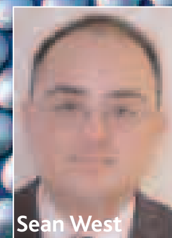
AN IMAGINATIVE REFINANCING HAS REALIGNED LAND SECURITIES GROUP'S FUNDING WITH ITS BUSINESS OBJECTIVES. **STEPHEN LEUNG,** CORPORATE FINANCE DIRECTOR, AND **SEAN WEST,** TREASURER OF LAND SECURITIES GROUP, REPORT.

Stephen Leung


Sean West

Evolution in the capital markets

Land Securities Group plc is the largest quoted property company in the UK. The group's liability structure had evolved over time and comprised legacy long dated public and private debentures and approximately 60% unsecured bonds and bank debt. The debt structure was put in place between 1963 and 2003 with coupons of up to 10%. The Group had adopted a predominantly unsecured debt strategy to fund incremental capital requirements with a stated intention of targeting an unsecured rating in the 'A range'.

Management had become increasingly concerned that the dependence on unsecured debt for future funding could increasingly constrain the business strategy of the Group. It appeared that the quality of the £9bn investment portfolio, which covered unsecured

Executive summary

- Land Securities' management initiated a debt policy review in late 2003, to address concerns that the company's dependence on unsecured debt for future funding could constrain its business.
- A hybrid approach was developed with Clifford Chance and Citigroup which allowed the Group the flexibility it required to change and develop its portfolio, while providing ratings stability to the company and its investors.
- The refinancing meant the group had to be restructured, and it was split into two wholly owned sub groups, a Secured Group, and a Non-Restricted Group.

debt over four times, was not appropriately reflected in our unsecured rating (A-). This rating reflected the significant strategic flexibility that the unsecured debt theoretically gave us, but which in practice the group was unlikely to use to its full extent. In addition the Group wished to have greater freedom to undertake joint ventures with their own secured debt – a common feature in the property sector. However, the use of secured debt, even on a fully non-recourse basis increases the risk that the unsecured rating would be downgraded – a 'notching' of the unsecured rating could occur if priority debt exceeds circa 20% of assets, not withstanding four times unencumbered asset cover for unsecured debt.

During late 2003, a debt policy review was initiated to investigate alternative debt strategies.

A NEW CLASS OF DEBT… A view was reached quickly that a debt strategy based entirely on secured Commercial Mortgage-Backed Securitisation (CMBS) financing would not be appropriate. The Group comprises a diverse property asset base and requires the flexibility to change and develop the portfolio. In conjunction with Citigroup and Clifford Chance, an alternative hybrid approach was developed using techniques from CMBS/whole business securitisation but retaining some of the operational flexibility offered by unsecured debt. An initial £6bn of the Group's assets were put into a new structure, forming a secured sub-group within the overall Land Securities structure.

The core principle is that the company's flexibility is determined with reference to the level of leverage. Loan to Value (LTV) and Interest Cover Ratio (ICR) levels trigger different covenant packages – at low levels of leverage the operational flexibility is in effect similar to an unsecured debt issue however as leverage and financial risk increases, a covenant package more akin to a CMBS comes into effect so as to mitigate the overall financial and business risk of the Secured Group. Importantly, the structuring around the Secured Group would allow senior debt with a AA rating to be issued, while subordinated debt is expected to be rated single A. A key difference in these type of secured corporate ratings is that they are structured ratings that are assessed through to insolvency and not based off the typical corporate horizon of three to five years. This will provide ratings stability to both the company but equally investors.

The new structure would also allow the company to ensure that both bond and bank investors were treated equally as they would sit side by side benefiting from the same reporting, covenant and security package. This clearly would be an improvement to the myriad of (often inconsistent) documentation that had been accrued over the years. From a practical perspective, the monitoring of the company's obligations under its lending agreements was significantly streamlined.

In order to facilitate the refinancing, a corporate reorganisation was required and resulted in the Group being legally split into two wholly-owned sub-groups, a 'Secured Group' and a 'Non-Restricted Group'. The Secured Group, which initially comprised £6.2bn of investment properties, is used as collateral for all secured debt. All secured creditors in the secured group are required to sign up to the Common Terms Agreement (CTA) which contains common covenants – bank, bonds and swap counterparties all benefiting from the same security. Different rights are provided to secured creditors depending on their ranking.

