

DEALS IN FOCUS

The transactions that got the primary markets talking

BBVA reopened the five-year senior unsecured market for Spanish banks in April, but post-deal spread widening shows the sector remains a challenging sell to investors

BBVA

Taking advantage of a revival in investor interest for senior unsecured debt from top-tier European banks, BBVA completed a €500 million five-year deal in April. Yet doubts remain over whether smaller Spanish banks will be able to follow in its footsteps, given lingering concerns on the sovereign side, problems in the real estate market (to which Spanish banks are heavily exposed) and the potential for further consolidation in the financial sector.

While there were other senior unsecured offerings by Spanish banks in April, including two-year issues from Banco Popular Español and Santander, the BBVA transaction was the only one to creep along the curve to five years. BBVA acted as joint bookrunner on the double-A rated deal, along with Barclays Capital, Deutsche Bank, Goldman Sachs and Natixis. Interestingly for a deal of such significance, no bookrunner was prepared to comment. Perhaps the performance of the deal in the secondary markets helps explain their reticence.

The bonds, which carry a nominal coupon of 4.875%, were priced at a discount to yield 4.914%, equivalent to 221 basis points over German Bunds or mid-swaps plus 180bp. As of May 3, the yield had pushed out to 5.07%, or 243bp over Bunds. The spread widening was not representative of what happened generally to financials debt over the same period. The yield to worst on three- to five-year debt in the financial institutions sub-set of the Barclays Euro Aggregate index tightened, from 4.55% on April 4 to 4.50% on May 3.

Deal terms

Issuer: BBVA
Structure: Senior unsecured
Size: €500 million
Issue date: April 4, 2011
Maturity: April 15, 2016
Ratings: AA-/Aa2/AA (Fitch/Moody's/S&P)
Coupon: 4.875%
Issue price: 99.831
Issue yield: 4.914%
Spread: 221bp over German Bunds; 180bp plus mid-swaps
Bookrunners: BBVA, Barclays Capital, Deutsche Bank, Goldman Sachs, Natixis

Despite assurances from the International Monetary Fund that saw Spain seemingly decouple from other PIGS countries, Portugal, Ireland and Greece, investors are still treading carefully when it comes to Spanish senior debt.

“The BBVA issue was a little on the tight end, given where the sovereign trades,” says Chris Bullock, a portfolio manager at Henderson Global Investors, responsible for the firm’s total return credit funds and European corporate bond fund. “For me, it was the wrong side of 200bp over swaps, but if the market weakens again and we’re back in the mid-200bp range, we may look to get more involved. That gives an idea on the relative value. However, at this tighter end of the range, it seems a little bit rich.”

Sovereign perspective

Sovereign debt issues cannot be overlooked, argues Bullock, when it comes to deciding investment strategies

for Spain. Other investors share that view.

“Real economic growth in Spain seems to be doing much better than Greece and Ireland: it is stable, it is growing slowly, and it is not negative. For the moment, this is a supportive element,” says Tom Mondelears, a managing director in BlackRock’s European fixed income portfolio management group. “What concerns me is the amount of private debt in addition to public debt. Private debt has been sitting at the 200% to GDP level for a while now and leverage is elevated.”

Mondelears also notes Spain is a big borrower overseas, with net foreign liabilities approaching 100% of GDP, a factor that could cause some market volatility. Combined with the high unemployment rate in Spain – which hit 20.7% at the end of March – he says economic recovery is by no means secure, which could cause more harm to the banking sector.

“We still don’t see value in Spanish financial debt, as moves to recapitalise the smaller banks and cajas have been too timid, and there is a lot of ‘extend and pretend’ going on in the real estate space. A larger recapitalisation will likely be needed,” says Howard Cunningham, a portfolio manager at Newton Investment Management, a subsidiary of BNY Mellon Asset Management.

Mondelears sees the Spanish banking sector’s recent restructuring as being similar to what Italian banks have done in an effort to reach more conservative core tier 1 capital levels. But he argues the Spanish banking sector faces specific domestic challenges.

