HIGH-YIELD BOND: FOCUS WICKES

Strong focus

THE HIGH-YIELD MARKET IN EUROPE had been effectively closed for more than a year. The very first few deals were getting away, and investor interest in the higher returns of non-investment-grade paper was once again beginning to show. It was a plain vanilla market. At this point, few would expect a highly exotic deal – involving a brand new structure and unconventional call options – to get away, let alone launch successfully and be upped on strong demand. But that is exactly what happened with the £290m equivalent dual-tranche, dual-currency deal for UK DIY group Focus Wickes.

Corporate profile

Privately-held UK Do-It-Yourself retailer Focus Wickes is the second-largest DIY group in the UK. It was formed out of the acquisition of the Wickes Group by Focus DIY in 2000 and subsequent purchase of Great Mills in 2001.The group has 267 Focus stores and an additional 164 Wickes locations.

Principal terms of the £260m equivalent bond

Amount type £190m mezzanine notes. €140m mezzanine notes
Marketing 12.00%-12.25%
Coupon 12.00%. 9.25%

FOCUS WICKES

Margin 776bp over Gilt. 776bp over Bund
Maturity 2011. 2011
Bookrunner ING,The Royal Bank of Scotland

In November 2002, Focus' long-standing venture capital provider, Duke Street Capital, along with management, sold 28.9% of their stake to Apax Partners. This was part of a recapitalisation to refinance a £170m outstanding bond used to finance the acquisition of Wickes. Geoff Wilson, Deputy Chairman and Group Finance Director, explains: "Part of that recapitalisation was senior debt and we drew down on a mezzanine bridge put in place by our principal lenders. The idea was to replace that with a bond."

Tim Hall, Global Head of Debt Capital Markets at ING, says that the ground was set for a strong new bond issue: "The company had delivered from an operating perspective and the performance of the company's exisintg bonds, underwritten by ING in July 2001, had been very good. Investors benefited further from the tender premium of around 20 points on the existing 11% bonds, and were happy to redeploy their gains in the new bonds. Moreover, the initial bond in 2001 also included a redeemable tranche (13% callable anytime at 102), so investors had direct experience in equating more aggressive call provisions with price for this issuer. In a nutshell, the performance of the original bonds set the stage for the new deal."

Around February the group began looking at the bond market to assess when it would be a good time to go. But while that was being structured the market underwent a dramatic change. At that time there were serious discussions going on in the market, which would affect the future of the high-yield structure. Debate was raging between senior lenders and bond funders as to the capital structure of such securities and how that could or should be changed to give better protection for bond investors.

Hall says: "New issuance ground to a halt, as banks were unwilling to accommodate upstream subordinated guarantees for bondholders. Senior bank creditors and high-yield investors were at loggerheads." However, between January 2003 and the time that the new Focus bonds were issued in July, banks and bondholders found a middle-ground that enabled new issuance activity to resume. Moreover, the tone of the high-yield market turned very bullish, taking its cues from the strong performance of the US high-yield market. Several new bond issues related to leveraged buy-outs (LBOs) preceded Focus during the first half of 2003, and these set the market precedents with respect to intercreditor matters in LBOs. "A lot of the nuances were sorted by the time we brought the transaction to market in July," adds Hall. "We benefited from a combination of a proven issuer and an excellent market environment."

Hybrid structure

The deal, which ended up as a hybrid between high-yield and mezzanine notes, was more than two times oversubscribed with around 120 investors involved in the transaction. As a result, the sterling tranche was upsized from £150m to £190m and came in at the tight end of price talk – which was originally set between 12.00% and 12.25%. The €140m euro tranche was 75bp lower as well. This is the largest European deal done in the retail sector to date.

