NO SMOKE WITHOUT FIRE

IMPERIAL TOBACCO
€5.9bn syndicated loan and €2.8bn dual currency bond, March and May 2002.

CORPORATE PROFILE
Imperial Tobacco is the fourth largest international cigarette manufacturer in the world following its acquisition of Germany's Reemtsma in May 2002. It owns many well-known brands including Lambert and Butler, Embassy, Regal and Superkings. It is listed in London and New York and has a current split rating of BBB with Standard & Poor's and Baa3 with Moody's.
www.imperial-tobacco.com

On 7 March 2002, Imperial Tobacco announced it had agreed to acquire 90.01% of the issued share capital of Reemtsma for a consideration of €5.2bn.

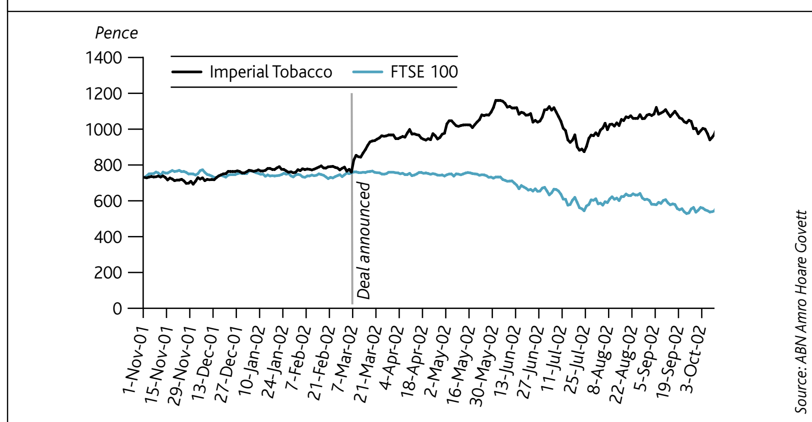
It also entered into an option agreement for the remaining 9.99%, valuing the entire group at €5.8bn. Financing for the acquisition was underpinned by a £1bn rights issue and bridged by a jumbo €5.9bn syndicated loan that has substantially been refinanced most notably with a three-tier €2.8bn dual currency bond, the largest bond issue ever from the tobacco sector.

The transaction seen as a whole sets a very good example of how to fund a large, transforming acquisition in a well-organised and managed way from start to finish.

John Jones, Group Treasurer at Imperial Tobacco, said: "We went to the bank market and raised an incredible amount with the promise that a large proportion would be taken out quickly in the capital markets. We followed it through in a very short space of time."

In fact, Imperial will have raised a whopping £8.8bn from various sources in connection with this acquisition (see *Table 1*.)

FIGURE 1
SHARE PRICE CHART.



PERFECT FIT. Reemtsma was a privately-owned company, with its headquarters in Hamburg, that had interested Imperial for a long time.

Going back to 1996 when Imperial demerged from Hanson, around 85-90% of its business was in the UK. Since then its international profile has increased organically and through acquisitions focusing on Western Europe, sub Saharan Africa, Australia and New Zealand. During the 1990s, Reemtsma headed east with operations in central and Eastern Europe and further across into Asia.

Jones said: "Put together, there is little overlap and a good geographical fit, with both sides staying away from the Americas to avoid the obvious litigation risks."

Imperial manufactures and markets under many well-known brands, including Lambert & Butler, Embassy, Regal, and SuperKings, together with roll-your-own tobacco, cigars, pipe tobacco and cigarette papers. The acquisition of Reemtsma in May 2002 significantly increased market share in Germany, the Ukraine, Russia, Poland and Taiwan, and makes Imperial the fourth largest international cigarette manufacturer in the world.

The acquisition process kicked off in autumn last year and gathered momentum towards Christmas and up to the announcement on 7 March. It was obvious there would be a huge funding requirement and Imperial brought three merger and acquisition (M&A) advisers on board – Morgan Stanley, BNP Paribas and Deutsche Bank, all confident that Imperial had the firepower to make the acquisition. This is extraordinary, because if you look at the balance sheet you would not expect a company with negative equity to be able to pull off a deal of this magnitude.

"The balance sheet is not a true reflection of the business," added Jones. "It reflects how the demerger from Hanson was accounted for – brands taken from Hanson were not capitalised at that time, and it does look strange."

But this does not present Imperial with a problem as its followers measure debt

against market capitalisation and understand its heritage. More significantly, the market appreciates its defensive quality and strong cashflow and perhaps having an obscure balance sheet even helps focus attention on the real issues.

