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RBC Capital Markets

A Healthy, International Sterling Bond Market is Vital for a Successful Post-Brexit Britain

The Sterling bond market facilitates inward investment into the UK, provides financial institutions and corporations with efficient access to capital and maintains the relevance of Sterling as a major currency. At a critical period for the UK on the international stage, the Sterling bond market can showcase the foundations from which the UK economy has thrived over the years; its maturity, outward-looking, progressive nature and investment expertise. To do this, it must continue to evolve and address some key structural challenges.

Rob Lamb, Managing Director, Head of UK & Ireland Corporate DCM, RBC Capital Markets

Since 2010, the Sterling bond market has seen over 500 issuers access over ~£800bn of debt, of which a healthy 48% has been from issuers outside of the UK. Global funders visiting the market have been motivated by a mix of the requirement for the currency itself, the funding arbitrage it often offers, the long duration of debt that can be accessed and the credit investor diversification it affords.

However, in contrast with consecutively record recent years in the US Dollar and Euro bond markets, supply in the Sterling market has flat-lined and was last year around 15% below 2012 volumes, despite a broadly based stimulus package enacted by the Bank of England following the Brexit vote.

In this context, why is the market still very important for global corporates, financials and SSAs and how might it evolve and grow as the UK relinquishes its EU member status?

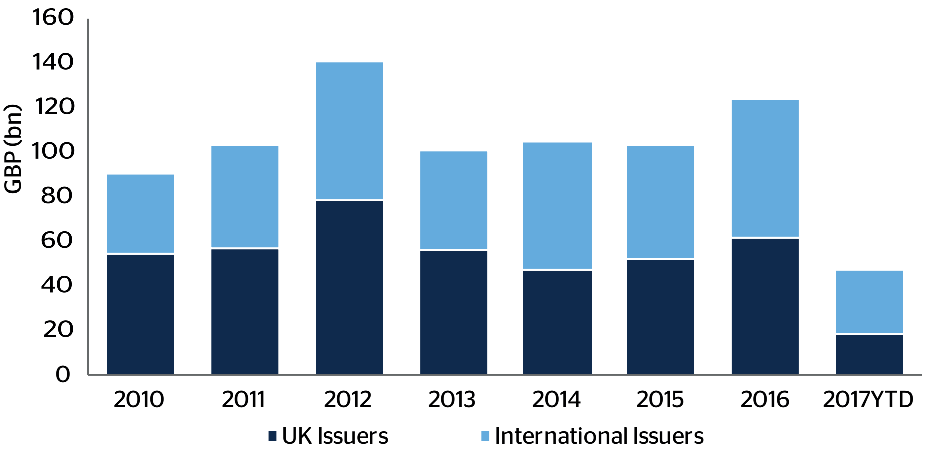
The seasoned pension fund and insurance firms in London and Edinburgh (alongside a growing international investor base) remain a natural provider of long-term debt capital for foreign companies looking to invest in UK infrastructure, especially in recent years as investors found themselves short of duration in a low Gilt yield environment.

For context, from a utility sector standpoint, Electricité de France has meaningfully invested in the UK and now produces 20% of the nation's electricity, making it the largest supplier by volume. Its capital expenditure has taken impetus from £6.5bn of bond financing over the past 7 years, making it the biggest utility issuer over the period and one of the top 10 international issuers of Sterling.

Elsewhere in the utility sector and very recently, a consortium of international infrastructure investors (including Macquarie and CIC, amongst others) bought a majority stake in National Grid's gas distribution assets. The purchase followed National Grid's £3bn foray into the Sterling bond market in September 2016, pre-financing the debt requirement from a new company and locking in low fixed rates for the foreign buyer of the assets (the bonds remaining in place following the expected change of control). Sterling bond investors' ability to analyse and price what was an innovative structure allowed the inward investment of capital and, arguably, provided National Grid shareholders with a price for the assets that they would not otherwise have achieved.

