Trends in Spanish corporate bond issuance

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Recent factors, ranging from monetary policy measures, attractive conditions and regulatory considerations, among others, are driving the trend of increased reliance on capital markets financing relative to traditional bank financing in Europe, including in Spain. While the trend largely applies to medium-sized and large firms, small businesses should benefit from the greater availability of previously tied-up bank credit.

The crisis that began in 2007 marked a before and after for the global financial system. The ensuing credit crunch, the prevalence of historically-low rates around the world supported by central banks and the impact of stricter banking regulations have fuelled global, and in particular, European corporate bond issuance. The result has been a deepening of debt capital markets and a reduction in reliance on traditional bank credit. Increased European debt issuance has largely been underpinned by the emergence of two major trends: i) the surge in euro medium term notes; and ii) the increased popularity of the reverse Yankee bond, as more and more US issuers take advantage of favourable conditions in Europe. This evolution in European corporate debt markets has been echoed in Spain, driven by the reduction in benchmark rates in response to ECB intervention, the compression of Spain´s risk premium, and the improved financial health of corporate issuers. While these trends in Europe and in Spain tend to benefit primarily medium to large issuers, smaller companies too can take advantage of the increased availability of bank financing previously earmarked for larger companies.

The crisis that erupted in 2008 and its impact on the global financial system highlighted the importance of diversified sources of funding to sustained economic development. Financial turbulence not only exposed bubbles in certain sectors, such as real estate, it also brought to the surface the structural weaknesses derived from excessive dependence on a single source of financing.

As a result of the crisis, Europe's companies have experienced tremendous difficulties in obtaining the funding needed to sustain their operations and investments in light of the predominance of bank financing as a percentage of their total financing mix. (Even today, nearly 80% of corporate borrowing comes from banks.) In contrast, bank weakness had a more short-lived impact on the Anglo-Saxon economies and a less protracted effect on private sector financing. This is in part due to the fact that based on 2014 figures, virtually 75% of the borrowings secured by companies in these economies came from the capital markets.

In recent months, we have been witnessing the gradual correction of this profound structural

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gap in the funding market. Continental Europe's companies are increasingly looking to tap the capital markets, diversifying their borrowing sources by issuing bonds which in many instances complement their bank loans and in others (less commonly) have replaced their bank financing altogether. This propensity to issue debt (bonds, debentures, promissory notes) has gathered traction despite the fact that the financing conditions offered by the capital markets are no longer so attractive in price terms. (Corporate spreads have been widening systematically throughout 2015.)

This article details, firstly, with the main factors driving the change underway in private sector financing dynamics, going on to then analyse the general trends shaping the European market and wraps up with an overview of the Spanish market.

General trends in the corporate debt market

In recent years, we have observed a growing propensity on the part of corporates to tap the capital markets in order to raise the funds they need to finance their business activities. This trend is being largely shaped by an effort to diversify sources of financing in order to prevent a repetition of the crunches experienced in the wake of the 2008 crisis.

There has been a structural shift in financing conditions in favour of capital markets. Larger corporates are reducing their massive reliance on bank financing, while smaller companies will remain dependent on traditional sources.

The first caveat related to the growing participation by non-financial corporates in the capital markets is the fact that this alternative is only an option for large companies and not for SMEs. Only larger companies have the capacity to assume the administrative and transparency burden required of them, while demonstrating sufficiently large financing needs as regards customary issuance volumes (250 million euros being the minimum offering size).

Large companies are also better able to absorb the fixed costs typically associated with any issuance, diminishing average costs for these issuers.[2] In order to address this matter, many countries, including Spain, have launched alternative fixed income markets designed to facilitate access to capital markets by medium-sized entities. Small companies, however, remain dependent on bank financing, as they are not big enough to accommodate issuance requirements and costs in any of these markets.

This is why capital market development is crucial. By covering large and medium-sized companies' financing needs, the banks are freer to respond to demand for funds from smaller companies.

