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International Debt Financing

ICAI Tower – BKC, Mumbai
21st May, 2016

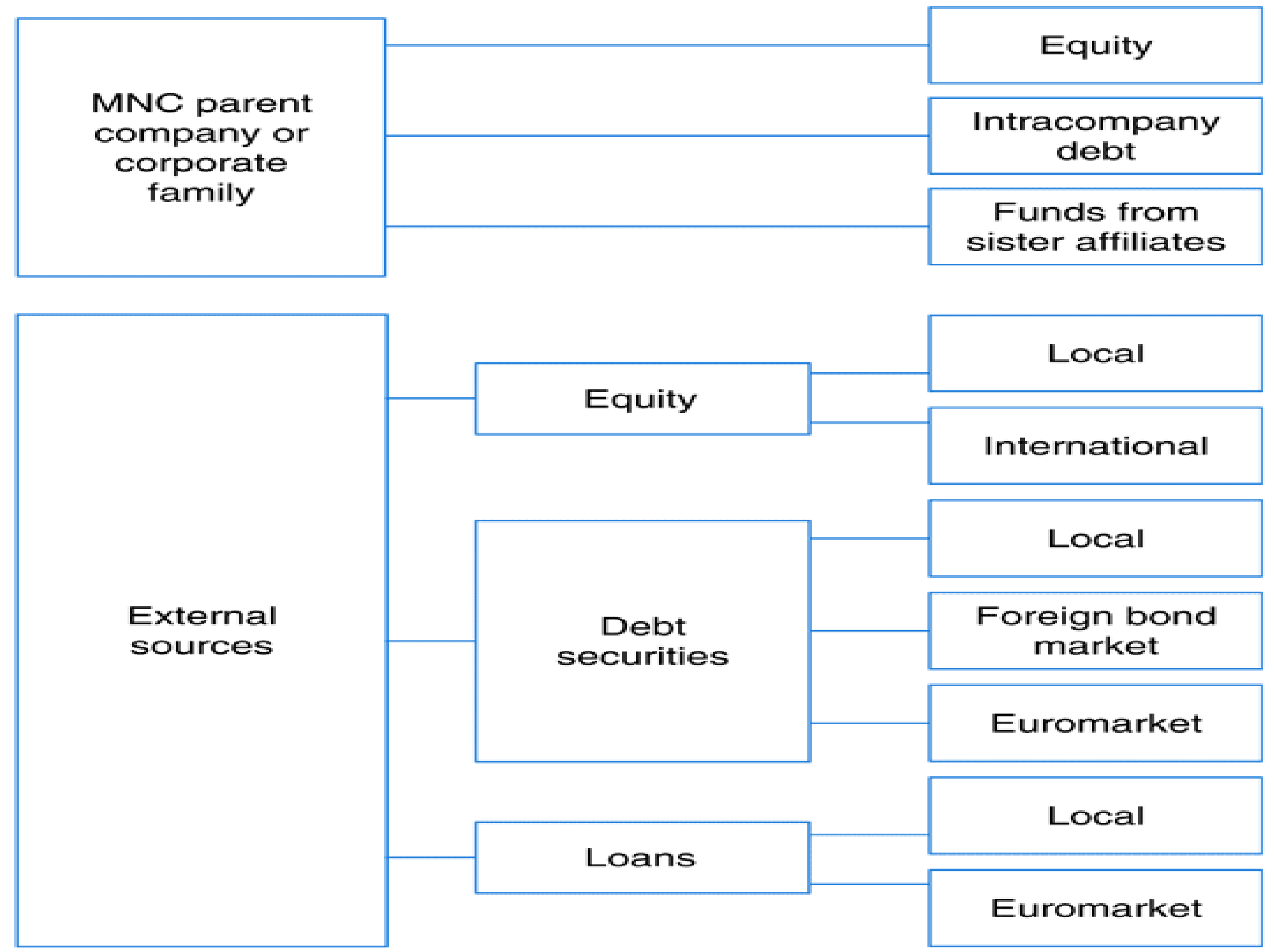
Background

- Sources of funds for international firms
  - Internal – retained earnings
  - External – debt/equity/loans/hybrids
  - Loans
  - All 3 can be raised domestically or internationally
  - MNC foreign affiliates can also raise money from within the MNC

Background

- The financing mix around the world
  - Firms use different capital structures globally
    - Internal capital generally utilized first
  - Equity and bond markets dominate the U.S.
  - Bond market dominates in Japan
  - Loans dominate in Europe

