UNITED STATES COMPANIES RAISING CAPITAL ABROAD

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1. FINANCING CAPITAL SPENDING

There is a Fortune 500 company, which may indeed be represented here today, whose financing priorities were described to me during the first quarter of 1980 as being size, flexibility, and cost—in that order. The timing is significant: it was the quarter in which the U.S. prime rate reached an unprecedented twenty percent, the quarter in which there was no fixed rate U.S. dollar financing in the Euro-market. There were few companies of any size that felt then that they could afford to put the cost of funds as their third priority.

A. Timing and Cost

In increasingly volatile securities markets, the trade-off between flexibility of timing and the cost at which it is possible to finance capital spending has become ever more important. For companies whose cash flow permits, it is possible to wait out periods of high interest costs, and to place market offerings when the cost and volume of funds are closer in line with the yield of capital investment and the state of balance sheet commitments. But the extent of available bank credit lines and commercial paper placements is not limitless. To use credit facilities designed for the short-term needs of daily cash management for capital financing is to run the risk of being caught by an outflow of funds for business purposes and to be forced into the securities markets at a time when the prospects for fixed rate issues are unpropitious, to say the least.

As it becomes more difficult to predict when a period of appropriately low interest rates will occur (and just what these "appropriate" rates will be) the cost of flexible timing of capital finance reduces the freedom to take business opportunities as they arise. Increasingly, the demands of current operations will limit the extent to which a borrower can afford to expand into profitable activities without taking longer-term high-cost obligations onto a balance sheet. The size of available short-term credit declines as it is used for capital finance; and borrowers have reduced freedom to make choices between long-term funding costs and business demands, making it impossible to extend operations into any area that cannot guarantee a yield that will compensate for the high cost of long-term finance.

You will notice that I have avoided the use of the expression "credit crunch," because I do not want to be quoted as predicting one. In New York you have to be careful how you are quoted. This was discovered by a former Archbishop of Canterbury who on arriving here was met by the press at Idlewild. A bright young reporter in the back row, after the usual questions about the ecumenical movement...
and so and so forth, stood up and asked the Archbishop, "Sir, while you are in New York, are you going to visit any of our strip clubs?" The Archbishop, being well trained for this kind of thing, engaged in the classic ploy of answering a question by asking another question. He said, "Are there any strip clubs in New York?" with holy innocence on his face. . . which disappeared the next morning when he opened the daily newspaper and saw the headline, "Archbishop's first question: are there any strip clubs in New York?"

B. Answers to the Dilemma

There are two solutions to the borrower's dilemma that are available in the domestic finance markets: to extend the size of money-market credit lines, and to issue long-maturity debt with an option to redeem the principal after a relatively short period, using capital raised at lower costs in an improved securities market. Although a borrower is then obliged to pay a high fixed-interest rate, the period over which it is paid is limited to that of a medium-term bond. This provides at least some insurance against the loss of competitive position that would result from a company's being locked into high interest costs while other producers in its industry are able to take advantage of lower interest costs on later borrowings.

(i) Domestic credit lines

The first of these "solutions" is becoming increasingly dif-ficult (and expensive) to achieve as Administration policies against inflation take effect. It is on the banking system, after all, and the volume of its advances that the pressure of monetary policy falls. Banks and money-market dealers cannot be expected to expand their lines of credit as the demand for short-term finance rises. Indeed, since a large proportion of commercial paper is held by corporations, whose own need for cash to finance their internal re-quirements can be expected to increase, the prospect for a general rise in money-market borrowing by corporations is particularly bad.

Further, there is no need for me to remind you that the cost of borrowing through short-term liabilities reflects the general expectation that eventually interest rates will fall. It is expen-sive to issue long-term debt. It is even more expensive to borrow from the domestic banking system or the money markets in the short-term, although over the life of a bond issue (even with a relatively short no-call period) the cost of short-term money can be expect-ed to average out at a similar level to that of the bond, while allowing the opportunity to switch into long-term debt should the markets improve. The cost of delaying a securities market financ-ing is measured in terms not only of business opportunities fore-gone, but also of the cash premium that has to be paid for short-term money at the present time.

(ii) Alternative markets

If a borrower has access to a market in bank credit and dol-lar securities that is genuinely independent of the domestic markets in which daily cash needs are financed and that takes an independent view of the U.S. economy and, hence, of the interest yields appropriate for dollar investments, these problems, even if they do not disappear, may be lessened. Where securities markets take dif-ferent views, it may be possible to raise capital at reasonable rates sooner in one market than in another, thus releasing the
pressure on cash positions before it would otherwise be possible to do so.