Having made this distinction, we list the factors that have been fuelling debt issuance in the capital markets by large companies, for the most part, and, to a lesser extent, by medium-sized enterprises (through multilateral exchange systems):

- *Access to sources of financing that offer repayment-at-maturity structures and generally longer maturities,* in contrast to the bias towards the shorter-dated paper offered by banks and their predominantly bullet-amortisation structures. These characteristics have prompted companies to opt for debt financing even when it may have been more expensive than traditional bank debt.

- *Reinforcement of banks' capital requirements in Europe,* which has led to a reduction in maturity of loans to non-financial corporations, affecting

[2] SMEs' reduced transparency and lack of external credit ratings tend to increase their borrowing costs, ultimately forcing smaller-scale companies to resort to banks.

their capability of funding investment projects with long maturity profiles.

- *Austerity efforts made by most eurozone economies in order to reduce public deficits,* which have reduced public-sector funding costs in capital markets. This reduction has helped to alleviate the crowding-out effect observed between 2009 and 2011, enabling corporates to return to the capital markets on more favourable terms.

- *The search for investment alternatives among risk asset classes against the backdrop of ultra-low rates,* shaped by expansive monetary policy on the part of central banks, particularly the ECB.

- *Renewed confidence on the part of economic agents thanks to recovery in the eurozone coupled with the strength of the US economy* that is reflected in the improvement of activity and consumption indicators, as well as in the labor market.

As a result, we are observing a slow correction in the high levels of dependence on bank financing presented by the European market in 2008. The share of non-bank financing in Europe has climbed eight percentage points to around 20% at present, compared to 12% in 2008. There is still a long way to go, especially if we compare this percentage with that of the US, an economy in which the capital markets were providing the private sector with 60% of its financing needs in 2008, a level which has since risen to 75%.

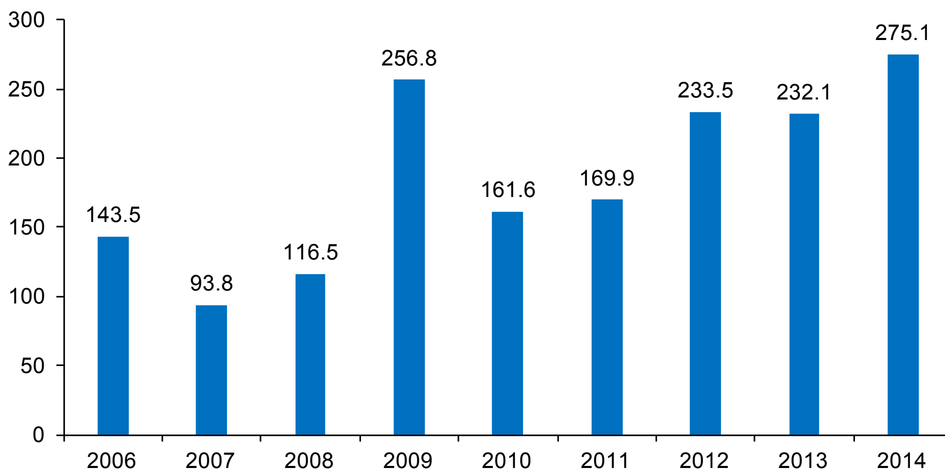
Trends in Europe

As stated previously, the massive bond buyback programme carried out by the ECB has fuelled appetite for corporate bonds. The fall of sovereign bond yields in response to quantitative easing has made private sector issues relatively more attractive. As a result, we have seen a 64% year-on-year surge in euro-denominated corporate bond issuance in Q12015, as well as an increase in the duration of the bonds issued.

As a result, European debt market issuance was higher in the first quarter of 2015 than in the entire history of the series. This general dynamic is underpinned by two major trends: the surge in

Exhibit 1

Debt issuance volume by financial institutions and non-financial corporates in Europe
(€ billion)



Sources: Bank of Spain, Dealogic, AFI.

EMTN (euro medium term notes) issuance and the advent of reverse Yankee bonds.

■ *Euro medium term notes*

The major issues carried out by companies such as Gas Natural, Iberdrola and Telefónica have taken the form of euro medium-term note programmes (EMTN), which consist of issuance by multinationals of bonds outside their home markets (via the 'euromarket') on a continuous basis under shelf programmes (which is less expensive than issuing one single larger issue).