It has a standard high-yield bond call structure except in the event of an IPO or trade sale. In these instances the premium to take out the bonds is much lower than would normally be the case on a traditional high-yield bond. Nick Coates, Head of High-Yield Debt Capital Markets at The Royal Bank of Scotland, says: "The call provisions were key to the structure from the point of view of the company. Having just redeemed its outstanding high-yield issue at a significant makewhole premium, the mezzanine notes offered the chance of an early redemption in the future at a much lower premium in the event of an IPO or a trade sale. It gave the company much more flexibility than a traditional high-yield structure and better economies than the alternative of traditional mezzanine."

From the point of view of the high-yield investor, the deal also includes a second lien security package and subordinated upstream guarantees from all significant operating subsidiaries. This gives a very robust structure for the European market, thus potentially enhancing investor asset recovery values.

Dave Williams, Focus Wickes' Finance Director, adds: "In the end the mezzanine notes had some interesting security features, benefiting as it did from second ranking after senior debt and the upstream guarantees. This is not something that bonds traditionally had."

In addition to providing a good solution to Focus Wickes' needs, the transaction could also signal a sea-change in the high-yield markets in Europe. Coates says: "The structure sets clear protocol on the relative intercreditor position of senior banks and subordinated noteholders. Thus, both groups could invest in the deal without confusion or concern over the capital structure." It is a first for the European high-yield market and is replicable. It could and likely will be used again by other corporates, and may open up the high-yield markets to more frequent issuance, as it relieves many of the fears that have plagued the market.

DAVE WILLIAMS
'In the end, the mezzanine notes had some interesting security features'

Adds Hall at ING: "The European market has never approached that of the US in terms of new issue volumes because there are still fears regarding what happens in the case of a bankruptcy. While this is clearly understood in the US, it is much less clear in Europe." The provision of upstream (subordinated) guarantees reduces the uncertainty, and the inclusion of second liens further strengthens the position of bond investors.

According to Wilson, the deal was a much-needed part of the group's overall financing. "It was a crucial part of the recapitalisation of the company from both the company point of view and the equity perspective. When Apax came along they put in about £130m of cash. The rest of the business would be financed with senior debt of £400m and the balance by the mezzanine notes. We wanted to do something that would be for the long term but would be reasonable cash pay and with the flexibility that we needed to manage possible future exit events."

"We hit a good window of opportunity. When Apax invested they put in circa £130m and the existing equity, Duke Street Capital and senior management, rolled over a significant proportion of their investment. The underlying bond market was fairly favourable, but the challenge was to have the right structure of bond in place in order to satisfy the needs of bond investors and square that off with our lenders," he adds. "It was a crucial bit of negotiation."

Although a long time coming, the Focus Wickes mezzanine notes were key to the refinancing of the company and involved a structure designed specifically to meet the long-term needs of the group. The ability to exit at predetermined cost that was most important for the company, and that requirement was met. In addition, it included some interesting features that could be used by other corporates looking to tap the high-yield market but concerned about investor response. All in all it was an innovative deal in a complex and changing market.

RUNNER-UP: HEIDLEBERG CEMENT

HEIDELBERGCEMENT

June 2003
€700m senior notes
Mature 2010,
Deutsche Bank, Citigroup, RBS

Part of a larger refinancing package, the €700m high-yield bond for group HeidelbergCement was a strong deal in a tough market. The deal was oversubscribed, and was upped from €600m on the back of strong demand. HeidelbergCement is a cement and building materials producer out of Germany.

The fact that the deal got done, and came in at a larger than expected size, shows a good response to the company, given that market conditions for high-yield were far from perfect. Conditions had improved, however, and Heidelberg took advantage of that in launching the deal when it did.

It was the largest-ever single-tranche euro deal, and was the largest high-yield done in Europe at the time of launch. HeidelbergCement is one of a number of fallen angel's to tap the high-yield market. The goals of the issue and financing package were to extend the company's maturity profile, improve liquidity for the group and broaden the group's funding sources.

In addition to the high-yield deal, the group launched a €1.5bn syndicated loan and a €404m rights issue. In total, the three pieces brought in €2.6bn for the group. The ability to get all three done in a relatively short period of time and have them all launch successfully show the dedication of the company and the arrangers.