GETTING ON THE RIGHT TRACK

JOANNA HAWKES OF ANGEL TRAINS EXPLAINS SOME OF THE ISSUES FACING THE ROLLING STOCK LESSOR IN THE FUNDING AND LEASING OF TRAINS TO THE OPERATING COMPANIES.

The purpose of this article is to outline the issues facing the rolling stock lessor, both from the perspective of financing the purchase of rolling stock, as well as leasing it to the trains operating companies (Tocs). It focuses mainly on the activities and experiences of Angel Trains (Angel).

BACKGROUND. The three rolling stock leasing companies (Roscos) Angel, Porterbrook Leasing and HSBC Rail (formerly Eversholt Leasing) were originally formed in 1994 out of the privatisation of British Rail. Their business is owning, maintaining and leasing rolling stock. At the time of public offer, fears of re-nationalisation under an incoming Labour government were high. Offers to buy from the finance sector were limited and consequently two of the three were the subject of management buy outs. Over subsequent years, however, Roscos have migrated towards their natural home for UK leasing companies, and each has become a subsidiary of a big financial institution: Royal Bank of Scotland (Angel), Abbey National (Porterbrook) and HSBC (HSBC Rail).

Despite a low public profile, the Roscos are perceived to be one of the success stories of privatisation. Leasing specialists have used established techniques, specifically the application of surplus tax capacity and low funding costs, to create a product that didn't exist in any prior form. Competition is acute among the three companies, from which the Tocs benefit, and ancillary support services have been improved and maintained. More than 50% of the staff employed at Angel are engineers involved in train maintenance, safety and product development. Since privatisation Roscos have collectively financed the purchase of £3.5bn of new rolling stock, more than 60% by Angel (See *Table 1*).

LEASING OF TRAINS AND CUSTOMER INTERFACE

GENERAL. Angel leases to 19 out of the 25 Tocs. Prior to privatisation a 'standard' lease structure was set up, which acted as an industry benchmark. Most leases were established for a period of eight to ten years until March 2004 co-incident with most of the existing franchise end dates then established. New train purchases have become the subject of new leases which have been running in

tandem with extended and renegotiated franchises. As the market has developed, lease contracts have become more bespoke and very heavily negotiated.

For a number of reasons – partly strategic, partly historic – Angel Trains finances about 80% of its portfolio in the banking market, rather than via its parent. *Figure 2* illustrates the current simplified industry structure.

TYPES OF LEASES. There are a number of variations in the types of lease structures, but generally capital rentals are fixed. Tax and interest rate exposure generally reside with the lessor for the period of the lease.

All new lease terms require the implicit endorsement Strategic Rail Authority (SRA), effected through the SRA 'Direct Agreement'. The direct agreement determines the rights of the SRA to act in the event of a Toc default. These rights need to be acknowledged by the lessor and other interested parties with security over the lease or the trains. Under Section 30 of the Railways Act 1993 and the Transport Act 2000 the SRA has a statutory duty to provide train services consistent with the passenger service requirement (PSR).

STANDARD MOLA LEASE. All of the former British Rail rolling stock assets are leased through the standard industry Maintenance and Operating Lease Agreement (Mola). Heavy maintenance responsibilities are directly with the lessor and maintenance expenditure is recovered through the 'non-capital' rent.

For much of the older stock, the non-capital rent is higher than the capital rents. All older leases are subject to the Opraf/Rosco Agreement, a wider and more favourable predecessor to the current Direct Agreement, and 80% of capital rents are 'underpinned' by the Secretary of State for Transport.

NEW LEASES IN RELATION TO THE PURCHASE OF NEW ROLLING STOCK. The requirements for new rolling stock has arisen out of the need for Tocs to meet their franchise commitments. Bespoke leases have consequently been agreed with individual lessees. Broadly, they fall into several categories set out below:

- **Longer term dry leases.** Long-term leases that exactly match the franchise term. Angel has no maintenance responsibilities (but is heavily involved in the negotiations). It retains direct audit and inspection rights over the maintenance and a veto on any significant changes to the maintenance arrangements. On expiry of the franchise Angel has the option to continue the maintenance regime directly with the manufacturer and to step in, in the event of a Toc default. In practice, Angel keeps close control over maintenance through its own project management.
- **Shorter term leases.** In these cases, the Toc has not yet secured a franchise extension, because it has not been awarded or even tendered. These shorter term leases may be dry leases where the maintenance regime works as above, wet leases where the Angel retains direct maintenance responsibility (even though it will often subcontract to the maintainer) or a 'soggy' lease, where it operates through a tripartite maintenance agreement with the manufacturer and Toc.
- **Lease linked to 'novated' purchases.** There are a few instances where a Toc has negotiated its own purchase contracts with train manufacturers in accordance with an original view to 'own and operate' but has found the use of capital and tax capacity can be more effectively maintained through third-party leasing. In these cases, Angel negotiates with manufacturer and Toc to effect a novation of the purchase contract.
- **No leases and 'speculative' purchases.** These are speculative purchases made in exceptional cases where there is a considered and justified risk that buying without a lease will enhance the ability to both market and price future leases. The most pertinent example of this was the purchase by Angel of 25 prototype Siemens Desiro UK electrical multiple units specifically designed by Siemens to target the large UK mark 1 replacement market. For Angel this resulted in quick and substantial subsequent leases of 84 class 360 Desiros to First Great Eastern (£75m) and 785 class 450/444 Desiros to South West Trains (£640m).

