

The Increasing Use in Portugal of Bond Placement with Banks as an Alternative to Traditional Credit Facilities Advantages of This Type of Structure

Morais Leitão, Galvão Teles, Soares da Silva & Associados

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By Pedro Gorjão Henriques and Maria Soares Do Lago

Financing Through the Issue of Bonds – Why Not?

Up until 2007/08, the financial markets were thriving and competition was one of the key points. Banks and investors were scavenging for profitable opportunities and only a few enlightened ones were unafraid of publicly saying this prosperity would not be as long-lasting as everyone seemed to be assuming.

Though typical bond issues have been a fairly common method of borrowing money in the open market for large and medium size corporates in Portugal, in the recent years we have been watching the rise of a new phenomenon: private placement of bonds purchased in full by a financing bank or a syndicate of financing banks as an alternative to traditional credit facility agreements.

When put side by side with traditional loans the question is no longer why, but why not?

The main reason for this trend is tax efficiency but there are other factors that make this solution appealing when structuring borrowing schemes.

The detailed legal regime confers to bond issues certainty and standard core terms and conditions and the fact that they are securities give the financing banks the possibility to easily sell them at a later stage or to use them as collateral for European Central Bank monetary policy purposes.

Generic Terms of the Portuguese Legal Framework for Bond Issues

The legal regime for bonds is set forth in the Portuguese Companies Code specifically for companies limited by shares (sociedades anónimas). Decree-law no. 160/87, of 3 April, extended this same regime to companies limited by quotas (sociedades por quotas).

There are several requirements that must be met by companies intending to issue bonds, and we shall outline the more relevant aspects for the purposes of this article.

The By-laws (estatutos) of the company must be definitively registered for more than one year – except if they result from merger or spin-off of companies and at least one of those companies is registered for more than one year; if the State or an equivalent public body holds the majority of the share capital of the company; or if the bonds are guaranteed by a credit institution, the State or an equivalent public entity (these requirements may be waived, in whole or in part, upon joint ruling of the Portuguese Ministers of Finance and Justice).

The Code sets a cap for outstanding bonds at any given moment: twice the company's own funds (capitais próprios). Nevertheless, since the amendment made to the Code in 2006, if the company is a listed company, if the issue is rated by a rating company registered in the Portuguese Securities Exchange Market Commission (Comissão do Mercado de Valores

Mobiliários) or if the issue is guaranteed by a special guarantee granted in favour of the bondholders, there are no limits to the amount of bonds issued by a Portuguese company. This amendment to the code was essential in order to allow companies to choose bond issues as an alternative to traditional financing.

There are also restrictions on the reduction of the company's share capital while bonds are outstanding.

The rule established by the Portuguese Companies Code is that the issue of bonds shall be decided by the company's shareholders. It is, however, possible to establish in the by-laws that the issue is to be resolved by the board of directors. The practice has been that companies who choose this financing option frequently also prefer this last approach in order to avoid the extra formalities inherent to a shareholder's meeting. In any case, the resolution on a bond issue cannot be taken if a previous issue is not fully subscribed and paid up.

Before 2003 all bond issues in Portugal were subject to commercial registration. In 2003 this requirement became applicable to private placements only. In 2006, when the Prospectus Directive – EU Directive 2003/71/EC of the European Parliament and of the Council – was implemented, it was deemed that the supervision of the CMVM (when approving the prospectus) and of the market managing entity was argument enough to justify abolishing the compulsory commercial registry for issues listed in regulated markets (independently of the public or private nature of the issue).

Tax Regime – Advantages of the Bond Route

Stamp Tax

Unlike credit granted under loan facilities, payments arising from subscription of bonds and interest due thereunder are not subject to Portuguese stamp tax.

Nevertheless, and precisely because stamp tax is not charged for the loan, if there is special security granted in favour of the bondholders to guarantee the obligations of the issuer under the bonds, the security so created will be subject to stamp tax.

Income Tax

Further, with the entry into force in 2006 of Decree-Law no. 193/2005 of 7 November, (as amended) investment income and capital gains deriving from the sale or disposition deriving from bonds are exempt from Portuguese income tax – and therefore not subject to withholding for such purposes – provided certain conditions are met.

