# NORDIC STATES WARM TO BOND MARKETS

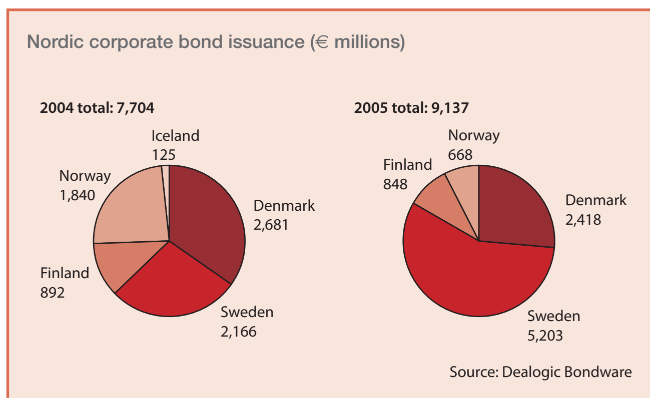
**Iceland's economic woes may be grabbing the headlines, but behind the scenes a revival of Swedish issuance is attracting investors to the region's largest corporate bond market. Alan McNee reports**

After a quiet period, the corporate bond markets in the Nordic region now appear to be bouncing back. A late 1990s M&A boom saw large-scale issuance, as the syndicated loan market struggled to cope with the demand for funds and the tenors required. Back then, companies such as phone manufacturer Ericsson, security firm Securitas and paper suppliers Stora Enso and M-Real were regular visitors to the international capital markets. However, a period of corporate deleveraging following the downturn at the start of the new century led to stagnation, with relatively little issuance in either the domestic or the Eurobond markets.

But the pendulum now seems to be swinging back. Bjorn Uhlin, ABN Amro's head of Nordic fixed-income origination in London, says a resurgence in M&A and the growing focus on shareholder value, with companies offering dividends and share buyback programmes, has led to a big increase in bond issuance in the past year. "We've seen deals done this year by Scania, Investor AB and SCA, and we're expecting a big uptick this year," he says.

However, issuance levels may be affected by a high volume of redemptions, as a lot of late 1990s bond issuance is coming up for refinancing this year. "In addition, increased new issuance requirements are mitigated by the very strong cashflows from Nordic firms, especially from oil companies and electricity suppliers," says Uhlin.

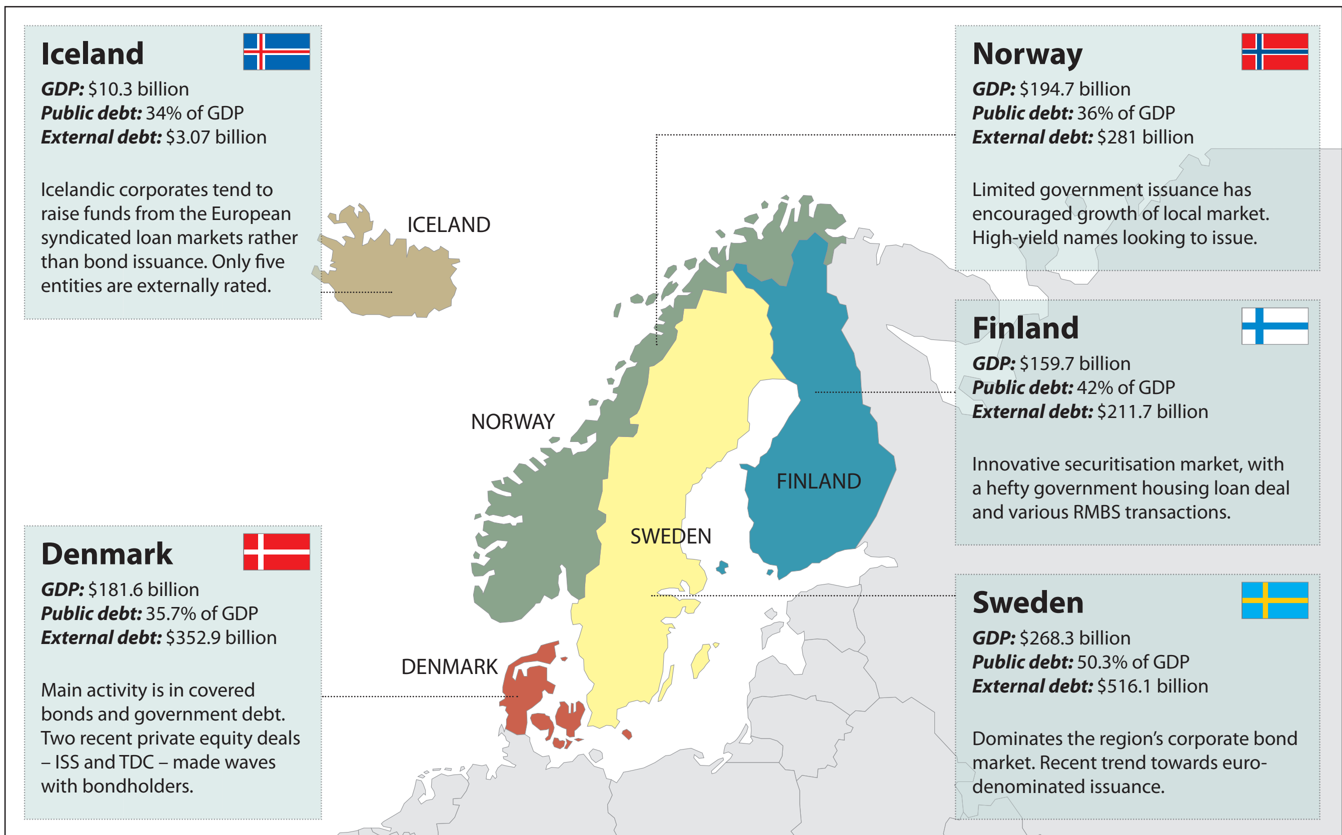
Sweden is the region's biggest corporate bond market, and Peter Serlachius, head of credit products at Handelsbanken Capital Markets in Stockholm, expects 2006 to be a strong year for Swedish corporate issuance. "We have seen larger-sized deals taking place, some of them Eurobond-type deals done in the local currency. For example, we recently arranged a SEK4.5 billion issue for [regional energy company] Fortum; that corresponds to almost €500 million, a sizeable issue. This illustrates that these larger-sized issues can get done, not just in the euro market but in Swedish krona as well."




