Financing alternatives for "Mittelstand" companies

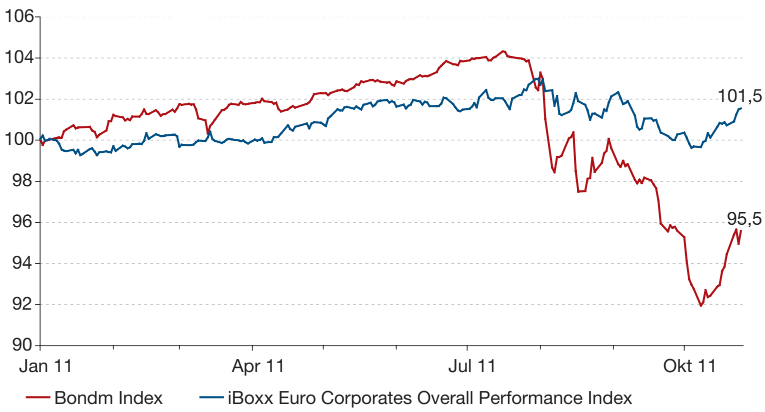
Choosing the right financing instrument and diversification level

Since the establishment of bond market segments at German Stock Exchanges, e.g. bondm in Stuttgart and the Entry Standard for Corporate Bonds in Frankfurt, several German Mittelstand companies have participated in the starting retail public bond hype. This hype has been especially driven by a "retail" pricing caused by, inter alia, misunderstood ratings and inexperienced (retail) investors.

In the light of the Euro-crisis and the US rating downgrade, investors became more cautious. The market realised that published ratings for "retail" bonds are company ratings rather than issue ratings, which disregard a potential structural subordination of the unsecured bonds vs. any existing secured bank debt. Furthermore, missing covenants increased investors' risk compared to market standard institutional bonds. Thus, the Bondm Index of the Stuttgart Stock Exchange lost 4.5% since January 2011, while the iBoxx Euro Corporates Overall Performance Index gained 1.5% during the same time period.

To avoid any misunderstanding: corporate bond issues are a proven and important financing alternative not only for Mittelstand companies to diversify corporate funding alongside bank and asset based financing instruments. However, such corporate bonds should comply with long-standing market standards, i.e. have adequate covenants, contain clear ratings and at-market pricings. Corporate bonds together with other financing instruments, especially bank and asset based financing, form important parts of a company's financing strategy.

Figure 1: Comparison Bondm vs. iBoxx Index



Source: Bloomberg

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Asset based financing

Asset based financings, such as factoring, leasing (incl. sale-and-lease-back) or a borrowing base working capital facility, might not be the right instrument for everyone. However, depending on a company's type of business, accounts receivables structure, inventories, fixed asset base, etc. may add an attractive and competitive financing alternative to the "classic" bank loan. While accounts receivables may be recognised by banks as a security for a loan at just 50% of their actual value, factoring can provide a cash payout in excess of 90%. And a (depreciated) fixed asset may only be recognised by banks at book value as a security, while a sale-and-lease-back can provide financing at up to 100% of market value.

Corporate bonds

The retail Mittelstand corporate bond market has left its juvenile stage and there will be less inexperienced investors purchasing underpriced securities. The market is moving towards the long-standing institutional corporate bond market with existing market standards for more professional, institutional structuring, pricing and "real" investment grade ratings.

Ratings are not carved in stone

As can be seen from the USA example, even an assumed safe AAA government bond can loose its AAA rating quickly.

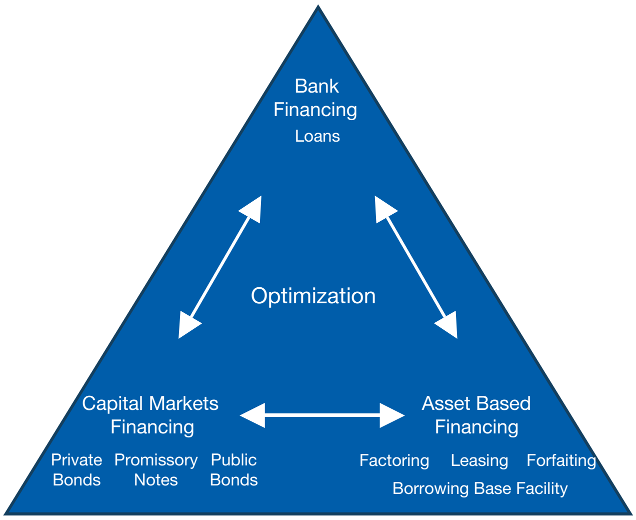
Thus, a today's investment grade rating may not be investment grade quality tomorrow.

Therefore, a company's decision process regarding the favoured financing product will change. The question is whether a publicly listed bond will indeed be more favourable than a private placement, as it imposes publication obligations to the issuer. Privately placed bonds still allow a bank-independent funding through institutional investors such as insurance companies or private debt funds, while the reporting requirements are much lower. On the other hand, an undisputed requirement for a private placement usually is a clear investment grade credit quality of the issuer, although an "official" rating by a rating agency might not even be required, as the investors conduct an in-house due diligence.

In the case of public bonds, German institutional "blue chip" investors generally require a rating by either Euler Hermes or one of the "big-3" rating agencies (S&P, Moody's or Fitch). Recent discussions with such investors suggest that, while an Euler Hermes rating has become acceptable, an investment grade rating from other agencies would still be questionable. Investors suspect that during the last two years, there has been a systematic "up-notching" of newly rated companies, similar to the situation in the program mezzanine sector about five years ago, where smaller, riskier companies had been "pushed" into investment grade ratings.

Last but not least, promissory notes (Schuldscheindarlehen) are also a type of securitised loans, similar to a privately placed bond. However, as promissory notes are mostly placed within the banking, Sparkassen and insurance sectors, the investor universe is smaller compared to a corporate bond issue, where all kinds of institutional investors can be approached. Furthermore, while bonds are usually fungible and add liquidity to the market, promissory notes are more difficult for investors to sell, thus limiting investor interest. This is, however, somewhat mitigated by the fact that for promissory notes, as well as for private bonds, investors do not have to conduct a mark-to-market evaluation, which is appealing in the light of today's volatile markets. On the other hand, as the documentation for promissory notes is less extensive than for bonds, it limits transaction costs and may be an ideal entry instrument into the capital markets, especially for smaller financing needs.

Figure 2: FCF Financing Framework



Source: Bloomberg

Bank loans

Bank loans are the classic financing instrument, which will never go out of fashion. While the financier universe is actually limited to banks, loans may provide a greater flexibility and – sometimes – more attractive pricing when compared to bonds. Nevertheless, so that it is not fully dependent on banks regarding its financing requirement, a company should – as far as possible – diversify its financing instruments.

Conclusion

While not every available instrument may be the right product for each company, one should however investigate which is the best-fitting instrument (or a combination of instruments) to optimise the financing structure in terms of financier diversification, interest burden, security value, redemption schedules, etc. The retail corporate bonds market, as represented by the Bondm Index, has dropped by almost 9% during the last three months, proving that the yield requirements by investors are inclining towards more regular capital markets bond levels. Consequently, rather than jumping on the "retail bond" train late, one should carefully consider all available alternatives – and they may prove to be the more attractive ones.