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Salomon Brothers

The Sovereign Issuer's Quarterly: Third Quarter 1995

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INTRODUCTION AND SUMMARY

Economic, Policy and Market Trends

Although industrial country growth has been slower than anticipated, prospects in some countries are improving: The U.S. expansion is accelerating moderately. The yen's slide and prospective policy initiatives will begin to restart Japan's growth over the coming quarters. However, European growth is slowing to trend, and no reacceleration is expected soon.

Fed easing will remain on hold while U.S. growth is accelerating, but conditions permitting new rate cuts will emerge before year-end. The Bundesbank likely will lower its repo rate somewhat further, following the latest (and probably last) round of official rate cuts for this cycle. The gloomy Japanese business conditions fully justified the Bank of Japan's latest discount rate cut to a record low of 0.5%.

The recent rally in the U.S. Treasury market has carried yields back to early summer lows. Stable inflation and new fiscal tightening — if credible — eventually could push long-term yields even lower. Evidence of sluggish German growth will translate into modestly lower bond yields near term. Japanese bond yields also are expected to decline somewhat in the next few months. The U.S. trade-weighted dollar has risen by about 6% in the past month and probably has room for further modest gains in coming months.

Equity Market Trends

Equity issuance volumes in the second quarter of 1995 were at the highest level in a year. On the other hand, net equity-linked security remains at depressed levels while equity market inflows have remained significantly positive. These conditions have created a new issue environment that gives equity-linked issuers unprecedented flexibility in terms of pricing, structuring and timing. As such, high-premium, short-call protection convertible bonds and other convertible-type instruments such as DECS are becoming increasingly popular.

Corporate Equity Derivative Trends

Even with the stock market at, or close to, all-time highs and many companies issuing new equity, other corporations continue to repurchase their shares in order to achieve various corporate finance objectives, including the following: (1) returning excess cash to shareholders in a tax-efficient manner; (2) offsetting dilution from acquisitions, conversions of convertible bonds or employee stock options; and (3) managing the capital structure of the corporation. In satisfying these objectives, the Salomon Brothers Accelerated Share Repurchase program allows a company to purchase a targeted number of shares immediately, with the final price of those shares determined by the average market price over a fixed period of time.

Merger-and-Acquisition Trends

Merger-and-acquisition (M&A) activity continued at its record-breaking pace in the second quarter of 1995 — with volume of more than 50% that of the second quarter of 1994. While activity was up across all areas of the market, the financial services, media/telecom and health care industries continued to dominate activity. Other industries with notably increased activity include utilities and retail food. As financial buyers finally started to participate in the deal flow, equity was the predominant choice of currency. Moreover, international M&A activity is becoming increasingly more significant as 1995 volume has nearly doubled compared with same-period activity in 1994. Cross-border activity was largely dominated by the United Kingdom, France, Germany, Canada, and Australia.

Fixed-Income Market Trends

The Treasury market is back on track and corporate financing spreads are near historically narrow levels. Investor demand — particularly in the insurance sector — has created a very attractive financing environment for corporate America. An expected, buildup in the new issuance calendar does pose a risk to this environment; however, on balance, spreads are likely to stay within recent ranges.

Liability Management Trends

Many recent liability management actions have been motivated by strategic rather than purely financial objectives. The strategic decision to restructure a business through a carve-out, split-up or spin-off may require approval of bondholders, and ultimately, a liability-management strategy. In this report, we review tactical alternatives for obtaining bondholder approval and describe recent transactions of this type.

Fixed-Income Derivative Trends

The current market environment can be characterized by a flattening yield curve at the short end, tight swap spreads and high volatility. Issuers can take advantage of this environment by creating synthetic fixed-rate debt by issuing commercial paper and entering into a swap where they receive a floating rate and pay a fixed rate. Issuers who expect Treasury rates to decrease can lock in the current tight swap spreads by entering into a swap spreadlock agreement where they agree to pay fixed and receive a floating-rate index.

Analysis of the Quarter

In this issue, we introduce a new section highlighting various applied quantitative analysis used to further corporate finance objectives. In this report, our analysis focuses on a statistical credit-rating model that has often explained more than 90% of the variation in ratings for companies in a given industry. Typically, only a few financial variables are statistically sufficient to explain a company's credit ratings. These variables usually include market value leverage, cash flow volatility, and a variable reflecting size. Recently privatized companies, companies undergoing mergers or acquisitions, or companies periodically reviewing their capital structure will benefit from the insights provided by the Salomon Brothers Credit Rating Model.

Question 1 *What is the economic growth outlook for major industrialized countries?*

Answer 1

- Overall growth prospects for some industrial economies have improved, at least to some degree.

- A modest rebound in U.S. growth is underway, but the second-half expansion will not be powerful enough to boost inflationary pressures. As leading indicators of U.S. inflation have continued to improve, final and price measures have peaked.

- European growth is slowing, but the unwinding of the Deutschemark's earlier surge, combined with the Bundesbank-led move toward easier monetary policies, will sustain trend growth in 1996. Germany's inflation has edged close to 2% and will remain low well into 1996. Inflation will rise moderately further in several European countries whose currencies have depreciated in the past year.

- Japanese core consumer prices are expected to stop falling by early 1996, but there is no threat of any major price pickup.

Question 2 *What are the economic policy prospects for major industrialized countries?*

Answer 2

- Although Fed policy currently is on hold, further new rate cuts are expected during the next six to nine months, reflecting gradual improvement in inflation expectations and the enactment of 1996 budget cuts.

- The Bundesbank has cut rates in order to counter the Deutschemark's earlier surge, sustained weakness in M3, and the slowdown of the German economy. The authorities have lowered the repo rate to 4.15% and are likely to push it lower in coming weeks. The benign German interest rate environment — combined with French Government moves to reduce deficits and, hence, underpin the franc — should allow the Bank of France flexibility to continue lowering rates closer to German levels. In the United Kingdom, slowing economic growth and a willingness to tolerate a temporary rise of inflation in response to past sterling depreciation suggest that base rates have peaked. Provided that the November budget is not too expansionary, U.K. interest rates could decline in the first half of 1996.

- The Bank of Japan's easing of official and market interest rates will not generate a quick economic response. Nonetheless, the economic support package to be release around September 20 will pack a significant punch. Real economic demand appears likely to reach at least ¥5 trillion, which would be sufficient to ensure a return to mild economic growth next year.

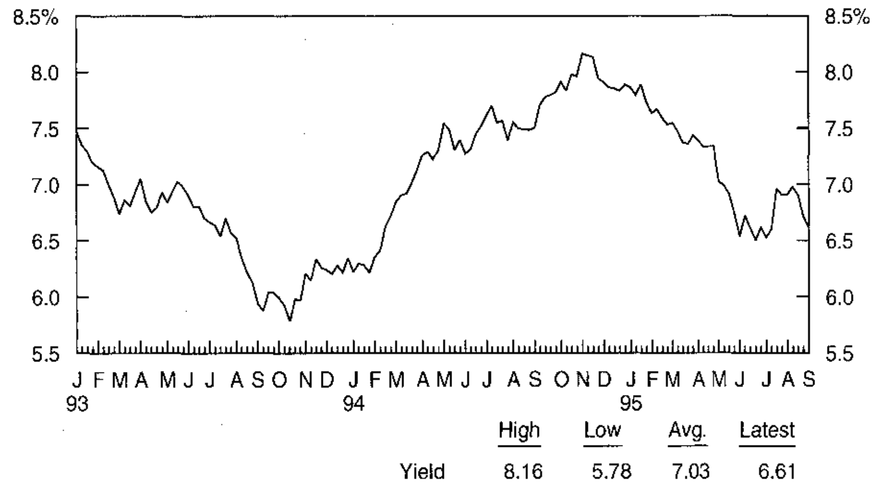
Question 3

How have the major markets performed in the second quarter of 1995?

Answer 3

• As Treasury yields kept inching down in the second quarter of 1995 (see Figure 1), total rates of return of selected U.S. asset classes were all strongly positive (see Figure 2). Even emerging market returns, which had been sharply down in the first quarter of 1995, came back very strongly in the second quarter.

Figure 1. 30-Year U.S. Treasury Yields, 3 Jan 93-1 Sep 95



Source: Salomon Brothers Inc.

Figure 2. Total Rates of Return of Selected Asset Classes, 2Q 94-2Q 95

Asset Class	2Q 95	1Q 95	4Q 94	3Q 94	2Q 94
Treasury	6.21%	4.68%	0.34%	0.35%	-1.04%
Corporate	7.28	5.73	0.43	0.68	-1.41
Mortgage	5.18	5.27	0.44	0.79	-0.54
High Yield	6.14	5.90	0.03	1.29	-0.45
Emerging Markets	22.31	-11.10	-8.15	14.25	-1.50
S&P 500	8.80%	9.02%	-0.74%	4.15%	-0.34%

Source: Salomon Brothers Inc.

