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HIGH YIELD BOND FOCUS

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THE ASCENT OF ASIA'S HIGH YIELD BONDS

As volumes of non-investment grade in the region continue to soar, experts consider the opportunities and difficulties for issuers and investors

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Covenants and concentration: surveying the market landscape

The rapid growth of Asia's high yield bond market in 2013 has offered an appealing funding opportunity for regional companies. It has also raised a focus on the importance of minimum standards surrounding such deals. ASIAMONEY speaks with a group of panellists about the opportunities and challenges in this vibrant market.

MODERATOR: MATTHEW THOMAS, CONTRIBUTING EDITOR, *ASIAMONEY*

DOMINGO CHEN, DEPUTY HEAD, CAPITAL MARKETS AND CORPORATE AFFAIRS, AGILE PROPERTY HOLDINGS

HAYDEN BRISCOE, DIRECTOR, ASIA PACIFIC FIXED INCOME, ALLIANCEBERNSTEIN

WALLACE LAM, MANAGING DIRECTOR, DCM, HSBC

TIM JAGGER, PORTFOLIO MANAGER, AVIVA INVESTORS

BRYAN COLLINS, PORTFOLIO MANAGER, FIDELITY INVESTMENT MANAGEMENT

MARK AUSTEN, CHIEF EXECUTIVE OFFICER, ASIA SECURITIES INDUSTRY & FINANCIAL MARKETS ASSOCIATION (ASIFMA)

L.L. TAM, EXECUTIVE DIRECTOR, KAISA GROUP

LOUIS RABINOWITZ, COUNSEL, LATHAM & WATKINS

GEORGE W. LONG, CHIEF INVESTMENT OFFICER, LIM ADVISORS

LAURA ACRES, SENIOR VICE PRESIDENT, MOODY'S ASIA PACIFIC

Asia's high yield bond market has gone from strength to strength over the last few years, but even with this steady rise in volumes the start of 2013 must have come as something of a shock to casual observers.

A total of US$16.7 billion of non-investment grade international bonds was sold by the end of May, more than 180% higher than in the same period last year, according to Dealogic. That breakneck pace of issuance has already ensured that this will be a record year for volumes.

There could be few better times, then, to gather a broad mix of market participants to discuss the market. The international bond market is not just an increasingly important source of funding for Asia's sub-investment grade companies. It is also, by extension, a vital source of revenues for banks, and a growing part of investors' portfolios. Everyone involved in the region's bond market has a stake in making sure this market develops in the right direction.

The most obvious talking point is the sheer amount of issuance from Chinese property companies, which now make up more than a third of all US dollar bond issuance from Asian sub-investment grade rated companies. These borrowers have been raising more from the US dollar bond market each year, but they have become such a prominent force that some investors and analysts are starting to worry about oversupply. We discussed this with our panel – and got a surprising debate on just how much this is really a problem, and what needs to be done about it.

An even more widespread topic, and one of some contention between different market participants, is the need for ratings. The growing proportion of unrated issuance might point to the maturation of the market but it also creates risks for investors – even those who do not invest in any of these deals directly.

The question of ratings is, rather like the strength of covenants, an area where investors and issuers will naturally seek different outcomes. We spoke to both sides about how compromise can be reached.

The high yield market is no longer restricted to five-year or seven-year callable bonds. Some issuers have even managed to convince investors to push maturities out to perpetuity, albeit while adding call options that should at the very least encourage those issuers to call those bonds in five or 10 years. These perpetual deals – a growing part of the overall Asian bond market – are often a source of friction between issuers and investors, and we got an interesting view from one of the investors on our panel about the "inherent contradiction" in selling a perpetual bond.

There is clearly a smorgasbord of topics that can be discussed in the market, but with a mix of investors, issuers and other key market participants, *Asiamoney* has pinned down some of the key areas to find out exactly what is making this market tick.

ASIAMONEY [AM]: ***The high yield market has grown rapidly over the last few years, and the first two months of 2013 saw an unprecedented burst of issuance from the sector. For how long can issuance volumes in the market keep getting bigger and bigger?***

BRYAN COLLINS, FIDELITY INVESTMENT MANAGEMENT [BC]: There's no reason why the Asian high yield bond market can't continue to grow

GEORGE LONG
LIM ADVISORS

and be a viable funding source for corporations and governments and other institutions, just like the US and European markets are.

We started investing in a dedicated way around six years ago but had always been invested in an ad hoc way before that. The growth of the market over the last few years has been really quite phenomenal. The pace of demand, the pace of supply, the development of the investor base; all of these factors have been remarkable to watch.

