RPBs: a valuable tool for managers of risk

Howard Goodbourn, Michael Turnbull and Russell Maybury outline the successful conclusion of the first re-marketable put bond to be sold in euros.

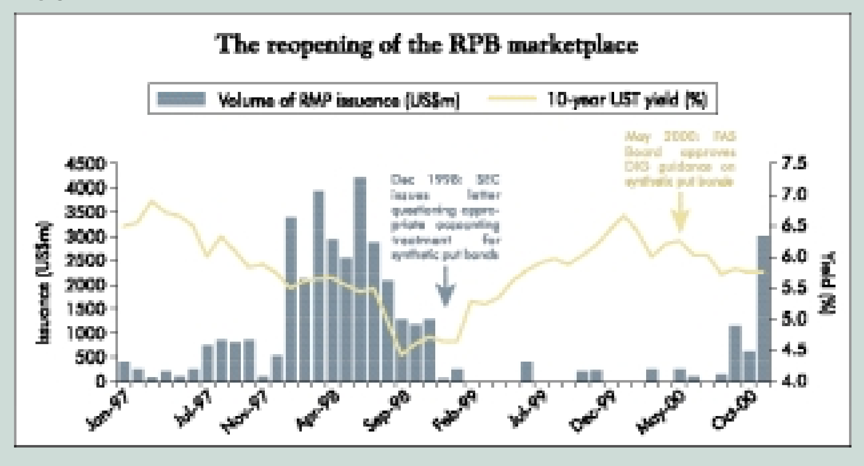
In November TXU Europe, a subsidiary of Dallas-based TXU Corp (formerly Texas Utilities) successfully completed the first re-marketable put bond (RPB) to be sold in euros. Here, we will outline the transaction from its early beginnings to successful conclusion. But, first, a short history of RPBs.

Although this is a relatively new concept in Europe, the RPB has existed for several years in the US in several different guises. The first RPB was issued in September1996 by GMAC in the form of a $600m 7put2 issue led by UBS Warburg using its PATS (puttable asset trust structure).

The market has grown rapidly since 1998 with a wide range of structures being used, such as REPS (Morgan Stanley Dean Witter) and PURS (Goldman Sachs) representing $30bn a year in 1998 as falling Treasury rates made the economics of the transaction increasingly attractive. From a capacity perspective, the market provides a degree of flexibility, with the US market having absorbed transactions as large as the $1bn issue for Nabisco, a transaction jointly lead managed by Morgan Stanley Dean Witter and UBS Warburg in 1998.

In December 1998, the SEC issued a letter questioning the accounting treatment for RPBs and, as a result, issuance tailed off. In 2000, the FAS board issued favourable guidance on accounting treatment under FAS 133, thereby re-opening the market.

In recent months – again spurred by falling treasury yields – the market is back to an issuance level of $2bn–$3bn a month. The RPB in the US market is therefore a well established product that investors find easy to value.



The rationale for RPBs

The underlying rationale for RPBs derives historically from the traditional cash put bond, where issuers effectively sold a put option to cash investors in return for a lower overall interest rate. Before 1990 this was the traditional route for issuers, but it had one principal failing in that cash investors placed a low value on the option and therefore provided issuers with inadequate interest savings.

Issuers overcame this hurdle by issuing shorter dated bonds allied to the sale of a receiver swaption. This package greatly increased the value to the issuer by selling the option to the more efficient derivatives market. However, an SEC letter in 1995 forced US registrants to mark-to-market sold options. In September 1996, the creation of the re-marketable put bond using a trust structure achieved both efficient (higher) valuation of the option and removed the mark-to-market problems.

