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A Guide to Asian High Yield Bonds

Financing Growth Enterprises

Second Edition

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WITH SHARON TAY

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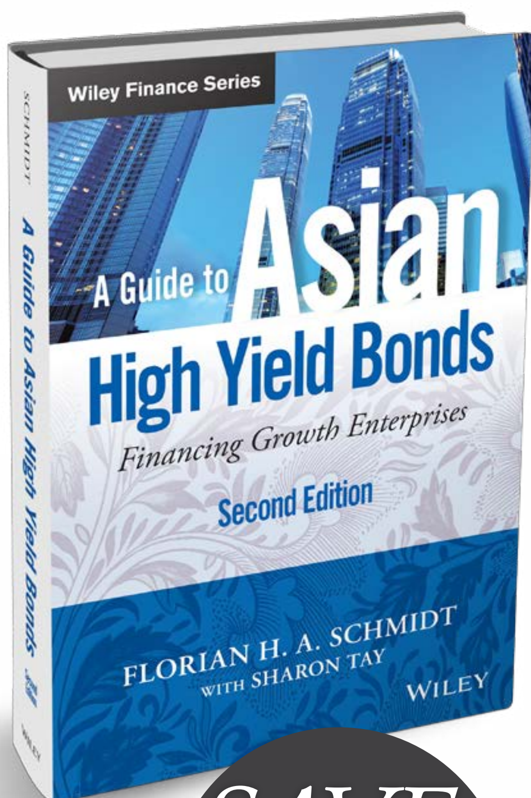

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CHAPTER 1

Why High Yield's Time Has Come in Asia

1.1 THE ASIA PULP & PAPER (APP) LEGACY

If we look back to the Asian debt capital markets into the last years of the 1990s, some 15 years ago, we find much that is familiar:[1] Asia was booming, just as it is today. Foreign investment, both portfolio and direct, was flowing into the region in prodigious quantities, as it does today. Then, as now, sovereign and quasi-sovereign issuers and financial institutions dominated the Asian G3 bond market in volume terms.[2] Then, as now, Asian corporate high yield issuers were raising increasingly large amounts of capital in the bond markets to fund their expansion, attracting the world's institutional investors to the high-growth Tiger economies of the region. Yet borrowing paradigms in the high yield market have become vastly different today. This book will explain why and to what extent.

In June 1997, Indonesian pulp and paper producer Indah Kiat was in the market once again, completing a US$600m 10 percent bond due in July 2007. Another issuer from the same country and sector, Pindo Deli, was in the market with a four-tranche bond in 1997, transacting a total of US$750m. Indah Kiat and Pindo Deli were, and still are, operating parts of the Asia Pulp & Paper (APP) group of companies, which collectively borrowed more than US$12bn during the 1990s, only to famously default on its obligations in 2001 in the long aftermath of the Asian Financial Crisis of 1997–1998.

Despite annual debt servicing costs that reached US$659m in 1999, when the group had fixed charge coverage of just 1.5 times, APP was still able to access the public debt capital markets as late as March 2000, when it raised a US$403m deal due in 2010 with a reoffer yield of 17 percent to finance its operations in China, and it somehow managed to issue a US$100m one-year private placement yielding 30 percent in July that year. The first missed interest payments came soon thereafter, in September.

APP is now synonymous with the aggressive borrowing of what might be described as the "first generation" of Asian high yield issuers—and their bonds' catastrophic endings. The company, which remains operational and, indeed, is the largest pulp and paper producer in Asia outside Japan, was by no means alone in overstretching itself in the international debt capital markets during those heady days. Moody's Investor Services (Moody's) registered 95 defaults by issuers domiciled in Asia in 1997 and 1998. Some of the better known names include Thailand's Bangkok Land, Finance One, Somprasong Land, TPI Polene and Thai Oil, Daya Guna Samudra and Polysindo from Indonesia, Philippine Airlines, and China's Guangdong International Trade & Investment Corp. However, the reality is that essentially every Indonesian or Thai private sector corporate bond issuer either defaulted or entered restructuring negotiations after 1997–1998. Indonesian textiles group Polysindo arguably issued the last deal in the original Asian high yield bull market: the now defaulted US$250m 9.375 percent bonds due in 2007 were announced in June 1997.

The effect on the young Asian high yield market was toxic—many of the specialist U.S. investment managers that had driven demand for the first generation of transactions, especially the Yankee bond issues specifically targeted at the U.S. market, sustained serious losses. These were compounded in 1998 by the collapse of U.S. hedge fund Long-Term Capital Management, the Russian default, and, in 2001, by the bursting of the dot-com bubble and the revelations of fraud at Enron. Such buy-side accounts typically pulled out of Asia and did not return for more than five years.

"Fee-hungry Western investment banks, investors greedy for yield but blind to regional risk, lax regulators, a local company with global ambitions but little regard for corporate governance—they all contributed to the disaster," was how *BusinessWeek* went on to describe the APP meltdown in 2001, running the headline: ASIA'S WORST DEAL.[3]

Fast forward 15 years into the first week of January 2013: Chinese property developers Country Garden (Ba3/BB–) and Kaisa Group (B1/B+) transacted US$750m ten-year and US$500m seven-year non-call four deals, respectively. The two issues would not have been particularly noteworthy had it not been for the former's US$18bn and the latter's US$9.9bn order books, allowing for pricing of 7½ percent and 10¼ percent, respectively. A week later the bid price of Country Garden's issue had risen to 102¾ percent to yield 7.1 percent, allowing another developer, Shimao Property (B1/B+) to raise US$800m 6⅝ percent notes. Despite leaving almost nothing on the table in comparison with secondary levels, the final overbook stood at a gargantuan US$17.5bn from over four hundred investors.

It was an unprecedented wall of liquidity, the same that had driven the Credit Default Swap (CDS) of the Philippines flat to that of France, implying

that the former should be investment-grade . . . or the latter not, the same that had driven Korean investment-grade issuers' yields well below 2 percent, that had made deeply subordinated non–investment-grade paper from China look irresistibly attractive at 7 percent.

Has Asia once again reached the stage where return is decoupled from risk but linked to relative value? Nachum Kaplan, IFR Asia-Pacific Bureau Chief wrote on January 9, 2013, referring to the large amounts of private banking money padding the order books for China high yield bonds: "Private banks used to pitch conservatism and wealth preservation to their high-net-worth clients and steer them away from exactly the sort of paper they are stuffing them with right now. The backdrop for this is the extraordinarily loose monetary policy that is keeping global interest rates low. The problem is that it is distorting the risk/reward equation into something worryingly unsustainable. . . . Desperation for yield means more and more players are booking these high-risk assets. And when the private bank bid alone can leave a new issue nine times oversubscribed, the inevitable consequence is that yields start dropping to levels that simply do not reflect the risks."[4]

Quantifying such risks is an almost scientific discipline in Asia with its varying bankruptcy laws and their sketchy implementation against frequently changing regulatory backdrops. Chinese high yield bonds, for example, are so deeply subordinated to the point of being equity-like. Their recovery values in a default scenario can therefore be minimal as the FerroChina and Asia Aluminum cases have shown. However, it doesn't even require a worst-case scenario to get a feeling for the risks involved. In early October 2011, only 15 months before Shimao transacted their US$800m 6⅝ percent notes, the due 2018s of the very same issuer traded as low as 68 cents on the dollar to yield no less than 20 percent. At the same time Country Garden due 2018s were bid at 74 percent to yield 18 percent, while Kaisa's due 2015s were quoted at 67 cents to yield a staggering 29 percent. If the mood reverses once again from the current exuberance into despair, and this could—like 15 months ago—well be caused by external forces with no apparent link to China's property market, such as the crisis in the peripheral Eurozone, capital losses in excess of 30 percent cannot be ruled out, a real threat for leveraged buy-side accounts.

With such warnings written on the wall, and the author of this book supporting the notion that the risk-reward profile of high yield bonds issued by Chinese property developers is technically and structurally distorted, a cynical observer may therefore ask how many of the causes for the APP disaster identified by *BusinessWeek* have changed since the Asian Financial Crisis and, perhaps even more so, the global leverage crises since 2007. Such a question would indeed deserve serious consideration. While it is beyond

this book's remit to assess the rigor of Asian regulators' scrutiny, it could not be denied that the profit motive remains as strong as ever in investment banks, that investors are still hungry for returns, that specific risks remain in many Asian countries, or that Asian companies' ambitions are once again sky-high, which is amply demonstrated by a combined transaction value for mergers and acquisitions in developing and newly industrialized Asia of some US$320bn in 2012.[5]

Khor Hoe Ee, former assistant managing director of economics at the Monetary Authority of Singapore therefore argues that "Asia needs to find the right balance between progress and prudence, innovation, and caution."[6] Balancing innovation with caution, Khor proposes three key principles to aid policymakers in the region:[7]

1. Credit standards must be maintained at all times, but especially in times of abundant liquidity and strong economic growth; easy credit is seen as a cause of financial instability.
2. Transparency is critical for financial supervision and market discipline to be effective; this holds particularly true for the introduction of new financial products.
3. Financial linkages must be understood, as the subprime crisis and the ensuing credit turmoil illustrated the increasing complexity and connectivity of financial markets and products.

Past experiences and the undeniable risks involved in easy credit inevitably trigger the question, what is to prevent the new generation of current Asian high yield transactions from coming to the same sticky end as their predecessors? How can it be argued that high yield's time has come in Asia?

