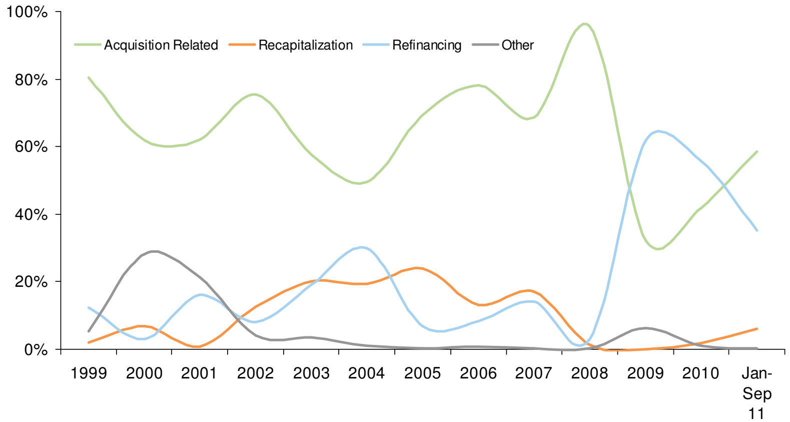
Estimated maturity profile of European leveraged loans



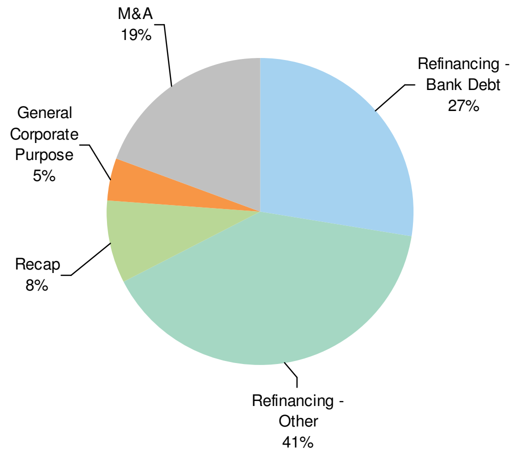
Pro Forma Debt/EBITDA Ratios



Deal Purpose Diversification (based on volume)



High Yield Issuance Q1-Q3 2011 by use of proceeds



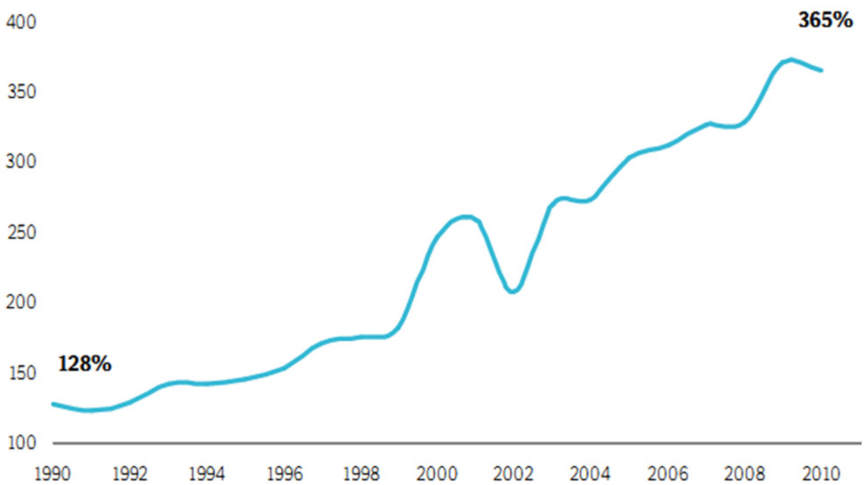
Source: S&P

AND SUPPLY IS CHANGING; BANK LENDING

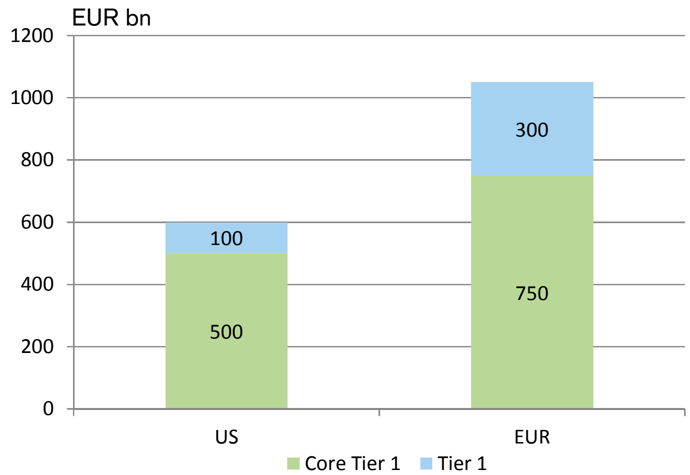
<u>Senior lending:</u>

- Deleveraging reduces access to funding
- New regulation; Basel III reduces access to funding and increases cost of capital
- Crowding-out from sovereign funding needs as well as bank funding needs

European bank assets to GDP (%)



Basel III impact (estimated shortfall in 2019)



