LATHAM & WATKINS

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Commentary

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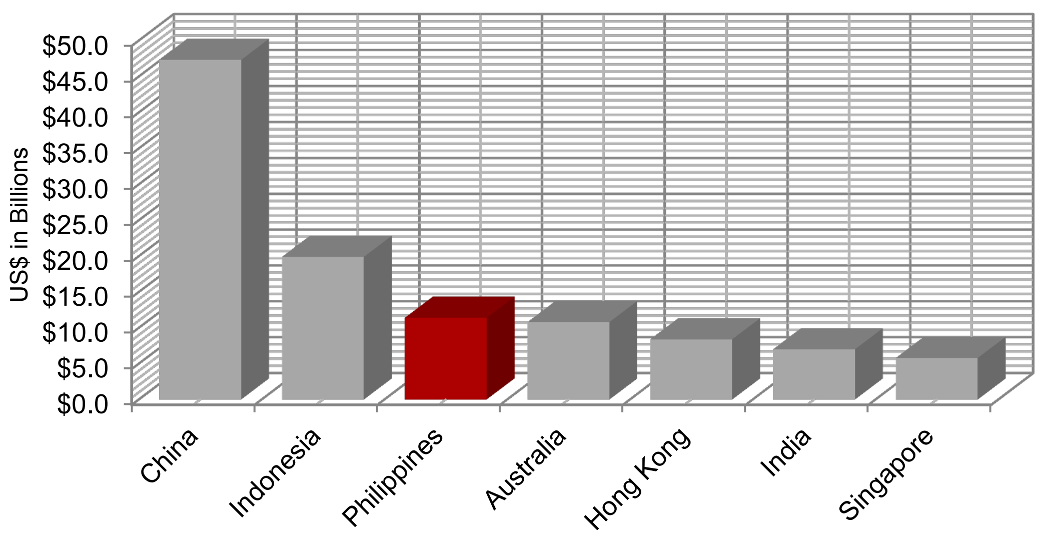
Five Eye-Opening Facts About the Philippine US$ Bond Market

The Philippine bond market differs significantly from other markets, but is expected to change as growth continues.

Philippine companies[1] have become avid borrowers of funds provided by the international high yield bond market, characterized in Asia by bonds denominated in US dollars without an investment-grade rating. In fact, Philippine companies issued US$11.4 billion of such bonds in the last five years, behind only China and Indonesia in Asia.

US$ Non-Investment Grade Corporate Bonds Issued by Asian Issuers (2009 through Aug 2014)



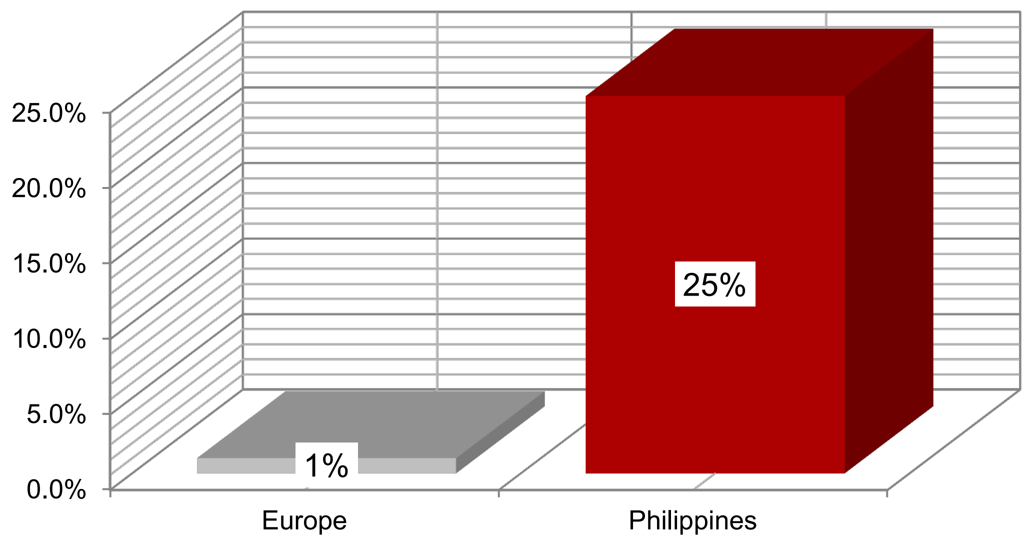
However, the Philippine bond market is characterized by some terms inconsistent with terms typical for such international bonds. Here are five eye-opening facts about the Philippine US$ bond market:

1. **Financial maintenance covenants in a bond? Around a quarter of Philippine bonds have them.**

Financial maintenance covenants — covenants that require companies to maintain certain levels of financial health[2] — are typical in loan agreements, but almost non-existent in bonds. For example, less than 1 percent of international bonds issued by European issuers contain such a test. However, the

Philippines is a different story. Around 25 percent of US$ bonds issued by Philippine companies over the last 10 years contain such maintenance tests.

Financial Maintenance Covenants
Philippine vs European US$ Bonds Issued in Last 10 Years



Why do bond markets favor incurrence covenants[3] and disfavor financial maintenance tests? One reason is that such financial maintenance tests can trigger defaults based on external events outside the control of the company. For example, a natural disaster such as a typhoon could disrupt a company's cash flow for several quarters, or force a company to borrow emergency funds, potentially triggering a default.

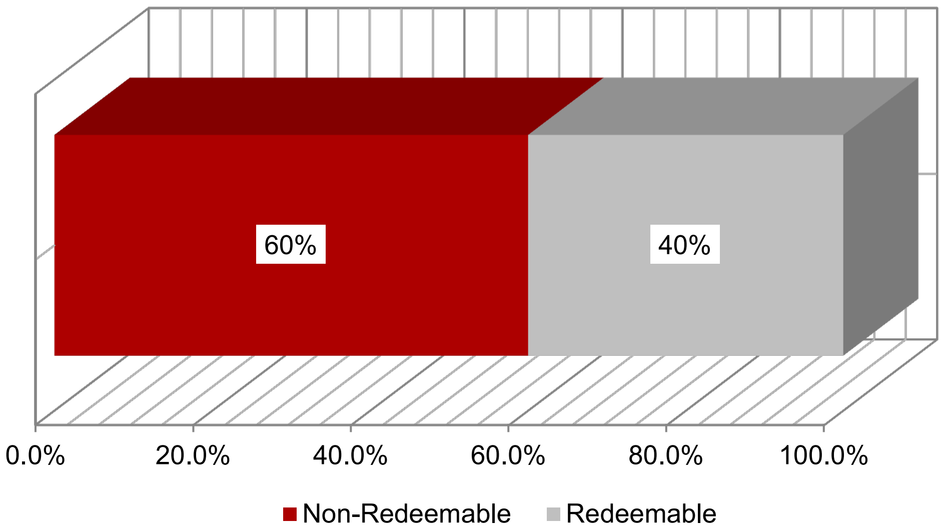
Such a default, if not waived, may cause cross-defaults in other loans and instruments, creating a financial crisis for the company, potentially forcing a company to file for legal protection from creditors — an outcome disfavored by all parties, including bondholders, because of the destruction of value typical in these situations.

While the process for a borrower under a loan agreement to seek and obtain a covenant waiver from its syndicate of lenders is relatively straight-forward, to obtain a waiver or consent from bondholders is an entirely different proposition. [4] It often will take many weeks to prepare a disclosure statement explaining the reasons for the waiver or amendment, then to solicit and to obtain such waiver or consent from bondholders, who are often numerous, often anonymous, and who may be scattered around the world. Also, bondholders will typically require a waiver or consent fee in exchange for such relief.

2. Optional redemption? More than half of Philippine US$ bonds with tenors over seven years do not provide the issuer the right to redeem.