Long-Term Capital



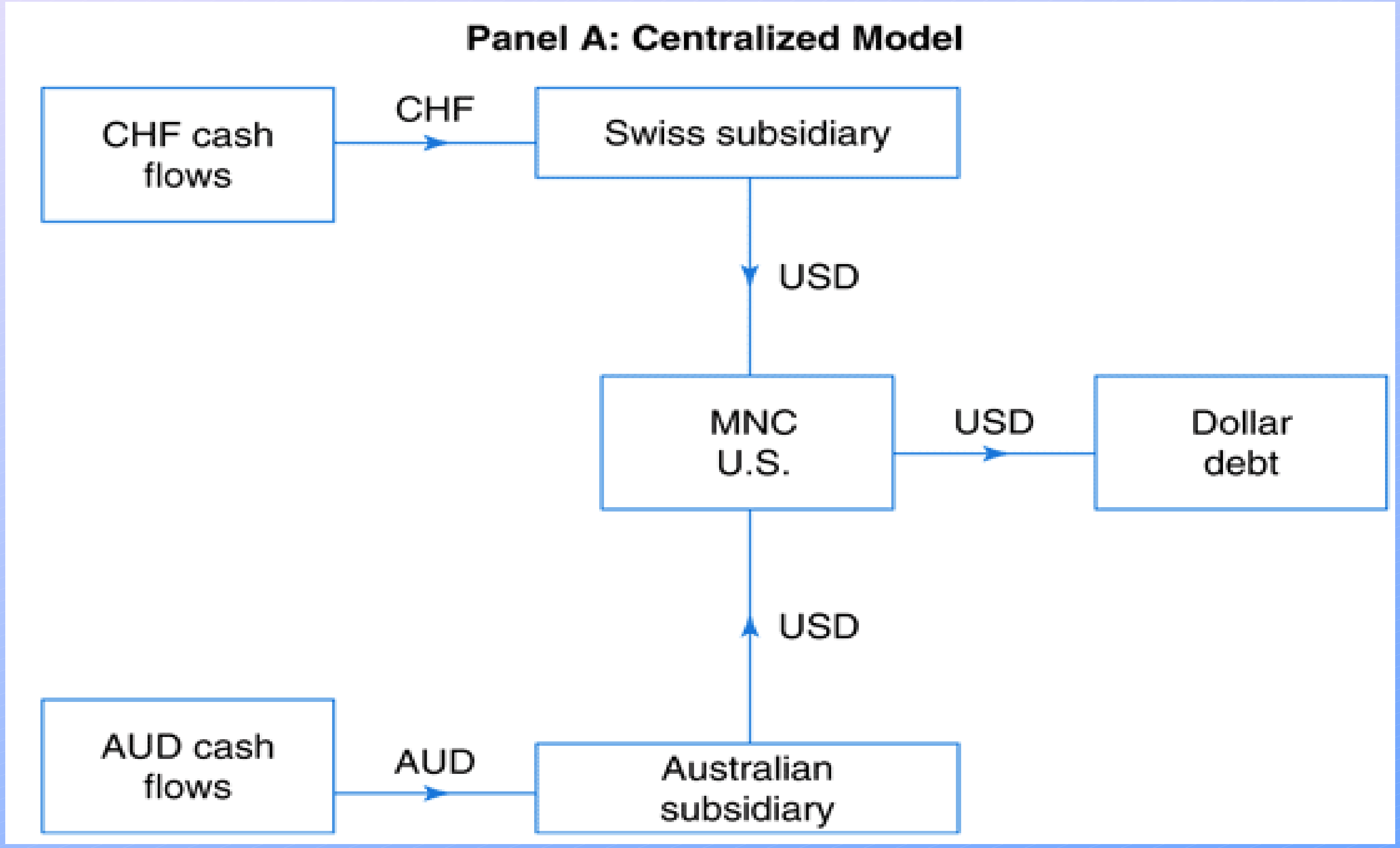
Characteristics

- Currency of denomination – can affect how much they have to repay; can match their revenue base though
- Maturity
- Nature of their interest payments
- Tradability
- International character – domestic vs. international