It is a volatile market and it can throw up issues. Corporate governance issues have always been there, not to mention the general emerging markets risk. But fundamentally, Asia needs a debt funding market that can provide an alternative to bank lending. That is what this market provides, and that is why it will continue becoming a deeper market over time.

The caveat is that if we see the market develop in silos – the offshore renminbi market developing separately from the dollar bond market, for instance – then that is going to be a problem because then we will not have the same standards developing.

TIM JAGGER
AVIVA INVESTORS

The risk of rapid growth in any market is that standards slip, and if this is not kept in check then you get into a situation where you have dislocations that can last for a very long time.

MARK AUSTEN, ASIFMA [MA]: It is interesting to look at Asia going forward, and ask what the region needs to keep growing economically. It is not going to be able to grow continually by exporting to the West, since the West is not growing. The model has to change, and the focus needs to be on a consumer-led model. That is going to require a deep capital market.

This means there is no reason why the high yield market will not continue to expand, but for that to happen it needs to meet global standards and be better harmonised across the region. You can't have these fragmented pools where you're trapping capital. You need a much more regionalised market to compete with Europe and the US in the future.

The high yield market is no different to other capital markets in this sense. It has to grow on the basis of greater standardisation across the region, which will in turn attract more investors, and then you have a virtuous cycle.

GEORGE LONG, LIM ADVISORS [GL]: A big factor driving the growth of the high yield market is declining interest rates, which have pushed people to look for yield. If risk-free rates were 8% or 10%, like they were in the past, you would not see so many people looking at the high yield market. There would still be demand because of all the other factors we're talking about, but when you're getting virtually nothing on deposits you look elsewhere for yield.

That has been great in some ways because it has pushed people out of banking deposits and into the fixed income market, which has stimulated the growth of the fixed income market in Asia.

DOMINGO CHEN, AGILE PROPERTY HOLDINGS [DC]: I echo George's point of view – and another driver is that over the past few years the equity market has been quite disappointing. That's why a lot of big funds need to look to bonds for a steady return.

TIM JAGGER, AVIVA INVESTORS [TJ]: One of the other key factors has been the increasing disintermediation of the banking sector. There are banking sectors you can point to throughout the region which arguably have a leverage problem, so there is a bit of a push on the supply side from banks saying they are full. That is part of a natural evolution.

We're getting some very high growth companies coming to the capital markets now as a sensible way of diversifying their funding sources. That will continue, particularly given that the arbitrage between capital market rates and bank funding rates is coming down. That will encourage issuers to come to the capital markets in Asia.

On the demand side, there has certainly been the development of a dedicated investor base. The retail investor base is very large, and is increasingly focusing on fixed income and high yield fixed income, in particular. They have had bad experiences investing in things like structured products and equities and they see high yield as a more tangible investment. They will not go away, particularly when private banks are providing large amounts of leverage for these investors as well.

LAURA ACRES, MOODY'S ASIA PACIFIC [LA]: I'd agree that the Asian investor base is developing, but we're seeing more and more deals get a pick-up from European and US investors as well. They are investing a lot more time and effort into Asian deals, and while a few years ago a firm might have had one fund manager in Pittsburgh covering all Asian markets, now they have teams in Hong Kong and Singapore that do nothing but look at Asian deals.

The raft of credit downgrades in Europe may also have encouraged some investors to look a little bit more favourably to the Asian market

place. In this region, we've had nothing but sovereign upgrades, but in Europe it has been the other extreme.

WALLACE LAM, HSBC [WL]: The other crucial difference between these regions is that, in a lot of mature markets, when you look at high yield companies you are looking at a credit that has deteriorated over time or has a non-investment grade rating because of leverage applied to the business.

But a lot of Asian companies are high yield because they are high growth. There's nothing wrong with them – they are actually pretty good companies – but they are in a growth phase, and they need capital to fuel that growth. The high yield market offers a great opportunity for them to diversify their funding sources and move away from a reliance on bank lending.

MA: The good thing for these companies in the long-term is that the high yield market promotes good governance, because it increases corporate transparency more than bank lending would. Better corporate governance is obviously something that is needed in this region.

AM: ***How does pricing in the high yield bond market compare to what issuers would have to pay elsewhere?***

WL: Three or four years ago, you would have conversations with corporations and the bank market would be substantially more attractive. But now those corporations can borrow at levels roughly equivalent to what they can get from their bank lenders, and even tighter sometimes. That is encouraging a lot of first-time issuers to look at the bond market in a serious way.