NO FALLEN ANGEL. Imperial has always been committed to maintaining its investment grade rating and has absolutely no plans of becoming a fallen angel.

"It was obvious that we would not be able to finance the whole acquisition through debt," said Jones. "Although tobacco companies are highly cash generative, and the ratios recover quickly, they do take a short dive post-acquisition."

With equity being more expensive than debt and excessive issuance increasing the possibility of share buybacks down the line, financial efficiency dictated a minimal equity injection. The impact on Imperial's credit ratings was assessed using Standard & Poor's ratings evaluation service and Moody's assessment service. Therefore, early in January, the round sum of £1bn was arrived at, which raised a net £983m. The split rating frequently spiced up the acquisition funding but immediately caused Imperial to stop issuing commercial paper from January onwards and replace that funding source with £350m from bilateral lines for the time being.

TABLE 1

BUSY IMPS

Date	Amount *£m equiv*	Amount *€m equiv*	Fund raising
Jan-Mar 2002	350	560	New bilateral lines secured to cover withdrawal from commercial paper markets
7 Mar 2002	3,688	5,900	Syndicated loan (see *Table 2*)
7 Mar 2002	983	1,573	Bridge to rights issue (undrawn)
29 April 2002	998	1,597	Rights issue (gross)
27 May 2002	350	560	Bond issue – tranche 1 (see *Table 3*)
28 May 2002	1,406	2,250	Bond Issue – tranches 2 & 3 (see *Table 3*)
July 2002	163	260	Private placements to complete the refinancing of the 3 yr syndicated loan (see *Table 5*)
TBA	869	1,390	Potential syndicated loans to retire 5 yr tranche of acquisition loan
	8,807	14,090	Total fund raisings brought on by the Reemtsma acquisition

TABLE 2

PRINCIPAL TERMS OF THE €5.9BN SYNDICATED LOAN.

Amount	Term	Fund raising
£250m	4.5 month	Short-term working capital bridge
€2,100m	364-day	Syndicated loan (fully repaid from the proceeds of the bond issue)
€1,400m	3-year	Syndicated loan (fully repaid mainly from the proceeds of the bond issue and two private placements)
€1,390m	5-year	Syndicated loan (to be refinanced through banking market. Watch this space)
€610m	5-year	Vendor Guarantee tranche (to remain as a guarantee until 9.99% option exercised, then as a revolver)

** The margin for all tranches was 175bp over Euribor out of the box, ratcheting down to 150bp after repayment of the working capital and 364-day tranches and 125bp on full repayment of the 3-year tranche.*
Mandated lead arrangers: ABN AMRO, BNP Paribas, Deutsche Bank, JPMorgan, Morgan Stanley, The Royal Bank of Scotland.

THE RIGHTS ISSUE. The £1bn equity issue underpinning the financing was announced with the acquisition on 7 March 2002 by way of a two for five rights issue of 208 million ordinary shares at 480 pence per share, a net £983m. The issue was struck at a 47% discount to Imperial's closing price the night before. It is common for share prices to fall after the announcement of a deeply discounted issue but Imperial rudely bucked the trend and its price rose 9% on the day (see *Figure 1*). The market endorsed the acquisition by taking up 97.4% of the rights and the rump was sold at 940p per share. This issue also took Imperial into the foreign exchange markets big time to swap the sterling proceeds into €1.6bn.

Will Coleman, Director, Corporate Broking at ABN AMRO Hoare Govett, said: "This issue was a tremendous success and a textbook example of how to manage a large rights issue in uncertain equity markets.

"The deal succeeded where others failed because it had the building blocks to succeed – an issuer with an unblemished track record, that had invested considerably in its investor relations over the years, and it was a compelling deal from both a strategic and financial standpoint."

The rights issue was led by ABN AMRO Hoare Govett, with Deutsche Bank and Morgan Stanley also underwriting the issue and providing a two-month £983m bridge to the rights issue in the proportion 70:15:15. The issue was completed before the acquisition was cleared by the European Commission in May and the bridge facility was never drawn.

THE SYNDICATED LOANS. Putting together bridge financing for this acquisition was not easy and Imperial needed confidence early on that it could secure sufficient funds from the banking market, given the magnitude, the purpose and finite number of banks that will lend to the tobacco sector.

Imperial prepared well and already had the three M&A advisers – Morgan Stanley, BNP Paribas and Deutsche Bank – onside to underwrite and arrange the syndication.

Jones added ABN AMRO, JPMorgan and The Royal Bank of Scotland to bolster the group. M&A, equity and additional syndication expertise were therefore brought inside the tent.

