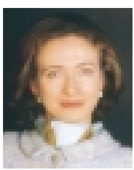
BUYERS KEEN FOR RAILTRACK



HENRIETTA PODD OF ROYAL BANK OF CANADA GOES BEHIND THE SCENES TO FIND OUT HOW THE STERLING BOND MARKET IS TAKING THE NEWS OF RAILTRACK'S RECENT DEMISE.

History shows that private railway companies have brought danger to employees, disappointment to travellers and ruin to investors. However, history is nothing more than an entertaining distraction if it fails to provide a guide to new investment. Railtrack and Enron's financial failure should provide many salutary lessons for issuer and investor alike. This article considers the reaction of sterling bond market to Railtrack's demise. It attempts to avoid conjecture as to the appropriate outcome for investors but looks more at the consequences of the administration for the market and other borrowers.

Railtrack plc bond issues 7 October 2001

- £135m 9 1/8% bonds 2006
- £350m 5 7/8% bonds 2009
- £100.679m 9 5/8% bonds 2016
- £300m 7 3/8% bonds 2022
- £259m 5 7/8% bonds 2028
- £400m exchangeable bonds 2009
- €11.5m index-linked bonds due 2009

BACKGROUND. As the operator of a regulated business, Railtrack plc, the principal operating subsidiary and main borrower in the Railtrack group, was subject to a special administration procedure under the Railways Act. The Secretary of State had applied for the Administration Order after refusing to advance grant payments to ease the company's financial problems.

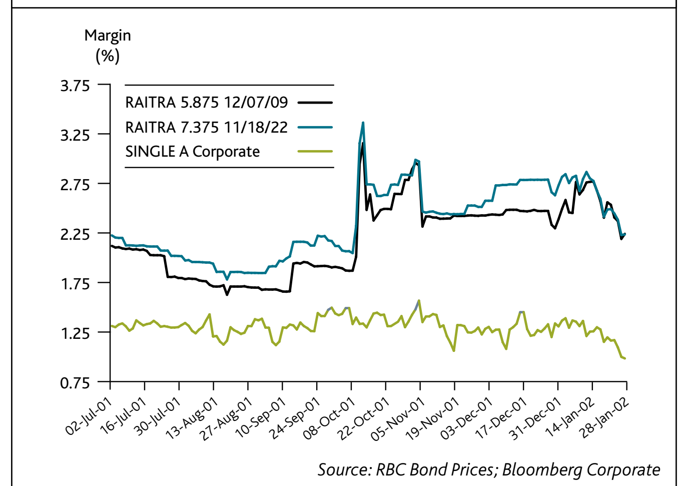
As a result of the order, proposals were made to each class of financial creditor. A standstill agreement was offered to bondholders, whereby, in return for amending certain terms of their facilities, the public sector would continue to ensure timely debt service. Those who refused had to 'take their chances'.

The Secretary of State also announced his support for a company limited by guarantee (CLG) as successor to Railtrack. Without shareholders, it was clear this would have to be largely term debt funded and would need a robust investment grade credit rating. After a very public debate, threats, proposals for the repurchase of the bonds and adjourned meetings, EGMs of each class of bondholders (except for the time being the exchangeables) agreed the standstill. They await the bid from the CLG and clarification of how they will be accommodated by the successor company.

THE MARKET'S REACTION TO DATE. The performance of Railtrack's bonds reflects a predictable reaction as traders marked out prices during the uncertainty immediately following the appointment of the administrator. Investors feared becoming forced sellers as the bonds fell below investment grade. As the

FIGURE 1

RAILTRACK BONDS' PERFORMANCE SINCE JULY 2001.



Source: RBC Bond Prices; Bloomberg Corporate

ratings stabilised during the period of unconditional government support, prices were marked up, only to underperform again, as confusion abounded ahead of the EGMs to agree the standstill.

More recently, Railtrack bonds have found buyers – they are the cheapest 'assumed' investment grade bonds (with the exception of

some telecoms) in the market, and a number of investors are confident that they are buying into a recovery story.