Further, the cost of banking finance in the alternative market may also be substantially below that available in the domestic market, making possible the profitable switching of a part of a cash-management program. Above all, a different general outlook, combined with the particular use of funds for capital finance, may make it possible to extend credit lines at relatively low cost during a period of tight money-market conditions. Rollover credits organized in the second market may underpin a flexible capital program without constraining the domestic working-capital program of a company. Both would cost less in terms of financing costs and would leave the borrower poised to take advantage of whichever securities market may be the first to make capital finance available at the "appropriate cost".

The independence of such a market obviously presupposes freedom from the monetary policies and regulations that limit the availability of funds in the domestic market. In order that the pricing of funds differ, it is also necessary that the outlook of investors be different from those in the domestic markets. This cannot be achieved without crossing administrative boundaries; and increasingly, borrowers who are looking for a source of funds that fits these criteria have been raising capital abroad.

C. Transnational Financing

The international financial market has developed since 1964 into the second largest source of available funds on earth. The estimated $1,450 billion of transnational financings break down into three groups. These are (1) the holdings of equity by non-nationals, (2) the internationally placed medium-term notes and bonds, and (3) the syndicated international bank credits. In addition, there is an international market in the credits of the banking system itself—including central banks and government placements—which is as yet of limited relevance to corporate borrowing needs.

The gross foreign purchase of U.S. equities in 1980 reached $74 billion. This has more than doubled the 1977 total of $26 billion in only three years and this interest in U.S. equities appears to be continuously increasing.

During 1980 the total volume of medium-term financing raised through securities issues and bank-loan syndications placed on an international basis was over $107 billion, without taking into account issues organized for foreigners in the domestic markets. Issues of dollar bonds for international borrowers totaled over $16.25 billion, of which more than half were placed with investors in the Euro-market and the remainder were syndicated in various domestic financial markets around the world. During the peak of the securities market's explosion of activity in the second quarter of last year—in June—$5 billion worth of debt issues were placed in the international market, compared with $7 billion placed in New York.

In 1980 there were some sixty-seven debt issues by North American corporations, of which sixty-one corporations were actually domiciled in the U.S. The value of those issues was $4.1 billion, and it is interesting to compare that figure to the value of comparable borrowings in 1975, the first year after the removal of the
interest equalization tax and the year of the full effect of the first big jump in oil price rises. In 1975 U.S. corporations issued $268 million worth of debt securities abroad—$268 million versus $4.1 billion last year.

Although figures for the securities markets compare favorably with the rate of capital formation in any domestic market, they are dwarfed by the volume of credit syndication over the same period. In 1979 the equivalent of $102.5 billion was raised in the Euro-market; in 1980, $89.1 billion. These enormous volumes are inflated by heavy borrowings by national agencies of countries with large balance of payments deficits with the U.S. But a large number of syndications, ranging from a $3 billion credit for Seagrams to credits for much smaller amounts ($20 million and upwards), have been arranged for corporate borrowers who have come to realize that the cost advantages and, more important, the strategic advantages of borrowing in the international markets are too great to be ignored.

2. THE INTERNATIONAL MARKET

A. The Relationship Between U.S. Markets and Euro-Markets

The different trade-offs between cost and availability of funds in the domestic and international markets indicate two major differences of outlook between U.S. and Euro-market investors. These involve, first, the valuation of a securities portfolio in terms of the performance of alternative currencies as well as alternative investments and, second, the views of various domestic economic policies taken by investors who have experience with Western European economic management.

There are also limits on arbitrage between the markets represented by barriers to the free flow of capital. Until 1974, when the controls on foreign borrowing in New York that had been imposed by the Democratic Administration in the early sixties were removed, a large proportion of the financing of even the foreign operations of domestic corporations had to be organized abroad. The office of Foreign Direct Investments limited outflows of capital; and the interest equalization tax was intended to limit the interest advantages available to foreign investors in New York compared to their domestic markets. The opportunity for domestic investors to buy international debt did not exist.

Since 1974, the possibility of arbitrage by domestic investors has limited the extent to which yields on the Eurodollar market can be expected to rise above those available in New York. A large increase in income that an investor can gain simply by transferring dollars into international securities will not continue where there is no risk at all on the arbitrage.