TXU Europe: a practical example

TXU Europe has a number of the key characteristics that made it a good candidate for RPBs. These can be distilled as follows:

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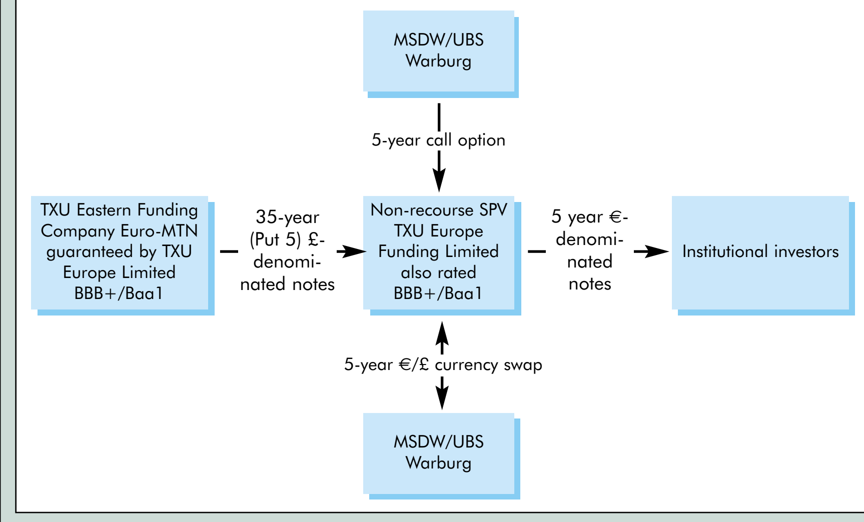
was not much more work involved than on a straightforward eurobond issue.

FIGURE 2



- a fundamental need to borrow in sterling and a natural requirement for long dated funding;
- an appreciation of the inverse nature of the sterling curve and a consequent readiness to accept extension risk;
- reporting under US GAAP; and
- preference to establish a profile with European investors.

Transaction detail: structure

The TXU Eastern Funding Company issues a 35put5 sterling-denominated note under its €2bn Euro-MTN (medium term note) programme, guaranteed by TXU Europe Limited. The notes issued under this programme are rated Baa1/BBB+ by Moody's and Standard and Poor's (S&P) respectively. These notes are then sold to a non-recourse special purpose company (SPV) incorporated in Jersey – TXU Europe Funding Limited, which funded this purchase by issuing five-year bonds that were secured by the 35put5 notes.

The five year call option is sold to Morgan Stanley Dean Witter/UBS Warburg and at the same time the SPV and Morgan Stanley Dean Witter/UBS Warburg enter into a cross-currency swap so sterling payments under the MTNs meet the euro liabilities of the five-year bond issued by the SPV.

"The key as far as the investors are concerned is that they are not party to the option or cross-currency agreements. They buy a five-year bullet maturity euro-denominated bond," says Russell Maybury from UBS Warburg, adding "The key emphasis throughout the marketing process was that this was a bond issued out of a structure, not a structured bond."

Value for TXU Europe

Howard Goodbourn, Treasurer of TXU Europe, outlined the value for the company as follows: "Using this structure we could lock in our downside at an attractive level and for selling the option we received a substantial premium which we were able to account for over the five-year put period. Although the five-year euro issue was offered at a premium, our actual cost in sterling was sub-Libor. We were also able to lock-in our strike rate ahead of time to maximise the value of the overall transaction."

Transparency of pricing

"Transparency of pricing" continues Goodbourn, "was a key issue for us. We were able to agree on certain screens that we could monitor to ensure that prices quoted to us were in line with current market conditions."

Documentation

The documentation was set up so the structure transferred as little structuring risk to the investors as possible. The bond could be viewed by investors as virtually pure TXU risk and it was a requirement of the ratings agencies that the SPV was as close as possible to pure pass through to investors. In total, the documentation took six weeks to com-

Marketing the RPB in Europe

The unique challenge facing the team for this transaction was selling the new structure to European investors. Up until this issue, only US investors had been approached. All parties were confident that European investors were keen to buy Baa1/BBB+ credits and a strong belief existed that the European investor was now ready for the marketing of increasingly complex structures. The roadshow followed conventional lines with a comprehensive tour through Europe, with London, Amsterdam, Frankfurt, Milan, Copenhagen and Helsinki being the main areas of focus.

The larger presentations were well attended with questions initially centring on credit and covenant issues rather than structural points.

As Mike Turnbull at Morgan Stanley Dean Witter explains: "From the outset the investors were focused on the complex credit and the possible risks in the structure. But investor fears that they might be exposed to the option part of the structure were soon allayed and patient marketing soon brought a key group of lead buyers into the book."