Question 4

What is the near-term market outlook?

Answer 4

• The outlook for U.S. fiscal policy and inflation will hold the key to the Treasury bond outlook. As U.S. growth accelerates back toward trend, U.S. inflation expectations are likely to stabilize over the coming months. With long-term Treasury yields currently near 6.50%, new yield declines will probably await clear-cut evidence that the effort at new fiscal tightening is making progress.

• Sluggish German growth and low inflation will permit a modest decline in bond yields in coming months. Other European markets will benefit from the benign German interest rate outlook. In particular, prospects for lower rates in France and the United Kingdom favor shorter-maturity debt in those markets. Among the higher-yielding European markets, inflation and policy prospects point to outperformance in Spain. Longer term, markets in Italy and Sweden remain vulnerable unless policymakers move further to restore fiscal policy to a sustainable path.

• In Japan, the spiral of the strengthening yen appears to have ended, but weak economic growth and perhaps some additional bond yield declines will continue until (1) new policy actions that promise stronger growth and more substantive deregulation emerge; and (2) external surpluses begin to decline significantly.

• The U.S. dollar's impressive recent advance could continue somewhat further, especially versus the Deutschemark, but significant new dollar strength is not expected anytime soon. At the same time, there is little risk of a return to the dollar weakness which prevailed earlier this year. In the long term, an expected narrowing of inflation differentials between the key economies should help to boost the U.S. currency, as U.S. price pressures recede, European inflation prospects stabilize and Japanese deflation comes to an end.

Figure 3. Summary of Economic Forecast, 3Q 95

	Growth	Monetary Policy	Fiscal Policy
United States	Below Trend	Easier	Possible Tightening
Core Europe[a]	Trend	Easier	Mixed
Japan	Stagnant	Easier	Easier

[a] Includes France, Germany and the Benelux countries.
Source: Salomon Brothers Inc.

Equity issuance volumes in the second quarter of 1995 were the highest in a year, closely approaching the relatively high levels of the first quarter of 1994 (see Figure 4). Equity carve-out initial public offerings (IPOs) totaled $1.7 billion, representing 24% of all IPOs.

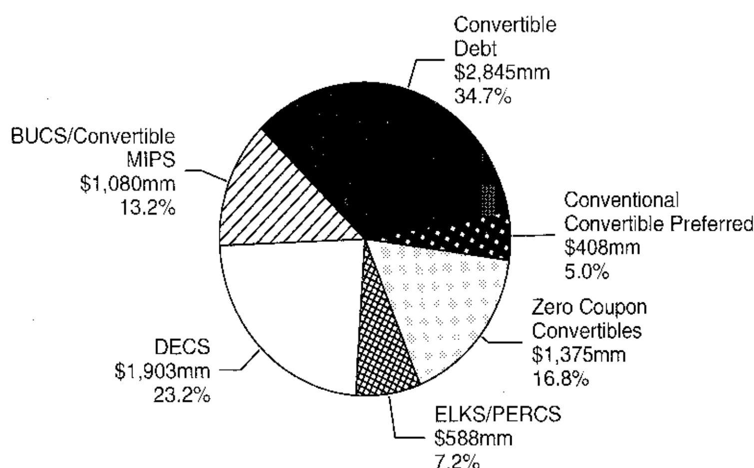
Figure 4. Total Equity Issuance,[a] 1Q 94-2Q 95 (Dollars in Billions)

	2Q 95	1Q 95	4Q 94	3Q 94	2Q 94	1Q 94
Common Stock and Convertibles	$14.7	$8.7	$8.5	$6.8	$8.1	$15.1
IPOs, Excluding REITs	6.9	3.8	6.5	4.2	6.6	6.3
IPOs of REITs	0.2	0.0	0.1	0.8	2.5	2.0
Total	**$21.8**	**$12.5**	**$15.1**	**$11.8**	**$17.2**	**23.4**

[a] Equity issuance excludes Rule 144A transactions and closed-end investment funds. IPO Initial public offering. REIT Real estate investment trust.
Sources: Securities Data Co. and Salomon Brothers Inc.

On the other hand, equity-linked security issuance remains at depressed levels. Issuance volume for the year to date is approximately $8.4 billion, down from $77 billion in 1994. In addition, calls and redemptions are withdrawing securities from the market, while inflows have remained significantly positive. These conditions have created a new issue environment that gives issuers unprecedented flexibility in terms of pricing, structuring and timing.

Figure 5. Equity-Linked New Issuance by Product Type, Jan 95-Jun 95 (Dollars in Millions)



Source: Salomon Brothers Inc.

In response to these market dynamics, VLSI Technology, a leading manufacturer of semiconductors, successfully issued a landmark $150-million, high-premium, short-call protection convertible bond in September.

The VLSI convertible is noteworthy because of its unusually high conversion premium (60%) and short call protection (two years), which in many ways mirrored a high-yield bond. However, unlike a high-yield bond, the convertible structure provided VLSI with enhanced flexibility in the form of far less-onerous covenant restrictions. Accordingly, the transaction was marketed widely to convertible bond and high-yield investors. In the

end, the transaction was seven-times oversubscribed, and VLSI Technology realized financing terms more attractive than those set forth in the initial price talk. Of the nearly 200 institutional investors that participated in the transaction, roughly 80% did not previously own VLSI common stock.

The DECS security created by Salomon Brothers in 1993 has also been one of the most successful innovations in the equity-linked market. Since the beginning of 1994, DECS issuance has accounted for 25% of the total $22-billion equity-linked issuance in the United States (see Figure 5).

DECS can be structured in two forms: (1) **equity DECS**, or Dividend Enhanced Convertible Stock, are shares of short-maturity preferred stock that are mandatorily convertible into the common stock of the issuer; and (2) **exchangeable DECS**, or Debt Exchangeable for Common Stock, are short-term debentures that are issued by one company and exchangeable for the common shares of another. Salomon Brothers created DECS in order to broaden a corporation's investor base. By appealing to defensive equity, "growth and income," and "equity income" investors, as well as traditional convertible investors, DECS tend to place less downward pressure on the underlying stock price than a common stock offering.

Equity DECS

Corporations principally use equity DECS as a high-equity-content financing vehicle that is potentially less dilutive and less costly than issuing common stock directly. Their relatively short maturity and mandatory conversion feature have persuaded the rating agencies to assign a very high equity content to these securities. Issuers have found that equity DECS provide significant capital structure advantages for little additional cost compared with traditional convertible preferred securities. As a result, equity DECS virtually have rendered obsolete other forms of mandatorily convertible securities.

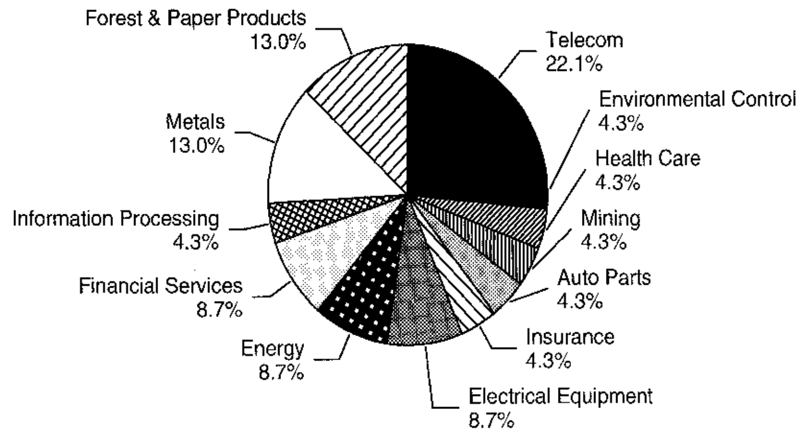
Exchangeable DECS

Exchangeable DECS typically are issued to monetize or hedge an investment in the common stock of another company. With the issuance of an exchangeable DECS, the issuer is guaranteed a sale price for the underlying common stock that is no less than the current market price and may even do better if the stock price rises. This issuer also is able to defer any taxable gain/loss on the direct sale of the underlying common stock. The exchangeable DECS are structured as debentures so that the interest expense may be deducted for tax purposes. Also, if the issuer wants to maintain its investment in the underlying shares, the exchangeable DECS can be settled in cash instead of stock at maturity. Few traditional exchangeable debentures (that is, with no mandatory conversion feature) have been issued in the past two years since the creation of exchangeable DECS.

