How Do Australian Businesses Raise Debt?[1]

Introduction

Over the past decade, the composition of bank lending has shifted from being primarily to businesses to now being directed predominantly to households. In part, this reflects greater demand for debt from households and a conscious shift by intermediaries to target this sector. But another important factor is that businesses have been increasingly willing and able to access debt directly through capital markets.

Traditionally, Australian (non-financial) businesses have relied more heavily on loans from financial intermediaries (intermediated debt) rather than securities issued in their own name (non-intermediated debt). This is especially true of small businesses, in part because the fixed costs and minimum issuance requirements involved in non-intermediated debt tend to be prohibitively high for businesses with relatively low funding requirements.

Larger businesses are likely to find the fixed costs and minimum issuance requirements of debt issuance less problematic. Nevertheless, they often find it difficult to attract Australian institutional investor demand if their securities have a low credit rating, as such bonds are excluded from the main bond indices. As a result, lower-rated businesses have typically followed one of two funding strategies: issuing securities that are backed by a third-party guarantor; or issuing into markets with a greater appetite for lower-rated securities, such as the domestic hybrid securities market or the US private placement market. There are, however, some signs that demand for conventional, lower-rated bonds is rising in Australia, a process that should accelerate this year following the broadening of the main bond index used by Australian fund managers to include BBB-rated bonds. This in turn may have some implications for the amount and credit quality of non-intermediated debt issued domestically by Australian businesses.

Broad Characteristics of Business Debt

Non-intermediated debt accounted for 21 per cent of Australian businesses' total debt in mid 2004, up from 13 per cent in 1999, with this trend more pronounced for larger businesses. According to company annual reports, the share of non-intermediated debt in the total debt of the 350 largest listed Australian businesses – the focus of this article – doubled over the five years to mid 2004, to around 40 per cent (Table 1). The greater use of non-intermediated debt has not led to a significant increase in Australian businesses' total indebtedness. Instead, Australian businesses have substituted non-intermediated debt for intermediated debt, with the dollar value of intermediated debt of the top 350 listed businesses actually falling over the period.[2]

1 *This article was prepared by the Securities Markets Section of Domestic Markets Department.*

2 *Businesses' total funding has, in aggregate, risen significantly over this period, reflecting retained earnings and equity raisings.*

Table 1: Australian Businesses' Sources of Debt Finance[(a)]
350 largest listed businesses, A$ billion

	June 1999				June 2004			
	Higher rated[(b)]	Lower rated[(c)]	Unrated	Total	Higher rated[(b)]	Lower rated[(c)]	Unrated	Total
Non-intermediated debt	**11.4**	**11.9**	**1.0**	**24.3**	**27.5**	**22.4**	**8.9**	**58.8**
Domestic bonds	1.5	0.9	0.3	2.7	6.1	3.5	2.5	12.1
– Unwrapped	1.5	0.9	0.3	2.7	6.1	2.2	0.0	8.3
– Credit wrapped	0.0	0.0	0.0	0.0	0.0	1.4	2.5	3.9
Offshore bonds	9.9	10.2	0.0	20.1	19.7	13.4	2.6	35.8
– Private placements	1.3	2.5	0.0	11.5	2.4	9.3	2.6	14.3
– Other	8.7	7.7	0.0	8.7	17.3	4.1	0.0	21.4
Hybrids	0.0	0.8	0.7	1.5	1.7	5.5	3.8	11.0
– Domestic	0.0	0.3	0.7	1.1	1.7	3.1	3.8	8.6
– Offshore	0.0	0.4	0.0	0.4	0.0	2.4	0.0	2.4
Intermediated debt	**34.8**	**30.4**	**46.2**	**111.4**	**19.5**	**33.7**	**35.3**	**88.5**
Total	**46.3**	**42.2**	**47.2**	**135.7**	**47.0**	**56.2**	**44.2**	**147.4**

(a) Domestic short-term securities were excluded from non-intermediated debt.
(b) Companies rated A- or higher
(c) Companies rated BBB+ or lower