Source: SEB

PROVENTUS

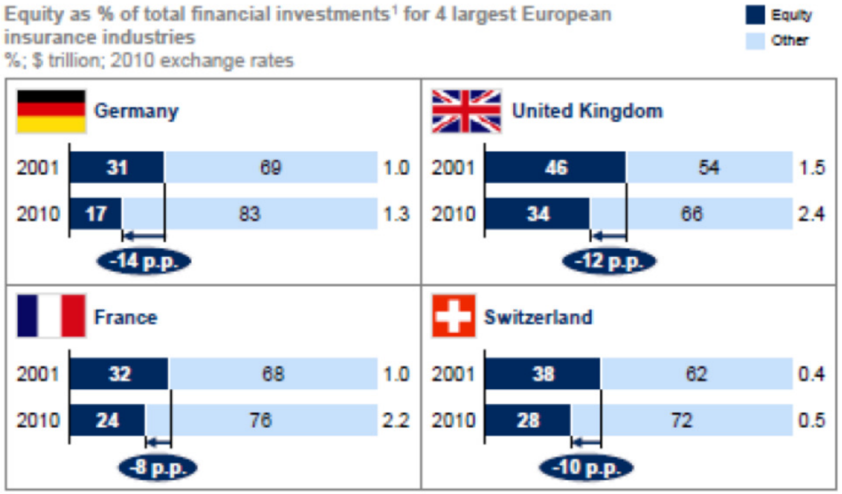
SUPPLY IS CHANGING; EQUITIES

Equity markets:

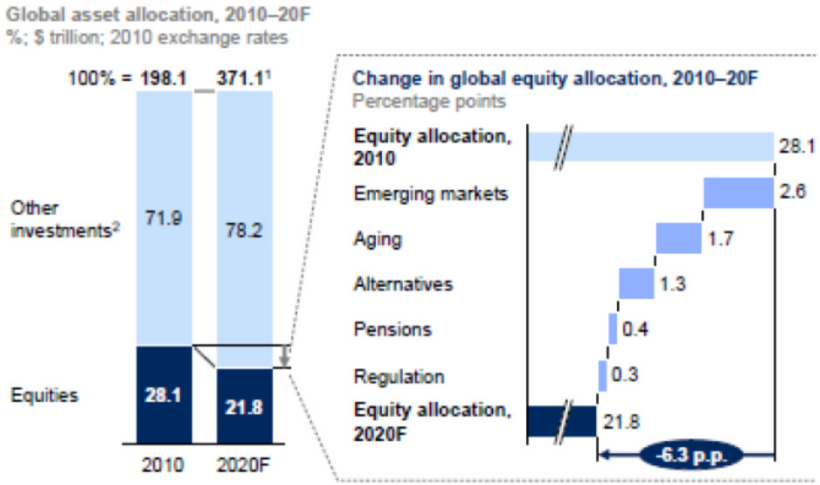
- Demography will decrease demand for equity
- New regulation; Solvency II will decrease allocations to equity
- Equity markets are primarily secondary markets – SSE; new issues equal approximately 1 % of trading volume: financial market vs market for funding/financing
- Equity gap for Europe (2010-2020) projected to be 3 trillion USD (needs 6 trillion and demand 3 trillion)

Insurers reducing equity allocations ahead of Solvency II (and majority of current holdings in unit-link accounts)

McKinsey estimates equity allocation to decrease from 28% to 22% globally over the next ten years



1 Includes investments for which policyholders bear the risk.
SOURCE: A.M. Best Company; annual reports; Association of British Insurers; Swiss Financial Market Supervisory Authority; McKinsey Global Institute



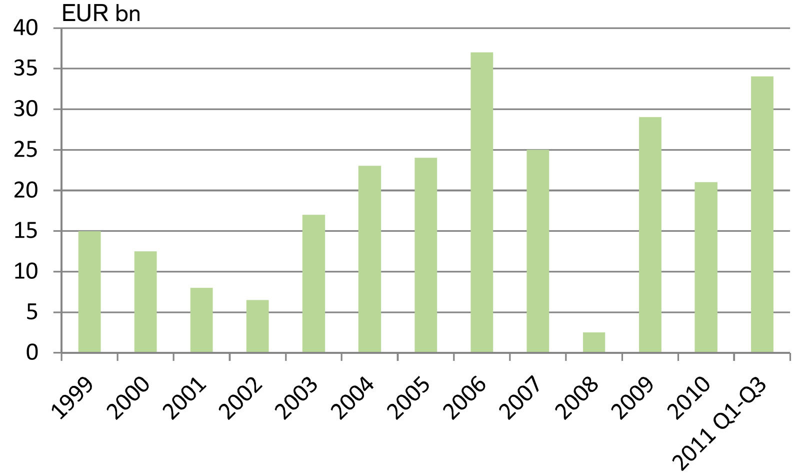
1 Based on consensus global growth scenario.
2 Includes cash, deposits, and fixed-income securities.
SOURCE: McKinsey Global Institute