L.L. TAM, KAISA GROUP [LLT]: Certainly, from a pricing perspective, it is getting really attractive. If you look at the tightening over the last few years, the market has become really competitive. That is even more the case when you do a dim sum bond and swap the proceeds into US dollars.

We do talk to banks a lot. In terms of pricing, bank facilities are comparable, but they impose stricter covenants than high yield bond investors. That makes for quite laborious discussions – especially when the funding cost, from our standpoint, is now cheaper in the bond market.

BC: Bond yields are as low globally as they ever have been, but the tightening is especially marked for Chinese property companies. They used to have to raise debt at a significant spread premium to other sectors of similar credit ratings, but that premium has now fallen significantly and many now trade tighter.

LLT: Even a couple of years ago there were so many Chinese property companies in the market, and investors made it clear that they wanted industrial names, or simply issuers from any other sector to diversify their portfolios, even at a cost of tighter yield. But they soon realised that the repayment track record of property companies is to a large extent impressive. No property companies have defaulted during the recent financial crisis.

TJ: There is also a difference nowadays in the use of proceeds. When you go back three or four years ago, property companies were issuing bonds to buy land, whereas recent activity is more driven by refinancing. That is a much better use of proceeds, from an investor's point of view.

AM: ***What about concerns about over-supply from Chinese property companies? How much does this factor into your investment decision?***

TJ: Among those investors who are less familiar with the Asian bond markets, there is certainly an idea that there is too large a concentration of

BRYAN COLLINS
FIDELITY INVESTMENT MANAGEMENT

Chinese property companies in the Asian bond market. When you look at the Asian corporate high yield index, Chinese property companies make up about 30%. You can manage around that, because there are still plenty of other choices you can make. But, certainly, when you're trying to raise money, that is something investors looking at a fund often highlight as a concern of theirs. I would argue otherwise.

LA: To throw some numbers at that, we rate 112 high yield companies around the region, excluding Australia and Japan. Fifty-nine of those are Chinese corporations, and 38 are Chinese property companies. There is a huge degree of concentration because, of course, of those 112 companies not all of them issue bonds. Less than 80 have issued rated bonds. But the vast majority of Chinese property companies we rate are bond issuers too, so suddenly your concentration goes up.

BC: About 40% of all the rated Asian high yield issuers are Chinese property companies, but if you start to include unrated issues, you get a little less concentration. But either way, from a portfolio perspective

MARK AUSTEN
ASIA SECURITIES INDUSTRY & FINANCIAL MARKETS ASSOCIATION (ASIFMA)

WALLACE LAM
HSBC

you need a very active management to avoid what is otherwise excessive concentration risk.

TJ: The risk-return profile of the Asian high yield market over the last seven or eight years has been far better than the US market and far better than the European market. But when you talk to investors that are more used to the US market, which is far bigger and has more diversification, it is clear that some of them see this as a problem.

HAYDEN BRISCOE, ALLIANCEBERNSTEIN [HB]: Supply is not the only issue. The Chinese property sector is still relatively new, but if you look at property companies in other markets, the leverage within the structures has been a lot lower. That has seen them overcome the test of time.

Our sense is that there is too much leverage among Chinese property companies at the moment, and it doesn't really matter what market you're in – significant leverage becomes very difficult for you when you have a cyclical downturn, whether that is in price, volumes, or funding.

The best performers have been the property bonds, but through the cycle, this sector is a risky proposition. We worry about the contagion risk. It will not be the strongest property firm but the weakest one that takes down the sector. That is always the case. It has happened in every country and every cycle. It is not the big guys that bring everyone down.

L.L. TAM
KAISA GROUP

GL: The answer to the question of over-concentration or over-supply depends in large part on whether people are managing their money based on benchmarks or, on the other hand, whether they have fairly broad mandates. We have a pretty broad mandate, so we don't have to always be invested in property sector bonds, but if you follow a very tight benchmark, the concentration risk has to be a significant factor.

BC: The amount of Chinese property exposure in the context of a broad, global portfolio is manageable. There is a problem in that it is, in aggregate terms, a highly concentrated and correlated sector. But because we do have a diversity of issuers, you can pick and choose the tenor, you can pick and choose where you are in the rating space, and you can even pick and choose where you are geographically, to some extent.