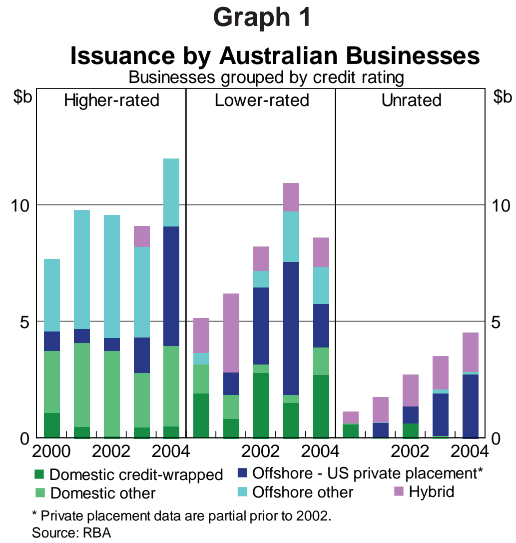
Sources: ASX; RBA; Salomon Smith Barney; UBS Australia Ltd.

The increased use of non-intermediated debt has been evident across the broad categories of non-intermediated debt: domestic bonds' share of listed Australian businesses' total debt rose from 2 per cent to 8 per cent; offshore bonds' share rose from 15 per cent to 24 per cent; and hybrid securities' share rose from 1 per cent to 7 per cent. It has also been evident across all credit ratings. In contrast, the fall in the level of intermediated debt has been most pronounced among higher-rated businesses.

A firm's credit rating has a significant bearing on the exact type of non-intermediated debt that it chooses to issue and the market into which the securities are issued. About 60 per cent of securities outstanding at June 2004 were issued offshore, with 40 per cent of these issued in the US private placement market, mainly by lower-rated and unrated businesses. (In contrast, only 6 per cent of financial institutions' outstanding offshore securities were issued in the US private placement market.) Domestic bonds and hybrid securities each accounted for a further 20 per cent of Australian businesses' securities outstanding. Within the domestic market, 40 per cent of lower-rated businesses' bonds have been backed by a third-party guarantor, that is, 'credit wrapped'. All the bonds issued by unrated businesses have been credit wrapped, though there is an element of self-selection in this as firms not wanting to issue unwrapped bonds are unlikely to seek a (relatively costly) credit rating. Hybrids are evidently the domain of lower-rated and unrated businesses.[3]

3 *For the purposes of this article, hybrid securities are regarded as being a form of (non-intermediated) debt, regardless of whether they are treated as debt or equity on the balance sheet of the issuing firm.*

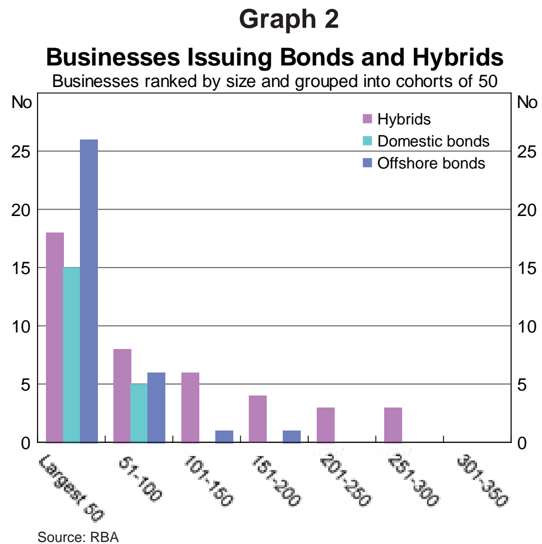
Consistent with these patterns in outstandings, over the past five years, lower-rated and unrated businesses have issued $16 billion (gross) of bonds into the domestic market, with $11 billion of this being credit wrapped (Graph 1). These businesses have issued $23 billion of bonds offshore, of which $18 billion has been in the US private placement market. Issuance of hybrid securities has amounted to $14 billion over the same period.