Issuer Profile: Industry

A wide array of industry groups, including telecommunications, forest and paper products, financial services, and metals have issued DECS. In Figure 6, we provide a breakdown of DECS issuance by industry group.

Figure 6. DECS Issuance — Underlying Stock Industry Group, Jun 93-Jun 95

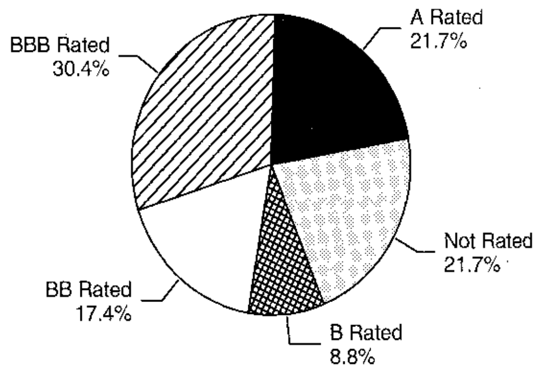


Source: Salomon Brothers Inc.

Issuer Profile: Credit Rating

Although some traditional convertible securities have been the domain of speculative credit issuers, strong credits and weak credits alike have issued DECS (see Figure 7).

Figure 7. DECS Issuance — Senior Debt Rating of Issuer, Jun 93-Jun 95

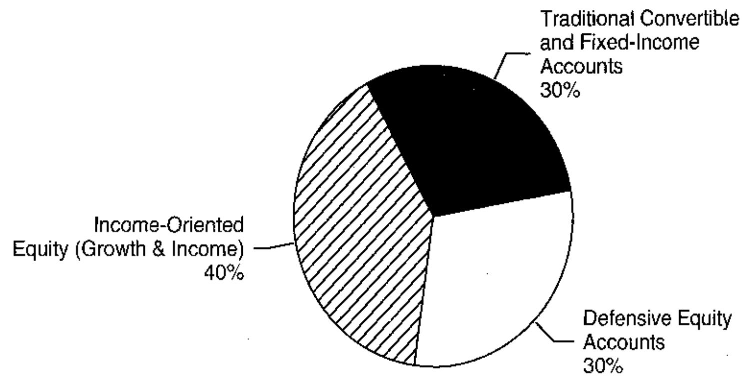


Source: Salomon Brothers Inc.

Diversification of Investor Base

Salomon Brothers has found that most DECS securities offered have been distributed to institutional investors that do not already own the underlying common stock — on average, more than 70%. In addition, most DECS securities have been placed with convertible investors that are willing to take additional downside risk in return for a higher coupon or dividend yield than that offered by a traditional convertible security. Many of these investors are so-called "growth and income" or "balanced" funds that seek capital appreciation and current income (see Figure 8).

Figure 8. Composition of DECS Investor Base



Source: Salomon Brothers Inc.

Stock Price Impact

We believe that despite a DECS's equity-like characteristics, the stock price impact of the announcement of a DECS offering is far less negative than that of a straight equity offering. In fact, for the offerings that Salomon Brothers has lead or co-managed to date, we have observed a slight positive announcement effect on the underlying stock price. The neutral to sometimes favorable stock price reaction likely is the result of the fact that DECS are not sold primarily to existing common stock holders. Also, by offering stock at a potential premium, issuers send a more bullish signal when issuing DECS versus a straight sale of common stock.

Non-U.S. Issuers

While the investor universe for DECS principally resides in the United States, three non-U.S. issuers have successfully employed the exchangeable DECS structure to monetize equity positions in publicly traded companies. Horsham Corporation of Canada issued an exchangeable DECS-like structure that is convertible into shares of Barrick Gold, a mining company. NAFINSA, the Mexican development bank, issued an exchangeable DECS-like security to monetize its remaining stake in Telefonos de Mexico (Telmex), which is one of the most actively traded stocks on the New York Stock Exchange (NYSE). Cointel also issued an Exchangeable DECS structure to monetize its stake in Telefonica de Argentina.

The Accelerated Share Repurchase

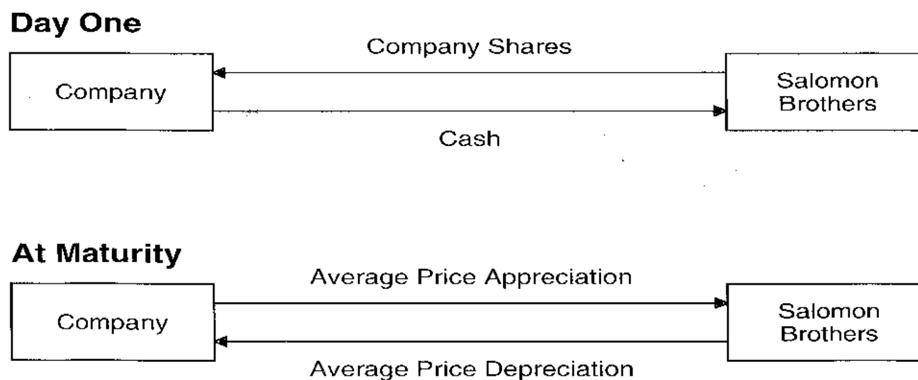
Even with the stock market close to all-time highs, many corporations continue to repurchase their shares for achieving various corporate finance objectives, including: (1) returning excess cash to shareholders in a tax-efficient manner; (2) offsetting dilution from acquisitions, conversions of convertible bonds or employee stock options; and (3) managing the capital structure of the corporation.

With the growth in corporate share repurchases, interest in enhancement strategies has increased as well. The most popular of these strategies has been the sale of put warrants on a company's stock. [1] However, unless they have a very strong price view, most companies tend to manage open market share repurchase programs with a goal of matching the average market price over a given period. To guarantee average price execution with enhanced accounting benefits, Salomon Brothers designed the Accelerated Share Repurchase program.

The Accelerated Share Repurchase program provides guaranteed average price execution by allowing a company to purchase and retire a targeted number of shares immediately with the final price of those shares determined by the average market price over a fixed period of time. For example, a company could immediately retire two million shares and still automatically realize the average market price over the next quarter.[2]

At the inception of an Accelerated Share Repurchase program, the company purchases a block of its own shares from Salomon at the current market price. As an integral part of the repurchase, the company agrees to a purchase price adjustment at the end of the transaction period (see Figure 9). The adjustment compensates the company if the average market price during the period is below the initial stock price. Conversely, if a company's average market price is higher than the initial stock price, the company pays the difference to Salomon. The refund or payment may be made in cash or shares of the company's stock. The net result is that the final cost of the shares retired on day one is the average market price over the period (see Figure 9).

Figure 9. Mechanics of the Accelerated Share Repurchase Program.

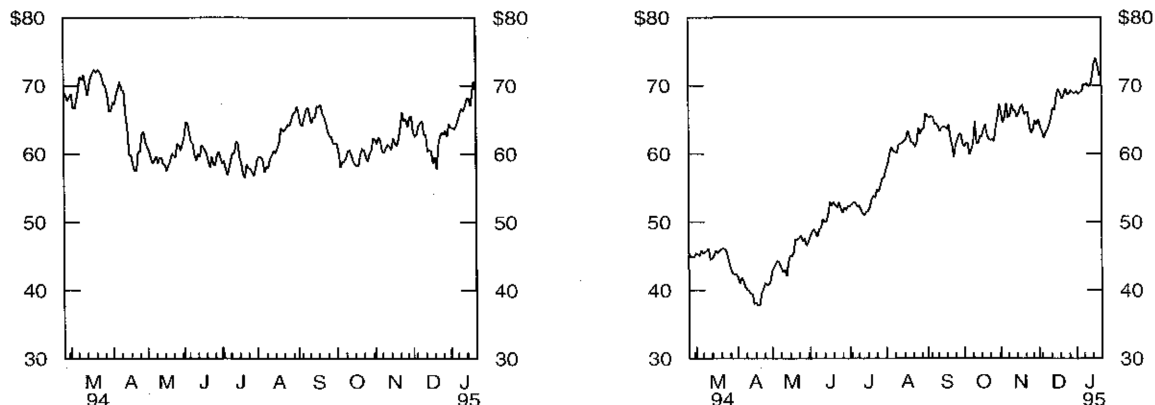


Source: Salomon Brothers Inc.

[1] For more information, see *Stock Buybacks: Strategy and Tactics*, Peter Blanton, et al., Salomon Brothers Inc, November 1994.

[2] The size of the program is a function of the company's objectives, trading volume, and the availability of shares to borrow from institutional shareholders.

