

XIII. PRE-SOUNDING, BOOKBUILDING AND ALLOCATIONS

The purpose of this explanatory memorandum is to provide some practical information on pre-sounding, bookbuilding and allocation processes, as often used in the prevalent ‘pot’ context of the European cross-border syndicated institutional primary debt markets today. Market practice in this area is continually evolving and individual transactions are structured according to their specific circumstances, so this memorandum is not intended to prescribe or endorse particular structures or practices. Rather it is intended to be both a document designed to enhance transparency for, and serve as a helpful point of reference to bookrunners when explaining their working practices to, colleagues, issuers and investors.

Bookrunners of new bond issues seek to ensure transactions are executed as smoothly and as efficiently as possible, whilst meeting the issuer’s size, pricing and distribution objectives (if any) and taking into account possible secondary market performance and an investor base willing to participate in this and subsequent transactions. Each bookrunner has internal procedures relating to the pre-sounding, bookbuilding and allocation process. These are applied to individual transactions, but may be tailored where appropriate to accommodate any issuer requirements, other bookrunner procedures and any specificities of the market segment concerned. In this respect, discussions with the issuer and between the individual bookrunners begin at an early stage and continue throughout the transaction.

PRE-SOUNDING

In certain market conditions (for example where there is high volatility and uncertainty and the issuer and the bookrunners are looking for confirmation of pricing rationale), seeking initial feedback from a small number of investors, representative of the issuer’s targeted investor base, may help the bookrunners in assessing the depth of demand and formulating appropriate initial price guidance, and so help guide the terms of the transaction ahead of a public announcement. In some cases, sufficient feedback may be obtained through disclosing general information not amounting to inside information under the EU’s Market Abuse Directive or other regulatory regimes. In other cases, this may be insufficient and more specific information, potentially amounting to inside

information, might need to be disclosed. In such cases, the bookrunners carrying out the sounding will initially indicate to the investors they wish to approach that they wish to sound them for a potential transaction on the basis of information that may amount to inside information and that the investors could be subject to legal restrictions as a result (including restrictions on trading in related securities) – i.e. the investor is to be ‘wallcrossed’. This may be understandably problematic for some of the investors concerned.

What constitutes inside information is, partly of necessity given the varied nature of financial business, not wholly precise, with the consequence that interpretations may differ. ICMA has issued Recommendation 1.30 so that bookrunners may confer, and hopefully agree, a uniform approach in the context of individual transactions (both as to whether information may be inside and as to the specific wallcrossing format). The views of the bookrunners however do not constitute legal advice and so cannot and should not be relied upon by the investors, who would need to consult their own compliance functions as to the potential status of the information and the potential scope of the restrictions (including their duration).

The practice of wallcrossing is naturally limited by investors’ ability and willingness (if they consider the related advantages worthwhile)¹ to be approached in this way and to provide meaningful feedback. Some bookrunners may sound ‘hypothetical’ transactions for which no issuer mandate has been granted (and where by definition no inside information can arise) so as to build up a continuous stream of information for use if needed. Investors may also make “reverse enquiries” – proactively contacting bookrunners to indicate interest in certain similarly hypothetical transactions.

BOOKBUILDING - DURATION

Generally, transactions for frequent issuers (with an established credit curve and documentation) move on an abbreviated timeline (and are less likely to involve roadshows or preliminary ‘red herring’ prospectuses) compared to transactions for inaugural and infrequent issuers.

In certain market conditions, with substantially more investor demand than supply, submission of investor orders can potentially exceed the

proposed new issue size many times over in a very short timeframe, with orders for billions of euros or dollars submitted in just a few minutes in some extreme cases. Aside the general show of market confidence, the additional orders may not bring issuers any material advantage (with even a small amount of oversubscription being sufficient for any desired increase of the initial anticipated size). This level of oversubscription reduces individual allocations and can delay the allocation process (extending the parties' uncertainty and potential exposure to market risk). A swift closing of the orderbook helps address this, but may leave some investors aggrieved at not having had sufficient time to place orders reflecting their full demand. Issuers may even face a situation where interest expressed during roadshows alone exceeds the proposed new issue size. These challenges tend to occur in the context of non-financial corporate issuance rather than in the context of issues by sovereigns, supranational institutions, international agencies or financial institutions.

Timing may present a challenge for some investors in that they may, for example, need to review their knowledge of the relevant transaction documentation, obtain credit approvals or to consult colleagues internally to consolidate interest stemming from several sub-funds (potentially across several time zones). There will also be different reaction speeds amongst a broad range of investors. In terms of documentation, frequent issuers (the majority of the market) usually issue off programmes, whilst inaugural or infrequent issuers usually come to market with preliminary 'red herring' prospectuses – in both cases published in advance of opening of the orderbooks. For investor convenience however, some bookrunners attach, or include links to, the relevant documentation to or in transaction announcements. Regular participation in an issuer's roadshows and other investor-facing communication efforts should also assist in investors being kept up to date, in advance of the new transactions, on developments regarding that issuer and so in being ready to participate. In this respect, the few investors participating in any transaction pre-sounding may not be better placed to submit orders on a timely basis.