## Growing from a small base

Nonetheless, domestic corporate bond markets remain limited in size. The main fixed-income markets in Denmark are government and mortgage bonds, which are both much bigger than the corporate bond market. Denmark's covered bond market is the second-largest in Europe, after Germany's *Pfandbrief* market. "In Sweden, corporate issuance has been on the rise, and in Norway there has been a small but fairly widespread market, filling the gap left by very limited government issuance," says Jan Svane Mathiesen, head of credit and equity products at Denmark's Nykredit in Copenhagen.

From 2000 to 2005, there was steady growth in euro-denominated issuance, much of which was driven by financial issuers, including municipals, sovereigns and supranationals. Peter Swärd, head of credit origination for SEB in Stockholm, says about 70% of issuance is undertaken by financials, with the remaining 30% coming from corporate bond issuers. "Up until 2000, most issuance tended to be in Swedish krona, but in recent years issuers have gradually been increasing their presence in the public euro market," he says. The choice of which




market to tap is driven by several factors, including maturity and issue size. Accordingly, several Scandinavian issuers have domestic as well as euro MTN programmes.

The bulk of Scandinavian public debt issuance is rated triple-B to single-A for corporates, and single-A to double-A for financials. However, Swärd says SEB has arranged and placed a couple of senior and subordinated non-rated high-yield bond issues, and further transactions are currently in the pipeline, reflecting the increased investor appetite for unrated Scandinavian credit.

Hakan Wohlin, head of debt capital markets and corporate coverage for the Nordic region at Deutsche Bank in London, says there has been significant growth of high-yield and crossover issuance by Nordic corporates. "We have just arranged a double-B rated deal without high-yield financial covenants, which traditionally wouldn't have got done without such covenants, and I think we'll see more high yield this year," he says. "There have been a number of fallen angels, including M-real, Metso, SAS and ABB, which have still managed to access the markets in the past couple of years despite their sub-investment grade status."

ABN Amro's Uhlin says he expects to see more companies whose credit ratings have gone down as a result of a conscious choice on their part to take on more leverage. "That's what equity markets now demand, and that will lead to an increase in high-yield issuance," he predicts. In Norway, a number of shipping and drilling firms are looking at using the high-yield market, and crossover credits have also been a significant factor in the growth of high yield in the region. A lot of credit funds and hedge funds can now move right along the capital structure, so this is an increasingly attractive market for them. Norway has relatively little investment-grade issuance, and those investment-grade issues that do come to market can command very tight spreads.

## The state of securitisation

"Securitisation is still relatively small scale in the Nordic markets," says Per Jäderberg, head of structured finance, debt capital markets at Handelsbanken Capital Markets in Stockholm. "Generally speaking, the Nordic states have a very competitive bank market, with cheap and flexible bank funding, and many companies that might consider securitisation opt to stick with bank funding."

As well as the bank market, the unsecured bond market also provides a tempting alternative to securitisation for many potential issuers. Deutsche Bank's Hakan Wohlin says securitisations have been few and far between, in part because unsecured debt enjoys such attractive pricing that there hasn't been much need for securitisation. "When it does happen, it's used more for project reasons – for example, to spin off a particular business line or subsidiary – than for raising capital," he says.

