A Brief Survey of

THE EUROBOND MARKET

The 1960's have witnessed a number of changes and innovations in the money and capital markets, both at home and abroad. Not the least of these has been the meteoric rise of the Eurobond market. This market is not, as the name implies, confined exclusively to Europe or European participants, but is an international capital market utilized extensively in the recent past by U. S. corporations.

Origins of the Market Prior to the emergence of the Eurobond market in 1963-64, borrowers who wished to float issues outside their own national borders chose a particular national market for the sale, such as the U. S. or Switzerland, and denominated all the bonds in the currency of the country chosen. Until 1963, New York was the principal market for foreign bond flotations. While U. S. investors were the chief purchasers of these bonds, they became increasingly attractive to foreign buyers because their yields frequently exceeded those on bonds sold domestically by the same borrowers. In addition, foreigners considered dollar-denominated assets attractive in their own right. The imposition of the Interest Equalization Tax in July 1963, however, spelled the end of New York as a major foreign bond market. This tax is levied as a percentage of the purchase price of a foreign security. While it is paid by the purchaser, in the case of bonds it generally is shifted to the foreign seller who must offer a correspondingly higher yield to attract U. S. investors.

Meanwhile, British authorities had been preparing the ground for the rebirth of London as the principal international capital market by easing pertinent legal restrictions and reducing certain taxes. Due to balance of payments problems, however, the authorities severely restricted access to the British bond market to a preferred list of Commonwealth borrowers. The dollar-denominated bonds sold in May 1963 by the Belgian government through the London market, principally to non-U. S. investors, may be considered the first true Eurobond issue.

Nature of a Eurobond A Eurobond issue is marketed by an international syndicate simultaneously in a number of different countries. All the bonds in a given issue are denominated in the same currency. Eurobonds are generally sold to investors in countries other than the one in whose currency they are denominated. In these respects a Eurobond differs from a foreign bond issue which is (1) denominated in the currency of the country in which it is sold, (2) underwritten by a national syndicate, and (3) sold primarily to investors in that country. Whereas a foreign bond issue is subject to all laws and regulations of the country in which it is sold, a Eurobond issue is generally exempt. In fact, the Eurobond market is virtually free of any direct regulation or control. All Eurobonds are "bearer," or unregistered, bonds to protect the anonymity of the investor. If the borrowing corporation fulfills the regulations of the country in which it is incorporated, income taxes need not be withheld from interest payments. The tremendous popularity of Eurobonds with investors can be explained in large part by the ease with which taxes on them may be evaded.

Marketing a Eurobond Issue A special set of problems attends each flotation of Eurobonds because the bonds must be attractive to investors of many countries. The quality of the borrower, the stability and convertibility of the currency chosen, and freedom from national taxation are among the principal concerns of potential investors. Principally in order to avoid tax withholding requirements, most American corporations and some European ones establish separate international financing subsidiaries, often solely for the purpose of raising funds in the Eurobond market. Although U. S. subsidiaries are usually incorporated in Delaware, Luxembourg and the Netherlands Antilles are also popular bases. The parent company generally guarantees bonds sold by the subsidiary.

A typical Eurobond issue is sponsored by a syndicate composed of four or five leading European banks and/or U. S. investment houses. The managing group then selects perhaps 20 to 50 more financial institutions from several countries to assist in the underwriting operation. These firms, in turn, form selling groups in their own countries or areas to effect the final placement of the issue. Thus, anywhere from 50 to 100 firms assist in the marketing of each Eurobond issue, regardless of its size. Because most single institutions reach a relatively small number of investors, a large number of firms is necessary to tap effectively the multinational market. Furthermore, the European capital market has very few large institutional investors. Once placed, the bonds may be delivered simultaneously in several cities, but payment is generally in one city. Payment in dollar-denominated securities is always in New York.

Demand for Eurobonds Wealthy individuals are attracted by the high quality, high yield, and virtually tax-free nature of Eurobonds. The Chase Manhattan Bank estimates that 70% to 80% of most issues is bought by individuals. The identity of these

individuals is harder to establish, however. Americans are discouraged from investing in Eurobonds as such purchases are subject to the Interest Equalization Tax. While undoubtedly a number of Americans do buy Eurobonds through Swiss or other foreign banks, thereby evading this tax, they apparently do not constitute a major class of investors. British citizens are seriously hampered in the purchase of any dollar-denominated straight debt asset by foreign exchange controls. Until recently, however, other major European countries outside Scandinavia placed no restrictions on the flow of funds into the Eurobond market.

