TRUE DUTCH COURAGE

■ KPN
KPN €5bn 'hard' underwritten offer of primary stock, 7 December 2001

■ CORPORATE PROFILE
KPN is a Dutch telecoms company focusing on three core activities in three countries: at home in the Netherlands on fixed network, mobile and IP/data lines, and on mobile in Germany (E-Plus) and Belgium (BASE). Almost 40,000 employees serve around 13.4 million mobile customers and 7.9 million fixed lines. The shares are listed on the Amsterdam, Frankfurt and London stock exchanges, with ADRs listed in New York.
www.kpn.com

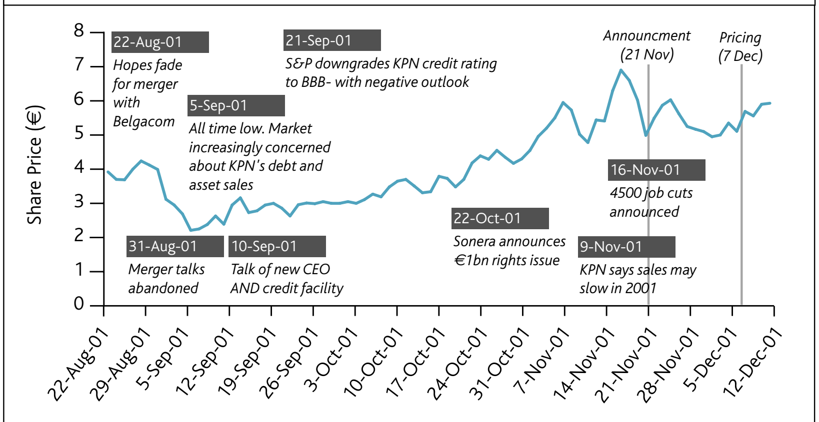
On 21 November 2001, Dutch telecom giant KPN announced a €5bn equity offering, with preferential allocation to existing shareholders that increased its share capital by 83% without wrecking the share price. It has been variously described as "taking KPN off the critical list", "their saving grace", "pretty ballsy" and "a stonking good deal".

A total of 1.02 billion shares were sold at €4.90 per share through a structure that allowed KPN to tap a wider universe of potential buyers and discouraged arbitrageurs from raiding the offering.

DIRE STRAITS. KPN was in dire straits in the summer of 2001. The €9.2bn spent acquiring Germany's E-Plus and €8.4bn for its UMTS licenses increased net debt to €22.3bn in less than 12 months and brought about multiple credit downgrades. The share price fell from a pinnacle of €72 per share in March 2000, to €38 per share before Germany's UMTS auction and down to an intra-day low of €2.03 on 6 September 2001 (see *Figure 1*). Successive attempts to strengthen the balance sheet with equity failed along the way, including merger discussions with Belgium's Belgacom that were abandoned in August. Even worse, a €5bn rights issue was scrapped in June 2001 after a fatal leak caused the share price to plummet 40% in just three weeks and the little Dutch boy was not around to plug the hole.

One of the bankers onside said: "If they hadn't had most of their debt in bonds, they would have been buried".

FIGURE 1
KPN'S SHARE PRICE UP TO 12 DECEMBER.



MONSTER RESCUE. KPN's Supervisory Board recommended the appointment of Cazenove immediately after the abandoned rights issue, which confirmed that "KPN needed an injection of equity to provide a permanent one-time solution to all their difficulties – a monster rescue equity issue to get debt off the agenda and eliminate any lingering doubts about the financial viability of the company."

As a prerequisite, KPN had to ensure it had credible top management in place and shore up liquidity.

By September 2001, the stock was in free fall, the bonds were well into junk bond territory and trading at 1,500bp over swaps. The board acknowledged there was a risk of not being able to repay €3.5bn due the following June.

Maarten Henderson, Finance Director, said: "The CEO designate demanded financial headroom in the form of a multi-billion euro credit facility before he would accept the appointment and I was given one week by the Supervisory Board Chairman to do the necessary."

The lending banks were called in.

Several bankers have said they arrived on Wednesday with one shirt and were unable to leave until Sunday after their banks had agreed to step up to the plate. KPN needed a €2.5bn facility to tide it over until 2004 but were not able to offer any traditional basis for obtaining credit approval. As the terms and negotiations got tougher, more banks were brought in and after four sleepless nights palatable terms were agreed but not at arm's length. The word "duress" has been mentioned.

Henderson had brought such pressure to bear at the top levels of KPN's core banks that he secured a new facility available in virtually any circumstance compared with the expiring facility where key covenants would have been blown. The final eight banks committed €312.5m apiece for three years and the deal was signed in the evening of 9 September 2001.

Carl Tack, Managing Director of Global Telecoms Group at Deutsche Bank, said: "The bankers concluded that the loan amount was not large enough to see KPN through 2004, but they had no better ideas at the time. The choice was lend or trigger bankruptcy within nine months. Had the signing of the facility been delayed just two days, the events of 11 September 2001 would have blown KPN up – the loan would not have been signed, the CEO would not have come on board and there would have been no equity deal."