In summary, over the past five years, 82 per cent of all non-intermediated debt raised by lower-rated and unrated businesses was either credit wrapped, hybrids or issued in the US private placement market. In contrast, only 25 per cent of higher-rated businesses' debt was issued into these markets.[4] Some background information on each of these markets is provided in Box 1.

Issuers in Each Market

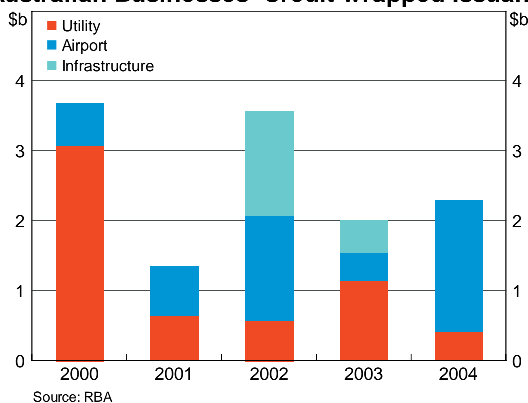
The propensity of a business to issue non-intermediated debt, and the type of debt issued, is more dependent on its size than its credit rating. Whereas 30 of the largest 50 listed businesses have issued domestic or offshore bonds, only 10 of the next largest 50 businesses, and very few of the smaller listed businesses have done so (Graph 2). Most likely this reflects the cost effectiveness of issuing debt securities in reasonably large volume. Four fifths of Australian businesses' domestic bond issues are at least $100 million, with offshore bond issues often larger. The use of hybrid securities also appears to be influenced by business size, but the relationship is less strong. Though hybrid securities are more prevalent amongst the largest 50 listed



4 *A single bond issue by Westfield Group accounted for 70 per cent of higher-rated businesses' issuance in the US private placement market in 2004.*

businesses, they are regularly issued by much smaller listed businesses. Two fifths of Australian businesses' hybrid issues are smaller than $25 million.

Within non-intermediated debt, businesses tend to view domestic bonds, offshore bonds and hybrids as substitutes. Less than a quarter of businesses with non-intermediated debt outstanding have issued securities in more than one market. Compared with financial institutions, which tend to view these markets as complements, (non-financial) businesses often find a particular market generally best suited to their needs. One exception is domestic issuers of credit-wrapped bonds, who almost always have also issued unwrapped bonds. This may be because investors are more willing to buy unwrapped bonds from businesses that have satisfied the credit requirements of the monolines in addition to those of the credit rating agencies.



The issuers of credit-wrapped securities have been utilities, airports and infrastructure businesses (Graph 3). Despite their tangible assets and generally solid cashflows, these businesses – which are often regulated oligopolies – tend to have credit ratings that are at the lower end of the investment-grade scale. This is because of their relatively heavy demand for debt, especially long-dated debt, to fund infrastructure. Nonetheless, the high quality of their assets means that they are often more attractive than other businesses to credit wrappers because they are likely to offer a high recovery rate in the event of a default. Anecdotal evidence suggests that while credit rating agencies consider recovery rates when assigning credit ratings, they are more likely to focus on default rates.

The US private placement market is particularly appealing to lower-rated businesses that do not necessarily wish to swap the proceeds back into Australian dollars, have relatively large but infrequent funding needs (and hence are less troubled by issuance-specific documentation) and wish to raise long-term funds. A broad range of businesses – including materials, energy, food and beverage and media businesses – has tapped this market.

Credit-wrapped bonds and private placements involve larger amounts and tend to have longer maturities than unwrapped domestic bonds and offshore publicly listed bonds (Table 2). Anecdotal evidence suggests that this is because credit-wrapped bond and private placement investors are more willing to purchase long-dated bonds than investors in other markets. Also, because the documentation associated with private placements and credit-wrapped bonds is relatively time consuming to prepare, businesses have an incentive to reduce the frequency of their issuance by issuing large, long-dated bonds.