1.2 NECESSARY CORPORATE DEVELOPMENTS BENEFITING ASIAN HIGH YIELD

It would be exceptionally naive of us to argue that a disaster like APP cannot happen again. Markets are inherently cyclical, driven up and down by imbalances between supply and demand. When liquidity is abundant, headline interest rates low, and credit spreads tight, investors have a tendency to ignore leverage and other questions of creditworthiness and concentrate instead on the return that higher yielding credits offer. We doubt that will ever change, and Khor refers to the classic principal-agent problem, elaborating that during the Asian Crisis shareholder's interests were ignored by bank managers who lent indiscriminately to certain companies and projects, either at behest of governments or because these projects were related to influential shareholders."[8] During the subprime crisis, the blame

had to go to the originate and distribute model, which gave lenders little incentive to worry about the credit standards for mortgages because they did not retain such loans. Paul Krugman in his work *What Happened to Asia* also highlighted the moral hazard problem caused by the perceived government bailout guarantees to banks, unregulated finance companies and megaprojects by their respective governments.[9] The same type of problem reoccurred during the Subprime Crisis with the "too big to fail assumption" when banks used short-term funds to invest into complex long-duration products including mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs).

While the paths into the Asian and Subprime Crises appear to share certain characteristics, such as capital inflows, abundant liquidity, and easy credit, we do argue that Asia's high yield market has changed to the better since the Asian Crisis of 1997–1998, and improved further against the backdrop of the recent and ongoing global leverage crises (from household to subprime to sovereign). Credits and bond structures as a whole are assessed rather differently, due diligence standards follow the rigorous model known from the U.S. markets, risk is not concentrated in a handful of issuers, and the investor base is not only more sophisticated but also more diverse and stable. That enlarged pool of investors is also—for the most part—more discerning and more cautious, understanding better how to recognize the warning signs that should have alerted bondholders to APP's imminent demise in 2001. For a start, since its renaissance began in 2003, the public Asian high yield market has shown admirable discipline in largely rejecting issuers whose principals were the same businessmen that presided over defaults or interminable restructuring negotiations in the wake of 1997–1998. They have also insisted on structures that offer maximum protection for bondholders, and on the highest degree of transparency with respect to the disclosure and the use of proceeds.

It is perhaps also fair to say that the traumas of the various crises changed issuers' perception of the market at some level as well. At the risk of generalization and oversimplification, we believe that in general issuers and their sponsors are less reckless about leverage and more concerned about maintaining and improving credit ratings than they were in the first generation of Asian high yield. But it is also clear that high yield bond issuers in particular have changed over the last 15-plus years. The dominance of the family- or founder-controlled mid-cap company is under no real threat yet in Asia, but an increasing number of Asian high yield bond issuers now have links with international private equity.[10] And, in a more globalized economy and financial marketplace than that of the 1990s, the management of companies with all kinds of ownership structures faced more pressure than ever to be an attractive destination of investment money and to maximize

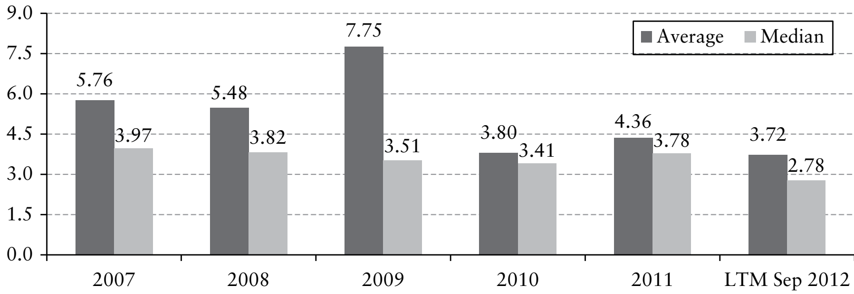

FIGURE 1.1 Average and Median Total Debt to EBITDA for Asian High Yield Issuers
Source: Moody's Investors Service.

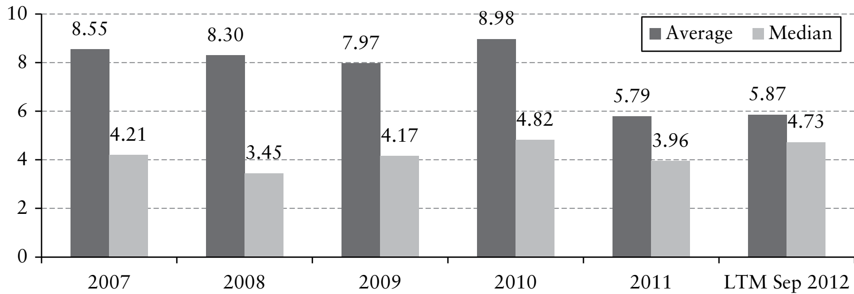

FIGURE 1.2 Average and Median EBITDA Interest Coverage for Asian High Yield Issuers
Source: Moody's Investors Service.

return on equity in order to maintain and grow equity valuations. The right amount of high yield debt on the balance sheet can help achieve this.

Issuers' financials are indeed healthier nowadays. Leverage measured in debt to equity improved from 170 percent to 30 percent in Korea, from 160 percent to 50 percent in Indonesia, and from 130 percent to 45 percent in Thailand between 1997 and 2007. While default rates of high yield issuers during the peak of the subprime crisis in 2009 appear still higher in Asia than in the United States and Europe, this result was distorted by the influence of China, a country where corporate leverage had slowly but steadily increased. However, stable median debt/EBITDA ratios as shown in Figure 1.1,[11] median interest coverage ratios, as shown in Figure 1.2, and median three-year funds from operation (FFO), as measured for Asia's high yield issuers from 2007 to last 12 months as of September 2012, as shown in Figure 1.3, demonstrate a high degree of post-subprime financial prudence, even in times of recovery, increased liquidity, and easy credit.

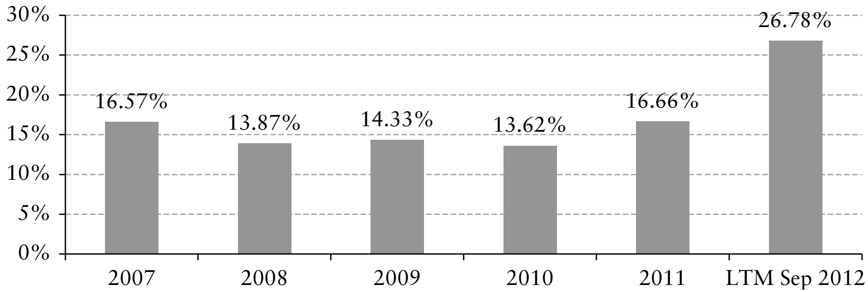

FIGURE 1.3 Median Three-Year Average FFO to Total Debt for Asian High Yield Issuers

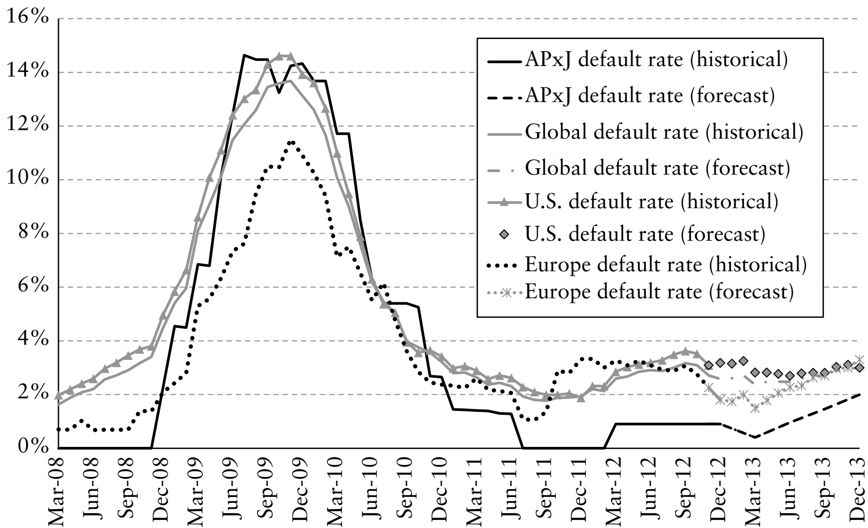

FIGURE 1.4 Trailing 12-Month Default Rate across Regions, March 2008 to December 2013

Source: Moody's Investors Service, as of February 28, 2013.

Note: APxJ refers to Asia Pacific ex-Japan, issuer-weighted, spec-grade default rate.

Consequently, and as Figure 1.4 illustrates, Asian default rates have fallen from their peaks in late 2009 to close to zero, and remain inside or at least in line with other regions.[12]

In short, corporate Asia's cash flows have improved, its ability to service debt has become much stronger, and its creditworthiness—if seen as the inverse of its default rates—has reached an all-time high. These are essential conditions for the resurgence of high yield bonds in the region.

It is important to point out at this stage that, in one sense, high yield in the broadest sense never went away after 1998. There was no shortage of non–investment-grade "corporate" borrowers trying to access the market in the immediate aftermath of the Asian Crisis. These included the perennially cash-strapped National Power Corp (Napocor), the Philippines' state-owned electricity generation and distribution entity. Napocor and other borrowers of its kind, such as its Indonesian equivalent Perusahaan Listrik Negara (PLN), however, were high yield only insofar as their debt had a non–investment-grade rating and therefore conformed to the term's strictest definition: "A bond with a low rating. Bonds rated less than Baa3 by Moody's or BBB by Standard & Poor's or Fitch are considered high yield bonds. They have higher yields because they have a higher risk of default on the part of the issuer" (Farlex Financial Dictionary).