However, the same factors that are having an impact on bond issuance could also help to boost future securitisation. Healthy corporate balance sheets following several years of deleveraging and balance sheet restoration have led companies to start focusing on their shareholder base, through share buybacks or dividends,

## Chilling news for Iceland's economy gives investors the shivers

It's certainly a rarity for Iceland to attract the attention of the international financial community, but the outlying Scandinavian country found itself right at the centre of a major financial storm this year.

Following a February report by Fitch in which the rating agency revised its outlook for the country's long-term sovereign debt from stable to negative, a number of reports – notably a critical piece of research by Danske Bank's chief economist Carsten Valgreen – raised questions about the country's external indebtedness and the financial viability of its three banks.

Worries about the level of leverage that Icelandic banks Kaupthing Bank, Landsbanki and Islandsbanki (now called Glitnir) have taken on in recent years, coupled with the perception that the country faces increased macroeconomic risk, led to a run on the currency. The Icelandic kronur, currently the world's worst-performing currency, has plummeted nearly 20% against the dollar since the start of the year. US money managers were reportedly refusing to extend credit lines to the banks and the Central Bank of Iceland was forced to raise interest rates by three-quarters of a point in March to 11.5% in a bid to stem inflation.

In an April 7 interview, central bank governor David Oddsson said economic growth may drop to 0% for a year. All this has sparked huge volatility in Icelandic credit: Kaupthing Bank and Landsbanki were two of the top five most active credit default swaps traded in March, according to broker GFI's monthly report, alongside names much more regularly seen on the list such as British Telecom, VNU and KPN.

One report from Morgan Stanley entitled *Icelandic Banks: Chill Out* suggested that the fixed-income markets had overreacted somewhat to the true risks that the country's banks face, although it did flag up concerns about Kaupthing Bank's capital market strategy. Moody's too issued a report in early April saying that it did not believe Iceland was facing any undue risks to solvency or liquidity, and that concerns about a crisis had been exaggerated.

But Danske Bank's report, *Iceland: Geyser Crisis*, was more damning, concluding that a financial crisis could be imminent. As well as describing the Icelandic economy as "the most overheated in the OECD area", and comparing the country's situation with that of Thailand before its 1997 crisis and Turkey just prior to its 2001 crisis, the authors talked of Icelandic banks "facing financial headwinds". They warned of "overheating" in the credit sector, following an explosion of growth in credit to the private sector (currently running at over 60% year-on-year) and a massive increase in external debt, which has risen to nearly 300% of GDP.

The report met with an angry reaction from Icelandic bankers. Gudni Adalsteinsson, group treasurer of Kaupthing Bank in Reykjavik, accused the authors of contradicting everyone else's conclusions, including that of the OECD. "They do disclose in the report that Iceland is not really a part of their research universe – which is definitely an understatement," he says. Landsbanki issued

City Hall in the Icelandic capital Reykjavik

a statement insisting that its liquidity situation, and the strength of the Icelandic economy, were much better than the Danske report suggested, while Glitnir chief executive Bjarni Ármanmsson told CNBC that the report was "way too pessimistic".

Speaking to *Credit* in March, Danske Bank's Copenhagen-based chief economist Carsten Valgreen insisted that he stood by the report's accuracy. In any case, a run on the krona culminated in the central bank raising interest rates by 75bp to 11.5%, and the government failed to sell any sovereign bonds at its monthly auction in mid-March, citing unacceptably high yields being demanded by bidders.

Reports of US money managers refusing to extend credit lines to Iceland as a result are particularly worrying to Icelandic banks, which have all been borrowing to fund expansion into overseas fixed-income markets. With a population of just 300,000, local banks and corporates have found it essential to look overseas for growth. For the same reason, local banks have been aggressive in tapping the international capital markets for funding.

Kaupthing's Adalsteinsson says Icelandic banks have grown rapidly in recent years, and much of this expansion has taken place overseas. "75% of Kaupthing's assets are now overseas," he points out. "For example, our biggest loan portfolio is in Denmark, where we own FIH, a Danish bank, which has a large and long-standing loan portfolio that can be securitised. Kaupthing also owns UK merchant bank Singer & Friedlander. So we have assets in hard currency overseas, most of which are granular and easy to securitise. We could securitise our Icelandic loan portfolio in theory, but it's largely comprised of names that are not well recognised by global investors."

Securitisation is only one approach to the funding that Kaupthing and other Icelandic banks need. Kaupthing has also done hybrid capital structures, and is considering two more issues at present.

as well as on M&A. "So there is still potential for expansion or returning cash to shareholders," says Wohlin. "There is also the rapid growth of private equity, which has helped to contribute to rising leverage ratios, and so traditional unsecured debt may become a more expensive way of borrowing money. This, in turn, could lead to more corporates looking at securitisation."

