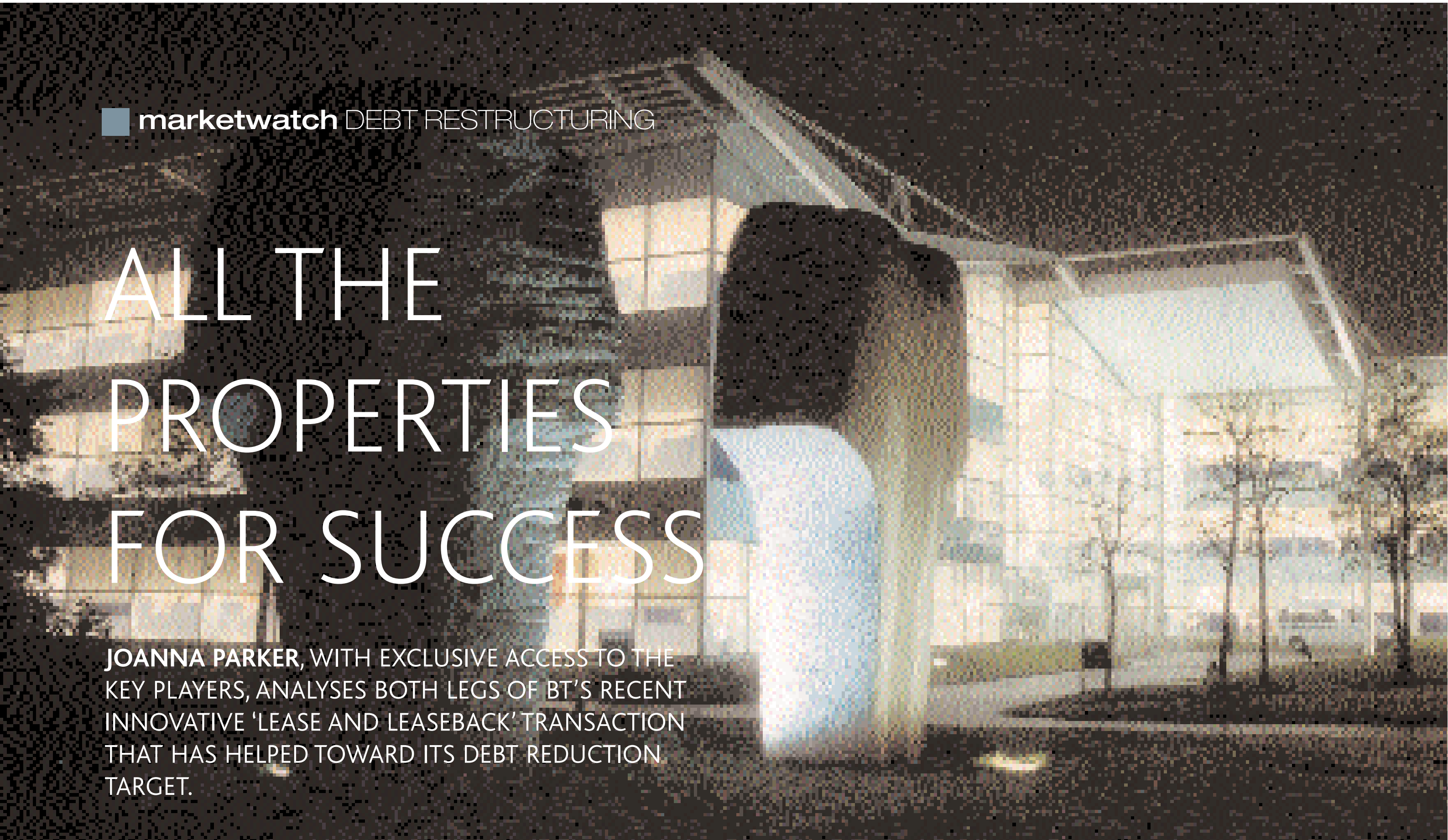


ALL THE PROPERTIES FOR SUCCESS

JOANNA PARKER, WITH EXCLUSIVE ACCESS TO THE KEY PLAYERS, ANALYSES BOTH LEGS OF BT'S RECENT INNOVATIVE 'LEASE AND LEASEBACK' TRANSACTION THAT HAS HELPED TOWARD ITS DEBT REDUCTION TARGET.

On 13 December 2001, BT completed a £2.38bn 'lease and leaseback' transaction that Chairman Sir Christopher Bland declared "another important step in BT's restructuring and debt reduction programme". Indeed, the deal presented a combined solution for long-term strategic and financing objectives as well as being the UK's largest corporate property outsourcing deal.