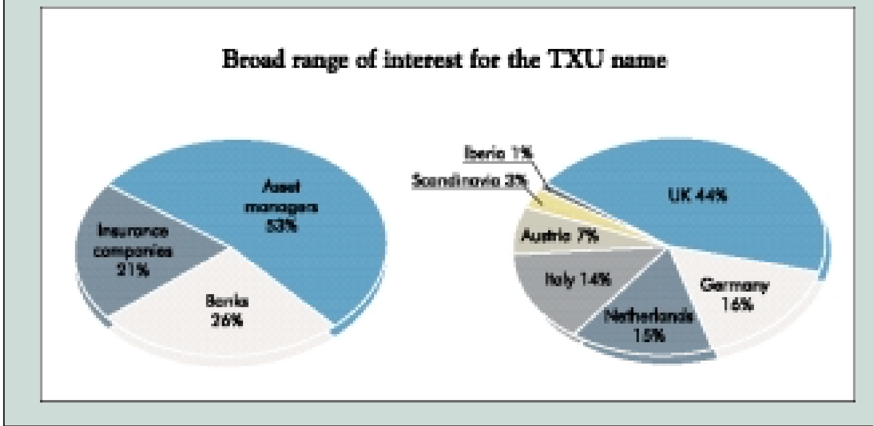
A lot of time and effort was taken by both lead managers in educating investors on the underlying concepts before moving on to the credit issues. Also, credit issues were not straightforward – a recurrent theme was a request for similar covenants to the existing long dated bond, the holding company status of TXU Europe, and concerns over the utility sector as a whole.

Bookbuilding

Identifying fair value required considerable analysis. Turnbull continues: "The pricing required the formulation of a view on the underlying credit and then identifying a structuring component for the transaction. It was essential to build a positive momentum to the trade to reach the tight end of credit pricing before allocating a reasonable structuring premium, taken from the precedent in the US market."

The bookbuilding process progressed well, with good interest from the UK, Germany and the Netherlands. But market conditions deteriorated sharply during the first week of the bookbuilding process in October, and it became clear

FIGURE 3



that overall market conditions would impact negatively on the success of a transaction. While the quality of the book was undoubted, market uncertainty was resulting in investors who would normally have been good for tickets of €25m-€40m submitting indications of interest of €5m-€10m.

The week of 16 October saw the markets go into freefall, led by the Nasdaq, and at that point it was decided that it would be better to temporarily postpone the official launch. Investors had bought into the credit story, though, and saw value in the structuring premium. The book held together through a two-week period of market dislocation, and by early November, and on the back of a period of stability, it was clear investors were keen to see the transaction proceed.

Against a more positive background, the size of the book grew easily to more than €500m. "For some investors it was actually their preference to see the deal increase to €500m, as that gave them a greater assurance of secondary market liquidity," says Russell Maybury of UBS Warburg.

Widespread interest

The successful conclusion of this pioneering financing led to widespread interest from the press and the financing community at large. *IFR* ("TXU Europe made an innovative entrance into the euro-denominated bond market") and *EuroWeek* ("TXU employs US puttable structure in European first") both covered the deal extensively.

A valuable tool for the treasurer

With both Yorkshire Power and TXU Europe having launched transactions last year, it is clear that further issuers in the UK with a need for sterling will be reviewing the attractions of RPBs.

First, Gilt and swap levels remain attractive, and issuers must question how much longer the inverted yield curve can it. Second, US GAAP accounting treatment continues to migrate across the Atlantic, and mark-to-market concerns are therefore likely to grow for UK borrowers – even if they do not report under US GAAP.

Third, the pace of M&A activity does not appear to be slowing, which brings into play another feature of the structure – when the borrower enters into the transaction, the one uncertainty (apart from refinancing risk) is the spread at which the bonds are likely to be remarketed if the option to extend is exercised and the issuer is averse to cash settling.

It can be argued that a borrower refinancing an acquisition can take advantage of the attractive funding offered by the impact of the premium and thereby significantly reduce his interest bill in the near term as he 'digests' his acquisition, safe in the knowledge that at the end of the put period it is likely his credit will be, if anything, stronger, leaving his one uncertainty (setting aside overall credit movements) within his control.

While RPBs should not be the sole borrowing instrument, it is certain that any treasurer with a broad portfolio of derivative and financing risk should take a closer look. ■

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Published 16 February 2001. Free to members of ACT