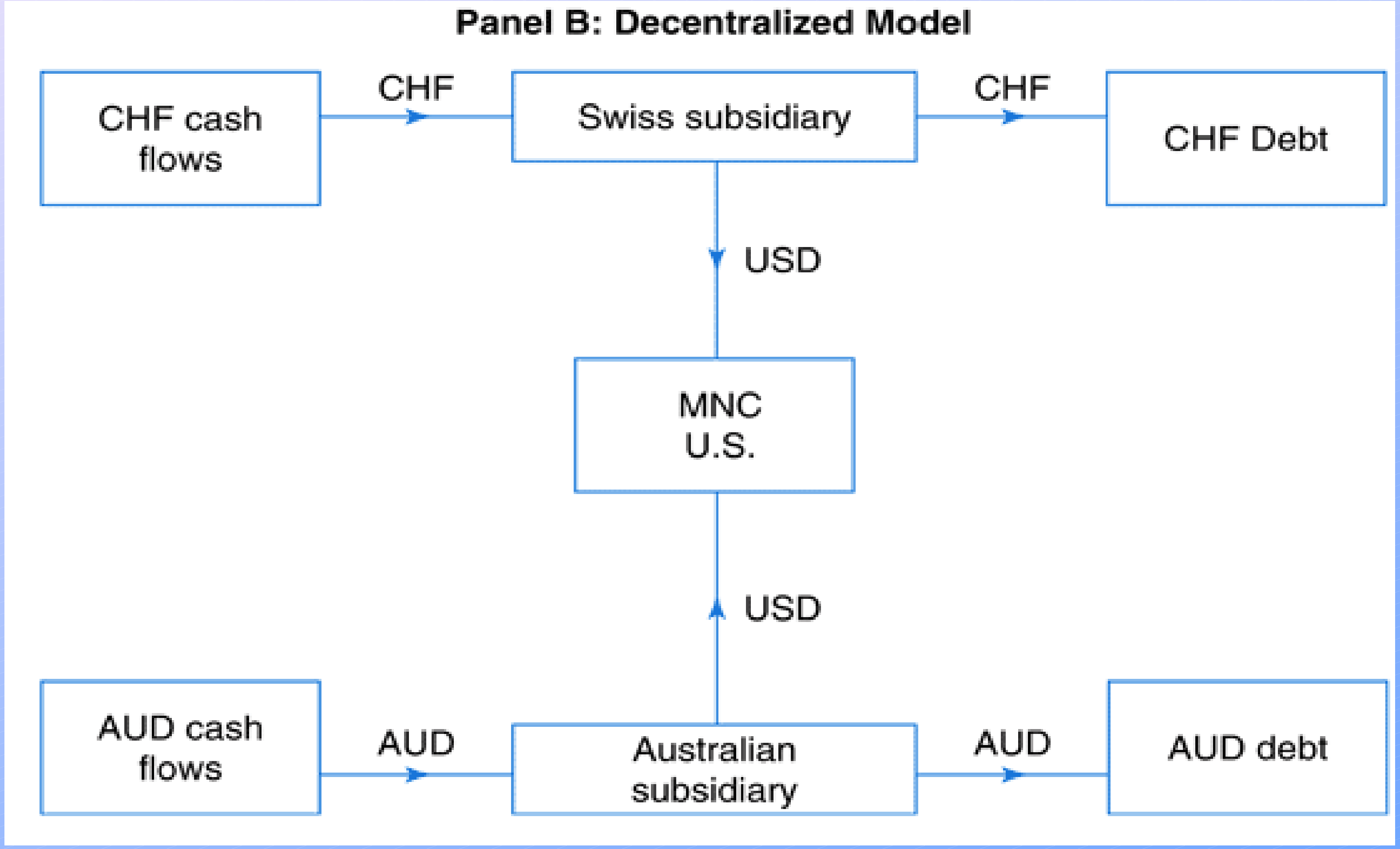
Characteristics

- Centralized versus decentralized debt denomination
  - Centralized debt denomination – borrow in $’s (headquarter’s currency)
  - Decentralized debt denomination – borrow in different currencies of subsidiaries
  - Balance-sheet hedge – balance foreign assets/liabilities

Debt Denomination



Debt Denomination



Debt Instruments

Is issuing debt in low-interest countries a good idea?

Debt Instruments

- Yes & No. Depends on the volatility of the currency.
- If less volatile: the cost should be the same as domestic loan
  - Assuming that you believe this then no because for the same cost you now assume forex risk

Debt Instruments

- If highly volatile: Taking a loan is cheaper. Forex risk can actually help – if currency that loan is denominated in depreciates you pay less of the principal back!

