SUCCESS BY RIGHTS FOR BT

The £5.9bn rights issue may seem like just another headline-grabbing transaction for BT but it was outstanding for what it has enabled the group to achieve and for underpinning the balance sheet at a grim time for telecoms stocks. The story of the rights issue cannot be told in isolation, and conveniently the October issue of *The Treasurer* carried an article by Andy Longden and Les Winnister (*Big is Beautiful for BT*, page 20) highlighting the recent BT fund raisings. This included a self-arranged £16.5bn multi-currency revolving credit facility, a $10bn global US dollar bond and inaugural €10bn euro bond arranged within the space of a few weeks, as well as considerable currency and interest rate hedging transactions.

BT's debt has multiplied over the past 18 months, with core debt escalating from £8bn peaking at £30bn in 2001 when the final payment on the German cellular acquisition was made. The £21bn capital expenditure for the UK, Irish and German 3G licences was largely responsible for this increased burden, which was initially bridge financed through BT's short-term (then A1P1) commercial paper programme.

The seeds for the rights issue were sown in October 2000 when BT announced a fundamental restructuring to alter the way the company operated. This was to be accompanied by a series of asset sales and minority IPOs. But market conditions rapidly deteriorated towards the end of 2000 with the collapse in TMT equity valuations, and the rating agencies began questioning the likelihood of telcos achieving their disposal targets. Lessons learned from other telecom IPOs contributed to BT reconsidering its own flotation plans, forcing the company "to migrate the previous funding strategy to a deliverable plan".

BT had to act decisively to reduce debt and create an environment where it could manage its own balance sheet without fire sales of assets. Bondholders were pressurising the company to reduce gearing, while credit rating downgrades were hampering BT's ability to issue commercial paper. Looking longer term, BT needed a stronger balance sheet to demerge its 3G business (mm0$_2$) and finance its broadband network, and "the rights issue provided the corner-turning exercise."

ADVISORS. BT has always valued its advisers and Longden said: "The role of Cazenove was critical to the success of the deal with its outstanding knowledge of the UK investment community." Cazenove has been broker to BT since the first round of privatisation stock in the mid-1980s and was appointed sole sponsor of the rights issue, leading the process as well as being the joint financial adviser. While Merrill Lynch has developed a debt relationship over the years, its involvement with BT has been increasing "through merit" as Longden puts it. It was appointed joint financial adviser and joint broker to the share issue and is also one of the global co-ordinators for the demerger of BT's 3G business, mm0$_2$.

■ **CORPORATE PROFILE.**
British Telecom is a household name in the UK and one of Europe's leading communications companies, offering voice, broadband, data, internet and wireless services.

www.bt.com

■ **FINANCIALS.**

Share price	£3.25*
Market cap	£27,737.48m*

*As at 12 November 2001

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SIZE. BT's market capitalisation prior to the rights issue was £41.7bn which by simple arithmetic would make any rights issue large. Market soundings indicated a range of what the market would bear, which was played off against how much was needed. It is easy to become blasé about the magnitude of BT's telecom financings but we really are talking telephone numbers here. £5.9bn is a colossal sum to raise and the issue holds the record as the largest ever UK equity offering and the biggest rights offering in history. It was launched just three weeks after Vodafone's $5bn share placement to finance the purchase of BT's Asian assets, which had already sapped telecom appetite.

The share price prior to announcement on 9 May 2001 was £5.685 and shareholders were invited to buy three shares for every 10 held at a price of £3, a deep discount of 47%. In other words, for every £56.85 shareholding, £9 of rights could be subscribed yielding a total of 13 shares at £5.07 per share, the theoretical ex-rights price. On the day of the rights issue announcement the shares closed at £5.24 per share. *Figure 1* shows BT's share price leading up to the rights issue and afterwards.

The issue was not underwritten, as BT's intelligence concluded the notion of UK institutions not supporting the rights issue was remote. More importantly, the £16.5bn self-arranged bank financing secured in August 2000 was earmarked to cover any shortfalls.

MARKETING. Peter Bonfield, Chief Executive, and Philip Hampton, Group Finance Director, conducted a huge roadshow, with more than 270 institutional investors in 18 cities across the UK, the US and Europe. Attendeees were generally supportive, since many had been calling for action, and the issue was perceived as "eminently sensible" said a senior banker. Chairman Sir Christopher Bland also had a high hit ratio, turning 80% of the investors he met into buyers.

BT's shareholder base was 83% institutional holders and 17% retail, which gave the issue another dimension. The logistics of marketing to and corresponding with more than one million shareholders with unknown levels of financial sophistication could not be underestimated. The sheer volume of prospectuses that had to be printed and dispatched was a challenge in itself. The message also had to reach individual shareholders, who were prevailed upon to subscribe for just short of £1bn-worth of rights. Substantial resources had to be directed towards newspaper columnists, regional brokers and financial advisers to spread the message accurately.