Anders Engstrand, co-head of capital markets at SEB in Stockholm, says the main assets securitised in the region include residential and commercial mortgages, trade receivables and consumer financing portfolios. "Currently, CMBS represents an asset class where we are experiencing strong interest and we expect to see increased issuance from the region over the years to come," he predicts.

Last year was a breakthrough year for hybrid capital instruments in the region, says Wohlin, with a €1.1 billion issue by Danish utility Dong and a €1 billion hybrid from Swedish utility Vattenfall. Hybrid deals suit Nordic corporates at present because they allow issuers to run the company with greater leverage without taking a cut in credit rating, as Wohlin explains: "Long-dated, subordinated hybrid instruments with deferrable coupons allow corporates to issue a debt instrument which costs a bit more than senior unsecured debt but which gives the advantage of preferential rating agency treatment. In this way, a company can perhaps pay a bit more for the target it's acquiring, and maintain an efficient capital structure."

### Don't ask – it's private

Private equity has become a hot topic in Scandinavia, as elsewhere in Europe. Two deals in Denmark last year were particularly significant. Danish telco TDC and cleaning services company ISS were both bought out by private equity firms. TDC was bought for $15.3 billion – Europe's biggest ever private equity deal – by a consortium of Permira Partners, Apax Partners, Kohlberg Kravis Roberts, Blackstone Group and Providence Equity Partners. The ISS deal involved a €3.8 billion leveraged buyout by Permira.

Bankers in the region report increasing concern by credit investors over the potentially negative impact of such deals on outstanding bonds. Since private equity buyers typically increase the leverage of their target dramatically upon taking control, holders of investment-grade bonds can see the credit rating of their securities deteriorate overnight. "During recent roadshows, we have met with demands from bond investors for change-of-control clauses," says Deutsche Bank's Wohlin. "Having said that, there hasn't been more general resistance from the wider investment community to private equity. For example, the TDC buyout happened without significant opposition from government, unions or other stakeholders."

Serlachius at Handelsbanken says change-of-control clauses have been inserted in recent Eurobond issues by SCA and Scania. "But in companies where the state owns a controlling stake, such as Fortum which is 51.13% owned by the Finnish government, or Vattenfall which is wholly owned by the Swedish government, there is virtually no need for this safeguard," he adds.

## Ups and downs for Finland

Finland has only nine corporate issuers with external credit ratings, most of whom issue in Eurobonds rather than in the domestic market. These include telecoms firms Elisa and Nokia, energy firm Fortum, nuclear power plant operator TVO, and pulp and paper firms Metso and M-real. About a dozen corporates also issue domestically, without the need for credit ratings. TVO and electricity supplier Fingrid have also done private placements in the euro market.

Riitta Salonen, Helsinki-based head of capital markets at Sampo Bank, Finland's second largest bank after Merita, says the main reason corporate bonds are not a bigger market in Finland is that the syndicated loan market offers very attractive funding costs. About €14bn of syndicated loans were done in 2005, compared with around €1bn of corporate bond deals. "The bank market remains competitive, with syndicated loan rates at about Euribor plus 20bp to 30bp," she says. "However, the syndicated market only really works out to five or seven years, so companies that need longer maturities or want to diversify their funding sources turn to the bond markets."

The secondary market is very thin, as domestic investors generally take a buy-and-hold approach. "Sampo makes secondary markets in all the bonds where we are bookrunners," says Salonen. "We have also placed domestic bonds with investors in other Nordic countries and with German investors." In general, about 70% of domestic bonds go to Finnish institutions.

If Finland's corporate bond market is fairly flat, the country has seen more excitement on the securitisation front. The first Finnish securitisation was of subsidised housing loans, and was done by the Republic of Finland through Fennica, which in 1995 became the first ever example of a government securitising its own assets. This was initially done in dollars, then moved to Finnish markka, and the latter issues have been done in euros. Of a total of €2.8bn, about €1bn is now outstanding.

Residential mortgage-backed securities have been slower to develop. Sampo issued mortgage-backed covered bonds last year, and will continue this year with a programme that should eventually total €5bn. "These, along with three covered bonds totalling €750m, are the only residential mortgage-backed securities so far done out of Finland," says Salonen. In 2004 the €200m Leverator securitisation was backed by mezzanine loans from Nordic buyout transactions, but so far there has been no commercial mortgage-backed security activity in Finland.

However, 2002 also saw forestry firm Tornator securitise €370m of forestry land, the first time this kind of asset has been securitised in Europe. Jan Svane Mathiesen, head of credit and equity products at Nykredit, says the Tornator securitisation was also the first (and so far the only) whole-business securitisation in the region. The deal was motivated by Finnish firm Stora Enso's desire to divest its forestry subsidiary Tornator in order to concentrate on core activities. It issued the structured debt through Irish special-purpose vehicle Tornator Finance.