Imperial did not have many requirements. It needed €4.2bn of acquisition financing, including a £983m bridge to the rights issue, a £250m short-term working capital facility and €1.3bn short-term working capital facilities to refinance existing facilities and provide committed headroom. The loan was structured for the outstanding amount to be paid down without penalty serving to make it attractive to a broader range of banks that may not like tobacco but could look on it as an asset play. Nevertheless, syndication was a challenge because it had to overcome the split credit rating, sector issues and opening leverage of more than four times Ebitda.

The €5.9bn facility was underwritten over 364 days, three-year and five-year maturities (see *Table 2*) so as to positively encourage early repayment or refinancing. Pricing out of the box was 175bp over Euribor for all tranches, assuming a minimum rating of BBB-/Baa3. The margin reduced to 150bp once the 364-day and short-term working capital facilities totaling €2.5bn had been repaid and down to 125bp following repayment of the €1.4bn three-year tranche. In fact, the margin dropped to 125bp within 85 days of the facility going unconditional.

MOVING GOAL POSTS. With the fairly complex structure of the syndicated loan under documentation, the goal posts moved a little. Reemtsma's vendors wanted to hold onto 9.99% of the stock, but with an option to put the stock to Imperial at any time up until July 2004. (Imperial get to call in the stock from 2005.) A separate non-transferable Vendor Guarantee tranche had to be carved out of the facility to enable the vendors to accept the credit risk of known banks. After the options are exercised, this tranche will revert back to a revolving credit facility and become freely transferable.

It was clear early on that the deal would be a resounding success, with many banks getting lower final holds than they would have liked. A further 22 banks came into the final syndication at various levels according to their status with Imperial. The six MLAs occupied the top level, taking €315m apiece. Imperial carved out the next tier to favour the remainder of its key banking relationships at that time with €250m each. Several banks were clamouring to get a position in this second tier, but Imperial held on to its principles and the remaining banks came in at their preferred take of €160m or at €120m.

Suzy Walls, Head of European Loan Syndicate at Morgan Stanley, said: "Striking a balance between conditions in the syndicated market and critical credit rating objectives, Imperial successfully positioned the event-driven tobacco-related facility to ensure a high hit rate among lenders. The deal was fully placed through the sub-underwriting phase, eliminating the requirement for subsequent sell-down. The asset remains well sought after in the secondary market and continues to trade strongly."

BEAUTIES ON PARADE. The six MLAs came on board in early January. At the same time as discussing the syndicated loan documentation, Imperial beauty paraded them all for the initial bond take out and JP Morgan was appointed as co-ordinator and bookrunner in February.

Later during syndication the second-tier banks were also paraded and each told the same thing – that they would not be informed if they had won one of the outstanding bond mandates until after they had signed up to the syndication. The beauty parade itself sets a good example of how to award a mandate – long gone are the days of who can provide the longest lunch.

Imperial prepared a detailed questionnaire, with 31 capital market-related questions covering four key areas: general, tobacco-specific, Imperial-specific and bank-specific (see *Table 6*). The answers were analysed in a matrix of eight competencies, including their ability to give reasoned arguments. At the same time, Imperial carried out its own review of capital market deals post 11 September 2001 to see who had sold corporate credit into the market in this difficult period and noted that some of the banks had limited recent experience. Knowing that there would be more disappointed banks than euphoric, Imperial ensured the process was as fair and transparent as possible. It spent the same amount of time with each bank and there were sound reasons for disappointment.

Citibank and HSBC were awarded the mandate early on in April to join JP Morgan as joint bookrunners, along with three German banks – Bayerische Landesbank, Commerzbank and West LB.

TABLE 3

PRINCIPAL TERMS OF THE €2.8BN BONDS.

Amount	Term	Marketing range	Margin	Fixed coupon
€750 m	3-year	120bp-125bp	115bp > mid swaps	5.75%
€1,500m	5-year	135bp-140bp	127bp > mid swaps	6.25%
£350m	10-year	170bp	157bp > gilts	6.875%

Bookrunners: JPMorgan, HSBC, Schroder Salomon Smith Barney.

TABLE 4

OTHER €8.4BN RELATED TREASURY TRADES.

Trade	Notional	Purpose
FX	€1.6bn	To convert the sterling rights issue proceeds into euros
Interest rate swaps	€6.1bn	To manage the euro interest rate risk
Cross currency swaps	€0.7bn	To change sterling issuance into euros

TABLE 5

PRINCIPAL TERMS OF THE €260M PRIVATE PLACEMENTS.