Around 60 percent of Philippine corporate bonds denominated in US$ with a tenor of seven years or more do not give issuers the right to redeem the bonds at their option. In other markets, it is very common to have optional redemption features for bonds with a maturity of seven years or more.[5]

Prevalence of Issuer's Right to Redeem Philippines US$ Bonds With Tenors of 7 Years or More and Issued in Last 10 Years

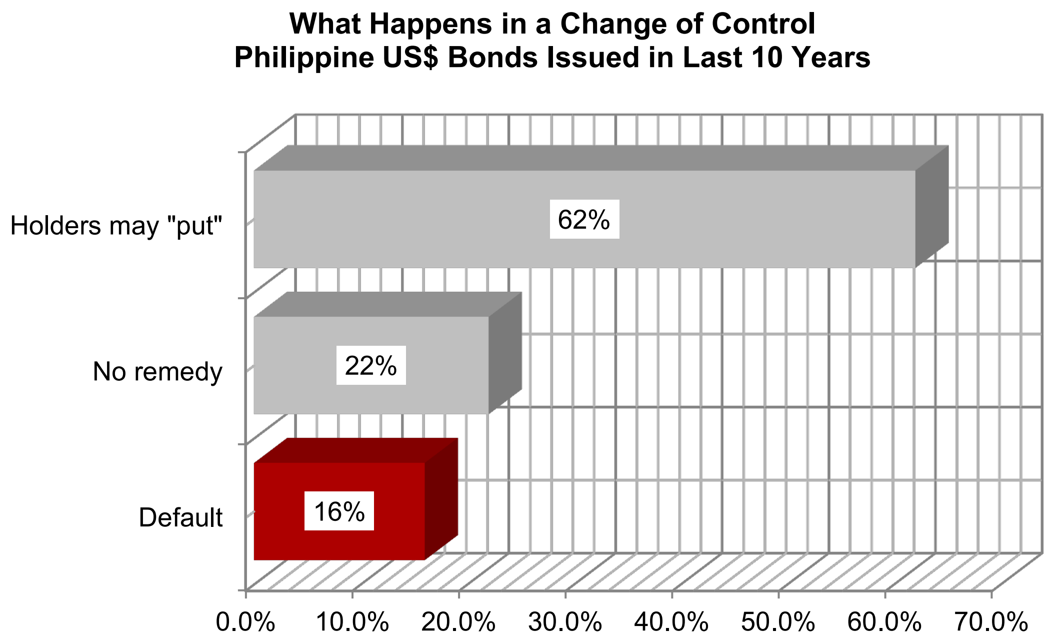


The ability to redeem bonds gives the issuer the flexibility to refinance the bonds if the prevailing interest rate environment makes new financing cheaper than the existing bonds, or to retire bonds if certain covenants constrain the company's ability to do certain things, such as a strategic acquisition or merger. Having an optional redemption feature could have a pricing impact on the bonds, but issuers may want to at least weigh any incremental cost against the added flexibility afforded by such feature.

3. Should a change of control be a default? In one out of every six Philippine bonds, it is.

US$-denominated bonds issued by companies outside the Philippines typically require the issuer to offer bondholders the right to sell — or "put" — their bonds to the issuer if control of the company is acquired by a new group. This is meant to give the bondholder the opportunity to assess whether it wants to continue holding the bond in spite of the change in ownership control of the issuer.

However, only 62 percent of US$-denominated corporate bonds issued by Philippine companies in the last 10 years offer holders such a "put" in a change of control.



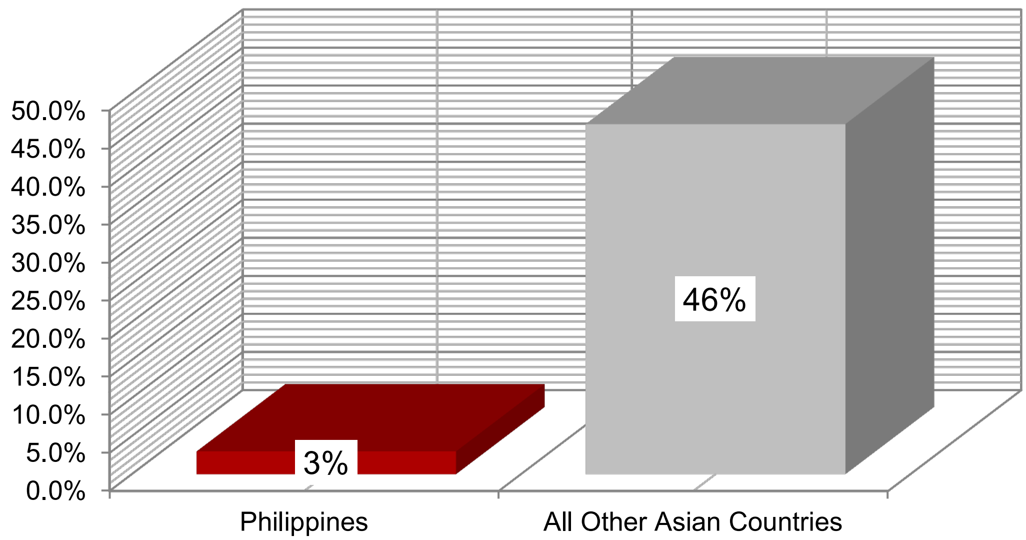
In 22 percent of such bonds, holders have no remedy whatsoever if the issuer sells control to a third party, even if the change of control would add significant new leverage or would otherwise damage the credit quality of the bonds.

