UK'S FIRST HYBRID DEAL

A nice package

Executive summary

- Rexam's €750m 60-year 6.75% hybrid was priced at euro-mid swaps plus 190 basis points. It was accompanied by a 9.9% equity placing to raise £286m that, combined, supported its BBB and Baa3 corporate rating.
- The group was keen to find a financial solution that worked for its shareholders by minimising dilution; was attractive from a debt holder perspective – which meant maintaining Rexam's investment-grade ratings – and was also cost-effective when compared with other financing options. It was also vital to get comfort on the tax treatment.
- The key to the hybrid's success was getting the structuring right. The process is very different from issuing a senior bond, where the terms and conditions follow a familiar path.

Packaging group Rexam made the headlines in June, when it completed a €750m hybrid bond deal that marked the European corporate bond market's first corporate hybrid security to be sold by a British company.

The deal, which was managed by Barclays Capital and Citi, followed Rexam's disposal of its glass business and two acquisitions it was contemplating to develop its beverage can and packaging capacity. The first was the purchase of North American manufacturer O-I Plastics, which was subsequently completed in June for $1.8bn. The second, a $300m deal to purchase two plants in Russia from Rostar that will provide additional beverage can capacity, is scheduled to complete later this year subject to Russian regulatory approval. Proceeds from the hybrid bond are being used in the funding of both acquisitions.

ENTHUSIASM IN EUROPE While Rexam is the first UK corporate to embrace the concept, hybrid bonds first appeared more than two years ago and have been enthusiastically promoted in Europe by investment banks and ratings agencies. Khalid Krim, European Head of Hybrid Capital Structuring at BarCap, says that they have proved successful ever since Moody's and Standard & Poor's redefined their guidelines at the start of 2005 and the market for European hybrids got under way. Hybrids have proved particularly popular with German companies to finance mergers and acquisitions; they have also been regularly used in France, Italy and Spain, and there are examples in Sweden, Denmark and Belgium. To give a recent example: hybrids are expected to form part of the refinancing for German manufacturer Heidelberg Cement's £7.85bn offer for Hanson in May.

THE ATTRACTIONS OF HYBRIDS Advantages include the fact that companies can use them to avoid diluting the stakes of shareholders by issuing extra shares and the ratings downgrade that often accompanies a debt-financed acquisition. However, Krim adds that while they can be used by companies to maintain their rating, they "don't make a bad company good".

As strategic instruments, they also have a positive impact on the company's earnings per share figure, which has led many issuers to come to regard the product as "cheap equity" rather than expensive debt. Peter Jurdjevic, European Head of New Products at Citi, notes that a company can optimise its capital structure by inserting a hybrid layer in its capital structure that creates a tax shield and lowers the company's cost of capital.

Rexam's own €750m 60-year 6.75% hybrid, which was priced at euro-mid swaps plus 190 basis points, was accompanied by a 9.9% equity placing to raise £286m that, combined, supported its BBB and Baa3 corporate rating. The hybrid is tax-deductible, accounted for as debt, but attracts 75% equity treatment by Moody's and 50% by S&P.

The group was keen to find a financial solution that worked for its shareholders by minimising dilution, was attractive from a debt holder perspective – which meant maintaining Rexam's investment-grade ratings – and was also cost-effective when compared with other

THE LANDMARK DEAL FROM REXAM, THE BEVERAGE CAN AND PACKAGING MANUFACTURER, IN THE EUROPEAN CORPORATE BOND MARKET MARKED THE VERY FIRST HYBRID FROM A UK CORPORATE. **GRAHAM BUCK** REPORTS.

financing options, explains Jon Drown, Rexam's Director of Group Treasury. A hybrid made a lot of sense as "it ticked all of the right boxes".

However, the timing was also very fortunate. Rexam had "only a fairly limited window of opportunity". Market conditions had already shown the first signs of their subsequent deterioration by mid-June and, within days, the sub-prime mortgage crisis in the US had begun to deepen. "We were very aware that the biggest risk to the transaction was that the benign market conditions prevailing at that time could change rapidly, leaving us 'on risk'," says Drown.

