E-BONDS: Will They Fly?

INTERNET BOND AUCTIONS CAN HELP CORPORATE ISSUERS LOWER THEIR COST OF CAPITAL

BY EMILY S. PLISHNER

LAST AUGUST, when Midland, Michigan-based Dow Chemical Co. became the first nonfinancial corporation to sell its bonds directly to investors through a Web-based Dutch auction, it was hailed as a watershed event in the investment banking world. The businesses of securities brokerage and trading had already been revolutionized by online brokers and electronic communication networks. Wall Street's most lucrative franchise, the control of new-issued distribution, was next. And corporate issuers could expect to reap the benefits of lower transaction costs and better prices for their securities.

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Why then, seven months later, is Dow still the only industrial corporation to conduct an online bond auction? Two words: bear market. Thanks to widening spreads on corporate bonds, raising debt capital was a difficult proposition online or off in the second half of last year. And corporate issuers decided that in a bad market, they were better off with Wall Street underwriters pricing the deal, rather than the open market. "There is a fear among issuers that in a weak market, the transparency of online pricing might work against them," explains Ralph Cioffi, senior managing director at Bear, Stearns & Co. in New York.

Maybe so, but it's hard to argue with the success of Dow's online auction. The company raised $300 million in five-year bonds using software developed by San Francisco-based investment bank W. R. Hambrecht & Co. The auction drew a far broader investor base than usual, and every successful bidder walked away with a full allocation. Dow is paying about the same interest rate it would have paid had it taken the traditional syndicate route, and it had to cough up less than half the typical underwriting fee. "To me, it's a no-brainer," says Dow vice president and treasurer Geoffrey Merszei.

It did, however, take some courage on Dow's part. Wall Street banks stand to lose a lot of power and revenue if they relinquish control of new-issue distribution, and they're not above fighting to save their bread and butter. Undoubtedly, plenty of corporate issuers will decide that a few basis points aren't reason enough to damage relationships with their investment bankers. But in the long run, Internet bond auctions, particularly for plain-vanilla investment-grade debt, could save corporate issuers a significant amount of money.

E-BONDS AND DUTCH AUCTIONS

The first corporate bond billed as an "internet bond," or "E-bond," was issued by Ford Motor Credit early last year. The $1 billion offering of three-year notes worked much like a traditional bond underwriting, except that the prospectus and other marketing materials were posted on the Web, and orders were taken by E-mail. The issue, however, was still priced by the lead manager, Lehman Brothers, not by the investors that ultimately bought the bonds.

Over the next three quarters, a handful of other Internet bond offerings followed, with issues by Daimler-Chrysler, the World Bank, and BASF, and, later in the year, by Bear, Stearns; Deutsche Bank; and, ultimately, Dow. While these offerings were all billed as E-bonds, the last three were the only issues priced and allocated through online Dutch auctions.

In a Dutch auction, investors bid for a particular amount of a security at a specific price. The best bids are accepted in the amounts requested until a clearing price is reached for the entire issue. All successful bidders then get their requested allocations at the clearing price. Offline, it's essentially the form that Treasury bond auctions take. But the Internet brings a new dimension to the process, making the model viable for securities with a smaller potential audience; namely, corporate bonds. While most investment banks are fighting it every step of the way, virtually everyone in the industry agrees that the Internet is already changing the way securities are distributed. And at least some players are preparing for the future. "It's better to be on the train than under it," concludes Mark Millender, managing director of debt markets at Bear, Stearns, the most prominent investment bank to promote the Internet as a new distribution channel for corporate debt. Both Bear, Stearns and Deutsche Bank have conducted their own auctions using proprietary software accessible through their Web sites.

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Dow, in contrast, used four co-managers for its deal: Hambrecht (which supplied the technology); Bear, Stearns; HSBC; and Williams Capital Group. The two-hour auction took place at Hambrecht's auction Web site, www.openbook.com, and, according to Leland Crabbe, a portfolio manager at Credit Suisse Asset Management in New York who participated in the cyberspace bidding, "it was the first [E-bond auction] that felt real to the market."