On the other hand, 16 percent of such bonds treat such a change of control as an event of default — a rigid and peculiar consequence, since the bondholders may prefer the new owners or may favor the ownership change because the new owners will strengthen the issuer's credit.

4. Sell to US investors? Philippine issuers have not taken advantage of the US market.

Even though the Philippines is the Asian country with the deepest historical and economic ties to the United States, and the United States has the largest and most sophisticated debt capital markets in the world, only one Philippine corporate issuer has sold a US$-denominated bond to US investors under Rule 144A in the last 10 years.[6] This is eye-opening, considering that during that same period, 46 percent of US$-denominated corporate bonds issued in other Asian countries were sold to qualified institutional buyers in the US under such rule.

Percentage of US$ Corporate Bonds Sold Into the US Under Rule 144A Philippines vs All Other Asian Countries in Last 10 Years



Is this because US investors are not interested in investing in the Philippines? On the contrary, when given the opportunity, US bond investors have shown a strong interest in Philippine credits. For example, US investors lapped up 53 percent of the sovereign bonds sold by the Philippine government in January 2014.

Corporate issuers in other countries understand the benefits of developing a strong investor following in as many geographic regions as possible. Selling to sophisticated US institutional investors, who invest considerable time and effort to learn and understand new credits, makes it faster and easier to sell to such investors in the future. The deeper and wider the investor base, the greater the demand for future offerings, which results in better pricing for the issuer.

When asked about this, Philippine market participants point to the strong liquidity in non-US markets and the perception that the United States is a market that requires more stringent disclosure standards. However, we may see increased interest in the US markets if there is any decline in demand in the non-US markets.

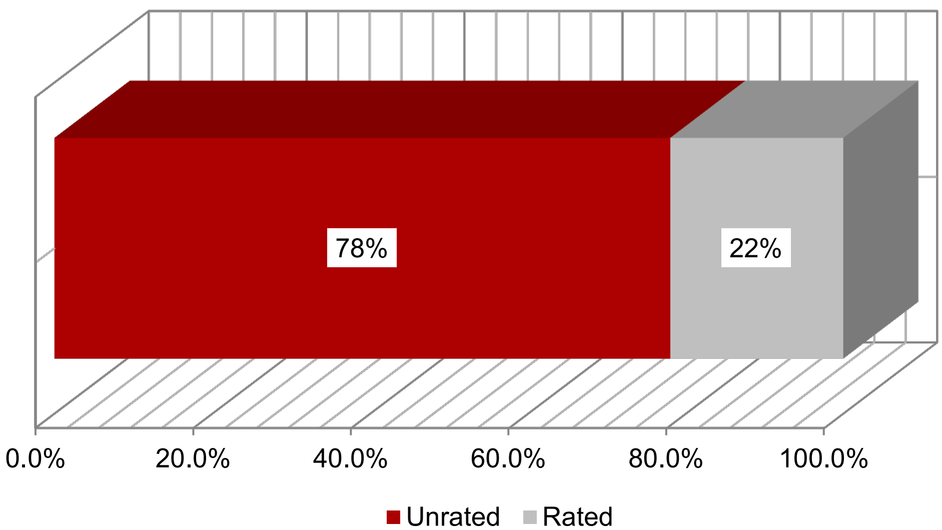
5. Ratings? Nearly 80 percent of US$ corporate bonds issued by Philippine private companies are unrated.