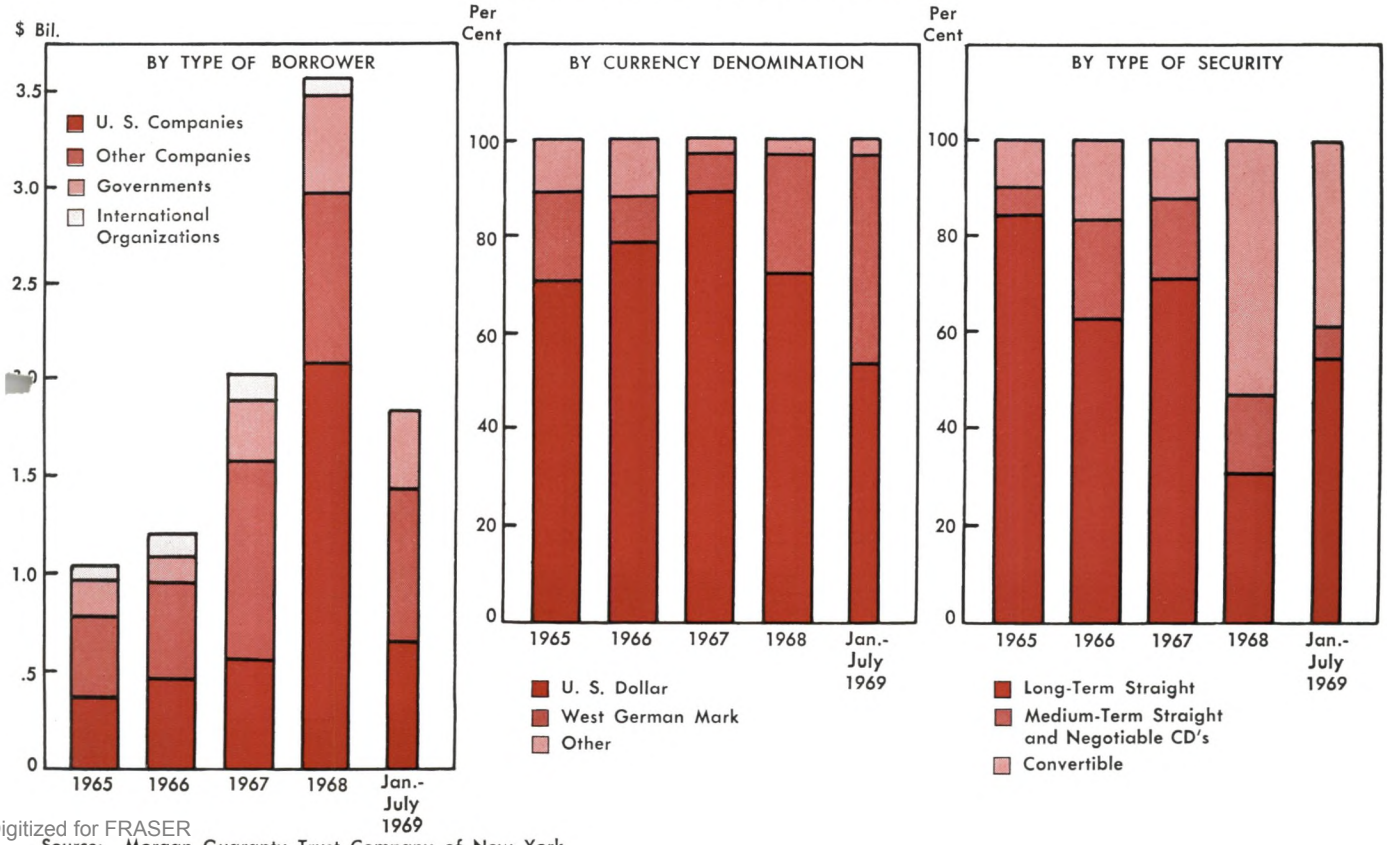
Based on the origin of subscriptions, Switzerland is the most important source of Eurobond demand, accounting for one-quarter to one-third of all purchases. A recent study by N. M. Rothschild & Sons estimates that 60% to 70% of these bonds ultimately is placed with non-Swiss residents.[1] Italy, Belgium, and the Netherlands have been important sources of demand at various times. Germany has been a major purchaser since early 1968 when Eurobond rates exceeded domestic long-term rates.

[1] N. M. Rothschild & Sons, *The Eurobond Market.* A study on the issuing and trading of Eurosecurities prepared at the request of the High Level Standing Group on Capital Markets of the Business and Industry Advisory Committee to the Organisation for Economic Co-operation and Development. February 1969. p. 9.

The Market 1964-1967 Between 1964 and 1967 the volume of Eurobond offerings expanded steadily from $700 million to $2.0 billion. During these years the center of activity shifted first from London to Luxembourg, and then diffused to include New York and Germany. Scandinavian governments and private Japanese corporations, both of which had been active in the New York foreign market, continued to be among the most frequent borrowers. International institutions, particularly the European Coal and Steel Community and the European Investment Bank, also utilized the market. As shown in the chart, however, private non-U. S. corporations were the dominant group of borrowers until 1968. During these years, the proportion of Eurobond offerings denominated in dollars climbed to about 90%, with long-term straight debt the most popular type.