In reality, however, borrowers like these are more quasi-sovereign issuers from non–investment-grade emerging markets nations. Napocor even relies on an explicit sovereign guarantee by the Philippines' Department of Finance. Regardless of their rating and the yield they may have offered, transactions for borrowers like these have never been high yield in the true sense of the word, and we prefer to characterize them as "emerging markets transactions." Their credit story rests on their sovereign guarantee or the expected support they would receive from the government in the event of a default. A "true" high yield borrower's credit story rests on its standalone credit fundamentals and the structure of the transaction.

True corporate high yield issues are non–investment-grade corporate bond transactions that are structured with a comprehensive set of financial and other covenants and, in some cases, a security package. These features are intended to ensure that, to the greatest extent possible, the funds provided by bond investors are deployed in, and do not leave, enterprises that generate earnings that will be used to service and repay the bonds those investors have bought. The covenant and security packages, which do vary across different Asian jurisdictions, are intended to give investors the greatest possible access to the assets of the issuer's key operating subsidiaries in the event of a default. While they share these trademark features, each high yield transaction is unique, with the covenants and security packages tailored around an issuer's specific corporate structure, cash flows, and the regulatory environment in the country of operations.

1.3 NECESSARY MACRO DEVELOPMENTS BENEFITING ASIAN HIGH YIELD

While we consider the corporate developments that made Asian high yield an investible proposition again, we should not forget the macroeconomic

situation of the region today. As the global economy struggles to emerge from events generally viewed as the deepest financial crisis since the Great Depression, centered around sovereign debt concerns in the Eurozone, with knock-on effects even on China, credit markets are once again exposed, at least temporarily, to high volatility, accompanied by a partial shut-down. Asia had experienced its very own financial shock in 1997–1998, after which the region was on its knees, crippled by external debt, inadequate foreign currency reserves, and collapsed currencies and asset prices. Surely, Asia is not immune to crises as the volatility in the equity and credit markets testified, but the region's healthier macroeconomic fundamentals have helped Asia to perform substantially better compared to other regions: more prudent treasury management at sovereign level, with less domestic spending and reduced fiscal deficits, an advanced financial architecture with well capitalized balance sheets and little exposure to subprime and CDO assets can be seen as key reasons behind this outperformance. Indeed, Asia appears to have established increasingly independent cycles with its fundamentals driving its recovery from ongoing financial crises. In many ways, the Asian financial crisis of the late 1990s saw Asia suffer acutely and in isolation, while the current crisis saw Asia last in and first out.

Recent developments testify to Asia's ability to continue to develop as a somewhat more independent economic zone, depending on the global financial system but not entirely beholden to it. Asia has clearly passed a tipping point in its importance of the global economy. China overtook the United States as the biggest contributor to global GDP growth in 2007, while economists have been trying to guess how soon the Chinese economy will unseat Japan and the United States to become the world's biggest. In December 2007, China had dislodged Germany as the world's third-largest economy and according to investment bank Goldman Sachs, China's GDP will overtake that of the world's second-largest economy, Japan, by 2015 and that of the world's largest economy, the United States, by 2040. PetroChina and China Mobile already rank amongst the world's 10 largest companies by market capitalization.[13] And while India's economy started from a smaller base, Goldman's economists also expect it to have passed Japan, Germany, France, and Italy in terms of real GDP size by the early 2030s.[14] Figure 1.5 shows the divide between China's and Asia's economic growth versus that of the United States.

Two of the principal causes of the Asian Crisis of 1997–1998 were inadequate foreign currency reserves to support exchange rates and an over-reliance on external debt. On both these fronts, Asia has made dramatic advances. Figure 1.6 illustrates the exponential increase in Asia ex-Japan's international reserves. China's foreign currency reserves are the by far biggest in the world, reaching US$3.31tr in the fourth quarter of 2012, up from US$220bn at the end of 2001.[15] When China broke the US$1tr mark back in

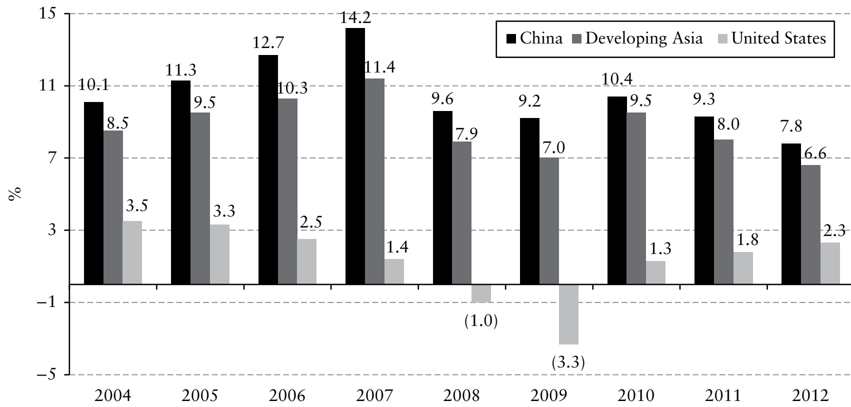

FIGURE 1.5 China's and Developing Asia's GDP Growth Compared to That of the United States
Source: IMF World Economic Outlook Update on January 23, 2013.

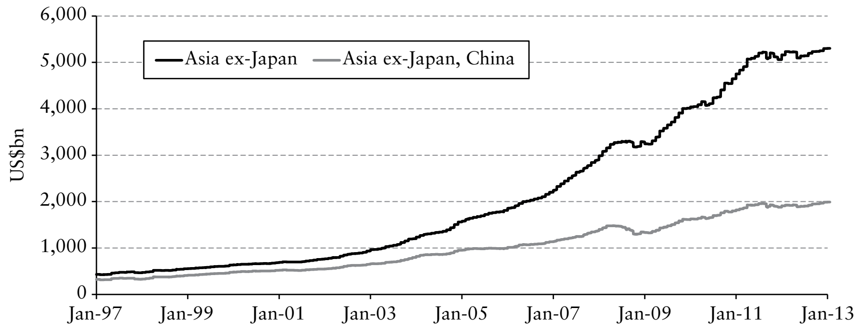

FIGURE 1.6 Asian International Reserve Assets, November 1997 to November 2012
Source: Bloomberg, as of January 31, 2013.

2006 the *Financial Times* wrote: "China's foreign currency reserves are likely to hit US$1,000bn this month: enough to buy Citigroup, Exxon, and Microsoft, with enough spare change for General Motors and Ford, as well."[16] One country with the worst hit currency of the Asian Crisis, Thailand, has recovered to the extent that its international reserve assets are now higher than those of the United States, at US$182bn versus US$150bn as of year-end 2012.

At the same time, as shown in Figure 1.7, the debt-to-GDP ratios in the core crisis economies of 1997–1998, Indonesia, Korea, and Thailand, has fallen to 25 percent, 34 percent, and 42 percent, respectively, according to

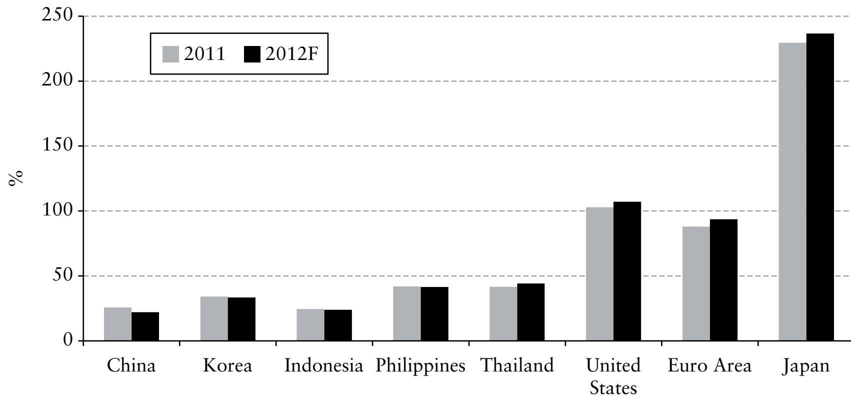

FIGURE 1.7 Total Government Gross Debt as a Percentage of GDP for Selected Countries
Source: IMF World Economic Outlook Database, October 2012.

IMF data of 2011.[17] This compares favorably with the United States at 103 percent and the Eurozone where ratios of most member states are well beyond the 60 percent criteria required by the Maastricht Treaty.

The concurrence of strong corporate balance sheets, low default rates, and a healthy macroeconomic backdrop explains *how* it was possible for the next generation of Asian high yield transactions to come into being. However, these circumstances do not explain *why* Asian high yield came back. They do not explain *why* Asian companies began to look at alternatives to their normal financing diet of retained earnings, bank loans, and equity. Yet Asian high yield issuance rose from US$1.7bn in 2000 to US$7.4bn in 2006, and again from US$2.1bn in 2009 to US$13.7bn in 2012, reflecting an overall compound annual growth rate (CAGR) of 18.2 percent.[18] In practical terms, the regional high yield market has developed from a nonentity into a highly active sector of the broader Asian primary bond markets—it has come back from the dead, twice.

So why do Asian issuers choose high yield bonds after years of favoring other financing techniques, particularly retained earnings, bank loans, equity offerings, and convertible bonds? And why do many market participants and observers—including the authors of this book—strongly believe that the potential of high yield bonds is only beginning to be realized in Asia? To explain this, we need to look at a whole range of factors, some more generic but highly relevant for issuing family enterprises; others are more country- and industry-specific; and finally, of course, complementing supply-side considerations are significant demand-side developments in the global credit markets in general and Asia in particular.