Away from its physical assets, the UK is also a compelling place to do business, offering skills and expertise that are attractive to international companies that use the Sterling bond market to fund their investment. Tata Motors acquired Jaguar Land Rover in 2008, which now operates as a private company and is seen by many Sterling bond investors as a UK credit, regardless of its ownership.

Sterling issuance volumes 2010-2017YTD



Source: Dealogic, RBC Capital Markets

Jaguar Land Rover has since accessed the Sterling bond market for £2bn in total and has invested to become the biggest car manufacturer in the UK, with 80% of its product exported outside of the country to 136 markets globally.

In addition to direct or indirect investment in UK assets, the Sterling market is likely to continue to offer big, sophisticated corporate issuers access to arbitrage vs alternative markets, with a host of international visitors (GE, AT&T and Nestlé along with many others) continuing to attract an eager investor audience.

Sterling also remains a major port of call for international banks that provide credit to UK businesses as they align assets with liabilities and evaluate the merit of Sterling levels next to other currencies. Regular international bank visitors include Bank of America, Citigroup, Rabobank and Wells Fargo, whilst 2017 has witnessed large deals for the likes of Deutsche Bank and Morgan Stanley (both of whom had been absent from the GBP market for a number of years). For this issuer base, Sterling is typically viewed as a useful complement to alternative global markets, whether for funding or capital requirements, with a sophisticated creditor base often prepared to support forms of transaction unviable in other markets (e.g. long dated or callable).

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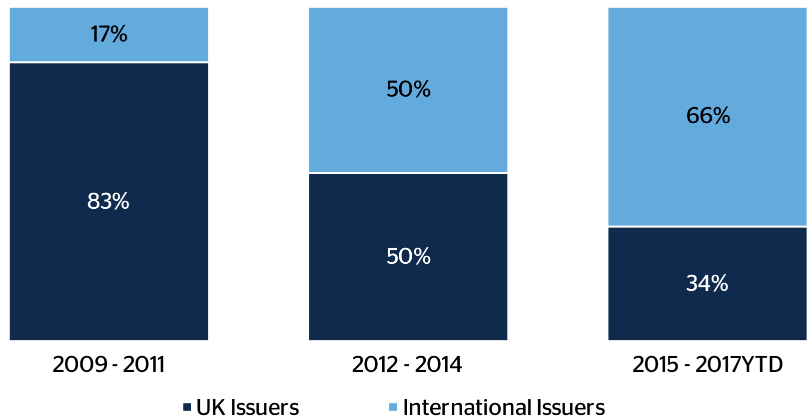
Sterling bank issuance 2009-2017YTD



Source: Dealogic, RBC Capital Markets

With access to alternative sources of liquidity, UK financial institution Sterling issuance has reduced materially and the internationalisation of Sterling bank issuance has increased from just 17% in 2009-2011 to 66% in 2015-2017YTD.

This has had knock-on benefits for issuers into other currency assets being purchased by multi-currency UK funds. London is viewed as a core marketing centre for fixed income product whether targeting US Dollar, Euro or Sterling issuance and this is unlikely to change in the near term. The role of the City of London in a post-Brexit world is clearly uncharted, but what is certain is that international banks intending to maintain a meaningful presence in the UK will consider access to Sterling debt markets as an essential component of their footprint in this country.

Sterling issuance from global SSA borrowers averages over £20bn a year, making it consistently the 3rd most important currency for this sector behind the US Dollar and Euro markets. It also means that the SSA sector remains the largest non-Gilt asset class in Sterling. Recent years have seen a wide and diverse range of SSA borrowers access the market, with as many as 32 different credits and well over 100 individual transactions in some years. Post the Brexit decision last year, the market saw the biggest influx of non-domestic investment into the Sterling fixed income arena for many years, which in part helped to fuel a near 30% increase in SSA supply YoY for 2016.

This dynamic has continued in 2017, helping to bring new names to the market such as the Province of Alberta which issued a successful £650mm short 5 year as their inaugural visit to the currency and the Province of Ontario which tapped the Sterling FRN market for the first time. This sector is able to deliver not only a wide and ever growing set of different credits but also meaningful liquidity with the biggest 3 issuers over the last 7 years having issued £84bn of long term debt (EIB £47bn, KfW £24bn, FMS £13bn).