The €2.5bn loan facility and appointment of the new CEO, Ad Scheepbouwer, were announced on 10 September 2001. With the liquidity backstop and Scheepbouwer on board, the new broom could sweep in a business strategy focusing on core assets and markets, a simplified organisational structure, headcount reductions and cost-cutting plans. Henderson and Tigelaar, both untainted by KPN's rapid downfall, revived their plans for a €5bn equity issue with Cazenove on 10 September. The next morning, KPN began negotiations with the first bank and ABN AMRO and Deutsche Bank were appointed to lead the transaction.

They went to extraordinary lengths to maintain secrecy – operating on a need-to-know basis with assignations with bankers in remote two-star country hotels.

DRIVING A HARD BARGAIN. An equity injection of €5bn was essential and after the debacle of the previous attempt success had to be assured. With the new corporate strategy and story for the investment case in hand, Cazenove advised the further essentials: the issue structure must minimise market risk; a substantial marketing effort must take place by the CEO and CFO in front of big pools of money; the rating agencies must confirm a stable outlook on the basis of a successful offering; and the Dutch government had to participate pro rata to its existing shareholding. KPN was also eager to honour existing shareholders.

The Dutch government guaranteed it would take up 34.7% of the offering pro rata to its shareholding sending the market very positive vibes – a government official put the magnitude of this undertaking into perspective when he compared it to the total cost of a mass transit railway system running from the north to the south of Holland.

The remaining €3.3bn was underwritten upfront on 21 November at €2.75 per share, a discount of 29% to the prevailing theoretical ex-rights price, but allowed for upside during the two-week book-building period. The structure allowed the issue to be priced without deep discounting to secondguess the price at which the whole amount would clear in the market. In the event they could have got the whole €5bn away at more than €5 per share.

CLEVER CONSTRUCTION. The issue itself was cleverly constructed. KPN took full advantage of Dutch law that can permit huge offerings without pre-emption rights for existing shareholders or the need for tradeable allotment letters, UK-style. But KPN chose to give its shareholders preferential allocations, allowing them to follow the company but not benefit from any value attributable to the bonus element of the 'rights' – or, in this instance, shareholder identification units (SIUs). However, the bonus element was minimised by pricing very close to the prevailing market price.

The preferential allocations were administered by way of non-tradeable SIUs dreamt up in some out-of-the-way hotel in Holland. KPN invited shareholders to subscribe up to €4.05 for each of their existing shares. However, it was guessing as to the ultimate price per share or the number of shares it would receive until book building closed. In short, shareholders knew how much they would have to pay, but not what they would be getting in return. Despite this ambiguity, about 60% of shares were purchased by existing shareholders, including the Dutch government.

The structure afforded investors protection against substantial dilution, while enabling the bookrunners to attract new investors and to price at the close of book-building, combining the best qualities of a rights issue and book-built offering. Both existing shareholders subscribed through SIUs and new investors paid the same issue price for the shares. However, shareholders subscribing through SIUs received guaranteed allocations, a clear benefit as the book for the remainder of the transaction was about four times covered. Further, by making sure there was no market in the SIUs it was difficult for hedge funds to short the stock, and over the two-week book-building period the price moved down just 15% from €6.02 on the day before announcement, to €5.11 on the last day of book-building.

WORLDLY WISE. The eight relationship banks were duly compensated for putting their hands to the fire on 9 September. ABN AMRO Rothschild and Deutsche Bank were joint global co-ordinators and joint bookrunners, taking 15% of the underwriting commitment, while of the joint lead managers Dutch ING and Rabo Securities took 15% each, and the remaining international core banks – Bank of America, Credit Suisse First Boston, JPMorgan and Schroder Saloman Smith Barney – each risked 10% of the €3.27bn two-week exposure.

The offering increased KPN's market capitalisation by €5bn that together with asset sales brought net debt down to €15bn at the end of June 2002. This addressed the imbalance between debt and equity. Interest charges hitting the P&L have reduced accordingly.

Investors were also rewarded with a 21% return between pricing on 7 December and close of trade on 12 December 2001 as the enormity of the issue's achievement sunk in.

Perhaps it is not so obvious that the hard underwriting agreement related to an issue size of €5bn. At the underwritten price of €2.75 per share, simple arithmetic deduces that 1.8 billion shares would have had to be issued. A courageous 149% increase over the prevailing number of issued shares and the company, the underwriters and the Dutch government were all up for it.

■ MAARTEN HENDERSON RECALLS

- Trying not to arouse suspicion while sneaking out to attend meetings without perjuring myself.
- Clandestine meetings with the core team in little hotels where the shareholder identification units structure was invented and switching over to harmless topics, such as bicycles, anytime a third-party came within earshot.