Figure 10. How the Pricing Adjustment Works



Initial Sales Price	$69.00	Initial Sales Price	*$45.50*
Average Market Price During Period	62.77	Average Market Price During Period	56.29
Refund/(Payment) at Maturity	$6.23	Refund/(Payment) at Maturity	$(10.79)
Final Cost of Shares Repurchased	*$62.77*	*Final Cost of Shares Repurchased*	*$56.29*

Source: Salomon Brothers Inc.

In both cases, the net result is that the cost of the shares retired on the first day of the period is the average market price over that period.

The Accelerated Share Repurchase program has the following features:

- **Market-indexed stock buyback program.** Just as many investors index a core portion of their investments to a market average, the Accelerated Share Repurchase program allows a company to index its stock buyback program to the average market price for its shares.[3] In addition, because the pricing adjustment is an average of all market trades, rather than actual purchases, the daily execution risk is transferred from the company to Salomon Brothers.

- **Accelerated accounting benefits.** By immediately retiring shares, the company accelerates the earnings per share and return on equity increases that result from a share repurchase program. For example, a two-million share Accelerated Share Repurchase commenced at the beginning of the quarter would result in two million less shares outstanding for earnings per share and return on equity calculations. This is twice the reduction in weighted-average shares outstanding that would result from buying two million shares over the quarter.

- **No ongoing administrative burden.** Because the company takes delivery of the shares on day one, and there is no further action until the end of the transaction period, the company eliminates the management time associated with a daily buying program.

[3] For a discussion of the benefits of indexing a stock buyback program, see *The CFO Quarterly — Second Quarter 1995*, Niso Abuaf, et al., Salomon Brothers Inc, June 1995, pp. 20-22.

- **The company maintains the flexibility to purchase additional shares in the open market through Salomon Brothers.** During the averaging period, the company has the ability to opportunistically purchase blocks of stock in the open market.

- **The accounting and tax treatment is similar to a regular open market repurchase program.** Based on current Emerging Issues Task Force guidelines, if the purchase price adjustment is optionally payable in cash or stock, there is no mark-to-market on the income statement. Furthermore, there should not be any tax consequences from this transaction since the company is transacting in its own stock.

Companies should consult with their legal counsel and auditors to consider all of the issues of entering into an Accelerated Share Repurchase.

• **M&A activity continued at its record-breaking pace in the second quarter of 1995.** Domestically, almost 1,700 transactions totaling $85 billion were announced, representing a 50% increase over the second quarter of 1994. This level brings the volume over the past 12 months to $371 billion, the highest level for any such period in history.

• **While activity was up across all areas of the market, the financial services, media/telecom and health care industries continued to dominate.** These three industries comprised almost half the total dollar volume and these figures do not include the Chase Manhattan/Chemical Bank, Disney/Capital Cities ABC and Time Warner Inc./Turner Broadcasting deals announced in the last month.

Most of the activity in the financial services industry is taking place in the banking sector as money center and regional players vie for market share in particular geographic regions or product lines. The media activity has been dominated by large network and studio deals as the media mega-giants jockey for share of the ever-increasing entertainment business. This industry has produced several large conglomerate companies with various forms of content and distribution assets. Health care mergers are taking place in the large pharmaceutical and services fields in order to consolidate funding of huge R&D budgets and produce competitive cost-cutting measures.

• **Other industries with notably increased activity include utilities and food retail.** The electric utility industry has seen four large transactions announced year to date, which is more than the one-per-annum trend of recent years. Significant regulatory and competitive issues are driving this activity and we may finally see significant consolidation begin to occur. Retail activity is occurring in most sectors with a particular pickup in the food area as a result of an excess supply of stores.

Figure 11. Ten Largest M&A Deals Announced in the Second Quarter of 1995 (Dollars in Millions)

Date Announced	Acquiror/Target	Industry	Value	Type
13 Jun 95	First Data Corp./First Financial Mgmt.	Business Services	$5,756	Stock Swap
10 Apr 95	Seagram Co./MCA Inc.	Media/Telecom	5,704	Divestiture
19 Jun 95	First Union Corp./First Fidelity Bancorp.	Financial Services	5,070	Stock Swap
05 Jun 95	IBM Corp./Lotus Development Corp.	Technology	3,366	Tender/Merger
07 Apr 95	AT&T/LIN Broadcasting Corp.	Media/Telecom	3,313	Squeeze Out
01 May 95	Wisconsin Energy Corp./No. States Power Co.	Utilities	3,037	Stock Swap
21 Jun 95	United Healthcare Corp./MetraHealth Cos.	Health Care	2,350	Stock Swap
03 Apr 95	Raytheon Co./E-Systems Inc.	Defense	2,255	Tender/Merger
12 Jun 95	General Growth Prop./Homart Dvp Corp.	Real Estate	1,850	Divestiture
10 Apr 95	Frontier Corp./ALC Communications Corp.	Media/Telecom	1,804	Stock Swap

Note: Includes stake of purchases of $100 million and greater.
Source: *Investment Dealers Digest.*

• **Equity was the predominant choice of currency, except among the larger deals.** Equity consideration was utilized in 75% of the transactions in the first quarter versus 25% for cash. Equity consideration comprised only 32% of the total deal value, however, implying a higher use of cash in the larger deals.

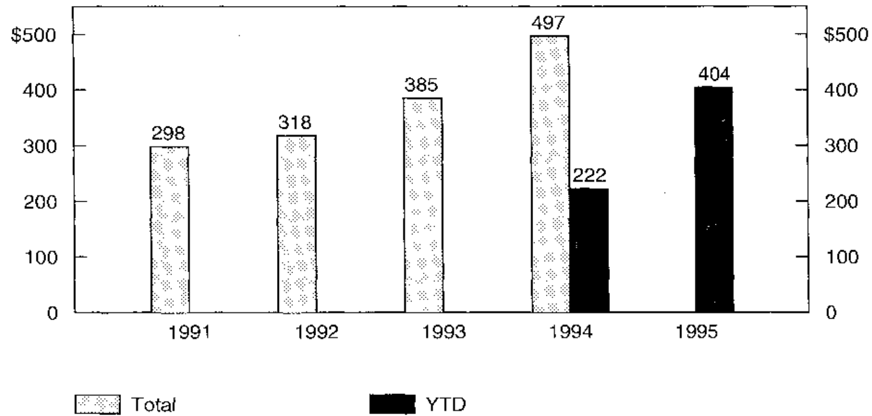
• **Hostile deals represented 8% of total deals announced.** While this is down from the 15% level of the first quarter, it represents a higher level of unsolicited activity overall relative to recent years.

• **Financial buyers have finally started to participate in the deal flow.** Financial buyers represented 5% of total activity, which represents a substantial increase over the past three years. This trend is occurring as principal investment funds have begun participating in nontraditional LBO sectors, such as media and technology, in an effort to invest their significant fund balances.

International M&A Activity Increases Significantly

• Worldwide volume for the year to date totals $404 billion, well ahead of last year's runrate of $222 billion (see Figure 12).

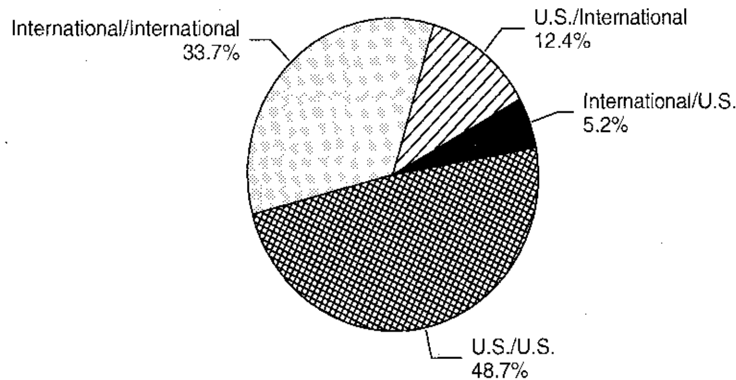
Figure 12. Worldwide M&A Figure Volume, 1991-YTD 1995 (Dollars in Billions)



M&A Merger and acquisition. YTD Year to date.
Source: Securities Data Co.

• **International activity is becoming a more significant component of worldwide M&A volume.** Such activity has increased almost fourfold year to date 1995 versus 1994, from $47 billion to $178 billion. Over the past 18 months, worldwide M&A activity has been split approximately 50% internal domestic deals, one-third purely international deals and the remainder consisting of incoming and outgoing cross-border activity. Figure 13 illustrates the breakdown.