These programmes afford issuers much laxer issuance requirements and faster time-to-market, while also offering enhanced liquidity.

■ *Reverse Yankee bonds*

European issuers have long been tapping the US market to raise financing in dollars (Yankee bonds); now we are seeing the reverse trend: US issuers coming to the European markets to issue bonds in euros, a trend that has grown significantly in the past year.

We estimate that, so far, in 2015, US issuers have issued three times more in euros than the previous year, with many US corporates raising money in the European markets for the first time. These issues are known as reverse Yankees, symbolising the reversion of the traditional financing process.

One of the factors driving this trend is the desire to take advantage of Europe's historically-low prevailing interest rates, which are currently below their US counterpart. The economic outlook for both regions and the measures taken by the monetary authorities suggest that the rate differential will persist and may even widen towards the end of 2015 and in the first half of 2016. The draw of euro issues is therefore a factor that could well have a significant influence on capital market trends during the next 12 months.

Table 1

Debt issuance volume by US financial institutions and non-financial corporates in euros

(€ million)

US Financial institutions and Non-financial corporates		US Non-financial corporates (without Financial institutions)	
2014	72,173	2014	37,218
2015 (*)	57,944	2015 (*)	39,463

Note: (*) Data as of May 2015.

Source: Bloomberg, AFI.

In a not unrelated trend, US issuers are fitting their euro financing policy within their exchange rate management strategy, of growing importance in light of the current environment of dollar appreciation. By raising funds in euros, US companies with businesses in Europe can achieve

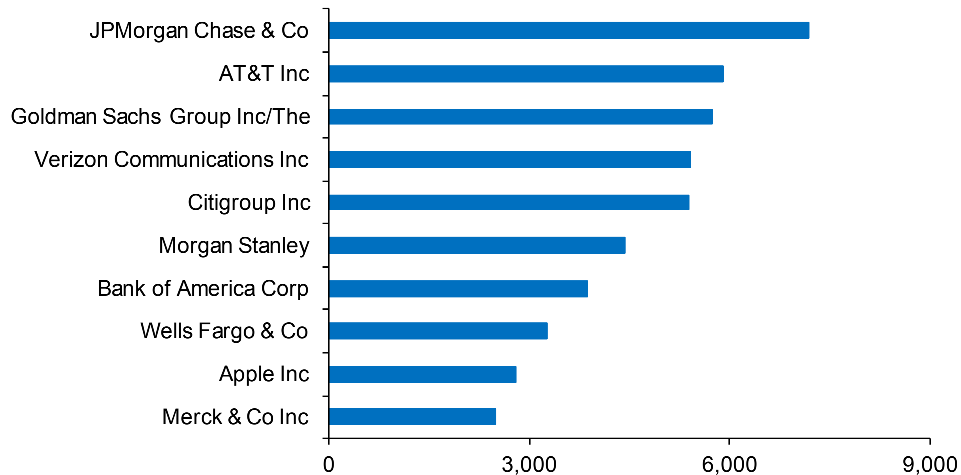
Whereas European and Spanish issuers have traditionally issued dollar-denominated bonds, we are now seeing the opposite trend (US corporates issuing bonds in euros). These bonds are known as reverse Yankees.

a natural exchange rate hedge as they will repay this debt in the same currency in which they generate profits. Moreover, to the extent that these companies expect dollar appreciation to continue, their effective borrowing costs may come down, as debt service in dollar terms will get cheaper.

The arrival of US issuers to the European market is certainly a favourable trend. On the one hand, this will make debt markets deeper and more liquid, one of the objectives of any bank disintermediation process. It also offers euro investors a product with which to diversify their portfolios, access to issuers with high credit ratings and exposure to new geographies. In short, although US bonds placements by European

Exhibit 2

US financial institution and non-financial corporate euro bond issuers, Jan-May 2015
(€ millions)



Source: Bloomberg, AFI.

issuers will continue to outweigh reverse Yankee bonds, the growth in these reverse flows evidences increasingly open European capital markets, which can only be welcome news in terms of financial disintermediation at the global level.

