'Reverse Yankees': a home run for US issuers?

An M&G Investments Fixed Income talking point

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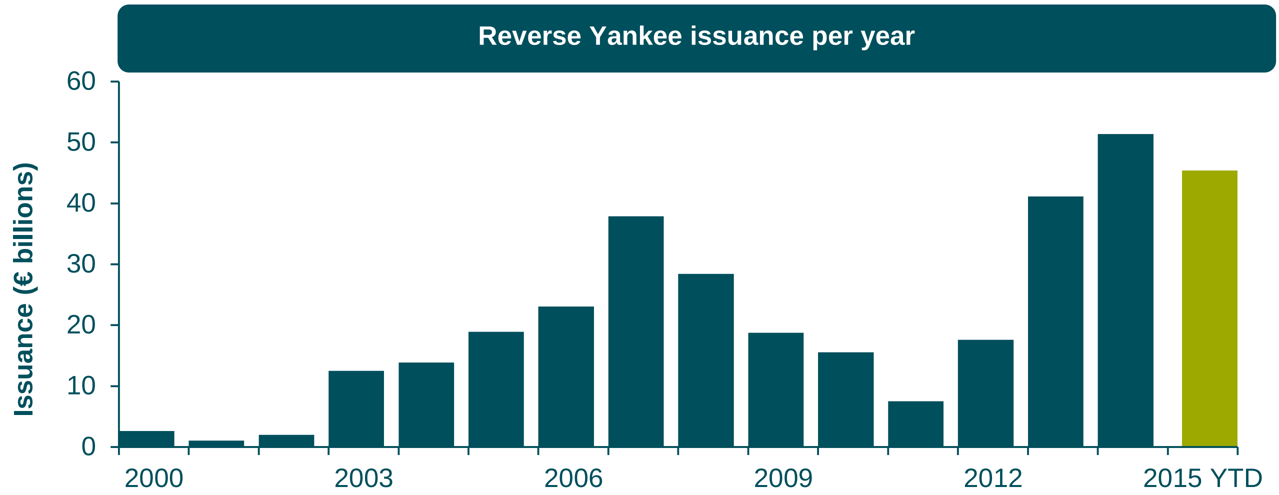
US companies have issued a record €45 billion of euro-denominated bonds known as 'reverse Yankees' this year, taking advantage of low pricing relative to dollars and Europe's increasing accessibility to international borrowers.

This creates investment opportunities for credit investors with a global view. Reverse Yankee issuers typically offer concessions such as attractive pricing to assure the success of their bonds. At the same time, pricing anomalies between euro and dollar bonds from the same issuer can offer relative value to an investor with the capabilities to acquire both.

The US bond market has traditionally been an appealing destination for global issuers due to its size, liquidity, varied investor base and universal currency. Indeed, issuance of dollar bonds sold in the US by international issuers – so-called 'Yankee bonds' – has grown steadily over many years as borrowers have sought to take advantage of these factors.

Today, however, a growing number of US corporate issuers are doing the opposite and raising debt in euros. This year a record €45 billion of reverse Yankee issuance was priced by early July, nearly surpassing the entire 2014 total of €51 billion[1].



Source: M&G, Bank of America Merrill Lynch as of 9 July 2015

Costs and benefits

Borrowing in euros is now a significantly cheaper option than dollars thanks to dynamics in the two credit markets that are creating opportunities for both issuers and investors in Europe. A rebound in US economic growth has led to growing anticipation that the Federal Reserve will raise interest rates which, as is usual, has repriced Treasury yields higher in response.

In corporate credit, the reaction to the prospect of a US rate rise has been much less usual. Rate increases are typically a response to either strong growth or inflationary pressure; since US inflation remains

[1] Source: Bank of America Merrill Lynch, as at 9 July 2015

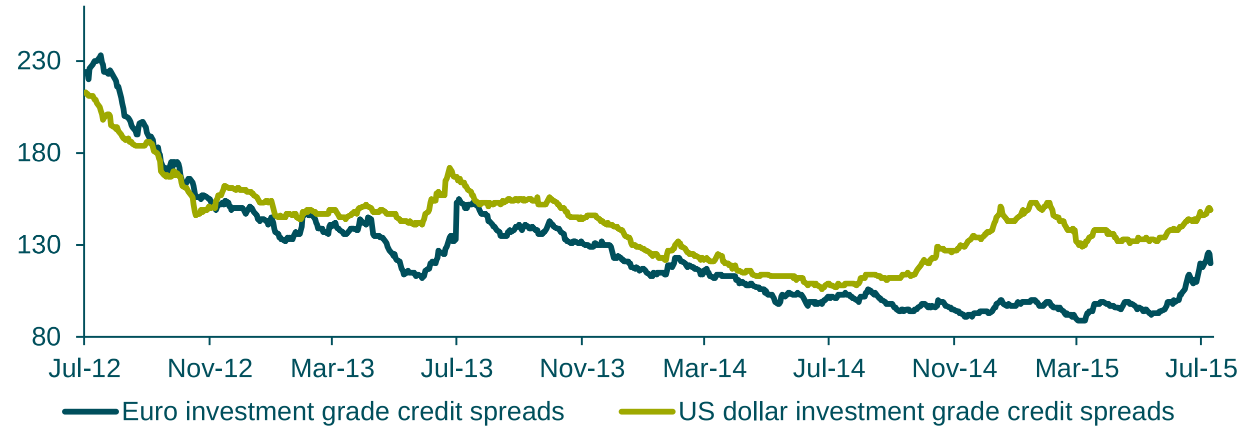
historically low, at 0.1% in the year to June 2015, the interest rate rise now under discussion reflects the bright outlook for economic growth.