Under the terms of the transaction, BT granted a 130-year head lease on circa 6,000 telephone exchanges and predominantly 999-year leases on more than 700 other properties totaling over 5.5 million square metres of office buildings, warehouses and telephone switching centres to Telereal Holdings Limited (see page 3). The consideration, at £2.38bn, represented the largest ever UK property transaction. The majority of the properties are leased back to BT over 30 years at an initial yield of 7.9%. Telereal has taken responsibility for over 350 BT employees as well as the risks and rewards of owning and managing the long leasehold interest in the portfolio. *Figure 1* gives an overview of the deal structure.

STRATEGIC DRIVERS. Geoff Almeida, Chief Executive of BT Affinitis – the corporate division set up to administer infrastructure – cuts the strategic objectives and main drivers of this transaction four ways:

- **focus –** on the core business, moving away from BT doing everything for itself and by outsourcing a non-core competency;
- **flexibility –** retaining a degree of control over occupancy of the properties that a standard sale and leaseback would not provide;
- **shed property risk (ie rental and dilapidations risk) –** the rentals are on a fixed rate inflator of 3% pa requiring a long-term transaction for the investor to be able to ride the life cycle risk; and
- **cost savings –** on running the £24m pa overhead function bringing in third party expertise and efficiencies of scale to achieve guaranteed savings of 20% during the first five years.

OUTPUT OVER INPUT. Almeida says "BT learned painfully the importance of getting performance measures and penalties appropriately pitched through its experience with soft outsourcing (cleaning etc)". 'Inputs' used to be the standard means of measuring remedies, eg an electrician is required to turn up within 40 minutes if a fuse goes at a computer centre. This lets the contractor off the hook regardless of how long it subsequently takes him to fix the fault, while 'outputs' measures ensure, say, the temperature of a building cannot vary. Severe penalties in multiples of rents ensure that output measures are achieved and these have been built into Telereal's performance contract. Future contracts should move towards 'outcome' measures with the ultimate outcome that the tenant is satisfied with the accommodation.

FINANCING STEPS. On the financing side, BT's endeavours to restructure and reduce debt have been well-documented, including recent features in *The Treasurer* magazine. Firstly, in October 2001, BT's Andy Longden and Les Winnister highlighted their fund raisings and in the December issue, BT's £5.9bn rights issue was profiled as one of the Deals of the Year. Longden said "In the 21st century BT became genuinely capital rationed and suddenly couldn't even invest in its core business. It needed to divest of low-yielding assets and sweat the remainder. Next up is outsourcing its fleet assets." With a main board that now focuses on shareholder return in greater earnest than ever before, this compels better use of funds than property investments.

Where you sit influences how this transaction affects BT's indebtedness. After considering substance over form, the accounting profession views the disposal as a £2.38bn reduction in BT's indebtedness with an adjustment to tangible assets. Likewise, BT sees it as another milestone towards successfully achieving the firm's £15bn net indebtedness goal by 31 March 2002. From a rating analysis perspective, however, the rating agencies add back both the asset and the adjusted debt to the company's balance sheet as such leases are often viewed as an alternative means of funding assets which are integral to the company's ongoing business. Moody's note that a reduction by more than 20% of collateral available for unsecured debt may adversely impact a single A unsecured debt rating by one notch. At 13%, BT has not breached this trigger but remains mindful of its cumulative bite.

BIDDING PROCESS. On 4 January 2001, BT announced it was in negotiations to realise the value of its extensive property portfolio. Almeida stated "There is a lack of credible counterparties for this type of transaction which makes it easy to know who to talk to but constrains capacity." From around 40 bidders, three emerged as real contenders but one promptly fell by the wayside of its own volition. Two remained – Telereal and Mapeley. Although 75% of the value of the transaction was tied up in a small number of key properties, the amount and expense of due diligence necessary to underpin a bid was enormous; the bid documents alone were delivered in weighty tomes. BT defied cynics sceptical that a lease and leaseback of this size could get away on the grounds of the essential legal due diligence, title work, measurement surveys etc. A great deal of due diligence was undertaken on BT's behalf on an agreed basis and this reliance on the vendor's due diligence made the deal feasible. The continued presence of Mapeley in the bid process gave the board confidence that BT would not see its price knocked down between accepting the bid and contract. In fact, the value obtained through the transaction increased in negotiations from early estimates of £2bn through £2.3bn announced in June 2001 to a final figure of £2.38bn.