One of the key requirements pertains to the domicile of bondholders. The first condition is that the bondholder is not domiciled nor has its head office, effective management or permanent establishment to which the income is attributable in the Portuguese territory. Also, the bondholder must not be domiciled in the so called blacklisted jurisdictions (countries, territories or regions subject to a clearly more favourable tax regime included in the list approved by the Portuguese Minister of Finance and Public Administration, currently Portaria do Ministro das Finanças e da Administração Pública no. 150/2004, of 13 February, with the exception of central banks and agencies bearing a governmental nature). In order to benefit from the exemption, the holder of the bonds must also not be an entity that is held, directly or indirectly, in more than 20% by Portuguese resident entities. Decree-law no. 193/2005 defines specific instruments in respect of the provision

of evidence of non-residence by the holders of bonds for the purpose of the above tax exemptions.

Portuguese banks were already exempted from withholding as there is no withholding tax on interest paid to financial institutions.

One further and central requirement is that the bonds must be held in a centralised system recognised by the Portuguese Securities Code and ancillary legislation. Currently the only system that fulfils all requirements is Central de Valores Mobiliários (“CVM”), managed by Interbolsa, Sociedade Gestora de Sistemas de Liquidação e de Sistemas Centralizados de Valores Mobiliários, S.A. (“Interbolsa”). This means that, in order to be eligible for the tax exemption, the bonds must be registered in the CVM.

CVM is composed of interconnected securities accounts, through which securities (and inherent rights) are held and transferred. Issuers of securities, financial intermediaries (direct registration entities) and the Bank of Portugal, all participate in this centralised system.

One of the singularities of this solution is that Euroclear Bank S.A./N.V. (“Euroclear”) and Clearstream Banking, société anonyme (“Clearstream”), the traditional settlement and clearing systems of the bond markets are not financial intermediaries registered with Interbolsa.

This could, and did, in fact, in the first transactions made using the CVM, cause some discomfort to some experienced investors.

Yet this is nowadays not a problem as the practice showed that the system works and holders of bonds may either: (i) hold the bonds in an account with a financial intermediary registered with Interbolsa (which is the case of most Portuguese banks); or (ii) hold the bonds in accounts of Euroclear or Clearstream, who in turn appoint a financial institution registered with Interbolsa for the purposes of holding accounts on behalf of Euroclear or Clearstream.

Also, similarly to global notes, book-entry notes can be used as collateral for the purposes of the European Central Bank’s monetary policy, as long as they fulfil the other applicable requirements.

Documenting Bond Private Placements

Private placements of bond issues generally do not involve a complex documental structure. This is very much due to the comprehensive legal regime and regulatory regime (at the level of the centralised securities system) that makes the contractual configuration simpler, and to the fact that, to the extent they are not to be admitted to trading – there is no requirement to publish a prospectus.

Traditionally the terms and conditions of the bonds – such as the issue date, maturity, interest type, interest rate and payment dates – are set forth in the term sheet, which is independent from the contractual package.

There should also be an agreement establishing the terms and conditions for the purchase of the bonds by the financing bank, which tends to be in the fairly standard format of a

subscription agreement (except for the fact that in this case, as the financing bank will be purchasing all bonds, the subscription agreement will not contain placement dispositions).

An agency agreement – which in the case of a Portuguese issue should be tailor-made in order to include not only standard paying agency clauses but also, if the issue is to be registered in the Portuguese securities centralised system, to establish the necessary procedures for the connection with Interbolsa – is also normally executed between the issuing company and a selected financial institution.

If the bonds are guaranteed by a special guarantee there should also be an agreement establishing the terms and conditions in which these are granted (security agreement).

A Trend to Stay

Having a favourable tax regime, simple and standard contractual documentation and the plus of being securities (as opposed to contractual positions in loan agreements) bond issues first came up as a fresh new approach to arranging the financing of Portuguese companies.

Today, one of the reasons for the initial reluctance in relation to this option – the fact that the issues have to be registered with Interbolsa (one of the requirements for the application of the special tax framework for non-resident entities) – fades away as the system proves its efficiency due to the great number of issues registered since the new tax regime came into force.

Private placements of bonds with credit institutions in Portugal are now a real alternative to the execution of credit agreements; they are no longer just another new trend but a trend to stay.