DC: We talked to European and US investors a few years ago, and they were quite sceptical, but our recent discussions show us they have become a lot more optimistic about the PRC [People's Republic of China] property sector. They prefer companies that are publicly listed in Hong Kong because, if you look at the whole property universe in China, there are over 10,000 developers – small, medium and large – but there are only around 200 publicly listed companies.

The government policies and measures, selling prices and transaction data about the market, are quite transparent. It is not hard to tell how the market is doing overall.

MA: I suppose it's not a question of oversupply, it's a question of undersupply from other sectors. As we talked about earlier, whether you look at countries or sectors, the market needs to continue to grow. That growth is probably not going to come from the Chinese property market, it will come from other sectors.

AM: ***Why are we not getting more supply from other countries?***

WL: There are slightly different issues in different countries, but to a large extent Southeast Asian corporations tell us they have plenty of options. They are typically well-banked by a mix of local and foreign banks. They have local currency bond markets that offer them a lot of liquidity.

Rather than any problem with the demand for capital, it is simply the case that they have a lot of options – and those options are often more attractive from a cost perspective.

AM: ***Are covenant packages getting weaker among Asian issuers?***

LA: We have a covenant scoring system for high yield bond packages and we have seen a fundamental deterioration for high yield issuers. That is happening globally, but it is particularly marked in Asia. Covenants are still a lot stronger than those we see in Europe and the US, but they are deteriorating more quickly.

This ties in with the market going absolutely gangbusters, which suggests that investors are not as tough as they have previously been in demanding strong covenant packages from Asian issuers.

GL: Most people don't pay attention to covenants. The retail market, for instance, doesn't look at covenants. Essentially what goes on is invest-

ment banks set covenant terms with issuers, and a few leading institutional investors give them some feedback. But even most institutional investors do not look at covenants too closely.

The basic question is whether you like the company, and whether the pricing is fair. Some types of covenants are absolutely vital, but in reality many are not that important.

LLT: To reduce market risk, nowadays most bonds have intra-day closing. That doesn't give investors much time to examine a covenant package, and many just say "standard high yield covenants", whatever that means.

BC: This is fine for repeat issuers, because you can compare covenants to their old deals relatively easily. But we get a lot of new issuers in Asia, and that is where taking time to look at covenants matters most. It is not just a question of determining recovery value, since you never want to get to that stage. The covenant package also determines how you value an instrument as it starts to weaken.

GL: We find it very objectionable when we get a phone call telling us there is an entirely new issuer coming to the market, and we have two hours to make a decision. There is no way you can make a decision in that time. You need a week or two to really look things over, especially for an unknown issuer.

BC: One of the major issues I have is that it's all well and good bringing a corporate to the market with strong covenants, but too often, after a year or two, with a simple consent solicitation and coercive terms, those strong covenants get taken away. That defeats the purpose of launching with strong covenants in the first place.

The other issue occurs at the trust level, with the monitoring of those covenants. So many times we see that certificates are not being submitted, there are multiple technical breaches, and then behind the scenes you get a consent solicitation that essentially waives all past indiscretions.

Covenants are important. They set a framework. They set discipline. They control wayward management. But there is no point having a good covenant package if it gets taken away within a short period of time, and being paid a half-point concession to take away something that could be a lot more valuable does not make a lot of sense for us.

LA: We've seen a lot of investors complaining about consent solicitations, but by the time the deadline has come around, you find that many of those deals are over-subscribed. From our point of view, there is a real disconnect from what we hear from investors regarding consent solicitations and the subsequent demand for deals.

BC: It's a prisoner's dilemma and that's what gets taken advantage of. I take your point, but from my perspective, consent solicitations taint the management for the future.

There is a distinction we need to make here, though. Some companies want to change covenants to tidy things up between old and new deals. That's okay. But when issuers should and will get penalised is when they want to make material changes to the protection that has been offered to investors.

LA: I do think we'll see more and more consent solicitations in Asia. A lot of the companies in Asia are high yield because they're high growth, so the older covenant protections that they had become far too restrictive as they grow.

BC: Those changes in covenants are understandable, but the important thing is that they do not set precedents for too many other issuers.

DOMINGO CHEN
AGILE PROPERTY HOLDINGS

When you sell a bond, you make commitments to your investors for the life of a bond – and in most cases, if there is a material change, then buy back the bond in its entirety.

HB: It is not the institutional clients that are coming out of in support of poor covenant packages. It is the retail investor base. The market has changed so much in the last few years that you can get away with relying on retail investors. But if an issuer does the right thing now they will find that institutional investors will be there in the downturn as well. They will not be able to rely on retail investors at that point.