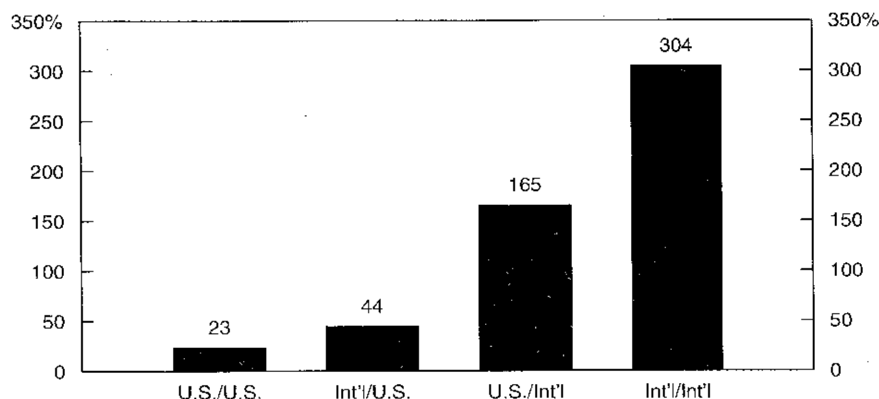
Figure 13. Worldwide M&A Volume by Category, 1994-YTD 1995



M&A Merger and acquisition. YTD Year to date.
Source: Securities Data Co.

• **Growth rates for each of the three international categories exceeds that of purely domestic M&A.** Deal volume in the purely international and cross-border categories grew at significantly higher rates than domestic activity, partly as a result of a smaller base of volume (see Figure 14).

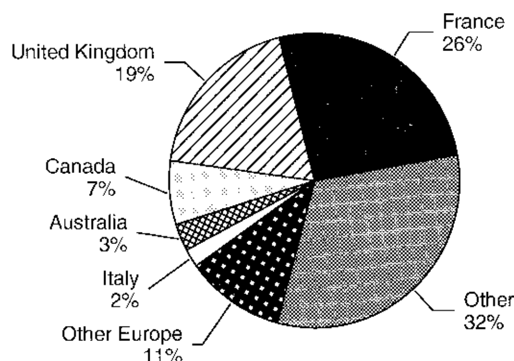
Figure 14. Growth Rate by M&A Category, 1994-YTD 1995



M&A Merger and acquisition. YTD Year to date.
Source: Securities Data Co.

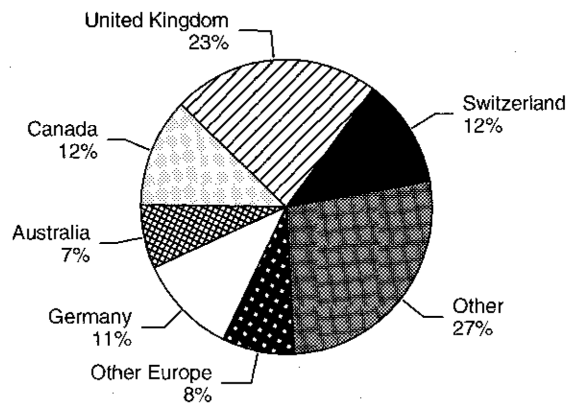
• **Cross-border activity is dominated by a few countries.** Inbound and outbound cross-border M&A tends to be conducted from or to a small group of industrialized countries. The United Kingdom, France, Germany, Canada, and Australia often comprise the majority of the cross-border activity, while other European countries account for up to an additional 10%. This cross-border volume can be expected to increase as the economies of these corresponding countries continue to improve and trends towards global consolidation persist in various industries (see Figures 15 and 16).

Figure 15. Outbound Cross-Border M&A Volume by Country, 1994- YTD 1995



M&A Merger and acquisition. YTD Year to date.
Source: Securities Data Co.

Figure 16. Inbound Cross-Border M&A Volume by Country, 1994-YTD 1995



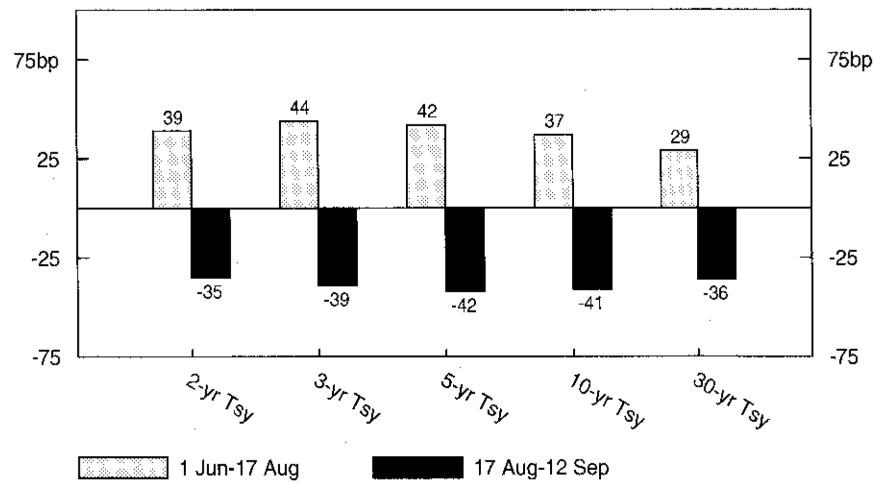
M&A Merger and acquisition. YTD Year to date.
Source: Securities Data Co.

The Treasury market is back on track and corporate financing spreads are near historically narrow levels. In this section, we discuss why investor demand — particularly in the insurance sector — has created such an attractive financing environment for corporate America.

The tone in the Treasury market has turned decidedly healthy, rejuvenated by August's short-lived correction.

Summer rally takes a holiday, but returns with renewed vigor. After long bond yields bottomed at $6^1/_2$% in June, a flurry of stronger-than-expected economic data created anxiety in the bond market. Fixed-income investors took profits, traders turned cautious and economists became less certain of imminent further Fed easing. Thin summer trading levels exaggerated the correction. But a correction it apparently was, rather than a return to the bearish climate of 1994. The yield curve has rallied by about 35-40 basis points in the August 17-September 12 time frame and we are likely back on track for Salomon Brothers' forecast of a $6^1/_4$% long bond in the next six months (see Figure 17).

Figure 17. Changes in U.S. Treasury Yields, 1 Jun 95-12 Sep 95

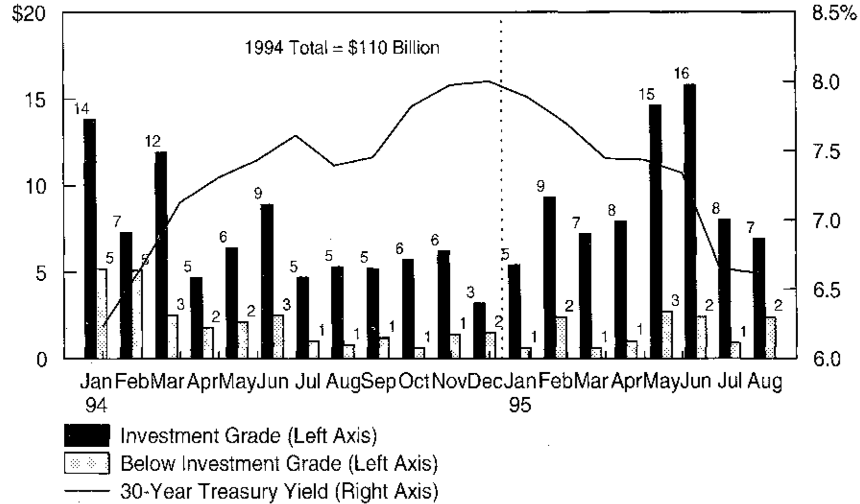


bp Basis points.
Source: Salomon Brothers Inc.

With spreads near historic tights, the corporate bond market faces some risk; however, such risk is offset, in large part, by continual insurance company demand for product.

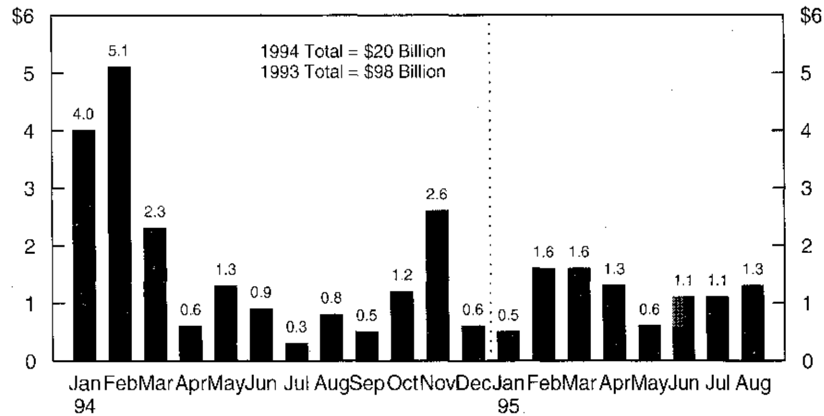
Will expected corporate supply widen historically narrow corporate spreads? On balance, we think not. A spurt of corporate bond issuance in June (see Figure 18), for example, caused financing spreads to widen by about ten basis points. The impact, however, was short lived, limited by the market's ability to absorb an above-average pool of new supply. Will we see this again? One could argue that the risk to spreads is perhaps greater than in 1993, when refinancing activity dominated issuance volume. In that situation, insurance companies needed to buy bonds just to keep the portfolio from shrinking. Today, refunding activity is a smaller slice of the underwriting pie, with few call opportunities remaining in the corporate debt portfolio (see Figure 19).