Besides those from the two investment banks, the other E-bonds were priced according to the usual mysterious ways of the syndicate business. That process takes place in private among a syndicate of investment bankers with a long history of back-scratching and IOUs. The ultimate price of an offering has as much to do with who owes what to whom on Wall Street as it does with the level of true demand in the marketplace. The Ford Motor Credit issue, notwithstanding the administrative and marketing work done on the Web, was no different from any other underwriting in this regard. "It's just glorified E-mail," says Millender.

What makes auctioned E-bonds revolutionary is that the market, not Wall Street intermediaries, sets the price. "That is the whole point of using the Internet," says Merszei. "Without question, the pricing will be more favorable to borrowers." He expected Dow's issue to price somewhere between 98 and 102 basis points over Treasuries. It came in at 101, with a clearing yield of 7.108 percent. And the underwriting spread that Dow paid to its bankers was half the usual 60 basis points of a syndicate deal. "Even if we'd paid 102, the all-in price would have been very competitive," says Merszei.

Michael Reuther, Deutsche Bank's U.K. treasurer and global head of funding and liquidity management, was also satisfied with the "all-in cost" of his E-bond issue.

E-Bond Trading Networks

W. R. Hambrecht's OpenBook (www.openbook.com for a demo). Dow Chemical has used Hambrecht's system, and Freddie Mac has committed to future reference bill auctions using the same core technology. Initial bids are marked with a time stamp. If the bidders improve their bids, they keep the initial time indicator. If more than one bidder comes in at the clearing price at the end of the auction, the awards are determined by which bid first. OpenBook offers anonymity to investors.

Bear, Stearns's DAiSS (www.bearstearns.com for a demo). DAiSS (Dutch auction Internet syndicate system) has no time stamp, because Bear's system builders found that investors don't want to be penalized if their Internet connections are accidentally cut off in mid-auction. Bear's system involves two rounds of bidding, with all bids visible to participants.

Deutsche Bank (Deutsche's general capital markets site, www.dbbonds.com, for more information). Deutsche has capabilities for both American- and Dutch-style auctions, either open or closed. Deutsche's own auction was blind, with bidders unable to see other bids.

MuniAuction (www.muniauction.com). MuniAuction, now renamed Grant Street Group, has hosted more than 1,300 Web auctions for $1.3 trillion in municipal, government, and agency bonds, but none yet for corporate bonds.

BondBook (www.bondbook.com). BondBook is a start-up financed by Goldman Sachs, Merrill Lynch, Morgan Stanley Dean Witter, Salomon Smith Barney, and Deutsche Bank, whose aim is to "[improve] liquidity and transparency" in targeted fixed-income markets. Although it intends to distribute corporate new issues eventually, it has not yet done so. BondBook is not planning any auction pricing online.

Market Axess (www.marketaxess.com). Market Axess is a competing platform with intentions similar to BondBook's. Current investors and dealers include ABN Amro; Bear, Stearns; Deutsche Bank; J. P. Morgan Chase; Lehman Brothers; and UBS Warburg. The venture is acquiring Trading Edge, a platform that allows for anonymous trading.

TradeWeb (www.tradeweb.com). TradeWeb conducts online auctions of U.S. Treasury bonds, and serves as a trading platform for government and agency bonds in the secondary market. It is not planning to get into the corporate bond market.

There are about 80 other secondary electronic trading platforms in the market. *E. S. P.*

HELP WANTED

Not surprisingly, when Merszei went shopping for a manager to conduct Dow's online auction, the A-list underwriters that usually vie for the company's business showed little interest. Only two banks were prepared to take the job; Hambrecht, which had plenty of experience with online equity initial public offerings but next to none with investment-grade debt, and Bear, Stearns, a prominent second-tier player in corporate debt underwriting.