The kind of strong growth that leads to rate rises is not normally associated with widening credit spreads (the component of a bond's yield that compensates the holder for the issuer's default risk) as companies' performance and creditworthiness typically benefit from the rallying economy. Yet credit spreads on dollar bonds have widened significantly in the past year.

This widening has variously been ascribed to the keenness of US investors to shed duration ahead of a rate rise, or to proactive selling of an asset class prone to bouts of limited liquidity. Whatever the reason, it contrasts sharply with a tightening in euro credit spreads – and precipitous falls in most Eurozone government yields – due to Europe's persistent economic weakness and the European Central Bank's quantitative easing efforts.

As the chart below shows, the difference between euro and US dollar investment grade credit spreads gapped out to unprecedented levels over the past year and even after some narrowing stood at 30bps in July. The gulf has created two different but related opportunities for investors with a global reach and currency flexibility.

Euro and dollar investment grade credit spreads



Source: M&G, Bank of America Merrill Lynch, as of 13 July 2015

Home bias and price concessions

While in previous years reverse Yankee issuance has been dominated by well known, repeat bond issuers, in 2015 issuance has come increasingly from less familiar names: the sort of borrowers only seasoned global investors would know about.

These issuers have to overcome the home bias associated with being a little-known, often debut euro issuer with a smaller presence in Europe. Cultural differences have also played a part, since the large single-tranche bonds considered the norm in the US can be hard to digest in the smaller, less liquid European market if brought by an unfamiliar issuer. This has at times led to a lukewarm reception and a higher risk that a new bond may underperform in the secondary market.

To make deals more appetising, reverse Yankee issuers often make large concessions when bringing their bonds to the euro market. That typically means offering investors a juicy new issue premium, by pricing a new bond at a higher spread than those of existing bonds from peers of comparable credit risk, ensuring that a new bond is priced to go.

These allow a US issuer to compensate European investors for its lack of familiarity while retaining the pricing advantage of issuing in euros. Other approaches include breaking down large single-tranche deals into smaller chunks better suited to Europe.

Danaher tests demand for its European debut

Danaher Corporation, a US-based manufacturer of test and measurement equipment for medical and industrial sectors rated A by S&P, on 1 July issued €2.7 billion of bonds through a four-tranche deal in the European investment grade market to finance its $13.8 billion acquisition of filtration group Pall.

The longest-dated tranche, an €800 million ten-year piece, priced at a spread of 130bps over mid-swaps (the mid-point of the bid and ask prices of the swap rate for a particular bond maturity; the swap rate is the rate charged to switch fixed cash-flow for a floating interest rate, typically Libor). This was very attractive compared to Danaher’s 2021 dollar bond which, at the time, was trading at a 45bps euro-equivalent spread and Danaher’s ten-year dollar credit default swap (CDS), which had an implied spread of 105bps.

The issue also offered a sizeable premium over comparable bonds from peers. For example, the 2023 1.25% euro issue from Illinois Tool Works (also a reverse Yankee) was trading at only an 80bps euro-equivalent spread at the time of the Danaher announcement.

The attractive new-issue premium from Danaher partly reflected uncertain market conditions at the time of issuance. However, it also evidenced Danaher’s wish to have both a successful return to the euro market (following its last euro issuance in 2006) and a smooth placement for the first leg of a planned schedule of up to $8 billion fixed rate issuance in coming years.

Scouting for value

Reverse Yankees present European credit investors with valuable opportunities to buy debt from highly rated US issuers at a premium to comparable European companies. And just as US issuers use the euro market to diversify their investor base, reverse Yankees provide European investors with more diverse exposure than domestic corporates alone.

However, more benefits accrue to investors who take a global view of credit. The further the investable universe can be broadened, the greater the scope to spot the kind of pricing inconsistencies value investors’ prize.

A global investor can evaluate a reverse Yankee in the context of the issuer’s other outstanding bonds, to assess which offer the greatest relative value regardless of currency. The current wide dollar credit spreads often make the domestic bonds of US groups more attractive than their euro offerings even after taking into account factors such as new issue premia in Europe. This can generate opportunities to pick up additional yield via the dollar market, for the same credit risk.

To analyse multiple markets and exploit cross-border pricing anomalies of this nature investors require extensive and rigorous global credit research resources. But understanding the fundamental credit profile of companies no matter which market they are selling their bonds creates huge opportunity to seek out compelling value wherever it arises, and not just in those Yankees that make it to Europe.

About the author

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David joined M&G in 2006 as Head of Institutional Portfolio Management in the fixed income team.

Prior to joining M&G, David worked for Merrill Lynch Investment Managers (MLIM) as head of their Global Bond Team. He was responsible for all global portfolios managed in London, and managed funds for MLIM's most prestigious institutional global bond clients. Previously, David worked for AMP Asset Management / Henderson Global Investors, Crown Agents Asset Management, and Eagle Star Insurance Ltd.

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