The really effective barrier to the transfer of international dollar holdings into the domestic market—which was not abolished with the interest equalization tax—has been the withholding at source of the basic rate of domestic income tax on dividends and interest payments of companies domiciled in the U.S. By reducing the yield on a foreigner's investment in the U.S. by up to thirty percent, this tax penalty means that there can be, in theory, a difference of thirty percent in interest rates before domestic issues become attractive. The difference has never actually approached such levels; but, on the other hand, the differentials

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that do open up can be very, very interesting indeed. Just consider the credit market in May of last year. The difference between the U.S. prime rate and the London interbank offered rate (the basis on which all Euro-credits are fixed or priced) widened in May 1980 to 5.3 percent. This difference was almost one third of the rate payable in New York at that time. There is an obvious advantage to raising funds in the international market when this happens; and discrepancies of this size do not, therefore, last long.

As borrowers take advantage of the gap, a large number of consequences develop that can be expected to equalize funding costs. As we have already seen, this happened in June 1980. The $5 billion of issues (out of a total of $12 billion) that were placed in the Euro-market that month peaked at a coupon of 9.5 percent, rates that were thirty basis points better than the best levels reached in the domestic bond market when it peaked that same month.

B. Leadership of the International Market

What was important in the bull market of the second quarter of 1980 was not so much the actual rates that each market ultimately reached, but the leadership of the international market in reacting to the trends in the financial futures markets as the second quarter began. The first issue to be priced at a substantial discount over that expected in the market was an international issue for GMAC. It was followed by a highly successful offering for J.C. Penney which, though priced well below the rates then available in New York, was increased by one third and remained oversubscribed. This pattern of the Eurobond market making its own policy decisions and leading New York is one that—for reasons I shall discuss later—we may find repeating itself.

It is not possible to attribute this to changes in exchange rates, permitting investors who value their assets in foreign currency to make allowance for the capital gain on their holdings when the dollar appreciates. The increasing liberalization of exchange controls, together with a growing volume of major-currency holdings outside the domestic economies of many large OECD nations as they move into balance-of-payments deficit, has made it increasingly easy for international investors to move their portfolios from one currency to another and take advantage of expected changes in relative exchange rates. As a result, Euro-market participants have come to value debt holdings not only in terms of the yield on the asset, but also in relation to their expectations of the trends affecting rates of exchange. These are not necessarily the same factors as those that dominate the pricing of finance purely in terms of interest cost on the New York securities market; and they naturally include a political as well as an economic assessment of a country's future.

During the drop in interest yields in the second quarter of 1980, this factor brought strong pressure on the Euro-market to limit its enthusiasm for dollar capital. As interest rates declined, the dollar exchange rate weakened and then fell dramatically in comparison to a variety of European currencies. Far from compensating for the loss in income, this further penalized holders of dollar issues, cutting the domestic value of their yields and holdings. The pressure of demand for securities developed in spite of, rather than because of, changes in the exchange rate.
It is in the other priorities of investors in the international markets—their view of the outlook for the American economy and the structure of their portfolios—that an explanation is to be found. Investors and investment managers represent a spectrum of needs, while the mix of transnational issuers whose debt is available also differs from the risks represented by purely domestic borrowers. Since the degree of risk taken by a portfolio manager is, in part, a function of the variety of issuers represented in the portfolio—as well as the credit of any individual borrower represented in it—the relative valuation a specific issuer of debt can make a dramatic difference in the issue's reception.

C. Access to the International Market

(i) Role of the universal banks

The syndication of an international banking credit has one further advantage as part of a financing program in today's markets. It is as part of an overall debt portfolio that banking credits are available in the international market. The institutions that handle banking finance are also those responsible for the placement of bond issues in the international market. It is therefore possible to use a credit as a vehicle through which to approach the bond market.

If you look at a tombstone advertisement announcing the consummation of a Euro-market bond issue, you will find it dominated by universal banks with a commercial-banking arm, which here in the U.S. would be prohibited under the Glass-Steagall regulations. These banks are themselves large takers of international debt, both on their own behalf and on behalf of clients whose portfolios they manage. They also maintain close relations with the major investment managers and investors in their markets and, together with the investment banks of established reputation in the market—of whom there are relatively few—they are in a position to sponsor newcomers in placing debt with retail investors.