Most, if not all, of the leading fixed-income underwriters have or are developing their own software to conduct on-line auctions, but few are yet prepared to use it for fear of cannibalizing their existing underwriting business. "We'd be kidding ourselves if we didn't recognize that the business is changing," admits Jim Merli, New York-based managing director/syndicate for Lehman Brothers, noting that Lehman already does auctions of money-market preferred securities. "If that's the way the market goes, we are prepared to respond."

Like most investment bankers, however, Merli is in no hurry to see it happen. Investors who participated in the Dow and Bear, Stearns auctions were reputedly discouraged by Wall Street salespeople. So too were interested CFOs and treasurers at other potential issuers. There were predictions that Wall Street dealers would refuse to trade the paper in the aftermarket, there would be no research to support the issue, the auction technology would fail, and not enough investors would participate. Some of the calls suggested that without the moderating hand of the syndicate desk to set allocations, investors might end up paying too much for the bonds. At the same time, CFOs and treasurers were told that in a volatile market, investors would beat down prices. "They were telling me it was bad for the issuer and bad for the investor," says Credit Suisse Asset Management's Crabbe. "But it can't be bad for everybody." Underlying all the arguments was the not-so-subtle innuendo that auction participants could expect retaliation when it came time to allocate the next traditional deal.

"Internet auctions still call for an educated salesperson to explain the underlying credit and the relative value of the issue," says one investment banker.

For the largest, most-favored investors, that's a significant threat. But smaller investors generating less commission for dealers, and CFOs who manage their company's pension fund in-house, are already at the bottom of the pecking order at the syndicate desks: their allocations in traditional deals can't get much worse. In a Dutch auction, where the best bid wins, smaller, less-well-connected investors are on an equal footing with the heavyweights, and are much more likely to get their allocation than they are in a syndicate underwriting.

At the end of the day, the intimidation apparently had little effect. Plenty of investors logged on for all three online Dutch auctions, pricing was good for the issuers, and investors got their full allocations. Trading volume in the aftermarket may have been light, but that was a positive sign. Investors that successfully bid for the bonds were hanging on to them. And according to Merszei, Dow has not been blackballed by other investment bankers. "Secretly, many of them—including senior managers—say this is the wave of the future," he says.

THE MERITS FOR ISSUERS

The great promise of Internet bond auctions for corporate issuers is a lower cost of capital. But one of the biggest sources of expected savings—lower sales and marketing costs—may not be as large as first imagined. All the parties involved in the Dow deal insist that a successful Dutch auction requires an active effort by salespeople, no matter how good the technology. "Software doesn't answer questions," says Chris Williams, founding partner of Williams Capital Group. "It still calls for an educated salesperson to explain the underlying credit and the relative value of the issue." Williams has a dozen people in fixed-income sales, and doesn't expect that to change.

While the four managers of the Dow issue halved their commission on the deal (30 basis points versus 60), the discount may in part be a reward for Dow's willingness to serve as guinea pig for the auction. "Everyone has assumed that OpenBook is aimed at cutting fees, but it's not," says Robert Goldberg, co-head of debt markets at Hambrecht. "For the issuer, it's a method that results in a better price and more transparency."

"Investors will accept less yield if they know the bonds are likely to go up in value." —Mark Millender, managing director of debt markets, Bear, Stearns & Co.

Indeed, the greater transparency of Internet auctions is the reason that issuers should realize better prices for their bonds. In traditional syndicate deals, underwriters often have an incentive to underprice the issue in order to attract big institutions with which they would like to do more business. Investors with large allocations can then make a quick profit selling the underpriced bonds in the secondary market, because of pent-up demand.

In Internet auctions, the book is built online in real time, giving participants a much better sense of the true demand for the securities in the marketplace. Consequently, they're apt to make better bids. "Investors will accept less yield if they know the bonds are likely to go up in value," says Bear, Stearns's Millender. And because the price reflects true demand in the market, successful bidders are also more likely to hold on to their investment. According to Stephane Paquier, Dow's corporate finance director, "We got long-term investors instead of traders. Most of our investors are keeping our paper."