LLT: We want to make sure that, if possible, we don't have to do any consent solicitations. It costs us. You need to pay half a point or even a full point to be certain that investors will provide their consent.

But it is worth noting that not every company understands how covenants work. I get quite a few phone calls from my peers in China asking me about exactly how the covenants work. There is a learning process for companies coming to the bond market. They often do not

LAURA ACRES
MOODY'S ASIA PACIFIC

realise until they have a sold a bond that there are certain things they cannot do because of the covenants.

WL: Covenants need to evolve along with a business. Take the ability to do joint ventures for property companies, for instance. It was constrained under the old high yield covenant package. As land becomes more expensive, the chances of forming a joint venture are much greater. These days, the covenant package has evolved to facilitate such genuine business needs, to which investors in general are agreeable.

AM: ***How important is it for issuers to get ratings before attempting to sell an international bond?***

BC: You don't have to agree with ratings – rating agencies, like investors, get it wrong sometimes – but it is a useful opinion. Any issuer that is coming to the market without first attempting to get a rating is giving a sign that it doesn't care about its creditors.

There are some legitimate reasons to not get a rating. For instance, there are a small group of companies that face sovereign ceiling issues. In those cases, we can have a discussion and try to come to some agreement over how the company should be valued. But for most companies, there are not compelling reasons to come to the market without a credit rating.

MA: We need to have to more rated issues in this market. If we want to attract a larger investor base to develop the market, that needs to happen. The trend for sovereign upgrades is going to help, since that is going to pull up ratings for many Asian corporations.

The investors are going to push for ratings more, as well. We have talked about the mentality among retail investors, but that will change when they get burned. They will naturally start asking for ratings more once they have suffered losses from unrated companies.

TJ: You have to ask questions about any borrower that is foregoing a rating for anything but a one-off trade. There is, for investors, a depth of market argument as well. You know that if you are buying unrated paper, there is going to be a lot less liquidity, because there are far fewer investors that have mandates for those bonds.

BC: The issue for me becomes when the number of unrated deals gets too large. A few unrated names in the market? Fine, I don't have to buy them. But when that bucket grows and grows, that impacts the wider market.

The argument some companies have is that they don't want to get a credit rating because it will put them in the high yield bracket. There is some justification for this, albeit in a strange way, because some retail investors might actually prefer unrated names than sub-investment grade rated names. But there is a moral issue there as to whether they should be selling a bond to an investor who would not otherwise buy the paper if it was rated as high yield.

LLT: For us, credit ratings are a necessary evil. You pay a rating agency to rate your company and publish a report on your certain weaknesses. But if you want to raise capital on a regular basis, you need to have a rating. Even if you don't like some of their comments, you have to live with them. It is difficult to raise a sizeable amount of money without a credit rating, and especially difficult to do that on a sustainable basis.

DC: The credit rating helps a lot in the selling process. It means it's a lot easier to find common ground with investors on the yield.

WL: When investors have any doubt over whether it's investment grade or high yield, unless it is a well-known household name or a large state-owned enterprise, most of them will make the assumption it's high yield, just to be on the safe side. They will not give issuers the benefit of the doubt.

LA: We've been talking about the investors' sensitivity at the point between investment grade and high yield, but the greatest sensitivity is at the 'B2'/'B3' space. 'B1' bonds can get done, 'B2' can get done with some difficulty, but 'B3' and below bonds are very few and far between in this region with the exception of a few repeat issuances in the Chinese property space. It is a step too far in Asia at the moment.

BC: I would argue the deciding factor as to whether that bond is issued successfully or not is largely to do what the sector and the jurisdiction in which the company operates. That usually goes hand in hand with the rating, because in those few cases there is usually a bit of a stink about the business anyway.

LA: There are 'B2' and 'B3' rated companies in the US and Europe rated at such levels because of issues such as size or having a high growth business model. By contrast, the vast majority of bonds in Asia that are rated 'B3' and below have that rating because they have been downgraded from higher rating levels.

HB: The information disclosures in the US are strong enough that you can be a bit more confident with single-B issuers. If you had a listed entity in Asia that issues information quarterly, my sense is that they would be able to do a deal.

AM: ***We've talked about ratings and covenants, both areas that should encourage companies to avoid default situations. But when the worst case happens, what is the result? To what extent has bankruptcy law in Asia been tested?***

LOUIS RABINOWITZ, LATHAM & WATKINS [LR]: China has an enterprise bankruptcy law that has been around for a few years now, but that really hasn't been tested to any great extent. Indonesia has also had a few experiences in the past. But by and large, bankruptcy frameworks in the region have really not been tested.

