Dealing with debt

Ian Williams talks to IROs and ratings agencies about mutual relationship expectations

Innovative corporate capital raising, particularly in the tech sector, is blurring the distinction between public and private companies. It is also eroding the line between debt and equity holdings. Non-voting stocks look and feel like a bond without the guarantees, and bondholders respond to their increasing weight in companies with a growing interest in corporate governance and management issues.

Symptomatically, the *Financial Times* reported this year that the proportion of risky 'B or below' loans has risen from 25 percent to 65 percent while paralleling what one might call the 'pioneering equity structures'. The *FT* further noted that 75 percent of all 2017 institutional loans were 'covenant-lite', offering few protections in case of default.

This means nervous bondholders now need almost as much stroking as shareholders. Lucas Scheer, president of New York-based LS Global Advisory Group, notes the changes. 'Their holding periods are now shorter as there's more flipping of the initial placement,' he says. 'And current ownership tends to be harder to uncover so it's important to have the IR department include availability to bondholders, large and small.

'Companies facing tender offers and consents, for example, need quick and comprehensive knowledge of their debt holders and the means to talk to them. If they want to talk to you, as more and more of them do, it's good to have somebody at the company prepared and ready to field that call.

'They're not going to be speaking to the company as regularly or as often, nor expecting the same, or as much, information as an equity investor, but it gives the debt holder a sense of respect not shown previously. I suspect that without increased communications, bondholder activism will grow.'

A change of approach

For some time, Dell Technologies' senior vice president of IR Rob Williams and senior vice president and treasurer Tyler Johnson have been on the sharp edge of innovative equity/debt mixing. 'We have equity issues – $14 bn in class V common tracking stock – but then we also have a $50 bn or so debt, so we're close to the rating agencies, which Tyler manages, but also close to the sell-side debt analysts, close to equity,' Williams explains. 'We have equity, debt and credit rating agency (CRA) analysts, and debt and equity holders.'

The combination rolled out two years ago to raise a record-breaking $50 bn for Dell's acquisition of EMC, which raised eyebrows with its astute management of bond ratings to save the new merged company billions in annual interest, and which was oversubscribed.

It was in response to similar, if less innovative, needs that in 2016 Andreas Larsson became Nordea's first senior IRO, head of debt IR and ratings. 'The company had conducted debt-focused outreach before, but it was conducted more directly by the funding team and treasury,' Larsson explains. 'By including it in the IR department, we believe we met a demand from bondholders for deeper information and discussions, with the financials, information and internal analysis coming from within the IR department.

'We could meet the demand better in this way, although we still obviously have very close contact with the funding team and treasury. But this way we can put more effort into bondholder information. It frees up time for the funding teams in the treasury department to do what they need to do.'

The new arrangement was so successful that a year later Nordea recruited a new colleague to join Larsson in coping with debt IR. The added advantage was in responsiveness and efficiency. 'The funding team had had the contact with both analysts and investors, but it mostly collected that information from us in the investor relations department,' says Larsson. 'Now

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we and the IR team sort out the context directly with analysts and investors ourselves.'

While the equity and debt side both wanted 'to be on top of the company-specific financial information', they differ in which facets interest them most.

'The equity side is more focused on the micro, the unexpected changes in results, while bondholders tend to look more at the long-term stability,' Larsson notes. 'But they also stand at risk in a really bad scenario', and are paying closer attention than before to breaking news about a company.

This is why, increasingly, bondholders are also developing an interest in corporate governance issues. 'It's very important to them, if someone literally runs away, commits a fraud or in some other way causes the company to collapse,' Larsson says. 'But they are also very interested in the day-to-day development of the bond price or the bond yield. They have a mark to market, or a rating downgrade, so even smaller movements could have quite a significant impact on a bond holding.'

Dealing with CRAs

There is a difference, however. There are dozens of analysts to help equity investors but debt holders rely, above all, on the rating agencies. While equity analysts are not usually reimbursed by issuers, in contrast, bond buyers pay the Big Three – S&P, Moody's and Fitch – for their assessments. An IRO with an eye for debt has to consider how to deal with the CRAs.