An added benefit of an open auction appears to be a broader distribution pattern among investors—something issuers like because it can reduce the volatility of the securities in the secondary market. The Dow-E-bond auction attracted 57 investors, about three times the usual number for a deal of that size. Bear, Stearns ended up with 129 investors, about twice the normal number. "It may have been investor curiosity as much as anything else," says Cioffi.

Whatever the reasons, the auctions clearly generated a lot of interest in the investor community. "The process unfolded just as our game theorists predicted: as the auction progressed, the

THE FLYING DUTCHMEN *Three companies have conducted online Dutch auctions of their bonds.*

Company	Date	Web location	Issue description	Clearing price	# of investors
Deutsche Bank	8/10/00	www.dbbonds.com	$250 mill., 3-yr. bond	111.5 basis pts.†	23
Bear, Stearns	8/10/00	www.bearstearns.com	$700 mill., 7-yr. bond	182 basis pts.	57
Dow	8/15/00	www.openbook.com	$300 mill., 5-yr. bond	101 basis pts.	57

† Deutsche's auction lasted 21 hrs. Bear, Stearns's began 2 hrs. after Deutsche's, but ended first. Both claim to be first.
SOURCE: ISSUERS

pace of bidding increased and the spread came down," says Cioffi, who handled his company's auction of its own debt.

"An auction is more interesting to a bull than a bear," says Prince.

And the initial concerns about liquidity in the aftermarket proved to be unfounded. Unlike stocks, bonds—even of large issues—are not terribly liquid, so the market-making support of the investment community can be important. Merszei says that in addition to the underwriters in the deal, major Wall Street firms reported to the company that they were making markets in the new bond. There just wasn't much activity. Although it is difficult to measure liquidity, Dow's E-bond is trading at prices and volumes related to the company's credit rating, the size of the offering, and prevailing interest rates. In other words, just like any other bond issued by the company. "Beyond the first few weeks, the mode of distribution—whether by auction or syndication—has no bearing on liquidity," concludes Merszei.

WHY THERE HAVEN'T BEEN MORE

So what will kick-start the market for Web-based bond auctions? The successful Freddie Mac auction of $5 billion in three-year notes on February 9 using Hambrecht technology could revive interest. The recent interest rate cuts by Alan Greenspan could also help. As Jon Prince, the McLean, Virginia-based managing director of debt marketing for residential mortgage agency Freddie Mac, says, "An auction is more interesting to a bull than a bear." After a miserable fourth quarter in the bond market, however, issuers are taking advantage of the improved environment, and coming to market as quickly as possible through the traditional underwriting method.

Companies may also believe that investors are not yet comfortable enough with Internet auctions. Not everyone wants to be bothered learning each variation of the process. J. W. Seligman portfolio manager Gary Zeltzer says he's not convinced that Dow's OpenBook issue was anything more than a one-shot deal. "It needs to be repeatable," he says.

Many investors will likely sit on the sidelines until one system is established as a de facto standard. That hasn't happened yet, and in a shaky credit environment with a recession threatening, it may not for a while. Hambrecht, however, recently scored a huge endorsement when Freddie Mac announced it would use the system for some large tranches of its mortgage-backed securities.

Both proponents and opponents of online Dutch auctions of corporate debt say one thing is clear: The system works best for large, plain-vanilla issues with good credit stories. That's why TradeWeb and MuniAuction (see "E-Bond Trading Networks") are already up and running with agency issues. For corporates, that means quality investment-grade debt, and maybe asset-backed securities. "It's always better to introduce change with well-known credits that don't need a lot of explanation," says Hambrecht's Goldberg.

Bear, Stearns currently has three online auctions in the pipeline for the first quarter, market conditions permitting. "Our plan is to make DAiSS [Dutch auction Internet syndicate system, Bear, Stearns's technology platform] become part of our normal new-issue protocol, and to offer it to all of our issuers," says Cioffi.

If only the rest of Wall Street were so accommodating.

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