1.4 ASIA'S CORPORATE LANDSCAPE OF FAMILY ENTERPRISES

Family enterprises, defined as entities where a person controls directly or indirectly a minimum of 20 percent of the voting rights and the highest percentage vis-à-vis other shareholders, play an important role in the world economy. Some of the world's best-known brands such as Porsche or Benetton are produced and distributed by family enterprises. Rafael La Porta, in his work *Corporate Ownership around the World*, finds a significant concentration of ownership in the corporate sector of the richest economies, whereas widely held exchange-listed companies, perhaps surprisingly to some, represent a minority.[19] Germany with its *Mittelstand* has become a prime example of family-owned businesses successfully running the bulk of an economy, occupying industrial niches and cementing leadership with high quality products and therefore competing formidably in an increasingly globalized business environment. But family ownership has also been and continues to be a very Asian theme. Hutchison Whampoa and Cheung Kong, controlled by Li Ka Shing, or the Samsung Group are some of the better known—investment-grade rated—examples. However, a look into the universe of Asia's high yield bond issuers reveals that almost all of them, whether the private sector steel maker in China, the coal miner in Indonesia, or the property developer in the Philippines, are family enterprises. This is an important fact to understand not only the financing specifics of these enterprises but also why the high yield bond market in Asia has been so slow to take off, but ultimately will have to develop into a pivotal tool to fund the growth of Asia Inc.

The most striking and obvious characteristic of family versus public enterprises is the existence of family and corporate goals. The former exert a strong influence on the orientation of the company, and the interaction between the two necessitates often complex decision-making processes. Targets and value concepts in family-owned enterprises are globally similar and always reveal the emotional attachment of the family to the company. Attributes such as responsibility, risk aversion, independence but also secrecy are common. All these are connected and summarized in Table 1.1.

1.5 TRADITIONAL GENERIC BUSINESS STRATEGIES FOR FAMILY ENTERPRISES

The emotional attachment of family owners to their companies leads to a heightened feeling of responsibility. While the overriding goal is to preserve the family enterprise to hand it over to the next generation, this, combined

TABLE 1.1 Overview of Attributes of Family vs. Public

Situation	Goals and Value	Characteristics
Development of the company	Emotional connect and identification of the family with the company	Responsibility
	Company as a private matter	Secrecy
Overlap of personal wealth and company money	Preservation of the family enterprise for the next generation	Long-term view Risk aversion
	Family plays a central role for the company	Retaining independence

Source: Stiftung Familienunternehmen/PWC ("Die Kapitalmarktfähigkeit von Familienunternehmen," Munich 2011).

with an inevitable overlap of personal wealth and company money, leads to a long-term orientation of its business strategy. Risk aversion and the avoidance of dependencies (which in the worst case could lead to the loss of the company) are other key attributes that lead to the family retaining its central position within and control over the company.

Family owners strategically focus on market opportunities, product quality, and research and development. Their corporate leadership is thus characterized by a proximity to the products or services offered. This product-centric approach has an impact on the financing avenues, which can best be described as traditional and conservative: traditional by the choice of funding instruments, conservative by maintaining the existing ownership and decision-making structures. This, in turn, has led to a relatively low usage of share financing in family enterprises and as such is much different from the approach of non-family or listed enterprises. In such listed entities financing is pursued by managers with a core competence in financing who employ a whole range of capital-raising alternatives with the overriding goal of maximizing shareholder value.

While a connection between leadership structures and financing patterns can thus be easily established, it is of central importance to understand that the family enterprise itself often represents the single most important investment of the owner. Such low-diversified investment strategies do have an influence on the management of perceived risks, leading to specific assessments of the leverage-insolvency risk relationship. In other words: indebtedness is viewed differently in family enterprises from the way it is in non-family enterprises. Furthermore, the desire of family owners to remain in control of economic and noneconomic strategies as well as

decision-making processes requires a robust majority in equity holdings, which leads to restrictions in equity financings.

Traditionally, most Asian family enterprises transacted their funding exercises outside of the capital markets, preferably using retained earnings or, with the above-mentioned caveats in mind, bank loans. Retaining earnings ties into the long-term characteristics discussed above by assuming that money made stays within the company. The family provides what can best be described as *patient capital*. The overriding goal to preserve the company typically entails a moderate dividend policy. Some families even do without any dividends, an approach that leads to a much strengthened equity base, thereby providing financial resources for new investments, independently of other funding pools. The basic principle of retained earnings leads to an overlap between private and company wealth which implies that the wealth of the family depends to a large extent on the well-being of the company, triggering careful decision-making processes and a fairly high degree of risk aversion.

A thorough and detailed analysis of strengths, weaknesses, opportunities, and threats of financing avenues other than retained earnings therefore did and does not always happen and, at first sight, may not appear necessary. Existing bank relationships usually provided credit limits on a when-and-if-needed basis. Such paradigms, however, are now changing rapidly, and any minimalist approach toward relationship-funding will be challenged against the backdrop of (a) an increased internationalization of the financial landscape; (b) the consolidation of the banking industry; and most importantly (c) regulatory measures such as Basel III with its severe impact on lender-borrower relationships. Financial crises and ensuing regulatory reforms have a strong impact on the lending behavior of banks, their willingness to fund growth enterprises, and the costs of borrowing. Indeed, capital markets globally are now benefiting from tighter credit and the convergence of loan and bond pricing, leading to the increased application of corporate bonds as a substitute to loan products.

Furthermore, the subprime and subsequent crises have amplified the competitive advantages of companies with access to domestic and international capital markets. In times of tight credit a highly diversified funding pool, including uninterrupted access to capital markets, has proven superior to the more traditional Asian funding approach comprising internal cash flow and loan financing.

Given that many family-owned enterprises are either rated non–investment-grade or have non–investment-grade credit metrics, high yield bonds should play a pivotal role within the context of corporate funding, and, indeed, they do so in the most mature and sophisticated capital market, the United States, where a substantial part of external corporate financing is

done with high yield bonds, and to some extent in Europe. Asia, on the other hand, being without a comprehensive scientific discussion on high yield bonds to date, and therefore without a broad recognition of the suitability of high yield bonds as a viable funding alternative, has been a laggard, both in terms of timing and new issue volume. This, however, is bound to change, driven not only by the already mentioned regulatory changes, but even more so by challenging growth requirements in an increasingly globalized and competitive world.

1.6 A THEORETICAL APPROACH TO DEBT VERSUS EQUITY FUNDING

Classic capital structure theories such as the *Modigliani-Miller Theorem* stated that there are advantages for firms to be levered, since corporations can deduct interest payments from taxes. As the level of leverage increases by replacing equity with debt, the level of a company's weighted average cost of capital drops and an optimal capital structure exists at a point where debt is 100 percent. The higher probability of bankruptcy costs associated with debt financing and the possibility of a transfer of ownership, as stipulated in the *Trade-off Theory*, would negatively affect the value of the firm and as such suggests not only a reduction of leverage but what is referred to as an "optimal" capital structure. Indeed the tax savings argument plays a minor role in the decision-making process of family enterprises when it comes to capital structure issues. Given that these approaches neither take internal and external environmental factors nor specific goals of family enterprises into account, the classic theories do not appear to be best suited to act as helpful parameters in assessing family enterprises' financing options.

The *Pecking Order Theory*, on the other hand, tries to capture asymmetric information that affects the choice by which companies prioritize their sources of financing between internal and external as well as between debt and equity. Companies do have a strong preference for internal financing; that is, to retain earnings. Once this source is depleted or insufficient, external debt is raised. Asymmetric information favors the issuance of debt over equity as such issuance suggests that an investment is profitable and the current stock price is undervalued. Equity financing would signal a lack of confidence in the board and a feeling that the stock is overvalued. An equity issue would therefore have to be transacted at a discount and/or lead to a drop in the share price, apart from bringing external ownership into the company. While the Pecking Order Theory contributes to a broader explanation as to how family owned enterprises *should* conduct their financings, it does not apply to all industry sectors, and neither does it hold in cases where

asymmetric information is a particularly important problem. One needs to consider that family enterprises are by nature heterogeneous. Certain means of funding may therefore be advantageous to one entity but not so to another.

The question of debt versus equity warrants a closer look at the capitalization of Asian high yield bond issuers. Table 1.2 provides a brief overview of the equity ratios of select Asia-Pacific high yield repeat issuers. An analysis of the most recent full year financials reveals that most of Asia-Pacific's repeat issuers of high yield bonds feature adequate equity ratios, ranging from 25 percent to above 50 percent. Studies conducted in Europe arrive at similar results ranging from 30 percent to 50 percent.[20] The prevalent textbook classification sees a company with an equity ratio below 20 percent as undercapitalized, and the commensurate debt level of debt of 80 percent being considered a potential threat to the company's sustainability. An equity ratio of 70 percent and above suggests an over-capitalization. While this does not pose an immediate threat to the company, especially as the return on equity can be increased with additional leverage, a long-term view suggests threats if the avoidance of leverage prevents investments into significant and profitable growth areas.