Corporate bonds are usually rated by one or more recognized international credit rating agencies. A credit rating is an assessment of the risk of default of a particular debt instrument. Credit ratings improve the efficiency of markets by allowing investors to benchmark a bond against comparable bonds of other issuers, or to benchmark the issuer against peers in the industry or region.

Credit ratings benefit issuers by broadening the investor base. Bonds that are not rated require sophisticated investors to rely more heavily on their own assessment of the creditworthiness of the issuer. Investors may pass on the opportunity to buy unrated bonds if they do not have adequate information to assess the company or instrument. In fact, some institutional investors are only allowed to invest in rated bonds, or bonds that are rated above a particular rating.

Given these advantages, it is notable that only 22 percent of US$ bonds issued by Philippine companies have been rated in the last 10 years. This could be attributed to the strong demand for Philippine bonds, making a rating, with its attendant costs, unnecessary. This could change, however, by a decrease in demand for US$ bonds issued by Philippine companies or by the default of a Philippine bond issuer.

Proportion of Rated US$ Bonds Issued in the Philippines in the Last 10 Years



Conclusion

As the Philippines continues to grow and the debt capital markets continue to deepen, some of the more standard features of US$-denominated bonds issued outside the Philippines should begin to infiltrate into the Philippine market. We have seen evidence that this process is starting, and we anticipate that more changes are coming. In fact, this process could be hastened with the 2013 upgrade of the Philippine sovereign into investment-grade status.

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Endnotes

1 For purposes of this paper, we have excluded US$ bonds issued or guaranteed by the Republic of the Philippines or those issued by Government-owned and controlled corporations.

2 A financial maintenance covenant requires the issuer to meet certain financial ratios, which include debt-to-equity, debt-to-EBITDA, or current assets-to-current liabilities, throughout the term of the bond. The failure to meet these financial covenants at any time would constitute a default under the bond, and potentially trigger cross-default provisions in the company's other debt.

3 Under an incurrence-based covenant, the failure of an issuer to meet the stipulated financial ratio would not constitute a default under the bond; instead, the only consequence would be the inability to incur more debt, make "restricted payments" or consummate a merger, until the stipulated ratio is met in the future.

4 For US$ bonds governed by English law, amending the terms of a bond typically requires the convening of a bondholders' meeting, which is not required for bonds that are governed by New York law. In addition, there is a recent court decision in the United Kingdom that restricts a company's ability to restructure its outstanding bonds through an exit consent – a process where bondholders are asked to exchange or tender bonds on condition that they commit to vote at the bondholder meeting in favor of amendments to the terms of the bonds. In the Philippines, 94 percent of the US$ corporate bonds issued in the last 10 years are governed by English law, with the remaining governed by New York law. One of the likely reasons is that nearly all of such bonds were issued outside the US under Regulation S, an exemption from the registration requirements of U.S. federal securities laws. There seems to be a notion that US$ corporate bonds sold into the United States under Rule 144A should be governed by New York law, and those issued outside the United States under Regulation S should be governed by English law. There is no sound legal basis for this notion. In fact, there are many US$ corporate bonds issued under Regulation S by companies in Asia, including the Philippines, that are governed by New York Law.

5 In a ten-year bond, the issuer is usually allowed to redeem the bonds after the five-year "non-call" period – the period during which the issuer cannot redeem the bonds. The non-call period is meant to assure holders of the stipulated interest rate for such initial period. After such period, the issuer is allowed to redeem the bonds at a redemption price based on the pricing of the deal, typically starting at par plus half a coupon, reducing ratably each year to par. Even during the non-call period, some issuers are given the option to redeem at a "make-whole" premium – a very expensive amount that is based on the net present value of all interest payments due up to the end of the non-call period, discounted using a discount rate equal to treasury rate plus a certain percentage (usually 0.50 percent).

6 Rule 144A allows sales to qualified institutional buyers in the United States to be exempted from the registration requirements of US federal securities laws.