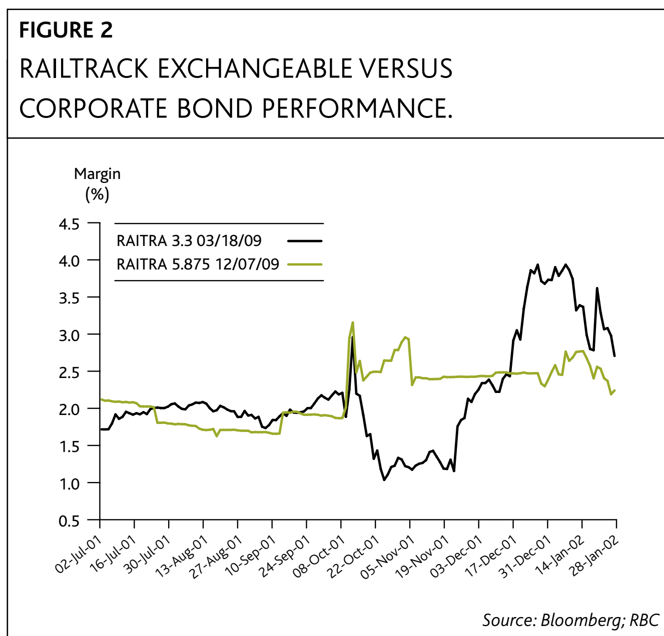
The margin on the exchangeables (which carry rights to Railtrack Group plc shares) on the otherhand, tightened sharply. This seems counter-intuitive given that, even ahead of the administration order, the option (with a strike price of £18.40) was heavily out of the money. The sharp improvement in price was driven by the credit derivative market whose participants discovered that the exchangeables were deliverable under credit derivatives contracts at par value.

Further analysis of the market's reaction to events highlights a number of factors, four of which are considered below:

- investor dependence on credit ratings;
- the value of covenants;
- conflicts; and
- administrative difficulties relating to bonds.

FIGURE 2

RAILTRACK EXCHANGEABLE VERSUS CORPORATE BOND PERFORMANCE.



Source: Bloomberg; RBC

USE OF CREDIT RATINGS. The increasing reliance of investors on credit ratings is familiar to all market participants. In an increasingly regulated and benchmarked environment, rating provides an external yardstick for investment professionals (although the agencies themselves remain unregulated in the UK).

Given this dependency on ratings, the agencies have had a difficult time in reminding the market of the limitations of their opinions. Principally, the Railtrack situation has illustrated:

- the subjective nature of ratings, especially where an essential service, such as the rail network, is involved; and
- the difficulty of predicting the effects of a catastrophic event.

The latter is the realm of portfolio theorists. But any subjective view based on circumstantial or prima facie evidence is open to – and should be subject to – reasonable challenge. Public sector arrangements abound with comfort letters and keep-wells which imply financial support, but do not state it lest the obligations come back onto the Public Sector Net Cash Requirements (PSNCR). Elsewhere, judgements are made about whether a service is so essential it cannot be allowed to fail. Investors should ask themselves whether they are in any worse position than rating agents to make these judgements.

To protect their position, the agencies have indicated that they are likely to become more active and may be inclined to announce more ratings changes rather than outlook changes. This rating migration risk (that is, likelihood of change in the rating) will cause greater volatility in the market. Greater volatility means higher cost of capital and/or a call for more rating related covenants.

COVENANTS. When ratings fail to live up to expectations, investors often fall back on covenants. Vociferous demand for restrictive covenants tends to follow periods of increased event risk (for example, 1988/90 post-RJR Nabisco and Hoylake, 1999-2000 post-leveraging and other corporate activity) but comes to an end when demand for bonds outstrip supply, as in 2001. So we might expect Railtrack's failure to have rekindled investors' demand for covenants.