The Non-Restricted Group has the freedom to choose the manner in which it funds incremental investments. This may take the form of loans from the Secured Group, unsecured debt, or alternatively by raising project-specific funding. However, the structuring around the Secured Group means that the funding activities of the unrestricted Group have no impact on the rating of the Secured Group.

THE NEW STRUCTURE WOULD ALSO ALLOW THE COMPANY TO ENSURE THAT BOTH BOND AND BANK INVESTORS WERE TREATED EQUALLY AS THEY WOULD SIT SIDE BY SIDE BENEFITING FROM THE SAME REPORTING, COVENANT AND SECURITY PACKAGE.

THE STRUCTURE, A BIT OF DETAIL… The LTV and ICR ratios determine the covenant tier level that applies and determines the parameters within which the Secured Group must operate. (see *Table 1,* Page 46). Ratio calculations are tested on a self-certification basis supported by semi-annual property valuations already undertaken as part of the existing financial reporting.

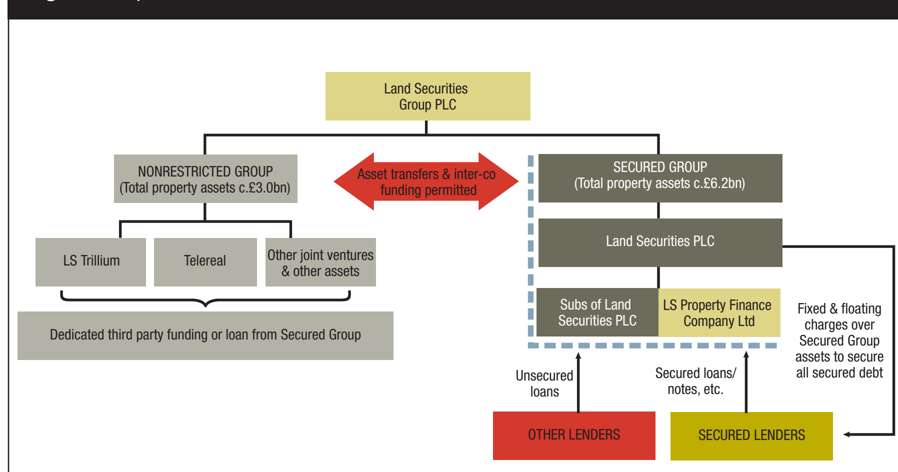
The covenant package addresses tenant concentration limits, sector and geographical diversity, the amount of development, debt maturity restrictions and hedging requirements amongst others. These covenant packages were defined with the business strategy clearly in mind. Accordingly significant input was required from the board and senior management, and analysis was undertaken to ensure that in any number of scenarios, the company would be in no worse position than the original provision under the old funding strategy. In developing this package it was necessary to work closely with representatives from all disciplines within the Group – the Secured Group comprises the majority of the Group's investment portfolio and it was essential that existing operational procedures could work within the structure. Tiers 1 and 2 are viewed as 'normal operating environments' where the Group has discretion to buy, sell and develop assets. In Initial Tier 3 the operating environment is more akin to a CMBS transaction with increased restrictions on business operations. Final Tier 3 and beyond is very much a protective environment which progressively relinquishes control to creditors.

This 'tiered' covenant regime can see the operating environment move both ways, i.e. it can become more restrictive as leverage rises, but also can become more flexible as leverage decreases. This feature persuades the company to manage its capital structure so as to achieve its business objectives.

The covenant packages are captured in the CTA – the terms of which apply to all creditors that wish to benefit from security and in order to do so they must 'accede' to its provisions. These provisions are shared by both bank and capital market counterparties, and the interaction between the creditors is regulated by Security Trust and Intercreditor Deed (STID).

A CRITICISM OF THE OLD DEBENTURES IS THAT THEY WERE VERY EXPENSIVE AND CUMBERSOME TO MANAGE ON A DAY-TO-DAY PROPERTY BASIS.