Trends in Spain

The trend observed in the capital markets at the European level has been echoed in Spain, which was hit very hard between 2008 and 2011 by the impact of the crisis on public finances. Deteriorated fiscal accounts, coupled with investors' loss of confidence in the sustainability of the eurozone, drove an unprecedented increase in Spain´s public sector financing costs, which virtually crowded-out the private sector issuers, not only as a result of the costs they had to bear, but also due to lack of supply.

Today, the strong recovery in Spain´s fixed-income market is evident through: i) the drop in average yields from 6.3% in 2011 to 2.4% in Q22015 (which translates into a decline in cumulative terms of 62.4%); and ii) growth in issuance volumes (a cumulative 42.3% between Q22011 and Q22015). The growth in corporate bond issuance contrasts with the correction in loans extended to large companies, which have shrunk by 37.3% between 2011 and 2015.[3]

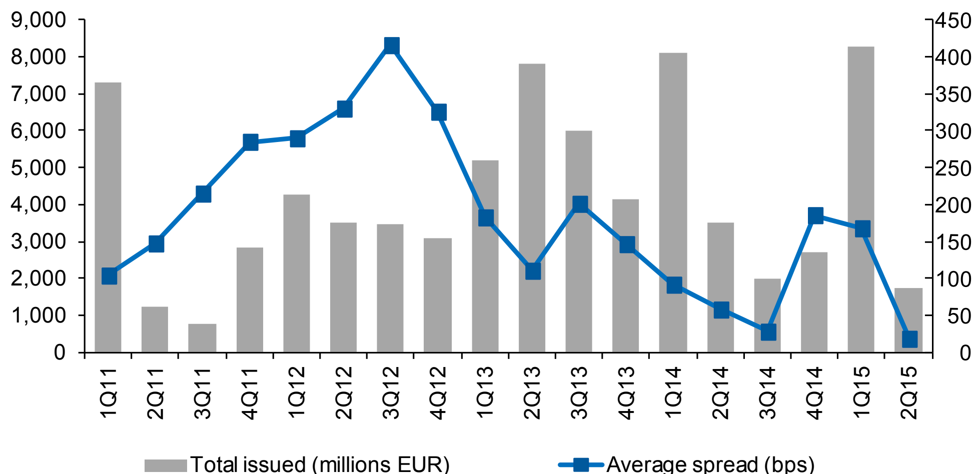
Strong growth in corporate debt issuance in Spain has been driven by: i) the downward trend in benchmark rates, in part shaped by ECB intervention; ii) the sharp drop in the Spanish risk premium; and iii) the improved financial health of non-financial corporate issuers.

As alluded to previously, the strong performance by the Spanish corporate debt market has a lot to do with its relationship to the public bond market, as corporate financing rates are ultimately the

[3] Data as of April 2015.

Exhibit 3

Total issuance (€ m) and average issue spread (bp)



Sources: Bank of Spain, Bloomberg, AFI.

sum of the benchmark rates and spreads applied on the basis of issuers' creditworthiness.

Against this backdrop, considering an average issuance spread of 142 basis points and an average term of 12.4 years in 2015, the yield demanded by investors has fallen to 2.4%, compared to a yield in 2011, at a similar spread and for an average term of 6.1 years, of 6.3%. In addition to consolidating expectations for economic recovery, which is translating into higher corporate profitability and solvency, the reduction in the Spanish country risk premium, which has dropped from 630bp to 115bp today, has undeniably had a hugely positive effect on the re-opening of the capital markets.

This investor appetite for corporate bonds has encouraged newcomers to enter the market and not necessarily only listed or private sector companies. At the end of 2014, El Corte Inglés issued bonds for the first time, while public entities such as Adif and Canal de Isabel II have also made their bond market débuts. This trend has also paved the way for longer maturities and even unrated issues (*e.g.,* ACS, which issued 500 million euros of unrated 5-year bonds at a yield of 2.7%).

