

The Choice between Bank Debt and Capital Market Debt in The Netherlands

Survey-based evidence

OFC research

2012

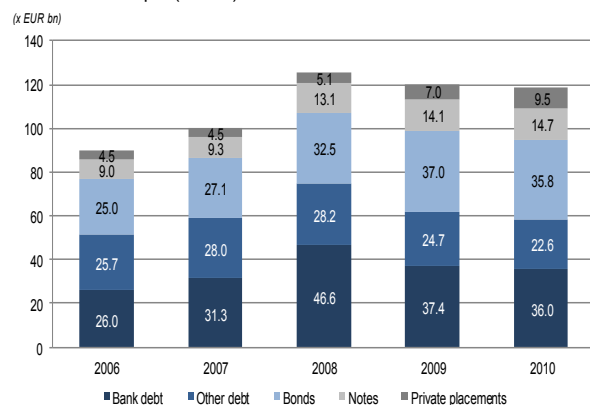
Introduction

Availability of (long-term) debt funding is essential for executing the corporate strategy of a firm. Insufficient funding levels might restrict a firm's growth ambitions and in the most extreme case prove to be a significant threat for the continuity of the firm. The financial crisis and the changing banking landscape (e.g. Basel III, government interventions) have made the firm's long-term funding strategy top priority for CFOs and group treasurers.

Dutch firms clearly changed their debt funding mix since the bankruptcy of Lehman Brothers in the Fall of 2008. Firms dramatically reduced the level of bank debt and raised substantial amounts by issuing debt capital market instruments (see figure 1). This started in 2008 and 2009 with bond issues by existing major issuers like Akzo Nobel, Heineken and KPN and was followed in 2010 by a number of smaller firms that made their first USPP issue like Boskalis, CSM and Logica. This trend continued in 2011 as firms like Arcardis, Fugro, Imtech, Trafigura, Van Oord, Vitol (all private placements), Akzo Nobel, Gasunie, Schiphol, TenneT (public bonds) and KPN (public notes) issued debt capital market instruments.

Figure 1. Development of interest-bearing debt.

This figure shows the development of bank debt, other debt and capital market debt (bond, notes and private placements) over time for the total sample (n=107).



As many large Dutch firms are facing the choice between bank debt versus non-bank debt, we investigated the motives underlying this key decision within a firm's funding policy. These motives provide additional insights next to more traditional firm characteristics, for example firm size (in terms of sales, EBITDA and assets), credit profile and total funding need (minimum size for a USPP issue is approximately EUR 50 million).

To gain these insights, a survey was sent in November 2011 to CFOs and group treasurers of large corporates (excluding financials and real estate firms) in The Netherlands. Large corporates are defined as listed corporates (on Euronext Amsterdam) and non-listed corporates that have at least EUR 400 million of revenues and EUR 50 million interest-bearing debt outstanding.

In total, 107¹ firms received the survey of which 42 were returned by either the CFO or the group treasurer. The response rate of 40% illustrates the importance of this choice between bank debt versus non-bank debt. 18 of these 42 corporates are listed. The respondents have an average revenue of EUR 2.8 billion per year over the sample period 2006-2010. Average total assets over this period amounts EUR 3.1 billion per year and the average amount of interest-bearing debt outstanding amounts EUR 0.9 billion.

In this survey we asked firms to rank their motives for either issuing debt capital market instruments or not issuing capital market debt (i.e. stick to bank debt). In addition firms were asked a number of questions regarding to their outlook of the banking landscape, debt capital markets and their expected action regarding (new) issuance of the debt capital market instruments.

The results of our survey are presented below starting with the motives underlying the choice between bank debt and non-bank debt followed by the outlook.

¹ ArcelorMittal, Shell and Trafigura are excluded from the sample because their size strongly influences the sample, leading to more balanced results.

Why issue capital market debt instruments?

Diversifying funding sources is rated the most important motive for issuing debt capital market instruments (figure 2). Alongside this motive, decreasing bank dependency/problems concerning available bank funding is rated as second important. The top three is completed by the longer maturity of debt capital market instruments, which extends the maturity profile of debt and thereby decreases refinancing risk as well.

These top three motives should be placed in the light of the financial turmoil and the new Basel III requirements. Banks are aiming to strengthen their balance sheet to weather through these turbulent times and to comply with the new Basel III solvency guidelines. Therefore banks take a wide variety of actions ranging from issuing new equity, divestment of non-core activities and/or by reducing the size of risk-weighted assets.

Furthermore, Basel III contains also new liquidity requirements, for example the Net Stable Funding Ratio (NSFR). The NSFR is intended to promote longer-term structural funding of banks' balance sheets, off-balance sheet exposures and capital markets activities. As a consequence banks show less appetite for providing long-term debt. In contrast, 2011 USPP transactions showed that 5- to 15-year maturities are well received by institutional investors.

Other important factors with an above average score (i.e. 2 or higher), are the attractiveness of capital market debt in terms of standardized covenants, pricing and available liquidity). Favorable pricing for debt capital market instruments is driven by a number of market conditions. Funding costs of banks increased (e.g. CDS spreads widened), while at the same time yields on US Treasuries, German Bunds and Dutch State Treasuries recorded unprecedented lows, thereby providing the issuers with low all-in interest costs. Liquidity of debt capital markets, in particular the USPP market remains favorable as deals are being 'upsized' and investors appetite for large(r) tickets is increasing.

Motives for NOT issuing capital market debt

Firms that are not considering issuing capital market debt are valuing highly the flexibility of bank debt (expressed in different ways) as shown in figure 3. The highest rated factor is flexibility of bank debt regarding the amount of funding that the firm needs (i.e. usage of credit facilities).