- Credit spreads
  - Risk premium paid above the risk-free rate
  - Can differ across countries offering savings
  - Tax differentials can offer incentives to take on debt in different markets

Debt Instruments

- Debt portfolios – can diversify across currencies just like one diversifies across stocks!
- Maturity
  - Structure borrowings so principal repayment is not clustered
  - Match maturities of assets (accounts receivable and inventory) with short-term debt and finance fixed assets (investments) with long-term debt

Debt Instruments

- Since 2000, many corporations started to issue very long-dated debt
  - Some as long as 100 years! Walt Disney’s were dubbed “Sleeping Beauties”
- The nature of interest rate payments
  - Fixed-rate debt
  - Floating-rate debt

Tradability

Can debt be traded?

Tradability

YES, debt can be traded.

Intermediated and direct debt

- Financial disintermediation – corporate borrowing takes the form of a tradable security issued in the public market

Tradability

- Private placements
  - Must be sold to a limited number of large and sophisticated investors
  - Investors must have access to substantial financial information regarding the company
  - Investors must purchase the securities for their own investment portfolios (not for resale) and must be capable of sustaining any losses

Types of Bonds

- Domestic bonds – bonds that are issued and traded in domestic market (country is country of currency denomination)
- International bonds – bonds traded outside the country of the issuer

Types of Bonds

Foreign Bonds – issued in domestic market by a foreign borrower (Ex. U.S. company issuing ¥ bond in Japan or an Indian company issuing INR bonds in U.S.)

- Denominated in domestic currency
- Marketed to domestic residents
- Regulated by domestic authorities

Global Bond Market

- Size and structure of the world bond market
  - Government bond market – most important in most countries
  - Domestic bond markets
    - Regulated by domestic governments
      - Required filing for issuances > $1.5 million (U.S.)
      - New public issues must be approved by MOF (Japan)
    - Usually annual coupons

Global Bond Market

- International bond markets
  - Generally regulated by issuer’s government, not borrower’s
  - Eurobonds – issued simultaneously in capital markets of several nations
- Need not comply with regulatory restrictions that apply to domestic issuers