The considerable retail shareholding presented more worrisome conundrums because their sentiment was harder to gauge. Forecasts were flying around that only 80% of rights might be taken up, leaving 20% unsubscribed. Rupert Hume-Kendall, Managing Director of equity capital markets at Merrill Lynch in London, explained that shrinking the potential 'rump' stock during the rights process was a key issue. During the roadshow a number of buyers emerged, so the market-makers sold them stock creating a short position that they covered by buying significant volumes of nil paid rights in the market. Having subscribed for those rights they were able to collapse their position. "We adopted a deliberate strategy of selling fully paid shares to investors visited on the roadshow against a long position of nil paid rights bought principally out of retail. By absorbing the stock in this way we reduced the rump by about 50%." Meetings were also arranged with hedge funds that had accumulated short positions while BT's stock was on the decline to persuade them of the merit of closing out their short positions with the 'rump' stock.

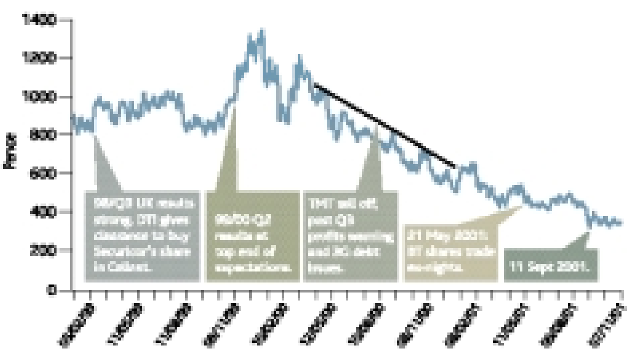
THE SECONDARY ISSUE. The remaining 'rump' of shares was placed on 18 June at £4.30 a share, raising £890m using an accelerated tender technique. *IFR* reported that "by 10am the bookrunners had received bids in respect of 295 million shares, making the books 1.5x covered. Bids ranged from 400p to 415p. By early afternoon the books were more than twice covered, with bids ranging from 400p to 452p. The books closed at 4pm, and at 6pm the strike price of 430p was announced, being the highest price at which the book was covered. That day BT's share price closed at 428p." Just another day in the office!

LIQUIDITY MANAGEMENT. Although a net borrower would usually attempt to dovetail loan maturities with anticipated receipts the magnitude of BT's debt portfolio and scale of the windfall receipts precluded this. Shorter term borrowings comprised £7bn-worth of 365-day medium term notes (MTN), while the £6bn commercial paper outstanding was issued on a daily basis in slugs of £200m-£300m out one and three month. Bundling these maturities would have created unacceptable refinancing risk and BT would have sacrificed the flexibility afforded by these instruments.

When the proceeds of the rights issue came in Winnister claimed that BT "had to become fund managers overnight." Today, BT is sitting on about £4bn in cash instruments, invested in-house, and through Citibank Asset Management, both charged with maximising the return within risk parameters approved by BT's board of directors. The £13bn in short-term debt will be repaid by April 2002 from cash and contracted divestment proceeds in line with BT's assurances to the capital markets.

FIGURE1

BT'S SHARE PRICE.



UNFINISHED BUSINESS. BT still has unfinished business to attend to. A general meeting on 23 October 2001 overwhelmingly supported the demerger of the $mm0_2$ 3G business (previously known as BT Wireless) and the creation of two new holding companies. Existing shareholders will become shareholders in BT Group plc and $mm0_2$ plc "allowing these companies to benefit from independent access to the debt and equity markets," said Bland. The balance sheet of $mm0_2$ will be capitalised with equity as the 3G networks still have to be built and financed. The bondholders would not have allowed this demerger without the rights issue and it made sense for BT to raise equity through the parent company balance sheet rather than an IPO, as France Telecom did with its Orange IPO.

The rights issue therefore was an enabling mechanism that bought BT time to restructure and dramatically improved its balance sheet. BT has been busy delivering its promises on time since. Debt was reduced by £10.4bn in the second quarter of this year thanks to the rights issue and a staggering £6bn-worth of disposals, including the jumbo £2bn LBO of Yell and £4.5bn divestment of stakes in Japan Telecom and Spain's Airtel.

Giving credit where credit is due, Longden attributes the issue to Philip Hampton, BT's Group Finance Director, saying: "It was bold and decisive…with hindsight a very good call", while looking askance at the challenges their European counterparts now face.

ANDREW LONGDEN'S TRANSACTION HIGHLIGHTS.

- Core component of a series of announcements aimed at reducing BT's debt burden and increasing focus in new BT.
- Well received by debt investors. BT makes good (and more) on promises made to investors in recent global and eurobond issues.
- Well received by rating agencies. BT through rights issues and divestments is able to reduce debt to manageable levels.
- Well received by BT's core banks. Enabled £11bn reduction in revolving credit facility renegotiated with all 11 banks.
- Well received by equity investors. £5.9bn raised was a strong endorsement of the plan for debt reduction and increased group focus.