With sensitive questions raised yet never entirely resolved about paid-for ratings since 2008, the Big Three jealously guard their independence, but they do have regular meetings and maintain relationships and regular contact with debt or equity IROs, often with an annual review process giving the agencies access to senior management. Additionally, one response to 2008 was the SEC approval for more CRAs.

All are small, some are paid by investors to conduct research and some even offer unsolicited ratings in a bid to attract customers away from the Big Three. One of the upstarts, constrained to anonymity by compliance, complains that while its analysts often have extensive relationships with some IROs and some issuers are often very open to talking to it, other IROs can be dismissive: 'I don't care what you're rating, we don't want any dialogue with you.'

While the big issuers go with ratings from all sides of the Big Three, they can supplement them. For example, one of the smaller CRAs – DBRS – is strong in the Canadian markets, so issuers tapping Toronto sometimes want an additional paid-for rating. 'Companies have different philosophies about how to

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interact with the CRAs, but for us it is transparency, the day-to-day dialogue, with phone calls or updates of what we are seeing,' says Johnson.

'We try for two face-to-face meetings a year but when we interact with CRAs we can be more open and transparent, for example with projections, which we don't normally give guidance on. In the end, however, they are interested in whether we will earn enough cash to pay principal and interest payments.'

Williams adds: 'We go to debt investor conferences and we talk to debt investors and sell-side analysts regularly along with Tyler and his team. It's the same model as equity, just a different time frame.'

What CRAs want

From the other side of the table, Brendan Sheehan, vice president and senior analyst at Moody's, looks at IROs with sympathetic detachment. 'We don't directly include a qualitative measure of the IR program in our ratings but a lot of things that fall into the purlieu of the IRO play a part in evaluating the credit quality of an issuer,' he explains. 'For example, management credibility is very important, and IROs can have a considerable impact on that by ensuring a consistency of messaging and facilitating access to the right members of the management team.

'We follow the public messaging from the company. It's important that what senior management and the IRO are telling the market place chimes with what we are hearing privately in our engagements with the CFO, CEO and others. We listen to the earnings calls, follow the meetings and note if there's any discrepancy in the messages that are being delivered. If so, we will follow up with the IRO and senior management.'

Sheehan points out that, while usually targeted at equity audiences, the earnings calls contain important information and Moody's analysts play close attention to earnings call transcripts, or listen to the calls live, and follow up as necessary.

'IR professionals can play an important role for analysts, as they are often the designated point of contact,' he says. 'We talk to all sorts of people in a company every year, and the IRO's ability to put the right people in touch and to provide information in a timely and consistent manner might not directly affect the rating itself, but it will help us to develop the most accurate understanding possible of the company and its financial position. That means the IRO can play an important role in providing context about the company, its competitive standing within an industry and in quarterbacking the people we talk to.'

Less frequent interaction

Of course, IROs vary in their outlook to the credit side. 'It's a tough one: so many different conversations and so many different IR professionals out there,' says Sheehan 'The IROs are usually very knowledgeable, not just about their companies but also about their peer companies and the sector. Generally, when they do talk to us they aren't telling us much different from what they say to the equity folks. The difference is in the emphasis, as clearly we are more interested in the factors that drive credit quality.

'It is important for an IRO to keep in mind when engaging with a CRA that we may want different information from what they are used to discussing with the equity analysts and to understand the sometimes competing interests of equity and debt holders.'

Sheehan adds that 'once a credit opinion has been created or updated, the company has 24 hours to comment before publication and while that is usually through the CFO or treasury, the IR officer is often involved as well.'

From his experience in the Brave New World of debt IR, Williams notes: 'While large debt investors or lenders also want to keep a close eye on the business, the interactions might not be as frequent. They don't have a quarterly focus, so they don't need to be as detail-oriented as equity analysts might be, and of course that is one of the attractions for the new breed of tech entrepreneurs.'

'Since the dotcom bubble burst, a lot of companies have postponed going public or intend to go private, and a big motivation is to get the long-term view the founders of the companies want without the short-term pressure of the equity markets, which is where the bond markets come into their own. I think debt/rating IR is important –and we'll be seeing more about it.'