The group put in place a senior bridging facility that could be used if needed; principally if market conditions had made it difficult to issue the hybrid bond prior to completion of the acquisitions. Rexam might well have had recourse to it were the transaction attempted today; conditions having become much less favourable since June. As it transpired, it managed to limit its time 'on risk' to only a couple of weeks, a period that included a European roadshow to promote the transaction to investors.

GETTING THE STRUCTURE RIGHT Drown cites the key to the hybrid's success as getting the structuring right and says work on this began early on. He says the process is very different from issuing a senior bond, where the terms and conditions follow a familiar path.

"Every clause needs to be considered both on its individual merits and on how it fits into the overall package that is being put together for investors," he says.

"We had a clear structuring 'wish list' that we had to make sure was consistent with obtaining the right tax, accounting and rating agency treatment, and which would result in a product that was attractive to investors. This balancing act ran right through the structuring phase."

The entire structuring process took 12 weeks, an apparently lengthy period but one that was needed because of the complexity and the inclusion of features not previously seen in the hybrid market. Drown praises the "high level of intellectual capital and original thinking" that was provided by the hybrid teams at BarCap and Citi.

The innovative nature of many of the features also meant that "suggestions and options we put forward to the new instrument committees of both Moody's and Standard & Poor's had to be analysed for their effect on the hybrid".

"The most important task in structuring Rexam's hybrid offering was to ensure that it met the company's funding objectives," says Jurdjevic, "while being market-friendly, so that potential investors could focus on the Rexam credit story without being distracted by the securities' structural features."

And as it was a key objective for Rexam to preserve its senior ratings, running alongside the bond structuring was a workstream to evaluate the overall rating implications of the proposed transactions. The group approached the ratings agencies in advance to confirm that the eventual package would actually achieve the desired ratings outcome. Although it presented them with "quite a challenge" in analysing some unfamiliar new features, the agencies managed to turn the analysis around and sign it off in little more than a week.

At the same time, Rexam wanted maximum flexibility in developing the structure while also protecting itself against future changes of view by the ratings agencies. As it transpired, S&P subsequently changed its methodology on a particular point just prior to the bond's launch, but agreed to protect the status that it had informally agreed to via a process known as 'grandfathering'.

Such protection is becoming more common, with agencies willing to grandfather transactions where they do change their initial views.

As outlined earlier, an advantage of a hybrid meeting certain requirements is that it achieves equity credit. Rexam, which wanted an overall financing package that maintained its investment-grade ratings, was able to test the equity credit applied by the agencies as the structuring of the bond developed.

ROADSHOW TO SMOOTH THE PATH Rexam further smoothed the path by carrying out a four-day European roadshow in France, Germany, the Netherlands and the UK to promote the deal and explain its "investor-friendly structure" to 100 prospective investors.

The work paid off, with many of this audience subsequently putting in orders and the offer was heavily oversubscribed. Total demand came in at €6bn against the target of €750m, with some individual orders exceeding €250m. The enthusiastic response included approving comments from banks unconnected with the deal, which observed that the terms compared favourably with similar European deals executed at significantly wider margins.

"It's interesting just how many investors praised the structure," comments Drown. "Feedback received during the roadshow suggests not all deals to date have had as much attention paid to the structuring, and while you can still get them out the door when market conditions are favourable, they will not achieve the tightest price possible."

While Rexam's success has broken the ice for UK corporates, it eventually opted for a euro hybrid, meaning that investors are still awaiting the first UK hybrid bond in the sterling market. The group initially considered a dual tranche – one in euros and one in sterling – for its offering, but decided its funding requirement wasn't big enough to merit a benchmark-size issue in both currencies.

"We therefore took the view that the euro market was likely to have the deeper demand base and we would be able to raise our

target funding from just the euro market – which, in the event, proved correct," says Drown.