TABLE 1
POST-PRIVATISATION ORDERS (1997-2001)

Trains	Lessor	Producer	Total vehicles	Total cost £m
390 Virgin West Coast Pendolinos	Angel Trains	Alstom	477	593
Class 67 loco EWS	Angel Trains	Alstom/GM	30	45
Class 66 loco EWS	Angel Trains	GM	250	320
333 Arriva Trains Northern	Angel Trains	Siemens	56	61
450/444 Desiro – South West Trains	Angel Trains	Siemens	785	640
360 Desiro – First Great Eastern	Angel Trains	Siemens	84	75
357 c2c	Angel Trains	Bombardier	112	92
175 First North Western	Angel Trains	Alstom	70	78
180 First Great Western	Angel Trains	Alstom	70	74
332 Heathrow Express	BAA	Siemens	56	69
220 Virgin Cross Country	GL Railease (now Angel)	Bombardier	352	407
168/0 Chiltern	HSBC Rail	Bombardier	9	7
375 Connex South Eastern	HSBC Rail	Bombardier	240	180
170 ScotRail	HSBC Rail	Bombardier	18	17
334 Scotrail	HSBC Rail	Alstom	120	100
220 Midland Mainline	HSBC Rail	Bombardier	96	115
375 New Southern Railways	Porterbrook	Bombardier	160	120
168/0 Chiltern	Porterbrook	Bombardier	35	30
170 Anglia/Midland Mainline/Central	Porterbrook	Bombardier	161	155
170 South West Trains	Porterbrook	Bombardier	16	15
357 c2c	Porterbrook	Bombardier	184	130
458/0 South West Trains	Porterbrook	Alstom	120	90
460/0 Gatwick	Porterbrook	Alstom	64	45
Grand total ordered post-privatisation			3,565	3,458

KEY FACTORS IN DETERMINING A RENTAL RATE. In general, lease rates are determined on a whole-life asset basis, typically assumed at between 25 and 35 years. Assumptions are made on releasing and refinancing risk over the full life. Newly negotiated leases generally relate to substantial levels of capital expenditure and will carry a specific risk for which a suitable return must be derived. Angel currently operates on a 'deal by deal' return criteria, with each contract having a bespoke financing arrangements. Typically, third party funders provide 80-90% of the debt with the balance funded directly by Angel. Issues such as construction interest, loan term, bullet can effect equity returns significantly. Financing terms are critical to commercial decisions, which often results in some lengthy funding negotiations.

Angel is continually re-evaluating its funding options and methodology in line with market changes to ensure optimal use of debt and capital.

SPECIFIC TYPES OF DEAL RISKS

REFRANCHISING & RELEASING RISK. If a Toc has only a short franchise, this exposes a lessor to short-dated repricing and releasing risk. This risk will be evaluated in the bid process and will address issues such as the likelihood of the existing franchisee securing a lease extension (in which case, it may build conditional releasing into the deal), the SRA's motivation towards new stock in evaluating new bids (generally high), general train desirability, performance and transferability, and potential competition from vehicles that may be cascaded from other routes by other lessors.

Generally, when a new train has been successfully performing on an existing route, the motivation of an incumbent to release is considered to be high. In addition, there are significant costs associated with changing trains, for example, driver training.

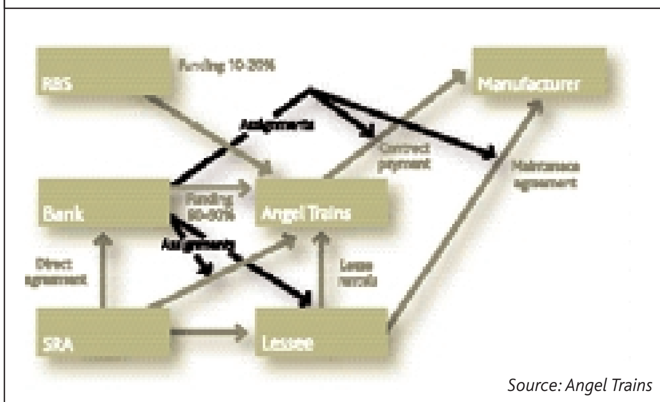
REGULATORY AND POLITICAL RISK. There are a variety of regulatory and politically rated risks which we have to be aware of:

- **Direct Agreements.** The form of the Direct Agreement has evolved and the SRA is gradually seeking more flexibility over its step-in rights – most specifically, the ability to 'cherry pick' from the assets leased under one contract, rather than operate on an 'all or nothing' basis, which presents more risk to the lessor.