Amount	Term	Margin	Arranger
€100m	18 months	3m Euribor + 0.85%	Caja Madrid
£100m	27 months	6%	JPMorgan

The German houses were brought in to capitalise on Reemtsma's name recognition and their ability to solicit demand from domestic investors.

THE BOND ISSUE. The roadshow for the bond kicked off on a Friday and took two teams, with the Chief Executive and Jones in 'Lambert', and the Finance Director and Group Financial Controller in 'Butler', across Europe in private jets not long after the equity roadshow wound down. They met 195 investors from 164 institutions in six days and achieved a resounding take-up of 80% as "it was very easy for investors to buy-into the story," said one of the bankers who went on the road show.

Imperial initially went out drumming up support for a 10-year sterling tranche with five-year euros and met with such overwhelming demand and reverse enquiry that a three-year euro tranche was bolted on.

The bonds were issued out of a €6bn debt issuance programme that was increased in May 2002. The £350m 10-year tranche was marketed at about 170bp over gilts. It attracted the most demand, coming in at more than four-and-a-half times oversubscribed at 157bp. It was so successful that the books were closed a day early on 27 May. The maximum amount Imperial was prepared to issue in the 10-year maturity was £350m, yet the tranche still made the record books by being the largest sterling bond issued by a Baa3-rated non-telco corporate. (See *Table 3*.)

IMMEDIATE COST SAVINGS. The euro tranches were also priced well inside the respective marketing ranges at 115bp for the three-year and 127bp for the five-year. At €1.5bn, the five-year was the largest Baa3 issue from a corporate in the euromarket ever. The €2.8bn bonds refinanced portions of the syndicated loan priced out of the box at 175bp, yielding immediate cost savings. Imperial offered a coupon step-up it views as academic because it is never expected to kick in and would be contrary to its commitment to maintain investment grade. Imperial held a derivatives auction immediately after the bond issue and swapped the sterling proceeds into euros and all the fixed coupons into floating. (See *Table 4*.)

Peter Capel, Vice President at JPMorgan, said: "Imperial's strategy of being very upfront, wishing to complete its bond refinancing in one transaction, galvanised investor attention and enabled the borrower to retain the pricing initiative.

"Riding the momentum of the equity roadshow and rolling straight onto the bond refinancing proved to be exactly the right strategy, in what has proved to be an increasingly difficult corporate bond market – especially for BBB-rated credits."

PRIVATE PLACEMENTS. Since then, Imperial has fully repaid the outstanding balance on the three-year syndicated facility, with the proceeds of two private placements also issued out of the €6bn debt issuance facility in July (see *Table 5*.) The first, through JPMorgan, yielded £100m for two-and-a- quarter years and the second, through Caja Madrid, raised €100m for 18 months, with both shortening Imperial's maturity profile.

Today, there is €2bn outstanding on the acquisition loan and, although bearing interest at a more palatable 125bp, the likelihood is that the €1.39bn syndicated portion will be refinanced. The September year-end trading statement fuelled such speculation when Imperial acknowledged that the £40m financing fees incurred on the acquisition had been fully written off.

This refinancing would bring the sum of Imperial's acquisition financings to €14.1bn, together with €8.4bn in related treasury trades in the foreign exchange and swaps markets.

Many companies will not see that amount of action in a lifetime, let alone nine months.

TABLE 6

SELECTED EXTRACTS FROM THE QUESTIONNAIRE.
(Employed as One of the Tools Imperial Used to Select the MLA's for the Bond Issue)

General
Provide a schedule of all corporate bond issues in Euro and sterling rated A or lower during 2001 and 2002 to date. Which of these have gone particularly well or particularly badly and why? Please comment on recent issues that are relevant for an Imperial issue (eg Gallaher, BAT, mmO2?).
Tobacco specific
Provide a spread history of the representative tobacco bonds over the last few years and provide commentary where necessary. In what respect do you believe that tobacco litigation would impact on any bond issue? What "tobacco premium" would you see Imperial paying versus a generic BBB / BBB- credit and how has this "tobacco premium" changed over the last few years?
Imperial specific
What would you recommend Imperial issue in respect of size, maturity, currency and other features? Please justify. What is your view on coupon step-ups and how do you think investors perceive them? Give examples of the major concerns investors will focus on for Imperial at this time.
Bank specific
What particular skills do you feel you would bring an Imperial bond issue? What would be your target investor group for an Imperial issue? Please provide details of the transaction team that you would propose to use on an Imperial transaction, including CVs.

JOHN JONES' TRANSACTION HIGHLIGHTS

- Maintaining momentum full on for nine months.
- Plunging into so many markets with so many instruments in such a short space of time.
- Looking forward to a bit more action in 2003!