The key attributes of business strategies carried out by Asian family enterprises, namely long-term orientation, independence, and risk aversion, have a strong influence on funding strategies and routes. Adequate or even

TABLE 1.2 Equity Ratios of Select Asia-Pacific High Yield Repeat Issuers

Issuer	Country	Equity Ratio
Fortescue Metals Group	Australia	33.3
Agile Property	China	29.1
China Oriental	China	41.5
Country Garden	China	28.1
Kaisa	China	28.7
KWG Property	China	30.7
Renhe	China	58.1
Road King	China	36.0
Shimao Property	China	29.9
Yanlord Land	China	46.3
Adaro Indonesia	Indonesia	43.2
Berau Coal Energy	Indonesia	25.4
Bumi Resources	Indonesia	16.0
Indika Energy	Indonesia	42.3
Lippo Karawaci	Indonesia	51.5
STATSChipPAC	Singapore	45.6

Source: Bloomberg.

high equity ratios testify family enterprises' preference for conservative funding. This is a global phenomenon, and in fact many companies around the globe even run internal guidelines for minimum equity ratios and other indicators. The single most important factor to strengthen these equity ratios is, of course, retained earnings, combined with a restrictive dividend policy. To avoid dependencies of certain entities vis-à-vis third parties and to ensure the ongoing supply of liquidity to all relevant entities most family enterprises benefit from a centralized financial management. All funding activities are therefore bundled in a single holding company. This thought process explains (1) why most Asian family enterprises issue high yield bonds as holding company debt, and (2) the structural subordination of Asian high yield bonds.

1.7 THE FACTOR "GROWTH" MAKES ALL THE DIFFERENCE

While the centralized cash pooling approach, at least in an ideal world, allows for maximum independence and efficient risk management, the factor *growth* requires some more balancing. Growth is absolutely necessary to develop the company, to compete successfully, and to increase the enterprise value. Growth, however, often requires funding volumes that exceed retained earnings, especially if it is inorganic; that is, driven by acquisitions. Equity funding faces obvious restrictions as the family owners would want to retain the highest degree of control over the company, even in an IPO scenario. Debt funding, on the other hand, could create dependencies from the lending banks, especially in times of tight credit and higher demands with regard to the size and nature of security packages.

As far as risk aversion as a key element of the generic business strategy for family enterprises is concerned, conservative CFOs may therefore avoid raising substantial volumes of debt from the loan or the capital markets and opt for a more conservative approach toward growth. Additional debt does by nature have a negative impact on a company's equity ratio. While a prudent maintenance of the latter should certainly not be argued with, it is a fact worth mentioning, however trivial, that corporate borrowings are repaid with cash flow rather than equity. A focus on cash flow–oriented indicators might therefore be more helpful when it comes to the identification and analysis of the right funding avenues for growth enterprises. Furthermore, an overly conservative approach toward growth may be a hindrance to the development and overall competitiveness of the company.

Funding growth in the debt capital markets through bonds, including high yield bonds, can therefore be considered supportive to at least two key aspects of the generic business strategy of family enterprises: long-term orientation through volume funding with bullet redemption (and longer

duration than bank loans); and independence through non-dilutive capital, raised from non-bank investors, governed by incurrence rather than maintenance covenants.

The importance of growth for debt funding was empirically researched by Susan Coleman and Mary Carsky, who used data from a 1993 National Survey of Small Business Finances.[21] Their goal was to determine the extent to which family-owned firms use various types of credit products. Employing logistic regression, the survey identified variables that predict the likelihood of using credit such as the size of a company (as a function of growth), age, and profitability. These predictors showed a positive correlation with debt funding, both in terms of funding volume as well as in terms of number of debt products employed. In other words, it is the need to grow that makes family enterprises depart from more traditional funding patterns into various debt products, including high yield bonds.

A working paper published by the European Central Bank on large debt financing went a step further to analyze the suitability of syndicated loans versus corporate bonds, sampling 1,377 corporates from the Eurozone that have used the syndicated loan and/or the bond markets between 1993 and 2006.[22] Firms using only the corporate bond markets featured the following characteristics: they had lower current profits, were better valued by the market, invested more, carried less financial leverage, and featured higher levels of short-term debt. In other words, they would be smaller firms with strong growth potential. The market-to-book value was used to gauge the growth potential of the samples. Expected future growth increases a firm's market value relative to its book value since intangible assets are not included in the latter. Bond-only borrowers posted a ratio of 3.26, compared to 2.40 for loan-only borrowers, 2.84 and 2.93 for infrequent and frequent (i.e., at least annual) borrowers. While the market-to-book value is more of a forward-looking measure reflecting investors' expectations, sales growth measures tangible past growth performance. Bond-only issuers featured year-on-year sales growth of 36.18 percent, whereas loan borrowers posted 16.57 percent. Companies that transacted both loans and bonds recorded 18.12 percent for infrequent and 18.46 percent for frequent borrowers.

Empirical studies conducted in the United States arrived at similar results. Denis and Mihov found that while forward-looking growth measures such as market-to-book ratios were not significantly different from each other, private borrowers with a median rating of BB experienced a higher growth of employees, capital expenditures, and sales than public borrowers featuring a median BBB+ rating.[23] Private non-bank borrowers (sample of 290 companies), using the 144A high yield bond market featured investment growth ratios of 0.29, compared to bank borrowers of the same rating scoring 0.142, or public investment-grade borrowers with a score of 0.074.

Growth has thus been empirically identified as a key driver behind bond funding in general and as *the* key variable for high yield bond funding for non–investment-grade enterprises. The suitability analysis that follows below explains further *why* high yield bonds have been recognized for growth funding in the United States and Europe, and why Asian companies, domiciled in the very region that has become synonymous for strong growth, yet traditionally favoring bank loan products, have started to follow this path. One sector specifically known for using the high yield bond market to fund its growth is the Chinese real estate market, outstripping all other industries.

1.8 AN ASIAN GROWTH MARKET: CHINA'S REAL ESTATE SECTOR

China indeed has grown into the largest source of public Asian high yield transactions in 2012, accounting for 68 percent of new issue volumes. Yet the existence of this market is more of an unintended consequence of the Chinese government's economic policies and regulations than anything else. China's financing sector is dominated by the state-controlled Big Four banks, whose adherence to government guidelines on lending priorities means that private enterprises receive less than 10 percent of the credit extended in China.[24] As a former People's Bank of China official has noted:

> *In the past two decades, the private sector has made huge contributions to China's high growth. It is also forcing the state sector to become more efficient. However, the private sector is still subject to widespread discrimination. . . . If the government is serious about sustainable growth, and a broad-based economy, it should start to dismantle the barriers to the private sector.*
>
> **Joe Zhang, "China's Private Sector in the Shadow of the State,"**
> ***Financial Times*, October 4, 2005**

Whether or when these barriers might be dismantled is not a question for this book. What is relevant, though, is that limitations on bank credit for the private sector in China mean that a host of the country's most dynamic enterprises often have no access to meaningful amounts of capital until they are able to access the public equity markets. China's domestic bond market has not been of not much help either, having been subject to quotas set by regulators and reams of red tape, as well as being open only to the most creditworthy issuers.[25] Capital starvation is a particularly serious challenge for companies in sectors that the Chinese authorities are trying to cool in an

effort to restrain inflation, notably the real estate industry, which has provided the bulk of Chinese high yield bond issuers so far, given that regulations prohibit such companies from utilizing the domestic loan market for landbank acquisitions. Yago and Trimbath may have been discussing the U.S. high yield market of the early 1970s, but they may as well have been talking about China in 2012 when they wrote:

> *Paradoxically, the companies with the highest return on capital, the fastest rates of growth in both market share and employment, and the greatest contributions to technological and new product innovation had the least access to capital. Simply put, successful, growing, and profitable companies were denied the money they needed to operate and build.*
>
> **Glenn Yago and Susan Trimbath, *Beyond Junk Bonds***
> **(New York: Oxford University Press, 2003)**

The disconnection between the providers of growth capital and—arguably—its most efficient and entrepreneurial users in China is one that the Asian high yield market has endeavored to repair by bringing international capital to issuers with operations in China. This is yet another example of high yield's capacity to innovate and open up new markets, in the tradition pioneered by Michael Milken in the 1970s, and it so far has been particularly valuable for Chinese real estate issuers. As of today Asian high yield remains a tiny market by comparison to its U.S. or even European counterparts, but Chinese real estate has emerged as its first subsector with a relatively well-defined credit spectrum and some at least rudimentary relative value trading opportunities. With 26 issuers rated by Moody's at the time of writing (and many more would-be issuers waiting), Chinese real estate looms particularly large in a market with 126 rated issuers in 28 industry groups and 14 countries, including Australia.[26]

Clearly, the high yield bond market has been of paramount importance to family-owned companies in an industry that is deprived of reasonable bank loan or bond financing avenues in its domestic market at times and for whom the sale of equity may not be a prudent option, but that find itself under pressure to acquire as much land as possible. China's real estate market is booming as the country's population shifts from the countryside to the cities, yet only a fraction of the population own private homes. Not surprisingly, prices have accelerated across the country as supply becomes more limited and demand from China's growing middle class continues to increase. Chinese developers naturally want to avoid disappearing without a trace as the still fragmented real estate industry begins to consolidate, and to ensure they have as much inventory as possible in case the country's

somewhat unpredictable regulators take further steps to limit the funding available to them or the supply of land. And, in these circumstances, it is the high yield market that can provide large amounts of long-term, non-dilutive funding where other financing products cannot.