TABLE 1

RECENT CREDIT RATING HISTORY OF RAILTRACK BONDS (NON-EXCHANGEABLE).

	1/01	4/01	5/01	8/10/01	9/10/01	11/2/01	1/02
S&P	A*-	A		A*-	C	BB+*	
Moodys	A2*-		A2		Baa1*-		

The beneficiaries of this increased diligence are likely to be the radically restructured utilities (particularly water). Investors are being offered the opportunity to buy highly covenanted, structured bonds where rating attempts to be forward, rather than backward, looking. I anticipate an increasing trend to value structured, senior bonds of a similar credit rating more highly than corporate offerings. This may be confirmed by the funding structure put in place for Railtrack's successor. Ironically, it is the rating agents which dictate the structure and the value of the covenants, so investors are again dependent on their risk analysis.

CONFLICTS. Bondholders are familiar with the conflict between the interests of debt and equity providers. In regulated businesses, other stakeholder interests have to be considered. Railtrack has highlighted the fact that bondholders are in an increasingly strong negotiating position because:

- the traditional equity model is seen as failing for many businesses and the solution is much higher leverage. The support of the long-term bond market is essential, not only for the success of Railtrack's successor, but also the private finance initiative and corporate borrowers; *but*
- bondholders must be cautious as the old, known conflicts are replaced by complex new ones with various stakeholders, including mezzanine debt providers, customers, regulators and government.

There is some evidence already that rating agencies and investors are being more diligent in reviewing the legal and practical regulatory framework imposed on a number of utilities and monopolistic businesses and the conflicts this can create.

ADMINISTRATIVE DIFFICULTIES. Whether the administrator or Railtrack's successor will offer to repurchase the bonds, the conduct

'THE BOND MARKET IS ROBUST IN THE FACE OF CORPORATE DEFAULTS AND REACTS MORE TO THE MACRO FACTORS OF SUPPLY AND DEMAND AND DETERIORATION IN THE GENERAL CREDIT ENVIRONMENT'

of the administration has highlighted a number of areas of difficulty related to buying back or changing the terms of fixed rate bonds.

In terms of redeeming bonds, cost is the main problem when prevailing rates are low. Early repayment may be advantageous to borrowers, but investors also realise that, at times of low liquidity, the issuer may be the only bid in the market. The Spens clause (the formula for ensuring that, on early redemtion, bond holders can protect their return by reinvesting in gilts) is now out of date and, generally, borrowers are negotiating their way around it. Even if the administrator chose to repay the bonds, given that various stakeholders in Railtrack are likely to receive very little or nothing, it would be difficult for them to pay full Spens compensation. A positive result of the Railtrack negotiations would be a debate about the future of Spens.

A material change in terms, such as early redemption at a negotiated price, is likely to require an EGM of often unknown, unregistered bondholders. Confusion seems to have beset Railtrack's EGMs, as the complex voting instructions were not adequately explained to the back offices of the various investors. Failure to understand voting procedure can result in the rights of a significant minority (or a lazy majority who do not vote) being overruled by a group of unexpected holders. Many long-term savings institutions may be surprised how influential the credit derivatives market now is in the bond market.

The bond market is robust in the face of individual corporate default and reacts more to the macro factors of supply and demand and deterioration in the general credit environment. So could the consequence of Railtrack's restructuring be a flood of issuance and widening credit spreads? The Government has not been shy in indicating the expected private sector investment in the rail network – the bond market, with its long maturities, will present the most attractive source of funds. In addition, 2002/2003 will see net issuance of gilts for the first time in a long while.

But with a large number of scheduled 2002 bond redemptions producing cash to be invested this year and a continuing asset allocation out of equities into fixed income, most do not think that oversupply will be the problem.

A greater risk is a sudden readjustment in all spreads, given that current levels may not be justified in light of increasing credit risk. In this environment, the CLG will have to convince investors and the rating agencies that the new structure can weather complex regulation, stakeholder conflicts and ambiguity in Government policy…and it must get the trains to run on time.

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