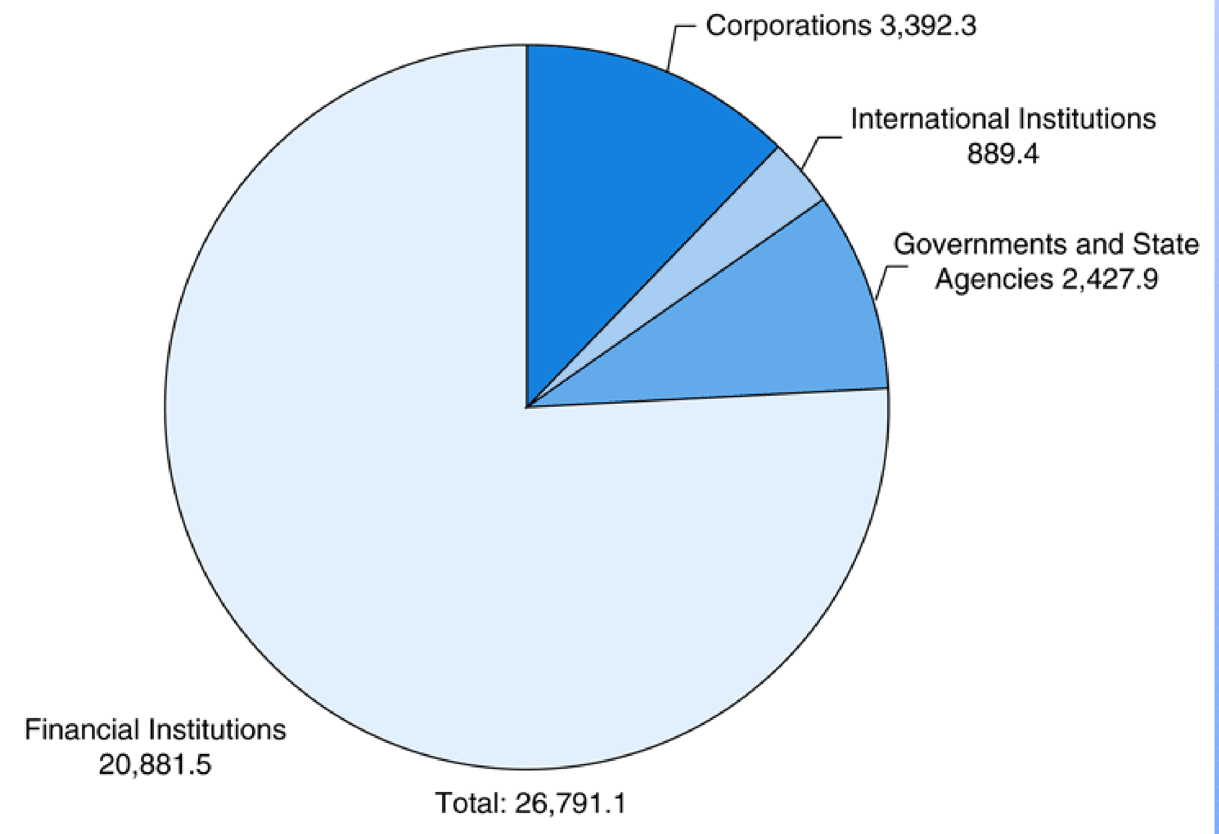
Global Bond Market

Which country has the maximum share in the global bonds market?

Global Bond Market

United States of America.
35.7%
Followed by Japan 14.4%

Global Bond Market



Source: Compiled from *BIS Quarterly Review*, December 2010, Tables 12A–12D.

Global Bond Markets

- The primary market for Eurobonds
  - Borrower contacts bank to serve as lead manager
  - That bank contacts co-managers to serve in a syndicate to share risk
  - Since 1989, most Eurobond syndicates have fixed-price re-offer method where syndicates largely sell offering at predetermined price

Global Bond Markets

- The secondary market for Eurobonds – the above bonds sold to other investors; over the counter market
- Global bonds – bond sold simultaneously in domestic and Eurobond market
  - These bonds lower borrowing costs by approx. 20 basis points
- Dragon bonds – Eurobond targeted at Asian market

Global Bond Markets

The types of debt instruments in the international bond market and their prevalence:

- Straight fixed-rate issues – coupon fixed
    - Zero coupon bonds or coupon
- Floating-rate notes – coupon based on base rate such as LIBOR or Euribor

Global Bond Markets

- Equity-related bonds
  - Convertible bond – convertible into a number of shares of equity on maturity
  - Warrant – grants the bondholder the right to purchase a certain amount of common stock at a specified price

Global Bond Markets

Currency of denomination

- Dollar *has been* the dominant currency
- Euro *is now* a dominant currency
- Also Pound, Yen and Swiss Franc

Global Bond Markets

Dual-currency bond

- Issued and paying currency in one currency but paying back principal in another
- Interest rate often higher
- Combination between straight bond and long-term forward contract
- Whether it is a good investment depends on movement of forex rate

International Banking

- Banks as MNCs
  - Merchant banks – banks that perform both traditional commercial banking and investment banking functions
  - Universal/Full-service banks – banks that provide a wide array of services, including securities activities

International Banking

- Globalization had fundamentally changed banking around the world from localized to one of the most global sectors in the world
  - Banking sector has become a larger part of many economies – perhaps too large (2007-2010 crisis has taught us this)
  - Enables spillover of stress across borders

International Banking

- Types of international banking offices
  - Correspondent banks – a bank that allows a commercial bank which doesn’t have an operation in a major financial center to conduct trade financing, foreign exchange services, and other activities

International Banking

- Representative offices – a small service facility that is staffed by parent bank personnel and designed to assist the clients of parent bank in their dealings with the bank's correspondents or with information about local business practices and credit evaluation of foreign customers

International Banking

- Foreign branches – legally a part of the parent bank but operates like a local bank
  - Much more expensive than setting up a correspondent
  - Subject to regulations of BOTH countries

International Banking

- Eurocredits – longer term loans in Eurobank market
  - Types of Eurocredits
    - Term loan – loan with a fixed maturity for a fixed amount
    - Credit line – allows borrower to withdraw as a loan any amount of money up to a fixed limit

International Banking

- Syndicates – group of banks that share risk
  - Lead bank negotiates with borrower over terms
  - Participating banks – banks that provide funding
  - Paying agent – the bank that receives the service payments from the borrower and distributes them to participating banks

International Banking

- Fees and Borrowing Costs
  - Periodic costs – interest
    - Interest rate (e.g., LIBOR + 1.5%)
    - Commitment fee (0.25% - 0.75%) on unused portion of credit
    - Agent fee
  - Upfront cost – 1% - 2.5% of total; deducted from principal

Cost of Funds

Minimizing the cost of debt internationally

Why source debt internationally?

- Evidence suggests credit spreads differ across countries
  - Differing perceptions of credit risk
  - Diversify funding sources
  - Cyclical differences – credit spreads tend to be countercyclical (widens in recessions)
  - Can borrow in countries low interest rates and invest in countries with high interest rates while hedging currency risk

Questions?


Thank you!

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