TABLE 2
ANGEL TRAINS DEALS – LEASE STYLE AND FUNDING ARRANGEMENT.

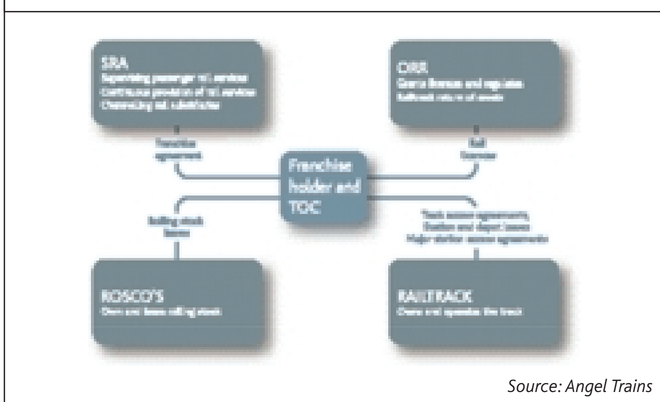
Trains	Lease style	Producer	Vehicles	Cost £m	Third Party Funder	Third Party Funding Style
Class 390 Virgin West Coast Pendolines	Dry lease to 2012	Alstom	477	593	West Coast Train Finance Bond Issue arranged through RBS	Securitisation
Class 67 loco EWS	Dry novated lease to 2015	Alstom/ GM	30	45	Export Development Bank Canada	Non-recourse loan
Class 66 loco EWS	Dry novated lease to 2015	GM	250	320	Export Development Bank Canada	Non-recourse loan
Class 333 Northern Spirit	Dry lease to 2004	Siemens	56	61	KFW	Long-term loan secured loan
Class 450/444 South West Trains	Desiro – Dry lease to 2021	Siemens	785	640	Club deal of German banks, KFW, Verkhers Bank, Hypovereinsbank, Bayerische Landesbank, DG Bank	Long-term club/syndication (in negotiation)
'Class 360 Desiro – First Great Eastern	'Soggy' lease to 2004	Siemens	84	75	Lloyds Bank (in negotiation)	Long-term loan secured loan
Class 357 c2c	Dry lease to 2011	Bombardier	112	92	Syndication led by Dresdner Kleinwort Wasserstein	Long-term secured syndicated loan
Class 175 First North Western	Wet, novated lease to 2004	Alstom	70	78	Lloyds Leasing	Lease and conditional sale agreement
Class 180 First Great Western	Dry, novated lease to 2004	Alstom	70	74	Lloyds Leasing (in negotiation)	Lease and conditional sale agreement

FIGURE 1
TYPICAL PROJECT FUNDING.



Source: Angel Trains

FIGURE 2
INDUSTRY STRUCTURE.



Source: Angel Trains

- **Mandatory modifications and government compliance.** Mandatory modifications may be imposed by the government at any time for safety, environmental or other reasons – for example, the current mandatory requirement for nationwide. implementation of train protection warning systems. Only 10% of these costs can be recovered through rental increases.
  Changes to the rail industry structure may be made at any time, for example, through a franchise remapping or through other recommendations, such as the recent Cullen report.
- **Railtrack specific.** Angel is only indirectly affected in its day to day operation as a result of the Railtrack being in administration. Tocs are dependant upon Railtrack to meet infrastructure upgrade targets so they can meet their franchise commitment. But these risks are managed though non-performance regimes agreed by the Tocs independently with Railtrack. Angel leases remains insulated against these factors.
  Where the Tocs are limited in their ability to conclude existing franchise negotiations with the SRA, the risk to Angel Trains in the underlying commercial transaction is minimised through selected SRA comfort.

INTEREST RISKS. Typically, the interest rate exposure is hedged at the time of securing the fixed rate lease. Transparency is offered to the customer in effecting the deal and no swap mark-up is passed through. In the current low interest rate environment, a few marginal pips on swap cost can affect the rental price.

Angel also offers the customer the option to float rates for a certain period, to the extent that the SRA approves this in the lease sign-off.

TECHNOLOGICAL AND PERFORMANCE RISK. No train is accepted for lease unless it complies with rigorous acceptances procedures. However, in certain circumstances, a poor-performing product that has cleared safety case and acceptance procedures will still present significant releasing risks.