The domestic hybrid security market is characterised by a relatively high degree of issuer diversity. Hybrid securities have been issued by businesses of all sizes and credit ratings. The

Table 2: Characteristics of Businesses' Debt Security Issues
2002 to 2004

	Domestic bonds		Offshore bonds		Hybrids[a]
	Unwrapped	Credit wrapped	US private placements	Other	
Total issuance (A$b)	11.4	8.8	23.4	16.7	7.8
Number of issuers	41	16	49	27	49
Number of issues	61	20	55	62	55
Average size (A$m)	190	440	430	270	140
Average maturity (years)	5	8	11	6	5

(a) Offshore hybrids are excluded owing to the small sample.
Sources: ASX; RBA; Salomon Smith Barney; UBS Australia Ltd.

broader use of hybrid securities partly reflects the considerable flexibility of these instruments, with businesses able to structure the securities to suit their expected cash flows and their balance sheet requirements.

While individual hybrid issues are, on average, smaller than those of other types of securities, they have ranged in size from $1 million through to $1.5 billion. The average maturity of hybrid securities issued in recent years is similar to that of 'vanilla' bonds issued in the domestic and offshore markets.

Investors in Each Market

The domestic and offshore bond markets are dominated by institutional investors. The available, albeit limited, evidence suggests that in Australia, the holders of lower-rated bonds are usually the same as those holding higher-rated bonds, namely banks, insurance companies and fund managers. Investors in the US private placement market are mainly insurance companies and fund managers. In contrast, anecdotal evidence suggests that somewhere between a third and a half of outstanding domestic hybrid securities are held by retail investors.

There are a number of possible explanations for the preponderance of retail investors in the hybrid market. First, retail investors have easier access to hybrid securities than to corporate bonds, since many more hybrid securities are listed on the ASX and can be bought in relatively small amounts. Corporate bonds tend to be traded over-the-counter and, because they are marketed without a prospectus, have a legal requirement that the investment be at least $500 000. In addition, retail investors may be less sensitive to credit ratings than institutional investors. Whereas some institutional investors are either explicitly or implicitly constrained by their investment mandates from participating in the hybrid market, a high-profile brand name may be more appealing to some retail investors than an investment-grade rating. Perhaps supporting this, many high-profile businesses have issued unrated hybrid securities. A third reason might be that some retail investors are, or at least have been, attracted by the relatively high yields on hybrid securities without fully appreciating the risk implications of a future conversion to equity.

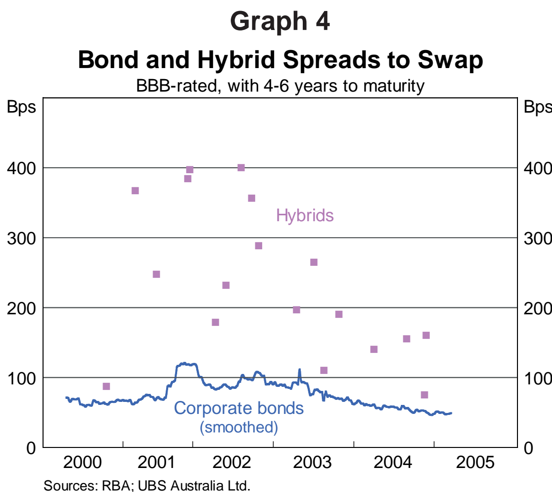
Institutional participation in the Australian hybrid market has, to date, been limited. While some institutional investors are not permitted to invest in hybrid securities by their mandates, others have argued that the credit risk in hybrid securities is priced too cheaply (perhaps because retail investors are mispricing the risks). However, anecdotal evidence suggests that interest from hedge funds and specialist high-yield debt funds has increased, particularly over the past year.

The Cost of Debt in Each Market

The cost of raising debt in the US private placement market varies considerably between firms, with client confidentiality and a lack of secondary market prices making it difficult to quote definitive prices. Nonetheless, the available evidence on primary issuance suggests that for a given Australian business, the yield on debt issued in the private placement market would be about the same as debt issued in the US publicly listed market. However, it is possible that for infrequent issuers the transaction and ongoing reporting costs, and hence total costs, are lower in the private placement market. Anecdotal evidence suggests that total funding costs in this market are competitive with Eurobonds.[5] Whether the effective Australian dollar cost would be lower than issuing in the domestic bond market depends, in part, on conditions in the cross-currency swap market.