Structurally, the Sterling market is not without its challenges. International issuers show concern at the trend for consolidation of the investor base such as the ongoing merger of Aberdeen Asset Management and Standard Life as one of a number of recent tie-ups. Buyer concentration is higher than visitors to the Sterling market are used to seeing in US Dollar or Euro markets raising concerns as to the depth of the market and its ability to promote healthy competition between the investors.

Top 10 International Sterling Issuers 2010-2017YTD

	Issuer	Issuance (£m)	Share
1	EIB	46,685	12.0%
2	KfW	24,340	6.3%
3	FMS Wertmanagement	12,570	3.2%
4	Volkswagen	10,192	2.6%
5	World Bank	7,905	2.0%
6	General Electric	7,197	1.8%
7	Rabobank	6,575	1.7%
8	Electricité de France	6,350	1.6%
9	CADES	5,820	1.5%
10	Commonwealth Bank of Australia	5,682	1.5%

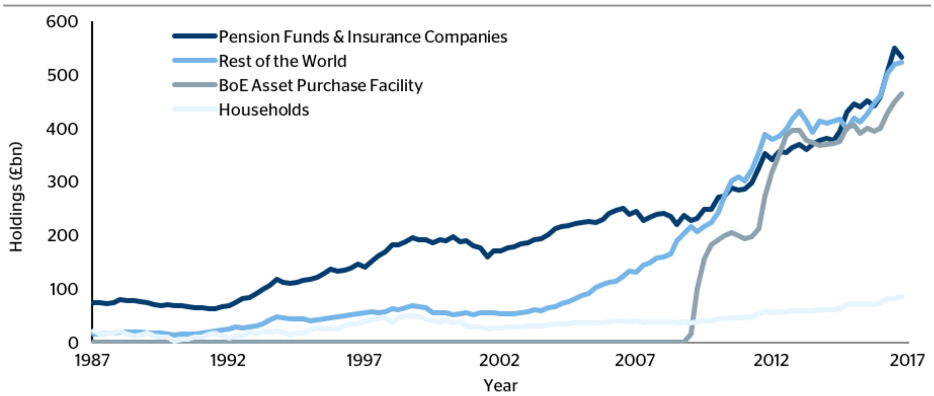
Source: Dealogic, RBC Capital Markets

There are signs that the international investor base is broadening as traditional European investors hunt for positive headline yield and central banks rebalance their portfolios. Transactions from the likes of Deutsche Telekom, BASF, Deutsche Bahn and Daimler have attracted healthy continental European participation from the usual home supporters and a long tail of Swiss-based accounts. Foreign central banks holding Sterling to match their reserve requirements have reacted to the weakening of Sterling by increasing their allocation to high grade Sterling bonds. As can be seen in the chart bottom left the UK Debt Management Office has been able to attract strong growth in holdings from non-domestic buyers, partly on the back of this dynamic.

Having said all this, when issuers get their timing right and liquidity is high, the results can be phenomenal and arguments around capacity rapidly fall away. Vodafone is a UK-headquartered company (although its reporting currency is now Euro given the importance of its continental European operations) and is renowned as a sophisticated global issuer. It saw value in long-dated Sterling issuance in mid-2016 when the injection of liquidity and investors' want for duration was at a high around the time of the Bank of England stimulus programme. It attracted demand of £4.6bn for an aggregate £1.8bn of 33 and 40 year bonds it printed in the same week, with over 250 unique orders across both transactions. The ability of Sterling investors to analyse and price the risk in such long-dated bonds in a fast-changing sector is testament to the expertise of the buyer base as much as the strength of the Vodafone credit, the excellent timing and dynamic approach taken by its funding team.

The Sterling bond market benefits from characteristics of credit expertise, discipline and open-mindedness that mean it should remain relevant for global issuers in the coming years, in spite of an uncertain Brexit outcome. ●

Gilt holdings 2010-2017YTD



Source: ONS

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