Table 2

Trend in the characteristics of the debt issued by Spanish issuers

	2011	2012	2013	2014	2015	Average
Amount (millions of euros)	12,125	10,800	23,161	16,317	10,025	72,428
Average life (years)	6.07	6.15	7.15	7.84	12.41	7.72
Average Yield To Maturity (%)	6.28	4.73	3.36	3.06	2.36	3.92
Average Spread (bp)	157.91	340.42	156.74	92.32	141.97	167.77

Source: Bloomberg, AFI.

Table 3

Debt issuance volume by issuer type
(€ billion)

Issue date	Issuer	Sector	Maturity	Amount issued	Spread	YTM	Rating
14-Jan-15	ARCELORMITTAL	Iron/Steel	14-Jan-22	750	265.00	3	BB+
21-Jan-15	GAS NATURAL FENOSA FINAN	Electric	21-Jan-25	500	75.00	1	BBB
27-Jan-15	IBERDROLA INTL BV	Electric	27-Jan-23	600	65.00	1	BBB+
28-Jan-15	ADIF ALTA VELOCIDAD	Transportation	28-Jan-25	1,000	119.40	2	BBB
6-Feb-15	ENAGAS FINANCIACIONES S.A.	Gas	6-Feb-25	600	65.00	1	A-
19-Jan-15	HIPERCOR SA	Retail	19-Jan-22	600	-	3	NR
26-Feb-15	CANAL ISABEL II GESTION	Water	26-Feb-25	500	98.00	2	BBB
13-Mar-15	CAMPOFRIO FOOD GROUP S.A.	Food	15-Mar-22	500	-	0	BB-
25-Mar-15	ENAGAS FINANCIACIONES S.A.	Gas	25-Mar-23	400	53.00	1	NR
1-Apr-15	ACS ACTIVIDADES CONS Y S.	Engineering & Construction	1-Apr-20	500	271.70	3	NR
31-Mar-15	OBRASCÓN HUARTE LAIN S.A.	Engineering & Construction	15-Mar-23	325	-	6	B+
25-Mar-15	REPSOL INTL FINANCE	Oil&Gas		1,000	356.00	4	BB+
25-Mar-15	REPSOL INTL FINANCE	Oil&Gas	25-Mar-75	1,000	395.00	5	BB+
24-Apr-15	RED ELÉCTRICA FIN SA UNI	Electric	24-Apr-25	500	65.00	1	BBB+
5-Jun-15	INMOBILIARIA COLONIAL S.A.	Real Estate	5-Jun-19	750	-	2	BBB-
5-Jun-15	INMOBILIARIA COLONIAL S.A.	Real Estate	5-Jun-23	500	-	0	BBB-

Source: Bloomberg, AFI.

It is also important to highlight the role being played by Spain's alternative bond market, known as MARF by its Spanish acronym, in fostering the market's development. In its first year in existence, it supported trading in the order of 231 million euros of bonds and debentures[4] and two promissory note programmes, totalling 130 million euros. The advent of the MARF has improved direct access to certain financial resources on the part of companies which, due to their specific circumstances, were not able to tap the official secondary markets (*e.g.,* medium-sized companies). MARF listing requirements are more flexible and less costly than those of their official secondary market counterpart (AIAF).

Outlook and conclusions

The corporate fixed-income market has sustained sharp growth in recent months at both the European and Spanish levels, reducing non-financial corporate issuers' traditional dependence on bank financing in Continental Europe.

Despite this trend, the structural differences between the financing markets in Anglo-Saxon

[4] Average issue size: 42.5 million euros.

economies and Continental Europe persist, with non-bank financing accounting for just one-fifth of the funding raised by non-financial corporates in Europe compared to nearly 80% in the US. There is, therefore, still room for additional growth in capital market funding in Europe.

Note that this diversification phenomenon is benefitting large and medium-sized companies, while smaller companies face structural constraints that prevent access to capital markets and alternative fixed-income markets. That being said, the opening up of the fixed-income market not only benefits larger issuers by providing protection against financial system instability, it is also important for small companies, as it frees up bank lending to better address their funding needs.