In order to address the above and with investors currently seeming to favour the ability to place orders over the potential for delayed and reduced allocations, many bookrunners are considering keeping orderbooks open where possible for a minimum period of one hour from the formal announcement of the transaction.

BOOKBUILDING – PRICE GUIDANCE

Some form of pricing information is required for investors to be able to decide what, if any, orders to place. Generally, bookrunners will open orderbooks after issuing initial price guidance. Even with prior feedback from the pre-sounding process, the guidance may need to be amended to reflect market conditions and response, with one or more iterations needed to identify the optimum pricing point. Essential to keeping this process efficient and to minimising the number of iterations, is that investors give clear commentary as to the extent, and limits, of their demand by reducing or cancelling their orders at specific pricing levels and/or deal sizes they consider will be unacceptable. Distinctly, issuers faced with ‘inflated’ orderbooks (see further below) risk being misled into seeking pricing tighter than the market is able to absorb, which may lead to transactions performing poorly in the post launch market. It is for this reason that bookrunners seek to “scrub” books ahead of allocation, as described below.

ALLOCATION

Orders on a new issue may exceed the issuer’s initially planned size. In some cases, the issuer may decide to increase the issue size, but, notwithstanding this, orders may even exceed any such increase. Issuers generally have very clear objectives for the amount they wish to borrow in advance of any deal announcement. These views are unlikely to be materially changed by the size of an order book. The challenge for bookrunners is firstly to reconcile (e.g. identify duplication) and consolidate the various orders (as books are generally built through several participating banks), secondly to establish true demand (as opposed to apparent demand) and thirdly to allocate the transaction in as efficient and fair a way as possible.

On the first aspect, efficiencies are being sought through increased automation with bookrunners increasingly connecting their bookbuilding IT solutions in a manner enabling unique investor identification.

The second aspect is complex. An investor might place an order larger than its true internal demand (order ‘inflation’) if, for example, it (i) anticipates that its order will be reduced on allocation because of oversubscription, (ii) overestimates demand that it was unable to confirm internally prior to

placing its order, or even (iii) anticipates particularly strong demand by other investors and so expects to liquidate part of its allocation in initial secondary trading to crystallise the initial issuance premium ('flipping'). In this respect, it seems that some investors are unable or do not wish to inflate their orders, others appear to do so frequently, and yet others may do so just occasionally according to market conditions. Leaving aside how order inflation might be treated under applicable market abuse regulations, bookrunners may well apply a discount factor to, or even entirely exclude on allocation, orders they view as being potentially inflated (bookrunner views in this respect will inter alia account for previous experience with specific investors). Investor transparency to bookrunners is an important factor in avoiding mischaracterisation in this respect. In particular, investors may find it helpful to explain orders that (i) appear to be out of proportion compared to orders on previous transactions or to apparent assets under management, or (ii) are placed or increased at a relatively late stage during the launch process (and so appear to be based on perceived levels of demand rather than on transaction fundamentals). This later aspect is further complicated in that delayed demand may be due, as mentioned above, to investors legitimately needing to confer internally with colleagues managing sub-funds. Whilst bookrunners try to manage investor expectations whilst order books are open, they are increasingly seeking (as one mitigant to order inflation) to limit disclosure of book size to just whether transactions are subscribed or not, without stating the scale of any oversubscription.

The third aspect is less complex, though 'scrubbed' final order books are, despite the bookrunners efforts, not certain to be entirely inflation free. Aside any preference being given to specifically targeted investor groups (for example where an issuer is seeking to diversify its investor base), some preference may be given to long term investors that (i) have shown interest in the transaction, for example through actively participating in roadshows, investor update calls, etc., and/or (ii) have a history of investing in the issuer or its sector, and (iii) do not have a history of flipping. Helpful participation in the pre-sounding process may be rewarded by some prioritisation during allocations, though this is limited and seems to have been insufficient for many investors to agree to being pre-sounded. A commercial relationship with other parts of bookrunners' firms is not a relevant consideration, being in any case restricted by regulation. Bookrunners frequently discuss their general allocations procedures with individual investors.

Investors' understanding of transactions ex-post may help moderate disappointments as to lower than expected allocations and, in this respect, many bookrunners are seeking to distribute, where possible, deal statistics to investors via sales desks within 48 hours of pricing.

Note

¹ *Any comfort as to an issuer making, if needed, a public 'cleansing' statement to at least limit the duration of any potential investor restrictions could be a relevant consideration in this respect.*