Fig. 1: Corporate Structure



A criticism of the old debentures is that they were very expensive and cumbersome to manage on a day-to-day property basis. The new structure allows properties to be efficiently and quickly introduced and removed from charge. Interaction with the Security Trustee is explicitly laid out in the CTA and STID.

At each covenant tier level, minimum hedging arrangements are prescribed. Covenant Tiers 1 and 2 offer flexibility to develop flexibility hedge strategies. As gearing increases, higher levels of interest rate hedging are required in line with the approach of CMBS structure.

The new debt can be issued in four different tranches, all governed by the CTA and STID, in order of seniority Priority 1 (P1), Priority 2 (P2), Subordinated and Unsecured debt. Core P1 debt may be issued up to 45% LTV. Debt issued in the next 10% LTV is P1 if the aggregate P1 LTV is less than 55% but must be capable of migrating or switching to P2 dependent on various financial tests. P2 debt can be issued up to an aggregate 65% LTV. The purpose of 'switchable' P1/P2 is to protect the long term rating of the Core P1 debt, for example if asset values fall such that P1 debt exceeds 55% – in effect it helps to stabilise the P1 rating. The switchable debt initially takes the form of a £1bn tranche under the bank facility, the drawings under this tranche have variable margins depending on the priority of the debt.

The amount of unsecured debt in the Secured Group is strictly limited to £150 million or 2% of the collateral pool to minimise the risk of unsecured creditors being able to destabilise the operation of the Secured Group.

Given the uncertainty facing the company and the property industry as a whole in relation to the possible introduction of Real Estate Investment Trusts (REITS), modified Spens have been included in the new securities. The optional redemption as a result of a REIT event will be at a price calculated with reference to the swap curve and a spread. The spread is determined by reference to the maturity of the notes. Additional redemption conditions are included for other events, on a modified Spens basis in line with the recommendation of the 'Group of 26'.

THE JOURNEY… GETTING FROM A TO B Work on the structure started in earnest at the end of 2003. The offer to be made to existing bond and debenture holders was to exchange their existing debt for new AA rated (P1) secured bonds. 75% approval of each class of existing bond and debentures was required in order for the proposals to proceed.

In order to be confident that the offer would be acceptable to the investor community, an ABI special committee was convened to permit private discussions with a small number of our largest bond investors. Five holders were selected representing approximately 37% in nominal value of outstanding notes. Presentation and

Table 1. The Covenant Tier Level

	Normal operating environment		Protective regime	
	Tier 1	Tier 2	Initial Tier 3	Final Tier 3
	Business operations substantially unaffected	Tighter disposal constraints, progressive liquidity requirement introduced	Substantial operating and financial restrictions	
Leverage spectrum	low	medium	high	
LTV	≤ 55%	≤ 65%	≤ 80%	>80%
ICR	≥ 1.85:1	≥ 1.45:1	≥ 1.20:1	<1.20:1
Testing	Semi annually	Semi annually	Quarterly	

detailed briefing sessions were provided to the ABI committee who were very constructive in terms of providing feedback on the proposed offer. This process was very transparent with the company disclosing its understanding of how the benefits (both financial and non financial) would be split between debt and equity investors.

Prior to discussion with the ABI the offering circular was developed to a near 'black' form, confirmation of the ratings level as well as fully developing the offer in the form of the 'Consent Solicitation Document'. Former Unsecured debt holders benefit from a rating uplift from A to AA and an enhanced covenant package with reduced event risk, whilst former debenture holders benefit from a rating, improved liquidity, a more diversified security pool of assets, as well as updated documentation. The ABI committee were able to endorse the offer that the company was making to the wider investor group.