Figure 18. Monthly Corporate Debt Issuance, Jan 94-Aug 95 (Dollars in Billions)



Notes: Includes industrial, financial and utility companies only. Excludes medium-term notes and Yankees.
Sources: Securities Data Co. and Salomon Brothers Inc.

Figure 19. Principal Amount of Corporate Securities Called in the Salomon Brothers BIG Bond Index, Jan 94-Aug 95 (Dollars in Billions)



BIG Broad investment-grade.
Source: Salomon Brothers Inc.

Supply-demand technicals remain positive. The life insurance industry generates more than $50 billion in investable cash flow every month. Most of this cash is plowed into so-called *spread assets;* that is, corporates, mortgage-backed securities, or MBS (pass-throughs and CMOs), and private placements. Corporates comprise about 65% of insurance company bond holdings, with MBS having recently shrunk from 26.4% to 25.3%. The remaining 10% is Treasuries and agencies — typically a parking place for cash before investing in other assets. The size of the industry's annual investment is impressive (see Figure 20). Along with state pension fund investors and other fixed-income portfolio managers ("total-rate-of-return" investors) the demand for corporate bonds remains robust and has driven financing spreads to current lows.

Figure 20. Annual Investment Levels of the Life Insurance Industry, 1991-94 (Dollars in Millions)

	Gross Purchases	Net Purchases
1991	$450.5	$80.8
1992	550.8	86.3
1993	681.8	97.8
1994	536.2	75.4

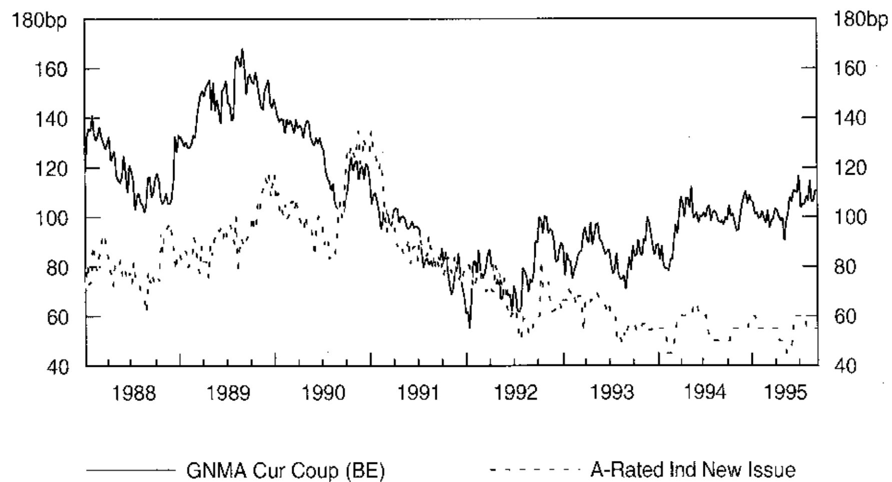
Source: *Best's Aggregates & Averages, Life-Health*, 1995 Edition, AM Best.

As a recent Salomon Brothers' report explains:

"Despite corporate bond spreads being near historic tight levels, insurers are forced to buy limited-supply spread assets because all their profits come entirely from the asset yield spread over Treasuries. Their choice is painfully clear — either staying in Treasuries and not even covering expenses or reluctantly buying spread assets and making smaller profits .... The accounting horizon for insurance companies impels them into spread assets even when traditional total-rate-of-return accounts are reluctant to commit funds since insurance companies are investing against their liabilities needs and not against asset benchmarks."[4]

The annual issuance of new spread assets is on the decline, while insurance company net demand for product continues to grow. Furthermore, the appeal of mortgage securities — particularly CMOs — has been tarnished recently by negative press, market volatility and a disappointing performance in 1994. The securities suffer from "prepayment risk" — so-called negative convexity — that is exacerbated when rate volatility is high, as it is now. Despite a widening of the spread premium of mortgages to, for example, A-rated industrial spreads (about 40 basis points currently), corporates continue to attract greater investor demand (see Figure 21).

Figure 21. Mortgage Spreads versus A-Rated Industrial New Issue Spreads, Jan 88-Sep 95



bp Basis points.
Source: Salomon Brothers Inc.

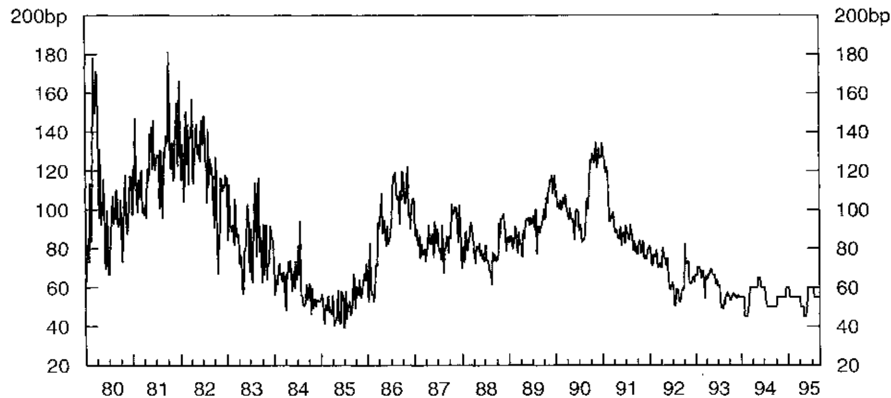
[4] See "Life Insurance Industry Investment Trends," *Bond Market Roundup: Strategy*, Yogesh Attre and Carlos Mosquera, Salomon Brothers Inc, May 26, 1995.

Do the supply-demand characteristics of investment-grade bonds increase the appeal of an investment-grade rating? Certainly. The predominant buyers of high-yield bonds are the mutual funds, which act as intermediaries for retail investors. Spreads in this market tend to reflect the ebb and flow of individual investors in and out of the sector. To the extent that this demand is less reliable or predictable than that of the insurance industry, spreads will exhibit greater volatility. Although the high-yield market is currently in excellent technical shape, it was effectively closed for business for two years in the early 1990s.

Sophisticated borrowers can use hedge strategies to optimize the timing decision for the Treasury rate and spread of a debt offering.

Can Treasurers bifurcate their Treasury rate and spread decisions? Although financing spreads have converged to historically narrow levels (see Figure 22), an uptick in supply can quickly widen out spreads. Hedge strategies provide a simple approach to accomplishing this objective. For example, if rates rally sharply in response to weaker-than-expected economic news and spreads widen, a Treasurer can use a *forward-rate* agreement to lock in the underlying Treasury rate of a financing. In the current flat yield curve environment, in fact, the rate locked in is only a small premium to the current rate. (This premium reflects the intrinsic negative carry.) Given the typical spread-widening impact of a Treasury rally, this strategy allows the issuer to price his offering later in a market that is less crowded and more receptive to new product. Similarly, if spreads narrow then an issuer can price a deal and "unlock" the Treasury component through a so-called *window* strategy. The Treasury rate can be fixed later when rates improve. Both strategies require the understanding and commitment of senior management to avoid post-transaction second guessing.

Figure 22. Intermediate-Term A-Rated Industrial New Issue Spreads, Jan 80-Sep 95



bp Basis points.
Source: Salomon Brothers Inc.

Liability management is playing an increasingly vital and visible role in the restructuring of corporate America. A recent Salomon Brothers' report details how and why U.S. companies are seeking to reinvent themselves through strategic actions that include the following: carve-outs, spin-offs, split-offs and targeted stock.[5] A critical first step in the implementation of a corporate "repackaging" often is the solicitation of bondholder approval, if the bond indenture is an impediment to such an action.

