Stumbling blocks on the road to SME bonds

The most common mistakes in the issuing process and how they can be avoided...

It is no secret that bonds have been a popular financing option for large institutions since the 20th century. Whether wars, railways or business expansions, much has been successfully funded in this way. Bonds are seeing a renaissance in the SME sector, too, finally enabling them to curtail the dominance of bank financing.

As a classic substitute for conventional bank financing, their use in this sector has been limited until now. This brings us to the first misconception about bonds: namely, that the conditions attached to them are comparable to those of current bank financing. After all, if we aim for a purely quantitative comparison, bonds most obviously come out in second place. Naturally, the advantages of the bond are primarily qualitative, such as a long-term guaranteed availability of funds (usually around five years) or the high degree of flexibility in the use of funds. It is also important to emphasise that the issuer may individually provide the creditor with security rights, although they are not mandatory.

It should be noted, however, that all of these benefits should be reconciled with market expectations. In the event of doubt, this can translate into higher yield requirements by investors and the aforementioned gap between bond coupons and the interest on a bank loan.

Pre-sounding as a backbone

Bond issuers are therefore well advised, as soon as the decision is taken to choose a bond as a financing alternative, to familiarise themselves with the market and its requirements. And here, we hit another stumbling block. These days, a thorough pre-sounding of investors is the backbone of every bond construction process and can determine success or failure even at an early stage. If this is conducted too late in the borrowing process, it not only threatens the success of the placement, but also adds to the likelihood that existing resources (such as potential collateral) are not used, or are indeed used, but only in a less-than-ideal manner. This therefore unnecessarily increases the cost of financing.

This of course also holds true if pre-sounding is indeed carried out on the market, but the findings from it are subjected

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to insufficient analysis and processing. Usually it comes down to a lack of time, which leads to processing errors.

Allocating sufficient time is a deciding factor when it comes to the capital market. Without allowing for appropriate time scales and a contingency plan, these days an issuer risks not only the issuing process completely failing, but also the possibility of further consequences on the capital market in later years. Investors, after all, are very slow to forget if someone damages their reputation in the market.

Following the rules of the timetable

A well-structured schedule is normally built around the date when the issuer's most recent annual and half-year financial statements are available, which form the basis of the bond. This is an indispensable part of the securities prospectus which is required for the issue of a bond and which usually takes about three to four weeks to formulate. This must be followed by a five-to-six-week process of gaining approval from the relevant financial supervisory authority (in Germany this is "BaFin", the Federal Financial Supervisory Authority). Only after approval has been granted the issue can be placed publicly on the stock exchange, usually every two weeks. As a rule, the bond process will thus take three months to complete. However, it can make sense to allow a much longer lead time.

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Making up for the difference

A possible reason for this might be, firstly, that the issuer is thus far completely unknown to the capital market and therefore it takes time and effort to gain investor confidence. A targeted PR campaign in the run-up can make the difference, very much so, in this regard. But a much longer planning period may also be required for the sake of window dressing the balance sheets. Depending on the success of previous accounting and financial reporting, it may be helpful in the run-up to adjust reporting methods to the standard format used in the capital market, such that the investor can be offered a picture that is as easy to compare as possible.

On the whole, investors can initially be brought up to speed by providing just the minimum information. An external analysis around 10 to 15 pages long on the issuer and the envisaged issue (credit research) can thus give significantly higher added value than extensive internally created documents. The principle of “less is more” becomes less valid, however, in the case of institutional investors with their own audit processes. In general, though, the following principle applies: the higher the volume of the envisaged issue, the more extensive the preceding audit process should be.

Outlook

And what holds true for the investor should ultimately also apply to the issuer. The more significant the envisaged bond is to the financing mix, the more extensive the audit and preparatory process should be in the run-up to the decision.