1.9 SUITABILITY OF HIGH YIELD BONDS FOR FAMILY ENTERPRISES

There is extensive theoretical literature concerned with the coexistence of bank lending and bond financing. The theory of financial intermediation tends to emphasize that banks and capital markets compete, so that growth in one is at the expense of the other. Fabian Kracht has identified key determinants in his analysis of high yield bond suitability for German family enterprises, all of which are universally applicable and as such just as relevant for Asian companies.[27]

1.9.1 Minimizing Funding Costs While Achieving a Sufficient Degree of Liquidity

Historically, syndicated loans for non–investment-grade borrowers have been a cheaper source of funding compared with high yield bonds due to the senior secured status of the former. Leveraged loan yields (calculated to a three-year refinancing) are currently 5.97 percent, according to a Credit Suisse research, 52bps tighter than high yield bond yields of 6.49 percent.[28] The average difference between these yields, however, was 83bps since December 2009, providing an indication that a price convergence between the products is on its way. This convergence is not only a function of regulatory pressures on banks, a more discriminate credit process, competitive challenges, and higher return thresholds, but also caused by the ongoing process of credit disintermediation. However, even under the assumption of a complete convergence of bond and loan pricing could high yield bonds be considered less economical if the new issue size is too small. Given the higher nonrecurring and third party expenses incurred during the new issue process firms would only tap the public bond markets when the issue amount is large enough to benefit from economies of scale. There should hence be a positive relationship between public bond financing and a firm's size.

1.9.2 Minimizing External Influence and Control

External influence by holders of high yield bonds is very limited. Investors, upon purchase of the notes, implicitly accept the relevant contractual documents and waive any direct influence on the management of the

a quarterly basis), however, should not be a concern to any modern and confident family enterprise. Neither should be the work and information requests related to international credit ratings. Chapter 5 will analyze this in more detail, but one of the key assumptions with regard to international credit ratings is that they provide creditworthy issuers significant advantages in terms of investor diversification and, directly related to the size of the investor pool and investment funds provided, cost of funds. Both far outweigh the costs associated with the information provided to the rating agencies. While such disclosure obligations may be opposed to the traditional view to see a family enterprise as a private matter, it is important to note that these requirements do not exceed what bank lenders would ask for and most Asian borrowers have been happily providing in the past, including business plans containing future numbers and ratios on a semi-annual or at least annual basis during the life of a loan provided. High yield bonds are therefore not necessarily inferior to bank loans as far as information requirements are concerned and are certainly superior versus equity capital markets transactions as only noteholders are given access to the relevant data, a far closer circle of recipients than the broad public in an equity offering.

However, at least a certain percentage of bondholders seems to have difficulties to "distinguish between the optimality of liquidating or allowing the project to continue," owing to information asymmetry and free-rider problems, according to a paper on large debt funding published by the European Central Bank.[29] The information asymmetry hypothesis suggests that a firm's choice of debt is related to a degree of asymmetric information a firm is exposed to. Such asymmetries result in problems and moral hazard between shareholders and debt holders.[30] Firms with greater incentive problems arising from information asymmetries are expected to borrow privately, given banks' ability to monitor borrowers' activities and to mitigate moral hazard.[31] As the degree of asymmetric information decreases, the scale of safety becomes less important, and the debt choice will be determined by other factors, such as transaction costs and the flexibility of covenants. Asian borrowers' often particularly strong desire to stay private (and/or unrated) and the real or perceived information asymmetry associated with this desire should be viewed as one of the more important factors, next to funding costs, which have given loan financing a competitive edge in the past in Asia.

Such borrowers, however, overlook two—initially perhaps less visible—opportunities that go hand in hand with the publicity associated with high yield bond funding of family owned companies: the perceived professionalization of the financial management and the enhanced name recognition. The former is a critical success factor for growth enterprises. Decisions to obtain and maintain international credit ratings are particularly important within this context, as the ratings process reveals areas that require improvement

with regard to the capital structure, liquidity profile, profitability, and others. The opening of a company toward a vigilant audience of global observers, and the external analyses conducted by the rating agencies, research analysts, and noteholders are clearly designed to identify and avoid negative developments. Owners and management of high yield bond issuers are hence encouraged to look at their company from an external debt provider's perspective, a process that typically leads to a stronger focus on cash flow and EBITDA rather than turnover.

Name recognition is the other winning aspect of heightened publicity. The global marketing campaign conducted prior to a high yield bond offering and the follow-up public relations work post offering can create substantial competitive advantages. Such advantages can relate to both increased sales and the ability to attract and retain higher quality personnel.

1.9.4 Maximizing Flexibility

High yield bonds do follow certain standards but are nonetheless very flexible funding instruments. All negotiable aspects of the indenture such as the use of proceeds, covenants, and carve outs provide at least as much scope for creativity as does the contractual documentation of bank loans. Gilson and Warner even state:

> *Junk bonds can provide more flexibility than bank debt in several ways. First, junk bonds generally impose far fewer, and looser, contractual restrictions on borrowers. For example financial ratio covenants are much less frequent. . . . These restrictions can produce opportunity losses if they prevent firms from taking net present value projects. Second, junk bonds provide flexibility because they typically have longer maturities than bank debt. This enhances the ability of the borrower to fund profitable projects which are long-lived. Third, junk bonds are less often secured, which gives management more discretion over the use of the firm's assets.*[32]

This relative advantage, of course, depends on the possibility to renegotiate. Any "renegotiation and liquidation hypothesis argues that borrowers with a higher ex-ante probability of financial stress are far less likely to borrow publicly,"[33] according to a working paper on large debt financing published by the European Central Bank. Bank debt is quite easy to renegotiate because there are fewer creditors to deal with. On the other hand, there are many examples of successful consent solicitations transacted by bond issuers.

Having operating flexibility in mind, Asian companies, like their counterparts elsewhere in the world, have been specifically drawn to high

yield by its use of incurrence covenants rather than the maintenance covenants typically found in syndicated loan transactions. The philosophical difference between these two sets of financial covenants provided issuers who grasped its consequences with further evidence that not all debt is created equal and another strong "freedom" incentive to replace bank debt with high yield bonds. Whereas maintenance covenants require an issuer to regularly monitor its key financials, cash flow, and leverage ratios, and maintain them within agreed ranges, incurrence covenants can only be triggered by predetermined actions by the borrower, including acquisitions, divestitures, and further borrowings. Unless any issuer takes any of these courses of action, incurrence covenants do not serve as early warning signals of deteriorating creditworthiness, unlike maintenance covenants for loans.

Incurrence covenants do, however, *aim* to preserve the quality of a credit by limiting its indebtedness, controlling cash outflows, and preventing the sale of income-generating assets. This is done by creating a ring-fence around the proceeds of the notes issue to prevent a leakage of funds. On the other hand, the covenant package is supposed to be flexible enough to synchronize management's need for operational latitude, shareholders' interests, and noteholders' interests by allowing issuers to grow their businesses, and to go through the ups and downs of business cycles without being in constant danger of a technical default.

Issuers indeed have come to realize that high yield bonds in various aspects offer them a substantially higher degree of flexibility than bank loan financing, while sparing them from conceding ownership of their company, which would be the case with equity and equity-linked issuance.

The one aspect where bank loans appear more flexible than high yield bonds are the payment streams. High yield bonds are bullet instruments with full payout, an advantage for projects requiring duration but a disadvantage if a partial payout is sought to avoid negative carry. Early redemptions, partial or in whole, are easy to facilitate and relatively cost efficient for bank loans, whereas high yield bonds typically feature call options from years 3 (for five-year issues), 4 (for seven-year issues), and 5 (for 10-year issues) at half a coupon cost. Earlier redemptions have to be transacted via a *make whole* clause, a route that is almost prohibitively expensive.

In terms of flexibility one has to arrive at the conclusion that high yield bonds are clearly superior in terms of their contractual design, whereas bank loans would be preferable with regard to their payment streams. Most high yield issuers are therefore attempting to generate a debt portfolio comprising high yield bonds and loans with a view of combining the respective strengths of the two. Raising a minimum debt stock via high yield bonds allows a growth company to benefit from the longer duration (and potentially larger borrowing volumes), while additional funds can be raised via revolving

facilities on a when-and-if-needed basis, to optimize payment streams. Revolvers are the most flexible form of bank debt. In a revolver, the borrowers pays a fee for the option to obtain additional funding up to an agreed ceiling amount. This option can be exercised as long as predetermined financial ratios are being met. Capital market access and credit ratings would provide issuers with a negotiation tool to obtain optimal (read: the most flexible) contractual terms for such loan facilities.

1.9.5 Financial Security through Duration

Duration is the most obvious determinant favoring high yield bonds over bank debt. All empirical works on the subject uniformly concluded that bonds with their bullet features provide longer duration funding versus the amortizing and cash-flow-consuming schedules of bank loans, making them not only more suitable for long-dated investments and projects, but also create a shield against external shock events, as the availability of longer duration volume funds makes financing exercises less frequent. High yield bonds typically feature final maturities of five, seven, or ten years whereas bank loans, whether bilateral or syndicated loans in most cases do not exceed five years with their average lives, taking amortization schedules into consideration, being even shorter.

1.9.6 Minimizing Collateral

Equally obvious are the strong advantages of high yield bonds versus bank loans with regard to the security/collateral package. High yield bonds are typically subordinated and unsecured, benefiting only from guarantees provided by the operating companies, share pledges, and a covenant package. Bank loans, whether bilateral or syndicated, are senior and almost always secured by otherwise unencumbered assets. Borrowers have to top up collateral should the market value of such assets decline below the agreed loan-to-value ratio. In such circumstances bank lenders would even approach family owners or proprietors for collateral, although this is more common in bilateral lending situations and rare in loan syndications. As mentioned before, bank loans also feature a package of maintenance covenant packages that are usually tighter than the incurrence tests high yield bonds are subjected to. This combination of clean borrowing with incurrence tests versus secured borrowing with maintenance tests should therefore be seen by a family enterprise as capital structure de-risking, while creating additional capacity to secured lending on a when-and-if-needed basis.