Getting such a proposal past BT's board in these days of tighter corporate governance was no mean feat. As with all major bids at BT an adjudication team was formed from various internal and external disciplines presenting different aspects of the deal under scoring criteria. External members included Citigroup as financial adviser and Ashurst Morris Crisp as legal counsel. The transaction went to BT's board four times at various crucial stages. Almeida, an MCT himself, extols the virtues of trust and joint initiatives between BT's property and treasury units. In fact, the transaction story as a whole is one of close cooperation and communication between all parties from Telereal, both sides of Citigroup, accountants, lawyers *et al* to the

CORPORATE PROFILE. Following the demerger of its mobile business mm02 in November 2001, the renamed BT Group plc remains one of the largest companies on the FTSE with in excess of 100,000 employees and a market capitalisation of around £23bn. Its fixed line network business serves 20m residential and 9m business lines. Profits from this business account for approximately 90% of group Ebitda. The fixed line network in the UK has benefited from capital expenditure in the order of £2-2.5bn per annum for many years and provides universal coverage throughout the UK. ☐

TABLE 1

TELEREAL SECURITISATION – STRUCTURED CORPORATE BOND (SETTLED ON 13 DECEMBER 2001).

Class	Amount	Rating	Structure	Coupon Spread	Reoffer	Type	Step Up Maturity	Expected
(1)	£m	(2)	(3)	(4)		(5)		(6)
A1	425	AAA/Aaa	FRN L+40bp	3m STG	L+40bp	Step up and Call	2.5x step up at 5 yrs to L+100bp	10-Dec-06
A2	175	AA/Aa3	FRN L+73bp	3m STG	L+73bp	Step up and Call	2.5x step up at 5 yrs to L+183.5bp	10-Dec-06
A3	240	AAA/Aaa	Fixed	5.5534%	G+75bp	Amortising	-	10-Dec-31
A4	410	AA/Aa3	Fixed	5.9478%	G+115bp	Amortising	-	10-Dec-31
B1	300	A-/Baa2	FRN 185bp	3m STG L+	L+185bp	Step up and Call	2.5x step up at 5 yrs to L+462.5bp	10-Dec-06
B2	215	A-/Baa2	Fixed/FRN	7.0980%	G+225bp	Step up and Call	converts after 10 yrs to 3m STG L+432bp	10-Dec-11
B3	35	A-/Baa2	Fixed/FRN	7.1285%	G+235bp	Step up and Call	converts after 20 yrs to 3m STG L+487bp	10-Dec-21
TOTAL	1,800							

NOTES:

(1) Bonds constitute direct secured and unconditional obligations. All benefit from the same security but class A1-4 rank senior to class B1-3 for payment of interest and principal.

(2) Anticipated rating by Standard and Poor's/Moody's. Class A1 and A3 have been credit wrapped by AMBAC Assurance UK Limited

(3) All floating rate tranches have been swapped into fixed rate (see text).

(4) Coupons are quarterly commencing with a short first coupon to 10 March 2002. FRN's based on Act/365 days and modified following daycount convention, with Fixed on 30/360 daycount and unadjusted following convention.

(5) Tranches A3 and A4 start amortising at year 11 and both have an expected average life of 21.7 years.

(6) Scheduled call at par on the expected maturity dates before the final maturity date of 10 December 2033 for all tranches.

telereal

CORPORATE PROFILE. Telereal is a joint venture owned 50:50 by Land Securities Trillium (LST) and The Pears Group, established to manage the BT property portfolio. Land Securities is one of Britain's leading commercial property and property services groups with fixed assets of £8bn comprising a mix of offices, shops, shopping centres, retail warehouses, leisure and industrial properties.

LST was acquired by Land Securities plc in November 2000 and combines capital, estate and facilities management expertise in a total outsourcing package. LST owns and manages the Department of Social Security's property portfolio and recently signed a 30-year contract with the BBC for the outsourcing of the London and Scottish estates. The Pears Group is one of the largest private companies in the UK, holding substantial property interests and with involvement in a large number of joint ventures. ☐

regulator, Oftel, and HM Tax inspectors.

CHANNELING EFFICIENCIES. Telereal is financed with £290m in equity, a £1.8bn asset-backed bond and further bank facilities to finance the £2.38bn BT property acquisition and associated costs. The bond was launched and priced on 7 December 2001 and closed on 12 December, enabling a handsome cash transfer to be made in favour of BT. It was the first time telecommunication properties have been used as collateral for asset-backed bonds in Europe, but judging from the number of enquiries received by Citibank it may well not be the last.