In 1965, U. S. corporations entered the Eurobond market for the first time. In February of that year, the U. S. Government had requested voluntary compliance by major U. S. corporations to a set of guidelines designed to improve the U. S. balance of payments position. These guidelines curtailed direct exports of capital for overseas development. In their search for capital, these corporations turned first to overseas banks for credit, and, in the latter part of

EUROBOND FLOTATIONS



Source: Morgan Guaranty Trust Company of New York.

the year, to the Eurobond market. Eurobond sales by U. S. corporations constituted about one-third of the total in 1965, a proportion which was not exceeded until 1968. As a corollary to the entrance of U. S. borrowers, New York underwriters soon became prominent in Eurobond syndicates.

Events in 1968 In 1968, the Eurobond market was deluged with offerings by American companies and the volume of Eurobond sales surpassed the combined total of the preceding two years. The surge in U. S. borrowing was triggered by the replacement of voluntary balance of payments controls with more stringent mandatory ones on January 1, 1968. Under the new controls, U. S. corporations were forced to rely almost exclusively on overseas borrowing to finance their foreign operations. American companies accounted for $2.1 billion of the $3.6 billion total of Eurobonds sold in 1968.

This dramatic change in the composition of borrowers was accompanied by an equally abrupt switch in the types of bonds sold. The market for long-term straight debt, which had hitherto absorbed the preponderance of Eurobond issues, apparently could not handle comfortably the influx of new issues at the prevailing interest rates, and most borrowers were unwilling to pay substantially higher rates. While some borrowers shortened the maturities on their straight debt issues to insure successful sales, a majority turned to bonds which were convertible into common stock of the parent company. The net result was that over half of the total volume of Eurobonds sold in 1968 was convertible, compared to 13% in 1967, and 86% of all convertibles were sold by U. S. companies. Indeed, virtually the entire growth in the Eurobond market in 1968 was attributable to convertibles as sales of long-term straight debt actually declined.

Convertibles were fairly new to the international bond market and proved to be extremely popular. The special appeal of a convertible bond lies in the combination of a good yield as protection in a bear market and the capital gains potential should the share price of the company's stock rise. With U. S. stock prices generally rising at that time, the conversion option was also highly valued. Several mutual funds composed solely of convertible Eurobonds were launched. Sellers of convertibles apparently felt that the risk of future equity dilution was more than offset by the ease of procuring funds at considerably lower interest rates than those prevailing on straight debt issues.

While U. S. borrowers dominated the Eurobond market in 1968, the dollar slipped somewhat from its preferred position as the currency of denomination for Eurobonds. Despite the fact that all convertible issues were denominated in dollars, dollar Eurobond issues dipped to 72% of the total, with issues denominated in West German marks rising from 8% in 1967 to 25% in 1968. The mark's growing popularity reflected investor confidence in the mark and the desirability of holding such bonds should the mark be revalued. Borrowers were attracted by the significantly lower interest cost of mark-denominated bonds compared to dollar bonds.

Recent Developments After a fast start in 1969 during which the trends of the previous year were accentuated, the Eurobond market staggered and then stalled. Total Eurobond offerings dropped from $1.2 billion in the first quarter to $0.5 billion in the second. Several developments contributed to this decline. High and rising interest rates discouraged some borrowers and diminished the appeal of long-term straight debt investments, as many investors preferred short-term paper. In particular, the short-term Eurodollar market, which offered rates of return in excess of 10% for 3-month deposits, represented keen competition. Rising interest rates on mark-denominated bonds made them less attractive to bond sellers as the threat of revaluation was no longer countered by a significantly lower interest cost. Concurrently, convertible issues became less alluring to investors as U. S. stock prices plunged. Two other factors contributed to a slowdown in offerings by U. S. corporations: direct foreign investment controls were eased somewhat, thereby lessening their dependence on the Eurobond market, and the heavy borrowing of 1968 undoubtedly alleviated the immediate need for new funds. Finally, Germany, Italy, and Switzerland adopted measures restricting to some degree the volume of Eurobonds sold within their borders. These countries acted to protect their relatively lower long-term domestic interest rates and to insure the availability of sufficient capital for domestic investment.

Conclusion The future growth and direction of the Eurobond market depends to a large extent on the health and stability of major currencies and the willingness of nations to permit foreigners to tap their domestic sources of investment funds. The ever-expanding list of new borrowers drawn to the Eurobond market and the variety of instruments offered suggest that the market will continue to play an important and unique role in international finance as long as underlying conditions are favorable.

Jane F. Nelson