That is a big source of uncertainty for investors, and it will be some time before they can really get some sense as to what their recovery rates will be, and how they will be treated as foreign investors. It is a huge issue for the market.

HB: It really is. I hope the regulators understand just how big an issue this is for investors, because even if most institutional investors are not involved in the cases that are being worked on now [Suntech and LDK Solar] they are watching them very, very closely.

They are going to be a litmus test for recovery rates offshore versus onshore, so these cases need to be handled very carefully.

AM: ***How do investors deal with the uncertainty over bankruptcy law? Is this risk priced into the market?***

HB: You can get out quickly, and take smaller size. You don't have to be involved in these deals, so it is to a certain extent priced in.

TJ: It is a big reason why there is an Asian premium. The risks are a lot more asymmetric in parts of Asia than they are elsewhere in the world, and that reflects in the spreads that similarly-rated companies pay when they're based in different jurisdictions.

LR: There have been many cases where distressed exchange offers have been done, rather than testing bankruptcy procedures.

BC: That is probably the best outcome for everyone concerned.

GL: I'd like to add that we have a private debt business and we are very aware that there have been lots of defaults in that sector of the market – and this is often not reported and covered by default databases.

Anyone that was out here in 2008 doing special situations saw 50% to 70% default rates too. But these are companies that no one has ever heard about, so the information is just totally buried.

We tried to put together a database of private debt issuance and defaults, which proved very difficult since everyone keeps these deals private. But billions of dollars was defaulted on between Chinese pre-IPO bonds, Indonesian mining deals, and other stuff.

This is a problem, because a lot of people haven't seen the real horror stories. I heard of some investors that got a zero recovery. That could happen in the public market too for structurally subordinated deals.

AM: ***Let's talk for a moment about perpetuals. By their very nature, structures need to be fairly flexible to be attractive to a broad range of issuers. But given frequent complaints over structures, does there need to be some degree of standardisation in Asian perps?***

TJ: It is a bit like unrated paper. If you have a strong name, you are potentially able to issue perpetuals with more aggressive structures. There will be investors out there that will buy that deal no matter how it is structured. And given that perpetuals are still largely a retail instrument, we are a long way from getting standardisation.

WL: The structure comes down in large part to what the company wants to achieve. Each rating agency will have different criteria, and the lowest common denominator of these conditions in aggregate can mean that the resulting structures that meet issuers' goals can also be pretty tough to sell to investors.

HB: But that's a highly-regulated part of the market. For the rest, anything goes.

TJ: If a deal hasn't got the scrutiny from rating agencies, it becomes very hard to value.

BC: There is an absolutely inherent contradiction that is taking place in the issuance of corporate perpetuals. The issuer is telling the rating agency: trust me, this is equity. Then they are going to investors and saying: trust me, it is debt and I'm going to call it in five years. They're lying to one of us, and that contradiction is not priced in appropriately.

AM: ***Do more US investors need to be brought into this market? Or is the Asian investor base growing big enough to absorb the supply you see coming over the next few years?***

WL: Back in the 1990s, when there was hardly any Asian investor base, issuers in the region had to do 144A deals. But now a lot of investors are here, and we have seen that a lot of these European and US funds have actually set up in Hong Kong and Singapore.

The end-buyers may be based in the US, but the actual office that is booking the ticket is in Asia. That means it is considered Asian when you calculate the order book, so the reality is that the investor base is a lot more global than orderbook statistics will tell you.

HAYDEN BRISCOE
ALLIANCEBERNSTEIN

HB: I don't think it matters where demand comes from. The more important point is that emerging market funds are taking off, and domestic funds are taking off. The next step is developing local markets in Asia, but to draw investors in we need to have more supply from quasi-sovereign corporations in local currency markets.

LLT: We did a 144A transaction earlier this year, because of the attractive yield. Some US fund managers complained that recently there have been very few issues by PRC property companies in 144A format.

Although they can buy in the secondary market for Reg S issues after a certain period of time has elapsed, the position that can be accumulated rarely satisfies their appetite. They much prefer issues in 144A format as they can build up their position in the primary market.

GL: The US high yield market is huge, so there is a lot more dedicated capital there that knows high yield. Until Asia develops large dedicated portfolios, the US will still be the buyer of last resort for this paper. ◢

LOUIS RABINOWITZ
LATHAM & WATKINS

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