Moreover, the flexibility of bank debt regarding the debt redemption/maturity profile (rank 3) and the flexibility of bank debt regarding terms and conditions, including covenants (rank 4) are highly rated

Figure 2. Motives FOR issuing capital market debt.

This table shows the survey response to the question: "What factors affect your firm's decision regarding issuing debt capital market instruments?" Respondents were asked to rate the question on a scale of 0 (not important) to 4 (very important). The overall mean and the % of respondents that rated a motive as either important (rate=3) or very important (rate=4) is presented. DCM = debt capital market(s).

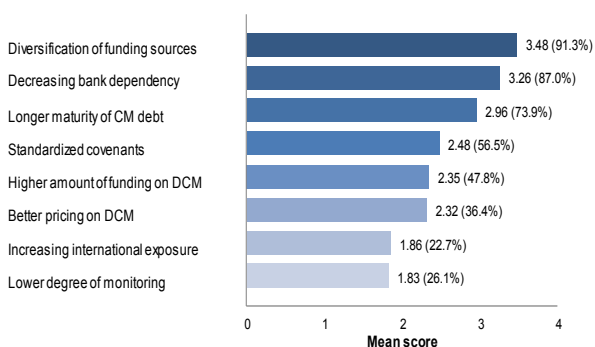
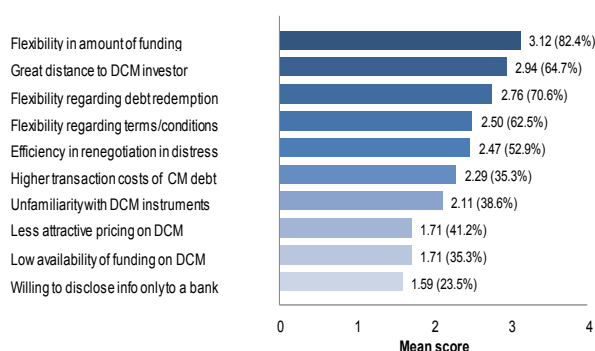


Figure 3. Motives for NOT issuing capital market debt.

This table shows the survey response to the question: "What factors affect your firm's decision not to issue debt capital market instruments?" Respondents were asked to rate the question on a scale of 0 (not important) to 4 (very important). The overall mean and the % of respondents that rated a motive as either important (rate=3) or very important (rate=4) is presented. DCM = debt capital market(s).



The great distance between the firm and the debt capital market investors is ranked second. This (perceived) distance is particularly mentioned by (potential) new issuers. In addition this motive should be viewed in the context of the fifth ranked motive “Efficiency of renegotiation with banks during financial distress” indicating that firms with a more vulnerable (credit) risk profile are somewhat more reluctant to enter the debt capital markets, leaving aside the question whether there is sufficient appetite for these kinds of issuers.

The final motive with a score above 2 is the higher (perceived) transaction costs of debt capital market instruments. The transaction costs depend however on the type of transaction. A prospectus is required for a (E)MTN program, bond issue or a 144A (SEC registered) private placement. In addition, public transactions also require a credit rating. Please note however, that these requirements are not applicable for a plain vanilla USPP transaction. Nonetheless, these higher (perceived) upfront costs should be weighted against the favourable all in interest costs, which is ranked sixth amongst the motives for issuing debt capital market instruments.

Outlook

About 60% of the respondents expect that obtaining bank funding will be come more difficult because of Basel III requirements. In addition firms expect that it will become more difficult to create a (international) banking syndicate because of the lack of confidence amongst banks. This is in particular a point of concern for the respondents with a below average size.

It therefore is no surprise that respondents anticipate a (further) shift from bank debt to capital market debt in the Netherlands. In particular larger firms within the respondent group believe that this trend will continue. Please note, that due to their size this group finds their way more easily to the debt capital markets.

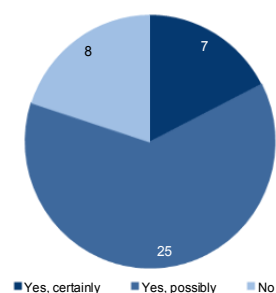
A key driver that could further encourage firms in to entering the debt capital markets is a (continental) European alternative next to the U.S., and to a lesser extent U.K., debt capital markets. About 77% of the respondents (strongly) agreed that the attractiveness of debt capital markets for their firm would increase if alongside the U.K./U.S. debt capital markets a European debt capital market would develop. This would certainly decrease the (perceived) distance between the firm and the end investor. Interesting to note is that large Dutch corporates do not require a specific Dutch alternative. The Dutch alternative scores an average 2.23 (out of 4) compared to 2.90 for the European alternative.

Finally, firms were asked to respond on the statement “*Our firm will issue or continue using debt capital market instruments in the future (next five years)*”. 80% (32 out of 40²) of the firms responded that they will possibly or certainly issue or continue issuing debt capital market instruments in the next five years (see figure 4).

Out of these 32 firms a large amount of firms (22) did not yet have debt capital market instruments outstanding at the time of the survey. This represents a substantial number of (potential) new issuers on the debt capital markets amongst the surveyed firms. Therefore, we expect that the shift to debt capital markets amongst large Dutch corporates will continue in the coming years.

Figure 4. Debt capital market outlook.

This table shows the survey response for the statement: “*Our firm will issue or continue issuing debt capital market instruments in the future (next five years)*.” The number of firms per category is presented.



² Two firms failed to complete this question, thereby reducing the sample size for this question to n=40

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