DELIVERY RISK. This is managed to a certain extent through a liquidated damages regime in the purchase contract, but delays in delivery where a loan facility has been negotiated with a backstop maturity date can affect project gearing and dent equity returns. This can be managed by maintaining a fluid relationship with the funder and securing a willingness from them to extend the loan term in accordance with delay.

OTHER LEGISLATIVE RISKS. Proposed changes in the accounting regime that may require lessees to partially reflect the leased asset on balance sheet may prompt lessees to rethink their leasing strategy in the future.

FINANCING OF TRAINS AT ANGEL. Since 80% of Angel funding is secured through third parties, we spend a significant amount of time negotiating with the market. This can often be quite challenging. The pool of lenders still remains relatively small and despite attractive terms and security there is a significant psychological hurdle to overcome to entice new entrants into significant lending. Finance structures can be complex and there is generally a steep learning requirement. A variety of methods have been used by Angel over the past three years to fund the increasingly large portfolio (*see Table 2*).

ISSUES THAT DETERMINE THE CHOICE OF FUNDING

FUNDING ECONOMICS. Ultimately, this will be the most significant incentive upon the choice of funder. Intense competition in the market mean the loan terms can have a significant impact on the price. The proportion of the asset a bank is prepared to fund, construction interest, loan term and bullet repayment have high sensitivity to project economics.

DEAL SIZE AND LEASE FRANCHISE TERM. Larger deals lend themselves to forms of funding with higher fixed costs. Long-term leases make securitisations and syndications more palatable.

For the West Coast Train Finance Bond (£480m) the 12 year franchise enabled highly geared securitised funding. For South West Trains (20 year lease) we are favouring a syndicated on balance sheet bank lending (expected to be £610m). For smaller shorter deals we have used bi-lateral bank borrowing.

POLITICAL WILL. Export Credit Banks will often be proactive in promoting the funding of its own exports. Export Credit Development Bank of Canada and Kredietanstalt für Wiederaufbau (KfW) are both keen sponsors of their own market (General Motors Canada and Siemens) and fund a significant portion of Angel's debt. EIB has been a prolific lender to the European Rail sector, particularly to Railtrack.

OPERATIONAL FLEXIBILITY. A significant criterion is the extent to which a bank will allow Angel to operate with minimal interference. Typically, we require freedom to make reasonable commercial changes to our documents, particularly maintenance arrangements, limited cross default from project to loan, the ability to have trains off-lease for sensible periods and minimal releasing conditions.

EXPERIENCE. The Angel team has been making regular financial contacts since 1996 and a number of banks now have a good appreciation of industry risk and structure , nevertheless the learning curve is steep and can be time consuming. To a certain extent we manage this , either by negotiating repeat deals with existing lenders or by introducing a range of new banks through a syndication process with an experienced lead bank . In general asset funders are more receptive to the long term required nature of financing than corporate lenders.

SPECIFIC FINANCING CHALLENGES. Angel has positioned itself such that it is an attractive proposition for the lending community (full recourse lending on A+ rated entity, RBS parentage, first mortgage of trains assets, full assignment of project documents, Direct Agreement comfort). In our experience banks agree with this sentiment at the outset and it works in our favour in bringing funders to the table. However, during the course of the negotiations we find undue weight is given to the broad corporate support and more attention is given to the asset and a 'project finance' style approach is adopted. This can present difficulties for us as we seek minimal interference in managing our assets and customer relationships.

Maintenance regimes present challenges for some funders. Rather than excluding themselves from maintenance responsibilities in the event of exercising their security on our default some have requested the right to step-in. This means they have sought closer inspection and control rights and maintenance covenants.

During the negotiation of the assignment arrangements banks will often seek to re-open a pre-agreed position with our customer.

Project style deals are generally transferable on reasonable grounds. Angel does not however allow funders to transfer to competitors.

Several major rail incidents in recent years coupled with the effects of 11 September are starting to create some challenges in the insurance industry and nervousness in the banking sector. We are starting to see closer scrutiny of existing insurance covenants.

CURRENT CHALLENGES AND THE FUTURE

RAILTRACK RELATED ISSUES. While this has no direct effect on our day-to-day business, it does effect investor confidence and the willingness of new investors in Europe to enter the market.

SHORT TERM FRANCHISES. Byers' wish to move towards short-term franchise over longer term has positive and negative benefits. Opportunities for refurbishments of trains and extensions to existing leases is increased but opportunities for larger deals is minimised. Angel will be working to capitalise on existing good relations to manage this.

A BRIGHT FUTURE. The outlook for train lessors remains positive. Whilst demand for significant new UK investment has slowed, and is likely to continue to slow, this creates the time to focus on growth potential within the existing fleet market and the newly developing international markets.

The recent award by Standard & Poor's of the A+ rating to Angel on a standalone basis, independent of its ownership, endorses the positive view for the sector. Angel will be using this in the future to look at ways to maximise the efficiency of its funding arrangements.

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