What leverage do bondholders have in influencing the direction of corporate restructurings? Not always that much. As the corporate split-up of Marriott Corp. proved, bondholders can often only resort to litigation as a means to express objections to a company's strategic plan. Nonetheless, in most situations, management would prefer a large-scale corporate restructuring — a major event in a company's history— to be executed smoothly with the support of *all* providers of capital, not just shareholders. Asset sale/merger test covenants are the typical source of friction in the corporate repackaging process. However, bondholders will in general respond favorably to a fairly-priced and properly-marketed solicitation.

What is the simplest approach to winning bondholder approval for a corporate restructuring? The simplest way is to ask. Soliciting consents to permit a restructuring is a clean approach, requiring the company to pay an "incentive" fee to bondholders and enlist the efforts of a dealer-manager and an information agent in the execution of the transaction. The indenture will determine whether a simple majority or a higher percentage of the principal amount must consent to gain approval. An incentive or consent fee is offered to bondholders even if the restructuring is viewed to enhance credit quality. For example, about five years ago, U S WEST and BellSouth solicited consents to internally merge their respective Bell operating subsidiaries. In the case of U S WEST, the company required $66^{2}/_{3}\%$ approval from each of 37 series of outstanding debt securities, totaling $3.7 billion. Although both transactions were at worst credit-neutral, a "nuisance" fee of $1 per $1,000 bond was offered. The magnitude of the payment in a consent solicitation will depend on the severity of the restructuring and its expected impact on ratings and credit quality. In general, consent fees can range from 0.1%-2.5% of the principal amount consented. For example, Chrysler Financial successfully completed a solicitation with a consent fee of $2.50 per $1,000 bond.

What other approaches are available that provide additional incentive to bondholders? Combining the consent with an attractively priced tender offer for the security provides a ready exit strategy for bondholders. A consent tender or exit tender is a tender offer for the relevant debt securities that is conditional on the simultaneous receipt of consent from holders of the required percentage of securities outstanding. In the case where that percentage is achieved, the consent vote is consummated and immediately thereafter the tendered securities are purchased by the issuer. Remaining bondholders are often left with a less-liquid security and an underlying indenture that may now lack protective covenants. The two-edged nature of the consent tender increases the likelihood of success. Consent tenders may be received more favorably than pure consents because the holder can exit the security for cash.

[5] See *Repackaging Corporate Assets*, Andrew MacInnes, et al., Salomon Brothers Inc, May 1995.

How can a company avoid the expense of a refinancing that typically accompanies a consent tender, if sufficient cash is not available? Issuers can combine a consent with an exchange offer into a new security. A consent exchange or exit exchange relies on the same "conditional" mechanism as a consent tender. The consent exchange enables the company to preserve its existing bondholders if a new security can be structured that bondholders find appealing. In the recent Times Mirror consent exchange, launched in December 1994, the new securities had identical maturities as the old securities but offered a coupon premium of $^{1}/_{8}\%$. One potential difficulty with the consent exchange approach is that the existing holders may not be natural holders of the new securities. This situation can arise when the fundamental credit quality of the bonds change because of the planned corporate restructuring.

Is there a refinement to the consent exchange that circumvents the above-mentioned "holder" problem? Yes. Salomon Brothers solicited the Securities and Exchange Commission for approval to conduct a fixed-spread exit exchange offer along with the ability to trade the new exchange security on a "wi" (when-and-if-issued) basis. This mechanism allowed investors to avoid the necessity of committing to own the new security. In 1995, Salomon Brothers executed the first such transaction for Columbia/HCA in an exit exchange offer for Healthtrust debentures that were assumed under a recent acquisition.

Figure 23. Summary of Tactical Alternatives For Achieving Bondholder Consent

	Description	Objective	Cost
Consent	Solicit consent to eliminate lien.	Relief from or elimination of covenants.	Consent fee.
Consent Tender	Tender for bonds conditional on requisite consents.	Relief from or elimination of covenants. Retire debt or allow for refinancing.	Tender premium (in place of consent fee).
Consent Exchange	Exchange bonds into new securities conditional on requisite consents.	Relief from or elimination of covenants. Preserve current bondholders.	Exchange premium (in place of consent fee). New structure "premium".

Figure 24. Brief Overview of Recent Selected Consent Transactions Related to Corporate Restructurings

	Company	Strategic Objective
Consent	ITT Financial	Sell subsidiary
	Promus	Split company: hotels/gaming
	RJR Nabisco	Split company: food/tobacco
Consent Tender	ITT Corp.	Split company into three entities
	Transco Energy	Eliminate restrictive covenants prior to acquisition by Williams
	Times Mirror	Sell cable assets
Consent Exchange	Times Mirror	Sell cable assets
	Columbia/HCA	Eliminate restrictive covenants following Healthtrust acquisition
	RJR Nabisco	Split company: food/tobacco

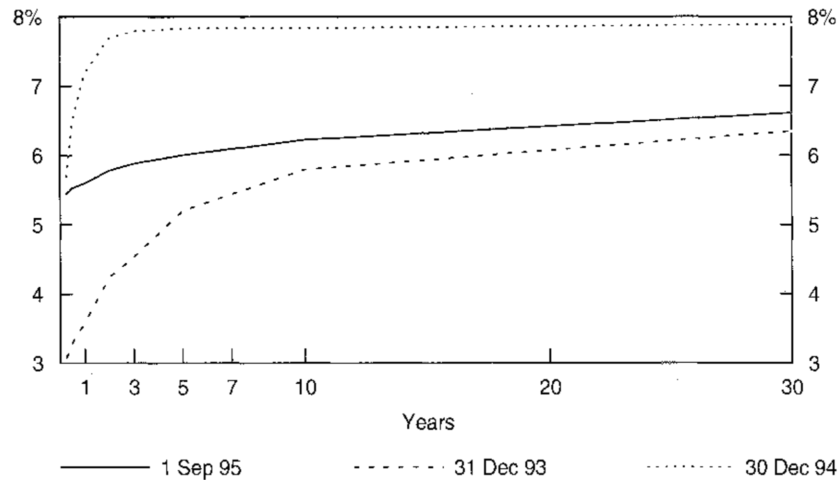
Question 5

What are the major characteristics of the current U.S. dollar fixed-income environment?

Answer 5

• In comparison with the end of 1994, the current market environment can be characterized by a flattening yield curve at the short end and a slightly steepening yield curve at the long end (see Figure 25).

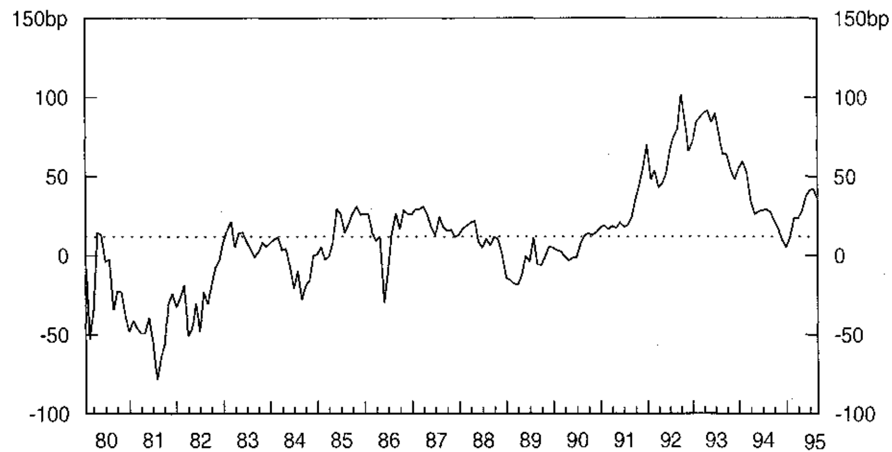
Figure 25. U.S. Treasury Yield Curves



Source: Salomon Brothers Inc.

• The 30- to ten-year Treasury spread has widened since the beginning of 1995, although it is nowhere near 1992 levels. It now stands around 36 basis points, versus an average of 12 basis points since the beginning of 1980 (see Figure 26).