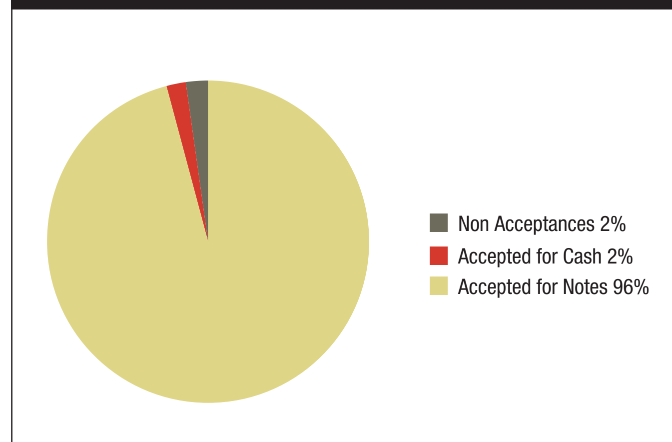
The offer was made to seven classes of bond and debenture holders. If they accepted the offer, they would typically receive the new securities or, in limited circumstances, be paid out in cash, the latter being required for those investors in jurisdictions where the new securities were not capable of being held. The redemption price was calculated on a pre-set formula that had previously been discussed with the ABI committee. New notes were issued (in a minimum denomination of £1,000) with any adjustments required being settled in cash.

Critical to the success of the transaction was the need to develop and document as fully as possible the offer prior to its announcement to bond holders – the completeness of the documentation allowed a strict voting timetable to be imposed minimising the possibility of investors building 'blocking positions'. In order to encourage investors to focus on the proposals and to keep to the targeted timetable, an early submission payment was offered to investors who voted in favour of the proposals within a compressed timeframe, whereby they would receive an extra cash payment.

Public announcement took place in September 2004 at the London Stock Exchange and the proposed transaction was launched with a presentation to which bank, bond, debenture, analysts and equity investors were invited. Because the new bonds were issued with a higher nominal value, but lower interest coupons, the exchange has crystallised a circa £600m exceptional loss. The loss is broadly equivalent to the FRS 13 mark to market value on the Group's old debt. In common with most UK quoted property companies, the equity market uses net asset value (NAV) as a benchmark against which to assess the value of our shares. The accounting loss on the debt exchange reduced NAV by £1 per share, but the share price was not adversely affected because the market was well aware of the size of the FRS 13 *Derivatives and other Financial Instruments* adjustment in our case. Indeed many analysts were already taking it into account and calculating an adjusted so-called triple net NAV. However given the materiality of the transaction it was equally important to communicate the rationale and benefits of the transaction to the equity community. Following the public launch, extensive bond, bank and equity roadshows were undertaken to explain the proposed transaction. The Group has in recent years actively managed and developed relationships with its bond investors and this undoubtedly helped the process of communication.

Debtholder meetings of each class of bond/debentures were held on 22 October 2004. All meetings were quorate and the results of the voting were announced in the afternoon with an average acceptance rate for the offer of 98%. The results overall are summarised in the pie chart.

Fig. 2: Bondholder Meeting Results (Average)



Final pricing took place on 26 October 2004 with settlement on 3 November 2004.

Our existing unsecured bank facilities could not survive the restructuring and we therefore had to arrange in advance of any announcement a new committed facility secured on the new structure that could be used to refinance and cancel existing unsecured bank debt. This facility was initially £1.5bn for five years split £750m at core P1 debt and £750m in 'flippable' P1/P2 form as described in the section above. Upon syndication of this facility an order book of around £3bn was amassed. Given this overwhelming demand for the facility, the company increased the size of the facility to £2bn split £1bn at core P1 level and £1bn in flippable form.

IMPACT OF THE REFINANCING/BENEFITS FOR THE GROUP The successful refinancing of the debt with the new debt structure has a number of benefits for the Group and investors. In summary, these are as follows:

Benefits for Group

- Substantial reduction in ongoing cost of debt for the Group
- Flexibility to raise asset-specific debt in the Non-Restricted Group
- Improved redemption pricing based on 'swaps plus' formulation
- A more flexible debt platform off which to issue various types of secured notes in a range of currencies.
- Simplicity in monitoring covenants
- A more stable ratings environment
- The ability to raise both AA and single A securities which will provide an opportunity to diversify the Group's debt investor base.

Benefits for investors

- Receive security over a broad asset pool
- Receive improved covenant package
- Stabilised Ratings
- Clearly defined inter-creditor arrangements
- More comprehensive and relevant investor reporting.

Stephen Leung is Corporate Finance Director, Land Securities Group.
Stephen.leung@landsecurities.com

Sean West is Treasurer, Land Securities Group.
Sean.west@landsecurities.com
www.landsecurities.com