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Retail bonds

CMS Cameron McKenna LLP

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The growth of retail bonds

2012 saw an increasing number of UK companies launching bonds specifically targeting retail investors, described as 'retail bonds'. These are separate from the far larger corporate bond market dominated by institutional investors and should not be confused with investment 'bond' products sold to retail investors by life assurance companies. Retail bonds are expected to remain popular throughout 2013.

Retail bonds are becoming a popular way for companies to raise funds, particularly at a time where capital-starved banks are not readily lending to businesses. This enthusiasm is being matched by investors, who are seeking alternatives to traditional savings products and equities. Not all retail bonds, however, are sold with the primary aim of raising capital. Some retail bonds are more of a marketing strategy aimed at cementing customer or employee loyalty and the sums raised can be relatively small.

What are retail bonds?

There are, broadly speaking, two types of bonds which, although quite different, are referred to as retail bonds:

1. listed bonds that are traded in lower denominations than the traditional corporate bond market on the London Stock Exchange's Order Book for Retail Bonds (the ORB) and
2. so-called 'passion brand' (or 'mini') retail bonds, which are not listed on the ORB and are not tradeable.

Retail bonds are essentially unsecured debt of the issuing company (similar to an unsecured loan note). Private investors are invited to lend to the issuer and their return is by way of a fixed annual return, typically paid once or twice a year. Yields may be fixed, floating or index linked and the returns vary according to the type of bond. Listed bonds pay cash interest to bondholders, while unlisted retail bonds may pay out in a range of 'currencies' such as store vouchers, products or customer discounts.

The rate of interest offered by companies issuing retail bonds is higher than those commonly found at UK high street banks (typically between 5% and 7.5%). This high return reflects the higher risk represented by retail bonds compared to cash deposits. They are not covered by the Financial Services Compensation Scheme and are dependent on the bond issuing company staying solvent.

What is the size of the market?

The ORB was launched in February 2010. The UK listed retail bond market has grown from £100 million in 2010 to more than £2 billion as of November 2012. Some 170 bonds were listed as of 30 November 2012 including bonds issued by National Grid, Severn Trent and Tesco Bank Personal Finance. Even the LSE itself has a retail bond and the ORB also contains a range of UK gilts. Several bonds issued before the establishment of the ORB are also traded on it.

The unlisted bond market is much smaller and includes brands such as John Lewis, King of Shaves, Ecotricity, Mr & Mrs Smith and Hotel Chocolat.

What advantages do retail bonds have for companies?

The first advantage of retail bonds is their flexibility. Subject to certain legal requirements, companies have free rein in defining the key terms of their retail bonds – including the repayment date, amount of interest paid and perhaps whether the interest is paid in cash or by way of other 'currencies'.

Secondly, retail bonds open up new sources of capital and are an alternative funding option to bank loans and private equity financing, which may be unavailable or too expensive for small start-ups and some other businesses.

Thirdly, the intention may be to target existing customers or employees of the business and the bond may be an opportunity to increase the company's profile and interaction with them and to engender brand loyalty.

Lastly, bond issuers may not incur all of the costs and delays associated with some other capital-raising options, such as equity issues and traditional bank lending.

Listed retail bonds

Listed retail bonds are essentially retail-size corporate bonds (that is, an instrument that promises to pay a given rate of interest, or coupon). They are listed and can be bought and sold in the secondary market via trading on the ORB. By virtue of their small denominations – e.g. denominations of £1,000 – these retail bonds are targeted at individual rather than institutional investors.

In order for listed retail bonds to be traded on the ORB, they must comply with the LSE Admissions and Disclosure Standards and must be admitted to the official list by the UK Listing Authority. They must also:

- be supported by a committed market-maker willing to provide electronic two-way prices throughout the trading day
- be tradeable in units of no larger than £10,000
- comply with minimum disclosure requirements for the retail regime under the Prospectus Directive, meaning that a prospectus will have to be drafted and approved before the bonds are offered or listed and
- be set up for settlement in CREST.

Companies legislation in the UK restricts the offer of securities by non-public companies. As a result, the issuer of retail bonds must generally be a PLC (though its shares do not need to be listed). It is usually relatively easy for a non-PLC company to access the bond markets by incorporating a PLC subsidiary to issue the bonds. In this case, the parent company may guarantee the retail bonds.