The bond was launched at a very good time, as the asset-backed securities (ABS) market, which was very active and in good shape, remarkably unaffected by the events of 11 September. The deal lifted ABS issuance in Europe to a record €125bn, up 47% on 2000. Although it was Telereal's deal, BT had cause for involvement; indeed it was a condition precedent that the telecoms giant was completely involved in the financing. James Brent, Managing Director, Real Estate and Lodgings at Citigroup, said "It was important for BT to know that the financing was efficient and the benefits were being shared with them. The financing relied on BT covenants and real estate and it was essential for BT to ensure the paper complemented their name in the capital markets. Debt service obligations impacted the rental BT would have to pay and a 1% saving over 30 years would enhance the head lease proceeds by 10%." The structure therefore produced real value for BT by lowering Telereal's cost of capital through high gearing and channeling back the efficiencies in the deal pricing.

ASSET-BACKED BOND. The bond, issued in seven tranches, increased the investor universe by structuring across three rating bands in the fixed and floating markets and across four expected maturities. (See *Table 1*.) Just over one third of the securities were triple A rated with the benefit of a credit wrap by AMBAC Assurance which lowers the overall transaction risk, increases the potential audience and avoids cannibalisation of BT's corporate credit sources. Ratings higher than BT's corporate rating of A-/Baa1 were achieved for a further £585m of the bond (tranches A2 and A4). As Moody's pre-sale report noted, "BT's default risk under the sub-leases is probably lower than the risk from the unsecured rating: in a distress scenario, it is likely that – given the public service nature of BT's operations and the importance to it of its fixed line network (even more so after the split) – both BT's creditors and Oftel would want to protect the value in BT and opt to maintain the business (reorganisation as opposed to liquidation). In this scenario, the rent will continue to be paid as long as the company generates sufficient cash... as an operating expense of the administration."

"Being an operating risk is a major selling point of this transaction. The risk involved in this deal is of a higher quality than normal credit risk in that should BT survive in any way shape or form, it would continue to pay rent on the properties," said Marcus Giancaterino of Citigroup's securitisation team. The property values themselves provide a layer of collateral comfort even though they constitute highly specialised and disparate commercial real estate not always in the most desirable sites. The locations do follow UK demographics fairly well with good distribution in terms of size and population.

One of the structural aspects of the whole lease and leaseback was the basis of rental growth over time. An index-linked rental

FIGURE1

STRUCTURE DIAGRAM.

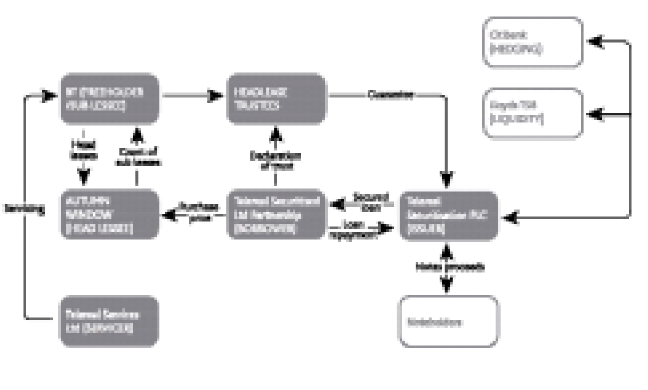
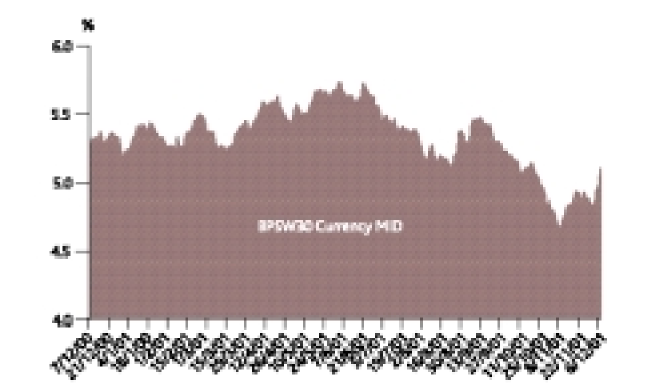
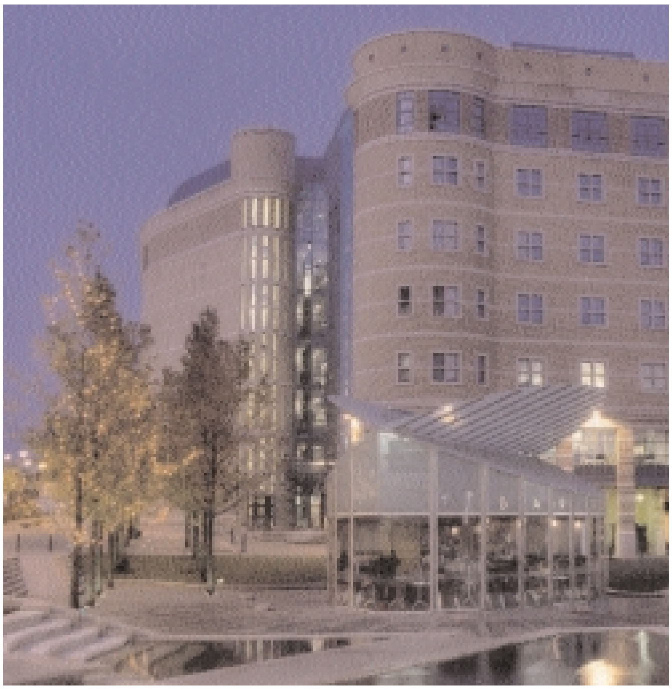