For some businesses, the total cost of raising credit-wrapped debt is evidently lower than the cost of unwrapped debt, in that the fees paid to insurers are less than the saving on yields. The fact that yields on credit-wrapped bonds tend to be around the same as on bonds issued by 'genuine' AAA-rated corporate borrowers suggests that investors are equally prepared to hold either type of bond. However, spreads on both wrapped and unwrapped AAA-rated corporate bonds tend to be higher than those on AAA-rated bonds issued by government and supranational/quasi-government borrowers, reflecting lower liquidity as well as credit quality.

The cost of issuing hybrid securities is less straightforward to calculate, given their relatively complicated structure. For example, convertible preference shares are equivalent to a combination of subordinated debt and an 'out of the money' equity call option. Other hybrids, such as reset securities, are appreciably more complicated. Nonetheless, it is clear that spreads on A-rated and BBB-rated hybrid securities have declined steadily over recent years – much more than similarly rated corporate bonds – and are now 75 basis points and 125 basis points, respectively, lower than in mid 2002 (Graph 4). Despite the sharp fall, hybrid securities are still more expensive to



5 *Eurobonds are bonds that are issued in one currency but sold offshore in one or more different national markets. For example, Australian dollar Eurobonds are bonds that are denominated in Australian dollars but issued and traded outside of Australia.*

issue than conventional bonds: convertible hybrids offer grossed-up yields to maturity that are on average 70 to 100 basis points higher than yields on similarly rated corporate bonds. That some businesses seem to issue them in preference to bonds suggests that, at least for these issuers, hybrid securities' greater flexibility, such as the ability to defer or cancel coupon payments or convert the securities into equity, outweighs their higher funding costs.

Conclusions

In recent years, Australian businesses have increasingly raised debt from a range of capital markets, rather than from financial intermediaries. Australian businesses have accessed a number of different markets in order to raise non-intermediated finance. Each of these alternative markets appears to cater to borrowers with different characteristics: the US private placement market attracts businesses that wish to borrow relatively large amounts at long maturities, some of which have revenues denominated in US dollars; the credit-wrapped market caters to domestically focused, highly geared businesses with relatively stable cash flows; and the hybrid market is particularly attractive to businesses that are unrated but have a high profile amongst households.

The growth of the non-intermediated debt market is generally supportive of financial stability. Instead of concentrating corporate credit risk on the balance sheets of a limited number of (mainly) domestic financial institutions – as in the case of intermediated debt, such as bank lending – non-intermediated debt disperses it more widely across bond holders in Australia and overseas.

However, the increased use of non-intermediated debt does raise a number of issues. One which has been discussed in previous *Reviews* is that the increased use of credit-wrapped bonds, while allowing lower-rated businesses to diversify their funding sources relatively cheaply, has led to a significant concentration of credit risk in a small number of monoline insurers.[6] While these insurers are all AAA-rated, and have large and well-diversified bond portfolios, periods of severe economic stress could result in a large volume of claims, perhaps undermining their creditworthiness.

Another issue is that some retail investors may not fully appreciate the risk implications of a future conversion of hybrid securities into equity. The number of investors potentially in this situation is, however, likely to be very small and the amounts involved are not significant from a systemic viewpoint. Moreover, to the extent that hybrid securities are issued instead of debt, rather than equity, they strengthen the issuers' balance sheet because often coupon payments can be cancelled or deferred and the securities can be converted into equity.

Regarding the private placement market, concerns have also been expressed about undisclosed covenants imposed by investors in these securities causing problems for investors in public debt and equity markets. Again, however, it is unlikely that this would have significant implications for the soundness of the Australian financial system as a whole.