Selected UK listed retail bonds

Issuer	Amount	Maturity	Coupon
Unite Group	£90m	7.5 years	6.125%
London Stock Exchange	£300m	9 years	4.75%
Primary Health Properties	£75m	7 years	5.375%
Severn Trent Water	£75m	10 years	1.3% RPI-linked
Tesco Personal Finance	£200m	8.5 years	5.0%
Provident Financial	£120m	5.5 years	7.0%
Places for People	£40m	10 years	1.0% RPI-linked
National Grid	£260m	10 years	1.25% RPI-linked

Unlisted retail bonds

Unlisted retail bonds are a fundamentally similar concept, in that investors buy company debt in exchange for regular interest payments and they must be issued by a public company. However, there are differences. Most importantly, unlisted retail bonds cannot be traded on the capital markets and are not transferable. As there is no secondary market, the amount invested can only be redeemed at maturity (unlike with listed bonds, which can be sold in the secondary market). Companies have typically chosen maturity periods of between three and five years.

As they are not transferable securities, unlisted retail bonds are outside the scope of the Prospectus Directive. Instead of a PD-compliant prospectus, bondholders are provided with an Invitation Document (or Information Memorandum). This document sets out the key terms of the bond (e.g. minimum amount required, interest, repayment date, disclaimers etc.) and other financial information, such as trading performance and future plans. The document falls under the financial promotion regime; it must be fair, clear and not misleading and must be made, or approved, by an FSA-authorised person.

The amounts raised by unlisted bonds tend to be smaller than listed retail bonds. Except for the John Lewis bond, every UK unlisted bond issued has raised less than £25 million (see the table below for some examples). In some instances, non-cash returns are paid in lieu of cash interest. For instance, Hotel Chocolat offered return in chocolate boxes while the fast-food restaurant chain Leon offers its bondholders restaurant vouchers.

These 'mini-bonds' can be as much a profile-raising opportunity as a funding exercise and are typically targeted at raising funds directly from loyal customers or employees who may be particularly drawn to these exotic coupons. It is worth noting that the tax treatment of these coupons needs careful consideration both by issuers (who may have to 'withhold' a portion of the cash value of the coupon and pay it across to HM Revenue & Customs) and by investors (who may have to pay income tax as a result of receiving a coupon, even where it not received in cash).

UK unlisted –'Mini bond'

Issuer	Amount	Maturity	Coupon
Mr & Mrs Smith	Aim to raise £5m	4 year initial period	7.5% cash coupon or 9.5% in Mr & Mrs Smith 'loyalty money'
John Lewis	£57.5m	5 years	4.5% cash coupon plus 2% in store vouchers
Ecotricity	£10m	4 year initial period	7% plus 0.5% for Ecotricity customers
The Chocolate Tasting Club (Hotel Chocolat)	£3.7m	3 year initial period	Bi-monthly deliveries of chocolates; equivalent to 6.72% for £2,000, 7.29% for £4,000
Leon	Aim to raise £1.5m	3 years	10% for £1,500 investment, 15% for £5,000+ investment. Payment in 'Leon pounds' redeemable after three years in any restaurant

How we can help

The CMS Financial Services & Products team has broad experience of a wide variety of bond issuances, acting for a diverse range of issuers and financial institutions. We are currently advising clients on both types of retail bonds and are ideally placed to help you with an issue in the retail bonds market.

If you would like further information on retail bonds or to discuss how we may be able to help you, please contact us using the details below.

Contacts

Michael Cavers
Partner, Financial Services & Products
T +44 (0)20 7367 3413
E michael.cavers@cms-cmck.com

Will Dibble
Partner, Financial Services & Products
T +44 (0)20 7367 3378
E will.dibble@cms-cmck.com

Jason Harding
Partner, Financial Services & Products
T +44 (0)20 7367 3138
E jason.harding@cms-cmck.com

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CMS Cameron McKenna LLP
Mitre House
160 Aldersgate Street
London EC1A 4DD

T +44 (0)20 7367 3000
F +44 (0)20 7367 2000

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