Figure 26. 30-Year Minus Ten-Year Treasury Yields, Jan 80-Sep 95

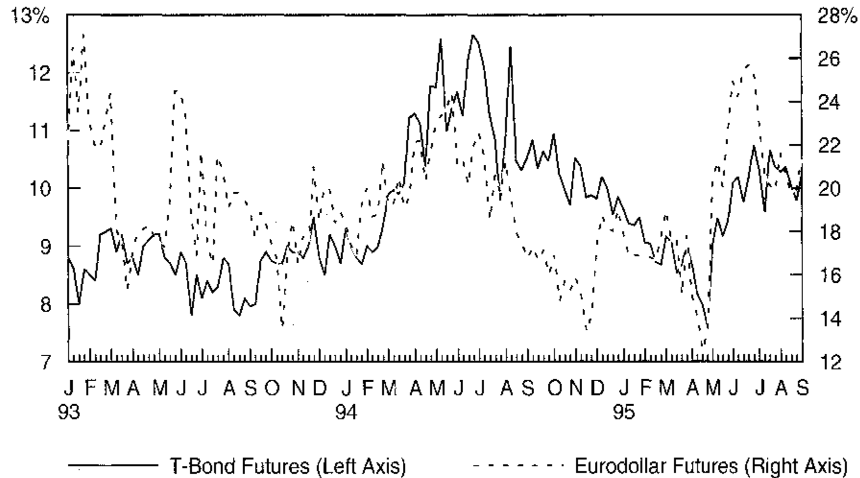


High	Low	Avg.	Latest
102	-79	12	36

bp Basis points.
Source: Salomon Brothers Inc.

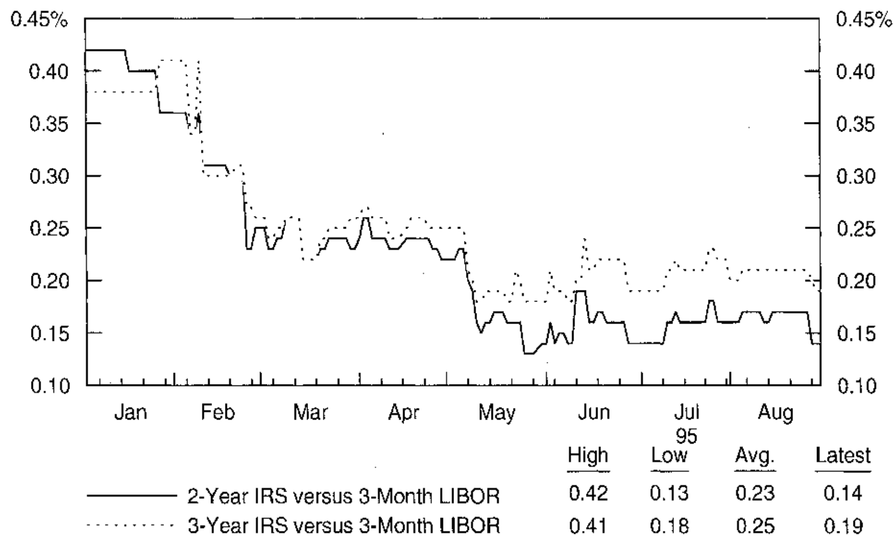
• Volatility continues to remain high, even though it has come off its peak in June (see Figure 27). The derivatives market can currently be characterized as one with high levels of volatility, tight swap spreads and a continuing trend towards simpler structures. In the structured note market, step-up callables and flat callables remain the most active products.

Figure 27. Interest Rate-Implied Volatility, Jan 93-Sep 95



Source: Salomon Brothers Inc.

Figure 28. Two- and Three-Year Interest Rate Swap Spreads, Jan 95-Aug 95



	High	Low	Avg.	Latest
2-Year IRS versus 3-Month LIBOR	0.42	0.13	0.23	0.14
3-Year IRS versus 3-Month LIBOR	0.41	0.18	0.25	0.19

IRS Interest rate swap. LIBOR London Inter-Bank Offer Rate
Source: Salomon Brothers Inc.

Question 6

How can issuers take advantage of tight swap spreads and high volatility?

Answer 6

• Interest rate swap spreads are at historically narrow levels, as illustrated in Figure 29. Issuers can use an interest rate swap to create synthetic fixed-rate debt at attractive levels as an alternative to issuing a fixed-rate medium-term note (MTN). The swap does not protect the company against liquidity risk associated with the refinancing of short-term debt.

• Issuers who find swap spreads attractive and expect Treasury rates to rally can lock in the swap spread via a *spreadlock* agreement. For example, an issuer who anticipates the need for three-year funds in one month enters into a swap spreadlock today and locks in the Treasury component anytime over the next month.

Figure 29. Terms of Swap Spreadlock Agreement

Notional Principal	$100 Million
Spread	20 Basis Points Over Three-Year Treasuries
Spread Lock Date	9/20/95
Treasury Rate Determination	Issuer Notifies Salomon Brothers Before 10/20/95
Final Rate Determination Date	10/20/95
Swap Maturity	09/20/98
Issuer Pays Fixed	30/360 Basis, Semiannual Payments
Issuer Receives	Commercial Paper Flat

Note: Levels are indicative only.

• Alternatively, an issuer can enter into a *cancelable swap* to take advantage of high volatility, at the expense of uncertain swap maturity. For example, the issuer raises three-year floating-rate funds and simultaneously enters into a five-year interest-rate swap to pay fixed that is cancelable in three years at the option of Salomon Brothers. The issuer pays a lower rate because of the following: (1) the amortized premium of the short-option position; and (2) narrow swap spreads.

• If the swap rate is higher in three years, the swap would be canceled. The sale of the option at attractive volatility levels would reduce the cost of funds. If rates fall or swap spreads narrow further, the swap is not canceled and the issuer could roll over the floating-rate liability for another two years. The savings versus a plain vanilla five-year swap is approximately 45 basis points. Those issuers who desire maturity certainty should enter into a plain vanilla swap as opposed to a cancelable swap.

Question 7

What are the trends of issuers as a response to the continuing discussion on the usage of derivatives?

Answer 7

• **Improved internal controls.** A number of companies have established written internal control policies for the use of derivative instruments. These specify the following:

(1) The reason companies use derivatives;

(2) The authority of the treasurer in terms of executing transactions (that is, size, maturity, complexity); and

(3) Periodic monitoring of exposures of notional amounts as well as mark-to-market exposures.

• **Improved external disclosure.** The annual reports of companies disclose more substantial information of the use of derivative products. FAS 119 requires disclosure of notional amount, current market value and the purpose of the derivative and other related information.

Even within the organization there is increased disclosure about derivative activities for senior management and board of directors. Debt and interest-rate derivative instruments are increasingly being consolidated for risk management purposes as they result in similar exposure to interest rates.

• **Movement to simpler structures.** Issuers in the current environment are inclined to execute simple transactions, including the following:

(1) Interest rate swaps;

(2) Cancelable interest rate swaps; and

(3) Caps, floors and swaptions.

The accounting uncertainty associated with various transactions is an additional factor that constrains the appetite for tailor-made structures.

• **Improved portfolio management techniques.** Companies are increasingly using advanced risk management tools to monitor the performance of their liability portfolio. Benchmarking techniques are used to maintain a desired mix of fixed- and floating-rate debt or a certain duration target.

Determinants of Credit Ratings

There are many situations where a company may want to answer one or more of the following questions:

• How much debt capacity does the company have to take on additional leverage and/or repurchase stock while maintaining its current rating?

• What financial parameters are most important to the rating agencies when determining the company's credit rating?

• What are the credit rating implications of various financial transactions such as a merger or acquisition?

• Does the company appear to be under- or overrated relative to its peers?

There is no substitute for good communications with the rating agencies as a means to help answer these questions; however, there may sometimes be differences between what the agencies say matters when ratings are determined and the factors that are correlated with actual ratings observed in the market.

Salomon Brothers has developed an analytical approach that attempts to answer these questions by determining the statistical correlation between a broad array of financial variables and credit ratings for a number of different industries. These financial variables may include the following:

• **Variables related to leverage:**

(1) Book value leverage

(2) Market value leverage

(3) Interest coverage ratios

• **Variables related to size**

(1) Total assets

(2) Total sales

• **Variables related to profitability**

(1) Cash flow

(2) Return on assets

(3) Return on equity

• **Variables related to financial stability**

(1) Volatility of cash flows

(2) Historical stability of capital structure

(3)Volatility of return on assets

• **Variables related to industry structure**

For many industries, we have found that more than 90% of the variation in credit ratings can usually be explained by a combination of only two to four of the above factors. Although the specific variables can vary significantly from industry to industry, we can make some general conclusions based on analyses of more than 60 separate industries:

- In almost every industry, a measure of leverage is usually the most highly correlated variable with credit ratings. This reflects the importance the rating agencies place on financial conservatism and commitment to managing financial risk.
- When considering leverage, there appears to be a higher correlation between credit ratings and market value debt/capitalization ratios than book value debt/capitalization ratios. This reflects the fact that market values reflect the market's expectations of future cash flows and earnings.
- In many cyclical industries, size appears to be the critical and, in some cases, dominant factor that differentiates credit quality among companies. This reflects the qualitative benefits that many larger firms possess, including product and geographic diversity, strong competitive position and market share, and the ability to withstand cyclical downturns.

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