6 *See for example, Davies, M and L Dixon Smith (2004), 'Credit Quality in the Australian Non-government Bond Market', Reserve Bank of Australia,* Financial Stability Review, *March.*

Finally, while issuance of credit-wrapped bonds, private placements and hybrid securities has increased noticeably, there has been only modest growth in the issuance of unwrapped bonds into the domestic market. In part, this has reflected relatively subdued demand on the part of Australian investors for lower-rated domestic bonds. While this does not appear to have impeded lower-rated businesses' financing efforts, having a diverse range of financing options available to corporate borrowers reduces their cost of capital and makes them less dependent on any one type of finance. The broadening of investment mandates for fund managers should increase the demand for lower-rated bonds, thereby providing an additional source of funding for lower-rated businesses. At this stage, it is unclear as to what extent this might facilitate an increase in the total indebtedness of lower-rated businesses, rather than simply change the composition of their debt.

Box 1: Sources of Non-intermediated Debt Finance for Lower-rated Businesses

As noted in the text, lower-rated businesses have tended to issue credit-wrapped bonds or issue into markets with greater appetite for lower-rated securities, such as the domestic hybrid securities market or the US private placement market.

Credit-wrapped Bonds

Credit-wrapped bonds contain an unconditional promise from a private sector guarantor – normally a specialist, or 'monoline', insurer – that they will continue to pay the interest and principal repayments of the bond should the issuer default. As the guarantors are generally AAA-rated businesses, the guarantee is sufficient to raise the credit rating on the bonds to AAA.

The issuer of a credit-wrapped bond pays the insurer an up front premium based on the insurer's assessment of the credit risk associated with that borrower. Anecdotal evidence suggests that this premium is generally one half to three quarters of the interest saving that the borrower expects to achieve by issuing a credit-wrapped rather than an unwrapped bond. Insurers are willing to provide credit wraps because they require less compensation to take on some businesses' credit risk than do bond investors. This might be because currently there is only a small pool of investors willing (or able) to invest in domestic lower-rated debt. Another reason might be that the credit wrappers are better able to build more diversified portfolios of lower-rated credit risk than domestic bond fund managers because they have internationally diversified operations.

Hybrid Securities

Hybrid securities contain features of both debt and equity. Those issued in Australia include: perpetuities (securities with no maturity date) as well as securities with a lifespan of a few years; securities that can be redeemed at the option of the issuer or the investor; some that are repayable with cash; and others that convert (automatically or voluntarily) to the issuer's ordinary equity (Table 1). In the event of the business being liquidated, all hybrid investors rank behind senior and subordinated debt holders but ahead of ordinary shareholders. In addition, unlike bonds, the coupon and dividend payments of many hybrid securities can under certain circumstances be postponed or cancelled, so there is a slightly higher probability of non-payment associated with hybrids than with senior debt. Accordingly, their credit ratings tend to be one to three notches lower than the businesses' senior debt.

US Private Placement Market

The US private placement market allows businesses to issue bonds to Qualified Institutional Buyers – investors who own or invest on a discretionary basis a minimum of

Table 1: Features of Hybrid Securities Issued in Australia

Type	Key features
Income securities	Perpetual securities with regular interest or coupon payments. They are only redeemable at the option of the issuer.
Perpetual step-up securities	Similar to income securities, except that the interest payment on the security increases if the issuer does not redeem the security on a certain date.
Converting preference shares	The security converts automatically into ordinary shares on the maturity date.
Convertible preference shares/notes	At the maturity date, the investor can choose whether to convert the security into ordinary shares or receive cash.
Reset convertible preference shares/notes	The issuer has the option to change the terms or redeem the securities on a predetermined date. The investor has the option to accept the new terms of the security, or to request an exchange. If an exchange is requested, the issuer decides whether it is for ordinary shares or cash.

US$100 million – such as high net worth individuals, banks and institutional investors, without having to meet the full reporting and disclosure requirements for publicly listed securities. These bonds need not be rated by one of the major credit rating agencies and can be tailored to meet the needs of specific borrowers (and investors), hence offering more flexibility than is available in public debt markets.

The market does, however, have some drawbacks for issuers. In particular, issuers are often required to agree to financial covenants and to punitive prepayment penalties if the debt is repaid early. Also, reflecting the market's customisation, preparing the documentation associated with each issuance can be time consuming.