In the securities market this sponsorship is important because there is no institutional system for rating credit comparable to that used in New York. Unless investors receive personal advice about a borrower's credit, it will not be possible to place debt with them, for there is no general class of debt assessment in terms of which it is possible to analyze risk. This means that the relationship between retail investors and the underwriting and managing banks in the Euro-markets is as much one of investment advice as straightforward offers of securities of a particular known quality. Because few retail investors have the apparatus at their disposal to assess credit themselves, the banks, acting as sponsors, must bring the quality of an issuer to their attention. To ensure a wide and ready market for a company's securities it is necessary that a representative cross-section of the banks with securities market relationships be aware of its credit. And there are few better ways of ensuring that awareness than the syndication of a banking credit among them.

The importance of personal contact to the international market is illustrated by the fate that befell the Eurodollar commercial paper market in the early part of the last decade. Despite the savings in cost that could be achieved by reducing the dependence of borrowers on banks for their short-term financing, European companies were not interested in weakening their relationships. The personal contact with their banker was an asset for which, they
believed, the reduced interest costs of a commercial-paper market could not compensate.

In part, because of the nature of their relationship with borrowers domiciled in Europe, underwriters and managers in the international market will want an opportunity to meet the senior executives of an American newcomer. For them the assessment of a company means coming to know its officers—personally—as well as the state of its corporate balance sheet. Any investment banker concerned for the success of the future development of a funding program in the Euro-market will arrange a series of meetings in such centers as London, Zurich, and Frankfurt during the syndication of a credit.

I wish to make one quick point here. At present there are outstanding 3,243 Eurobond issues, and there are approximately one thousand Eurobond issues that have already matured. That is about four and one half thousand separate issues, though a number of those are repeat transactions for the same borrower. Of that number of issues there are only eighteen delinquencies or defaults. Of those eighteen delinquencies or defaults, it is my recollection that approximately seventeen are by U.S. corporations that are subject to SEC overview.

(ii) Cost of international funding

The cost of a funding program compares very favorably with that available in New York. If you compare the rates payable on three-month drawings of comparable banking credits in Europe and New York—prime with ten percent compensating balances in New York against three-month LIBOR plus a three eighths percent margin in the international market—the average margin in favor of LIBOR over the past five years has been 147 basis points. At its widest, the margin has been over 6.75 percent and the LIBOR rate has never been above that fixed against prime during that period.

For a bond issue also, the cost of raising capital in the Eurodollar market has been below that in New York on many occasions during the past two years. The yields on, for example, two GMAC issues maturing in 1984—one a triple A rated domestic, the other a Eurobond—have been lower in the Euro-market for over half the business days during the past two years, including, of course, the beginning of the bull market in the second quarter of 1980.

The mechanics of an issue are determined by the need to free investors from tax obligations outside their home countries, and in particular to avoid the withholding tax on income from the securities of companies domiciled in the U.S. Obviously this cannot easily be done for equity issues, for which international investors have to come to New York. But for a bond or convertible issue it is possible to arrange a financing subsidiary outside the U.S. through which the funds can be transmitted to the parent without incurring a tax liability for the investor. For this, a domicile that has a reciprocal tax agreement with the U.S. government is necessary, the most convenient one being the Netherlands Antilles.

A corporation using this market for the first time through a banking credit would be well advised to establish an issuing subsidiary at the same time in preparation for opportunities that may develop at very short notice. With an established reputation and an organization capable of handling the mechanics of a Euro-issue, a company has access to an alternative source of capital, which can
be used both to supplement present credit arrangements and to
guarantee access to medium-term capital as soon as interest costs
fall to an acceptable level.

(iii) Criteria for participation
I started with the dilemma that occurs when capital-market
interest rates reach a level that forces the financing of capital
expenditure, as far as possible, out of short-term financial instru-
ments, while at the same time the government is tightening monetary
policy. In order to ensure the availability of finance as it is
needed, it would be invaluable to have access to an alternative and
competitive source of capital—one that can be expected to react to
improvements in the economic outlook even more quickly than the
domestic markets. The international market provides just such an
alternative.

MR. HAWES: Do you mean to imply anything by your comment on
the limited number of defaults in the international market?

MR. VON CLEMM: I want to say only that without an SEC and
without 150-page prospectuses, so far the record of the sponsoring
institutions—the universal banks that dominate the Euro-market—is
something that should attract at least grudging admiration, if
not full-scale admiration.