FIGURE 2

30 YEAR STERLING SWAP RATE.





BT'S BRINDLEY PLACE PROPERTY

could have appealed if the capital market was deep enough to match the funding. Periodic market rental uplifts were no good for the lessor with known financing costs to service, nor for the lessee looking for stable operating costs. Rental of £190m pa with a steady 3% growth rate was therefore settled upon monthly in advance. BT ends up paying a total 'accommodation charge' of £6 per square foot annually for the provision of the properties and life cycle maintenance.

The coupon averaged 20 basis points lower than BT's corporate debt. On the face of it, this dispels another myth that structured paper is more expensive than unsecured corporate debt. But transaction costs were not insignificant. It is expected that titles to 300 properties will be sent to the registry every week starting with the most valuable properties in a process that could take years. A side benefit is that BT is being forced to tidy up and perfect its titles prior to assignment which is a worthy housekeeping exercise in itself.

The deal affords BT the flexibility it needs to manage its property portfolio with specific allowances to vacate 35% properties over the thirty-year term without penalty, as well as retaining a share in any super profits arising on disposals. More property can be vacated on relatively favourable terms and in particular through the transfer of the economic responsibility for third party leased property to Telereal. BT gains the ability to exit these properties too.

SWAPPING SWAPS. The fixed rental deal cried out for fixed rate financing although only 50% of the bond was at fixed rates. BT had significant fixed rate swaps in its portfolio that would become surplus to desired levels with the reduction in managed debt. Around £1bn of swaps were switched over to Telereal, but not without BT extracting some value. BT identified several suitable swaps that were then novated over to Citigroup, repackaged and passed over to Telereal. Not only was the bid/offer spread narrowed from the 20 basis points typically on 30-year swaps in this size but counterparties were prepared to pay through an auction process for the credit enhancement achieved by switching out of BT to Citigroup credit risk. Swapping these swaps also meant Telereal could circumnavigate the market risk associated with the high volatility of the 30-year swap rate in the month between exchange and completion (see *Figure 2*).

Citibank have been one of BT's closest advisers over the years and co-lead their 2001 global $10bn bond. After BT discussed the potential transaction with several banks, Citigroup came up with this structure to match BT's corporate objectives. Over the 'chinese wall', Citigroup acted for Telereal as sole book runner for the £1.8bn structured bond with Barclays and The Royal Bank of Scotland as co-leads. BT is full of praise for all the advisers.

Citigroup's Brent said "The BT transaction will change a number of established views on the execution of property transactions. It has demonstrated that value can be extracted from a large number of non-typical property assets within a relatively short period of time by using a sampling approach to due diligence. Even more importantly, the transaction has demonstrated that the 'Holy Grail' of raising debt finance at a lower cost than the tenant's issuance spread can be achieved with well structured finance".

Like the strategic benefits, not all the financial benefits are immediately quantifiable for BT. Yes, BT receives a cash windfall of £2.38bn along with an exceptional accounting profit of around £600m in fiscal 2002 as well as crystalising around £2bn in tax losses and property rentals starting 17% below market. Longden adds "The deal has been priced and executed in a very low interest rate environment with inherent option value that may prove massive if the leases don't run to term".

Meeting strategic and financial objectives is very gratifying. This deal is attracting attention from other telecom companies and holds appeals for other property-rich (utility) companies. Thought provoking stuff.

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