"We did take soundings on sterling hybrid demand, though, and it was pretty clear that the demand is there for a sterling hybrid. When an issue does eventually take place, it should prove very successful."

Given Rexam's success, why haven't more UK companies used hybrids to date? One explanation is that company boards must be comfortable with the whole concept of a hybrid and the issue of tax deductibility has raised concerns.

Krim reports that BarCap had indications from top legal firms that the tax issue was unlikely to prove a sticking point, but adds: "It's actually difficult to structure a hybrid unless and until you have an actual deal to work on."

Jurdjevic observes: "Some market participants had expressed reservations about the interplay between UK tax principles and the rating agencies' equity credit requirements, but Rexam's offering demonstrates it is possible to satisfy both sets of criteria, although, as is the case with any debt offering, a UK issuer must have a good business purpose for executing the transaction."

"Certainly it is vital to obtain a high level of comfort on the tax issue," says Drown, who adds that Rexam sought formal opinions from its accountants and lawyers, as well as separately canvassing the views of a QC.

And, as is the case with any new financing instrument, a considerable amount of due diligence on the implications is required before a hybrid can or should be issued; significantly more than something more 'vanilla' would need.

IN VOLATILE CONDITIONS At the time of writing, another unanswered question is whether hybrids can perform in the current, more volatile market conditions.

"When we were originally considering our offering, a big worry was the knowledge that benign credit conditions couldn't last forever and we wanted to get the deal done before the correction happened," says Drown.

Having duly arrived since then, the recent deterioration in conditions means the remaining months of 2007 are likely to evidence a pent-up demand for bonds.

However, although investors have a lot of liquidity that they need to put to work, he believes it will be difficult for hybrids to perform well in these more difficult conditions, "especially a hybrid in the crossover space such as ours as the lower-rated credit markets are usually those to close down first when conditions become volatile, although we are pleased to see that our hybrid has widened considerably less than the benchmark crossover index".

But Drown is optimistic over their long-term prospects and believes that, in sitting somewhere between debt and equity, they make a valuable contribution to a company's capital structure.

"With hybrids having been used very successfully in mainland Europe by a range of blue chip corporates, it's clear that more UK companies are now getting seriously interested."

Jurdjevic agrees that now Rexam has paved the way for other UK issuers, follow-on hybrid issuance from UK issuers is likely. Hybrids offer an attractive financing option in the right situation, in Rexam's case these being acquisitions that created a funding requirement, a commitment to defend its ratings and the ability to develop a bond structure that addressed all of the main concerns.

"There have been suggestions that the investment banks have pushed hybrids because of the higher fees they attract, but that is simply not true in our case," says Drown.

He agrees that they are clearly not right for every situation and carry both a higher margin and fees than senior bonds. However, fee levels are not punitive and the base fee for Rexam's bond was lower than the level of fees being charged for senior bonds a few years ago.

"Set against our objectives this was absolutely the right product," he explains. "We had a clear set of priorities and the funding package we put together delivered what we set out to achieve. The fact that the execution process was so smooth was due in large measure to the expertise and professionalism of both our structuring banks and our other advisors [Allen & Overy and PricewaterhouseCoopers]. There was a real feeling of the whole team working towards a common objective and all the relationships gelled extremely well."

BarCap's Krim believes that Rexam's hybrid is likely to prove the template for further issues by UK companies. Despite the recent market jitters, he expects hybrid issues to be "back up and running" within months.

"The prime motive is to support M&A deals, but hybrids should also be of interest to privately owned companies that don't have access to the equity market, as it allows them to extend their capital base," he suggests.

"A hybrid is a strategic instrument and the fact that companies can use them to avoid earnings per share [EPS] dilution makes them very attractive."

Graham Buck is a Reporter on *The Treasurer.*
editor@treasurers.org

Khalid Krim, European Head of Hybrid Capital Structuring, Barclays Capital
020 7773 2526
khalid.krim@barcap.com

Peter Jurdjevic, Managing Director, European Head of New Products, Citi
020 7986 8978
peter.jurdjevic@citi.com