MR. HAWES: Do you attribute that record to bank screening
of issues?

MR. VON CLEMM: There is another side to that question. It
is not too hard to get that kind of a record if you do not do busi-
ness with companies that would be rated in this country below the
level of, let us say, single A. There are some transactions that
have been done for lesser credits, but you can make a fairly good
record if you will not do business with most people in the world.
The Euro-capital market is a completely useless allocator of re-
sources when it comes to young and new ventures. I believe that
is unfortunate and something that ought to be worked on.

However, a great many of the four and one half thousand
names that have been introduced to the international market over
the last fifteen or twenty years were not terribly well known at the
time they were introduced. Without the sponsorship of these
very potent universal banking institutions (they need not be the
lead manager but they have to be well represented in the sponsoring
group) many of those securities would not have been placed. Not
that they could not have been placed at all; it is a question of
relative pricing. U.S. corporations are not going to do an issue
in the Eurobond market unless they can get the money at a cheaper
net cost. We are talking about what it is that opens up the alter-
native capital market by making funds available at a cheaper net
cost than is available elsewhere.

MR. HAWES: Michael, would you pause one moment and charac-
terize either the companies that have come to the Eurobond market,
or the companies that should come, or maybe the ones that should
not? Is there a level of U.S. ratings, for example, that would
suggest that one can make it in the Eurobond market?
MR. VON CLEMM: Until now it has been the case, by and large, that companies with less than a BAA rating in the U.S. have not appeared frequently in our market. That is the line below which people start to ask a great many questions, the first of which is, why are they coming to the Eurobond market? The image of the U.S. company and its banker as being a pair of well-heeled carpetbaggers is one that does tend to bubble up to the surface of people's minds from time to time. One has to say, however, that with the U.S. absence from the market for the whole period from 1974 until about 1979, Euro-investors realized that they were getting shorter and shorter of U.S. sovereign-risk credits and U.S. corporate credits in their portfolios, and they have been in a generally hospitable frame of mind for the last two or three years.

To give some examples of companies that are using the market, there was a convertible bond issue for Pepsico which was signed in London about three or four days ago. Again, there is an issue being introduced to the market for Southern California Edison. This is very unusual, because in the whole history of the market I think there has been only one other U.S. electric utility that has come to the Euro-market—and that was so long ago, the issue has probably matured by now. We believe that following Southern California Edison there will be a substantial number of U.S. utilities that will learn that this is an alternative market which they should not ignore. Southern California Edison, by the way, has been very well accepted. There was a lot of nervousness about whether European investors even remembered what U.S. utilities were. While a lot of equity in U.S. utilities was held by foreign investors right after the war, it tended to be disinvested over the last fifteen years or so. But this issue and this name have been well received, and there will be others.

MR. HAWES: We have one last comment by Steve Friedman.

MR. FRIEDMAN: It is actually a question. Michael, what is the level of straight equity financing in the Eurodollar market? Is it increasing?

MR. VON CLEMM: To my recollection, there has been one Euro-equity issue done. There are convertible bond issues with warrants, but there has been only one pure Euro-equity deal done.

MR. FRIEDMAN: Why is that?

MR. VON CLEMM: The one pure Euro-equity was Investors Overseas Management.

MR. FRIEDMAN: Are the convertibles seen by their issuers primarily as equity or debt financings?

MR. VON CLEMM: I think there is no single answer to that. Certainly, in our view, those who insist on a twenty percent premium cannot possibly be thinking of them as equity financings. There are others, most likely non-U.S. issuers of convertibles, who accept a five percent premium and they obviously do consider those as equity transactions.

MR. HAWES: I just asked Michael Coles if he had anything to add. Do you have a comment?
MR. COLES: I would reinforce what Michael said about timing. The markets do different things at different times. They act independently. Going back to June 1980 when interest rates in both markets came down very, very rapidly—the ability to move on an almost overnight basis in a rapidly declining market obviously helped issuers in the Eurobond market as opposed to those in the U.S. markets.

MR. VON CLEMM: Maybe I should add, since I gave the recent examples, that the Pepsico deal was decided here late Friday night and it was introduced to the market in London on Monday morning. It was signed on Tuesday evening; that is a forty-eight hour turnaround. It is not terribly pleasant for the people who have to carry it out, but it is rather a positive feature of the Eurobond market.