1.9.7 Conclusion

Neither bank loans nor high yield bonds can perfectly optimize all the financial objectives of a debt-funded family enterprise. However, either product fulfills certain objectives. High yield bonds certainly minimize external influence and control, keep the disclosure of internal data reasonable and to a relatively close circle of noteholders, create an upside by professionalizing financial management and name recognition, while maximizing contractual flexibility. The most obvious strengths of high yield bonds, however, are the creation of financial security through duration and their unsecured nature. Bank loans, on the other hand, appear only superior in terms of overall economics (although regulatory pressures and the resulting tighter allocation of credit are in the process of changing this) and their flexibility of payment streams.

As such the above analysis has shown that most financial objectives of family-owned enterprises can be met by the use of high yield bonds, even from a traditionalist perspective. Given the increasing challenges the traditional funding approaches are facing from the regulatory front as a result of the subprime and leverage crises, this is a hugely important finding. Lowering the dependence on the availability of bank credit by diversifying the providers of debt capital into a multitude of fixed income investors from various geographies provides for an important additional layer of insulation against fat tails and should therefore become a priority objective (in addition to the six objectives analyzed above) for family enterprises. As mentioned, terming-out the maturity profile via capital markets–based funding also creates additional security against external shock events, but also against unfavorable short-term interest movements. Finally, the very fact that a company is capital markets–eligible and the reduction of collateral through the utilization of high yield bonds makes such a company a much more interesting proposition for banks to lend to, in turn maximizing the availability and flexibility of funding avenues.

1.10 A WALL OF LIQUIDITY

Of course, having borrowers willing to access the market is only half the equation—there must also be a ready and willing investor base. As credit conditions improved across the globe after 2010, liquidity in the international financial system once again swelled to prodigious levels, driven to a large extent by Asia's high savings rates, huge inflows into the fund management and private banking industries, and the growth in bank deposits.

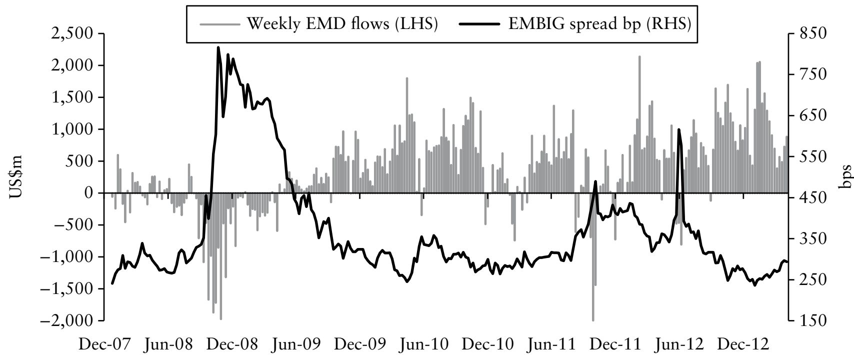

FIGURE 1.8 High Yield/Emerging Markets Fund Inflows
Source: ING, as of December 2012.

To be sure, demand for Asian high yield bonds has ebbed and flowed, but the long-term trend has been one of mounting appetite for exposure to corporate Asia, turbo-powered by a glut of liquidity that built up again and again once global credit conditions were considered benign. Not surprisingly, the sheer scale of investor demand for Asian high yield at most times was a critical enabling factor in the market's development, giving issuers a greater sense of confidence that they could execute bond offerings successfully. Figure 1.8 shows the inflows of money into high yield and emerging markets funds between 2007 and 2012.

In a market awash with money, decent returns grow harder to find, first in traditional investment-grade credit markets, which seem to have turned into proxies for U.S. Treasuries, then in emerging market sovereigns such as the Philippines or Indonesia which nowadays trade flat or a fraction higher than many investment-grade sovereigns from Europe, and eventually even in U.S. and European high yield.

The traditional yield premium paid by Asian high yield issuers often proves irresistible for many of the same overseas funds that had lost interest in Asia's non–investment-grade corporate bond product after the disasters associated with the first generation of deals. The biggest hitters in the asset management world even began open trading operations in Asia. Pacific Investment Management Co. (PIMCO) became one of the first U.S. asset managers to establish a regional trading desk, in Singapore, in March 2006. Some commentators at the time wondered why PIMCO bothered—after all, Asia's entire G3 market was only worth US$34bn in 2005, which is a drop in the ocean for an asset manager with the world's largest bond fund.[34] But Michael Gomez, Joint Head of Emerging Markets at PIMCO in Newport Beach, California, disagreed. "There is a broadening scope of opportunities.

In the past, the [Asian] market was dominated by sovereigns and quasi-sovereigns. Now there are far more opportunities in high yield and local currencies. We feel that liquidity will continue to develop over time as the market grows and interest picks up."[35]

The emergence of, and confidence in, Asian high yield bonds have been put to the test on several occasions, though. While the market had to face up a threat of the same magnitude as the Asian financial crisis during and after subprime, it has emerged much faster this time and arguably with a higher degree of maturity. In fact, one could argue that Asia's financial architecture, at both sovereign and corporate levels, has never been better positioned to withstand and absorb external or even internal shocks than at the present time. This view is supported by an analysis of the most notable differences between the first generation of Asian high yield transactions and those of today. One of these is the much broader buy-side participation in today's issues. While the pre-crisis higher yielding Eurobonds or floating rate notes issued by Asian non–investment-grade corporates were heavily placed with Asian investors—notably the now-defunct Korean merchant banks—fixed rate Yankee bonds (such as the APP group issues) were almost entirely distributed to a select number of U.S. investment managers. With the benefit of hindsight, it was surely unwise for the region's borrowers to be so heavily reliant on just two groups of investors, when one of them (the Korean merchant banks) lacked the necessary credit analysis and risk assessment skills for high yield, and the other (U.S. investment managers) was based on the other side of the world, perhaps lacking an in-depth understanding of the intricacies of Asian and Indonesian credit as well as risks and rewards.

After the Asian Crisis, as capital once again built up in Asia, the buy-side pool changed dramatically: a large number of new hedge funds and asset management companies set up shop in the region, while banks started to look down the credit curve in search of better returns for their proprietary trading desks or investment books. This was accompanied by the emergence of the private banking sector, which, as a reflection of Asia's accumulation of wealth, became an important investor bracket in Asian high yield bonds. The upsurge in regional demand from different kinds of real money buy-and-hold accounts, as well as from more trading-oriented and speculative fast money buyers, provided substantially more diversification and impetus to Asian high yield transactions in benign markets as multiple over-subscriptions of new issues have demonstrated. What it did not do was help to stabilize the market during periods of shock and volatility as the subprime crisis amply demonstrated. When highly leveraged holdings of hedge funds and private banks needed to be monetized, the market crashed with perfectly viable credits trading as low as 30–40 cents on the dollar. The market remained shut for new issuers, ironically for much longer than

TABLE 1.3 Asia's Dedicated High Yield Investor Base Has Room to Grow in Asia

Region	Number of Dedicated High Yield/Credit Funds	Number of Fixed Income Funds	Total Number of Funds	Funds' Assets
Asia	5–10 percent	261	1,568	US$2.93bn
Europe	20–25 percent	932	4,370	US$8.51bn
United States	25–30 percent	1,578	6,314	US$12.65bn

Source: Investment Company Institute.

the U.S. high yield market where the subprime had crisis originated. This can be explained by an excessive use of leverage by many Asian investors, but also by weaknesses in the composition of the investor base: real money buyers who understand high yield are still rare in Asia—as shown in Table 1.3. The number of dedicated high yield/credit funds is approximately 5 percent to 10 percent of the fixed income funds universe.

As Asia's financial system recovered and then prospered after the 1997–1998 crisis, it was inevitable that a greater share of high yield transactions would be distributed to regional buyers, and this has certainly been the case. This increase in Asian participation in regional high yield has even given rise to the emergence of "Reg S–only" placements, mainly focused on the private banking bid with comparatively little institutional participation, in which issuers were able to place high yield bonds without having to market into the United States at all. Foregoing the U.S. institutional real money bid may be feasible for primary placements, but such bonds have the propensity to be less liquid than offerings sold under Rule 144A tranche and to underperform in times of stress. The day when even the largest high yield bond issues can be exclusively distributed to a solid and quality investor base in Asia, and the Asian market emulates its U.S. counterpart in that respect, is still some years away and will depend on the build-up of a genuine specialist high yield investor base. Having said that, it is also true that the Asian high yield market would not have come as far as it has without the rise of indigenous demand from the private banking industry and other regional investors.

Just as the restructuring of corporate America gave birth to the junk bond market in the 1970s, the new generation of Asian high yield has been engendered by a set of circumstances particular to the region at this stage in its development. Rapid economic growth of specific industries and their issuers; record low regional default rates; pressure on principals to increase returns; issuers' increasing awareness of high yield's benefits as a senior, unsecured form of long-term, non-dilutive, and cost-effective capital with a multitude of applications; resurgent global investor interest in Asian credit;

the formation of an indigenous investor base, specifically supported by private wealth management firms; the emergence of private equity and sponsor capital; and, of course, hugely favorable global credit market conditions have all played their part and will continue to shape the market's growth. But it is probably the indefatigable spirit of entrepreneurialism from Asia's family-owned enterprises animating this region that has been the most essential precondition for the emergence of a high yield bond market, and permits us the most confidence in its future.