“We’ve seen a lot of high level recapitalisation by a couple of banks in Italy, which is dealing with this process more efficiently than, say, the Spanish. It’s less complex [in Italy] because Spain has the big caja sector with a lot of smaller cajas that are trying to restructure or merge into bigger entities,” he says.

Greater clarity on the restructuring of the cajas needs to be in place before smaller Spanish banks are able to issue unsecured debt, says Bullock. “Some of the smaller savings banks, particularly in the north, are actually well-capitalised, well-run institutions. But in terms of wider access to the market, it is going to be easier for those banks that have greater scale and are publicly listed.

“We are not confident on what their consolidated numbers really look like, and are waiting to see whether the recapitalisations actually get done. Given the rally [in spreads] that has already happened this year, we don’t think necessarily that investors are missing out. It makes sense to be conservative and wait,” he says.

Paying a premium

In terms of a premium for smaller Spanish banks, Bullock says it would need to be higher than where UK mid-tier banks and building societies currently trade. “In the UK, investors have better access to management, better understanding of the numbers and, in our view, in the UK the sector is still trading quite wide.”

Second-tier Spanish banks might struggle to find buyers in the primary market given the continued uncertainty over banking reform and sovereign debt. The prospects for bigger Spanish names such as BBVA and Santander appear healthier, but even they could face future challenges, according to Cunningham.

“The two dominant Spanish banks are a tougher call. Generally they have avoided the worst excesses in their domestic market, and their significant non-Spanish operations are a source of strength. But it is hard to estimate the collateral damage that could flow through from either a sovereign crisis or deeper



Manuel González Cid, CFO at BBVA, and the bank’s Madrid head office

problems among second- and third-tier banks,” says Cunningham.

However, just as the Spanish sovereign outlook has improved relative to peripheral Europe, some investors argue that BBVA and Santander should be treated as a different category to the rest of the country’s financial sector.

“There is huge differentiation between the big two banks and the others,” says Philippe Bodereau, head of European credit research at Pimco. “You’ve seen some issuance from second-tier commercial banks, so there has been an improvement in the funding conditions because at the end of last year nobody could issue anything. But it is in the senior unsecured market where there’s clearly a big differentiation between the top two banks and the rest.”

It has become prohibitively expensive for other domestic banks to issue unsecured debt, adds Bodereau, which bites into earnings, compresses margins and hits profits. And although Ireland’s decision on March 31 not to impose haircuts on senior bondholders may have opened the window for banks across Europe to issue unsecured debt in the short-term, discussions on future bank resolution and the role of private creditors in that process are far from over. This

could have major implications in the longer term.

“Are investors willing to invest in senior debt in the PIGS, or in Spain in particular? I have my concerns,” says Mondelears. “The big names, maybe, but the reality is that we don’t have 100% clarity on the EC’s resolution mechanism. The grandfathering period [exemption from the resolution] up to 2013 is still unclear: we don’t know yet whether it will be set in stone. Once these factors are made clear it could be very positive for existing bonds in the banking sector, and then you’ll see a lot of senior debt bonds come to the market.”

Covered bond appeal

This uncertainty helps explain the surge of secured debt by European banks, particularly covered bonds.

“If you look at the covered bond market at the moment there’s been a lot of issuance in Spain. This market has more value than the senior market because you get very similar spreads and yield, with some extra security,” says Mondelears.

Nevertheless, Bodereau expects there to be appetite for senior unsecured debt in countries such as Spain. “There will be an investor base for senior debt, albeit significantly smaller than what it was pre-crisis. Pricing levels are also going to be quite different than before the crisis, although there is unlikely to be much of a difference from where bonds are trading now. European banks are going to have to pay up to get the deal done.”

The added premium in holding senior unsecured debt reflects the growing risk that government bailouts for banks are no longer implied, adds Bodereau.

“The knee-jerk reaction after the bail-in discussion in January was to say, ‘I can’t be bothered to do credit work so I’m going to the covered side.’ What it means now is if you buy senior unsecured bank debt, you take credit risk. That’s fine; that’s our job and we’re comfortable with that. For each country it’s going to be different; for each issue it’s going to be different. Investors must be compensated for the risk they are taking.”

Gillian Carr