Source: SEB

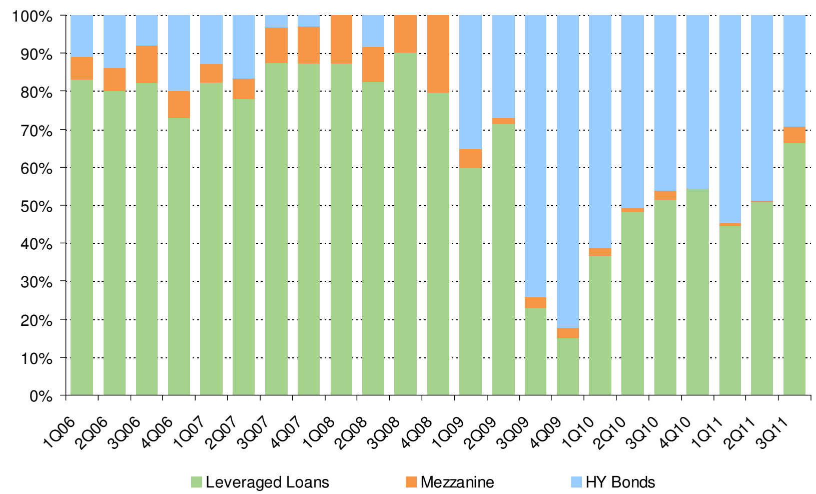
CONCLUSION REGARDING FUNDING MARKETS

- Banks are likely to take a decreasing share of corporate funding due to deleveraging, regulation etc.
- Equities are unlikely to be able to “fill the gap” due to demographics, regulation etc.
- We need a much more active, liquid and transparent market for funding from other sources such as bonds and private loans
- Bonds may also be a more efficient form of financing at this time – both from a capital allocation and a governance perspective
- **A developed market for financing is a prerequisite for efficient allocation of capital and supply for midsized European companies and thereby for growth and employment rates in Europe**

European High Yield Bond issuance



European Leveraged Loans – Share of Total Volume



Source: S&P LCD

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EQUITY VS DEBT INSTRUMENTS

	Equity	Bonds	Loans
Exit	In public markets relatively easy thanks to good liquidity	As with equities although liquidity more limited	Usually not
Voice	At AGM, board appointment etc and increasingly through informal channels such as the press etc	1) At establishment of the contract, 2) In case of default or sometimes through bondholder committees etc.	1) At establishment of contract, 2) In case of default, rarely through informal channels
Contractual		Limitations on the management of a company	

Equity is a standardised contract and a perpetual instrument and regulated by law, while bonds and loans are limited in time and regulated mainly by contract

THE LOAN CONTRACT AS A GOVERNANCE TOOL

Lenders influence via contracts

Lenders and bondholders have significant influence via the contract. Most of this influence is in the negotiation of terms when the contract is put in place, such as;

- Information requirements, dialogue
- Observer seat on board
- Financial covenants (maintenance)
- Financial covenants (incurrence)
  - Change of control
  - Limitations on acquisitions
  - Limitations on investment
  - Limitations on additional indebtedness
  - Restrictions on transfer of assets
  - Restrictions on dividends and group contributions
  - Restrictions on change of business
  - Restrictions on group/internal dealings, arms-length etc

- Debt holder's main impact from a governance perspective is at the establishment of the contract, somewhat more limited during monitoring and redemption.
- The loan contract means that debt holders (somewhat counter intuitively) may have a much more direct influence on the company than shareholders.
- Shareholders govern for maximizing potential given a certain risk level, whereas bondholders/lenders govern to minimize risk.
- Terms in the contract are there to prevent the risk from increasing without the bondholder/lender having a say.
- The relationship between managers and bondholders/lenders centers around the terms of the contract.

IMPACT OF THE CHANGES IN THE FUNDING MARKET

- The bond holders and lenders will over time constitute a new and more active player on stage in the corporate governance system.
- There is (and will be) the same range of players as in equity markets, everything from passive long only actors to “activists”.
- In a widely held company, the management and board may be (or at least should be) closer to the debt holders than to the shareholders.
- Valuation of bonds and loans also has a much greater impact on the company that the valuation of shares.
- Bondholders and lenders have a lower risk tolerance then shareholders
- **But, constructive lenders and bond holders will guide the focus to value creation and also drive discipline in strategy and financial decisions such as investments.**

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CONCLUSIONS

- Non-bank debt funding will be crucial to address the financing of mid-sized companies going forward, not least in Europe
- Debt instruments have interesting potential as tools of corporate governance – not least in the creation of an informed and motivated community of financiers.
- The debt contract has the potential – if rightly applied – of being a positive influence on the governance and management of the company; for value creation rather than rent seeking.

- **In all – new debt investors will be crucial for funding of midsized companies in Europe over the next decade at least and they will also change the dynamics of corporate governance.**

- Paradoxically, some of the efforts discussed to incentivize equity investments – notably tax neutrality – risk stimulating the secondary equity market and at the same time dis-incentivizing the market for corporate funding.
- Regulators, politicians and market actors in Europe should put a greater emphasis on stimulating the development of a well functioning bond market, such as:
  - Improved transparency and liquidity
  - Improved legal environment – trustee functions, standardization of terms, disclosure requirements
  - Broadened investor base – retail as well as institutional investment policies