NOTES

1. For the purposes of this chapter, Asia refers to Asia outside Japan and Australia.
2. G3 refers to debt securities denominated in U.S. dollars, euros, and Japanese yen.
3. M. Shari, "Asia's Worst Deal," *BusinessWeek*, August 13, 2001.
4. Nachum Kaplan, "Asian High Yield Is a Dumb Bet for Smart Money," IFR Asia, online edition, January 9, 2013.
5. *Asia-Pacific M7A Bulletin, Year-End 2010*, PriceWaterhouseCoopers LLC, 2011.
6. Khor Hoe Ee and Kee Rui Xiong, "Asia: a Perspective on the Subprime Crisis," *Finance & Development* 45, No. 2 (June 2008).
7. Ibid.
8. Ibid.
9. Paul Krugman, "What Happened in Asia?" Massachusetts Institute of technology (Cambridge, MA, 1998).
10. Avago Technologies (Kohlberg Kravis Roberts and Silver Lake Partners), Hynix Semiconductor (CVC), C&M (Goldman Sachs), Sino-Forest (Morgan Stanley), and Mandra Forestry (also Morgan Stanley) are all Asian high yield bond issuers that were or are either controlled by, invested in by, or have close links with, private equity firms.
11. EBITDA (earnings before interest, tax, depreciation, and amortization) is a key measure of a company's ability to generate cash and will be frequently used throughout this book.
12. "2013 Asian Corporates High-Yield Default Rates to Remain Low," Moody's Investor Service, February 27, 2013, p. 3.
13. Financial Times Global 500, as of September 28, 2012.
14. Dominic Wilson and Roopa Purushothaman, "Dreaming with BRICS: The Path to 2050," Global Economics Paper No. 99, Goldman Sachs, October 1, 2003.
15. List of countries by foreign reserves, in http://en.wikipedia.org/wiki/List_of_countries_by_foreign-exchange_reserves, citing IMF sources.
16. "China's Reserve Riddle," *Financial Times*, October 20, 2006.
17. Public debt, International Monetary Fund, April 2012 World Economic Database.
18. Source of issuance levels: Bloomberg; source of CAGR calculations: author's own.
19. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Corporate Ownership around the World," *Journal of Finance* 54, no. 2 (April 1999): 471–517.

20. Fabian Kracht, *High Yield Bonds als Ergänzung zum traditionellen Bankkredit: Eignungsuntersuchung am finanzwirtschaftlichen Zielsystem deutscher Familienunternehmen* (Gabler Verlag, Springer Fachmedien Wiesbaden GmbH, Wiesbaden, 2010), 34.
21. Susan Coleman and Mary Carsky, "Sources of Capital for Small Family-Owned Businesses: Evidence from the National Survey of Small Business Finances," *Family Business Review* 121, no. 1 (1999): 73–86.
22. Yener Altunbaş, Alper Kara, and David Marqués-Ibáñez, "Large Debt Financing: Syndicate Loans Versus Corporate Bonds," European Central Bank, Working Paper Series, no. 1018 (March 2009).
23. David J. Denis and Vasil T. Mihov, "The Choice among Bank Debt, Non-Bank Private Debt and Public Debt: Evidence from New Corporate Borrowings," *Journal of Financial Economics* 70, no. 1 (June 2002): 3–28.
24. The "Big Four" Chinese banks are Bank of China, Bank of Communications, China Construction Bank, and ICBC.
25. This inefficiency was acknowledged by the Chinese leadership in 2007, and, on August 14, the China Securities Regulatory Commission promulgated Trial Measures for the Issuance of Corporate Bonds, which was widely seen as an effort to create a more market-driven corporate bond regime for Chinese companies. Until these measures make themselves felt, though, Chinese companies will continue to rely on bank lending and, to a lesser extent, equity funding, and offshore high yield bonds. As Chen Yaoxian, Chairman of China Securities Depository and Clearing, said: "Without a prosperous bond market, China's capital markets will remain immature" (Xinhua, March 8, 2007).
26. Asian High Yield Compendium, Moody's Investors Service, June 2013.
27. Kracht, *High Yield Bonds*, 120.
28. Leveraged Finance Outlook. 2013 Outlook for U.S. High Yield Bonds and Leveraged Loans, Credit Suisse Fixed Income Research, December 3, 2012.
29. Altunbaş, Kara, and Marqués-Ibáñez, "Large Debt Financing," 10.
30. Ibid., 10.
31. This hypothesis refers to the usage of bilateral loans versus syndicated loan facilities.
32. Stuart C. Gilson and Jerold B. Warner, "Junk Bonds, Bank Debt and Financing Corporate Growth," University of Rochester (1997), 6. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=.
33. Altunbaş, Kara, and Marqués-Ibáñez, "Large Debt Financing," 10.
34. In March 2006, PIMCO had more than US$500bn of assets under management (AUM), and its Total Return Fund, managed by Bill Gross, was the world's largest bond fund, with more than US$92bn of AUM.
35. "Asian Leveraged Finance, A Special EuroWeek Report," *EuroWeek* (December 2006), 2.

About the Author

Florian H.A. Schmidt is Managing Director and Head of Debt Capital Markets, Asia, with ING Wholesale Banking, based in Singapore. He has been professionally involved in Asia's debt capital markets for more than twenty years. During that period, he has originated and executed a large number of high yield bond issues, both public and private, including several landmark transactions. Among these were the first ever high yield bonds from Vietnam and Mongolia, a US$200m senior notes issue due 2018 for Vingroup, and Mongolian Mining Corp's US$600m senior notes benchmark due in 2017. The former was named "Best Vietnam Capital Market Deal 2013" by FinanceAsia and IFR Asia each, the latter was named "Emerging Asia Bond of the Year 2012" by IFR, "High Yield Bond of the Year 2012" by IFR Asia and "Best High Yield Bond 2012" by Asiamoney; eAccess' US$420m senior notes due 2018 represented the first dual-currency high yield offering from Japan and were named ""Best International Bond and Best Leveraged Financing 2011" by Asiamoney, "Japan Deal of the Year and Most Innovative Deal 2011" by FinanceAsia; Pt Bukit Makmur Mandiri Utama's US$315m senior notes due 2012 were named as "Best Indonesia Capital Markets Deal of the Year 2009" by FinanceAsia and IFR Asia; and Indika Inti Energi's innovative debut US$250m senior notes due 2012, named "Best High Yield Bond 2007" by FinanceAsia; benchmark offerings for China high yield names including China Oriental's inaugural US$550m senior notes due 2017 and Central China Real Estate's US$300m debut senior notes offering due 2015. Mr. Schmidt was also involved in some prominent Asian high yield distressed restructurings, including PT Davomas Abadi and Titan Petrochemicals.

Praise for

A Guide to Asian High Yield Bonds

"This book is a winner because it covers an area of Asian finance which deserves this comprehensive study by a professional in the industry. The good news is that Florian Schmidt writes with an easy style so that this complex subject is easily digested. I particularly liked the historic view and the specific cases which bring the subject to life. I was particularly delighted that Florian starts with the Asian Pulp and Paper disaster which we all remember and represented somewhat of a watershed for high yield fixed income markets in Asia. Other interesting and relevant cases are covered which gives the reader an idea of the lessons that can be learned from various crises. The book looks at the risk/reward balance required for successful bond investing. It also covers macro developments that impact the high yield bond market such as inadequate foreign currency reserves that led to the 1997–98 Asian crisis. Most interesting is the section on family enterprises in Asia and what that means for assessing the market and assessment of risk. Probably the most interesting parts of the book discuss requirements and characteristics of high yield bonds in specific sectors: TMT (technology, media and telecom), real estate, metal and mining. In each of those sections, I loved the case studies and particularly the interviews with key industry executives. Another section deals with the secondary markets for high yield bonds: characteristics of the buyers, regulations, trading, value analysis, hedging, etc. Finally, requirements of structuring high yield bonds is not only useful for practitioners but for anyone who wants to understand how such bonds originate. It's a useful and interesting book not only for those interested in high yield bonds but for any investor who wants to understand investment markets in Asia."

—Mark Mobius, Executive Chairman, Templeton Emerging Markets Group

"This is the right time for a book on Asian high yield. In many respects, the Asian high yield story is the Asian story. All the big themes in Asian markets—emerging economies, dynamic issuers, fast-growing companies, hot cash inflows, weak governance, high leverage and even higher risk—converge in the high yield space. Schmidt captures all of these themes with a journalist's eye and a banker's insight. The book is as entertaining for the observer of Asian markets as it is informative for the professional working in them."

—Nachum Kaplan, Editor in Chief, *IFR Asia*

"The Asian credit market, and high yield in particular, is growing rapidly and has emerged as a viable asset class for investors worldwide. There is, however, a shortage of quality investment literature that focuses on the Asian credit market and that stands alongside other well-known investment texts. *A Guide to Asian High Yield Bonds* fills this void. Despite its focus on the high yield asset class, the book is wide-ranging and covers each topic in detail sufficient to both educate the reader and provide value-added knowledge. The book is relevant to both the novice and the more seasoned investor."

—Richard Brown, Head of Credit Research, Asia, Schroders

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