EQUITY: NORTHUMBRIAN WATER

Proving ground

IN A MARKET-CHANGING DEAL, for the first time institutional investors and a public equity placement won against private equity in a competitive auction process. The £389m deal saw the purchase of Northumbrian Water from French group Suez by a consortium, followed immediately by an accelerated IPO and public listing on AIM in London.

Boutique Collins Stewart was bookrunner on the equity deal, with Deutsche Bank and Ecofin – a financial investment firm – advising. David Martin, Group Treasury Manager at Northumbrian Water, says: "The purchase of the company was financed through the £389m equity launch and a £686m loan facility, which was arranged by Deutsche Bank."

Ecofin and Collins Stewart came up with the idea of involving institutional investors for a high dividend yield and the potential for upside later on in the

Corporate profile

Northumbrian Water Group plc's main subsidiary is Northumbrian Water Ltd, a UK-regulated water business, but has other interests including engineering and environmental consulting. The group had an annual turnover of £504m before tax and profits before tax of £93m at year-end 2002. The original Northumbrian Water Group was formed in 1989 and was owned by French group Suez until its sale and IPO in May 2003. Northumbrian is involved in significant service and environmental improvements.

Principal terms of the £389m IPO

Amount Raised £389m
No of shares 389 million
Share Price at launch 100p
Date of launch May 2003

form of capital appreciation through growth. As private equity funds usually expect much higher returns than the implied 8% dividend yield, the consortium could offer a bid that would create much more value from the perspective of the company.

Terry Smith, Chief Executive of Collins Stewart, says: "It was known that Suez was in asset disposal mode and looking to dispose of Northumbrian Water. Between ourselves and Ecofin the idea emerged of us buying the company, and we came up with the concept of the accelerated IPO – meaning the deal would be hard underwritten by us and we would then sell it on to institutional investors in a short period of time."

"That sounds straightforward, but it was quite a complex process," he says. "First of all, we were entering a competitive auction process that was already underway. We were entering it quite late and had to persuade Morgan Stanley – the advisor for Suez – that it was a credible structure and bid."

The consortium went out to about 30 institutional investors to determine market appetite, and received hard copies of expressions of interest to take back to Morgan Stanley with the bid. The process had to be completed in a rather short period of time because of the current stage of the auction, which added to the difficulty. Investors showed healthy appetite for the deal – which was marketed as 389m shares at 100p each, to give a pro forma 8.1% dividend yield. This also meant the consortium could use an 80/20 debt/equity split at the group level, which was well received in comparison with the typical 90/10 split for licensed water companies using securitisation.

This was also a good thing from the UK water regulator Ofwat's perspective, as the regulator likes to see a cushion of equity in such a deal. Chris Green, Finance Director of Northumbrian Water, adds: "It was a very appealing structure from the perspective of Ofwat, given the debt-to-equity ratios, and the fact that gearing for the licensed water business was unaffected."

New and credible structure

Smith at Collins Stewart says: "The most difficult part was probably convincing the vendor's advisers that we had constructed a new and credible structure. It was a bold move on their part to include the bid and run with it."

The goal for Suez was, of course, to maximise price and put in place a structure that would work best for Northumbrian Water. From the beginning Suez planned to sell between 75% to 100% of the company. In the end the group held on to its 25% stake. Green says: "I think it is a good indication of the company's faith in Northumbrian Water and the structure of the deal that they retained their 25% stake." It reduces Suez's debt by about €3.1bn. When the sale had been completed, the arrangers went ahead with the accelerated bookbuild and sold the deal.

"What really stood out about this transaction is that the institutional investors agreed to participate in the deal without any prospectus and with no opportunity to meet senior management," says Martin. "This really shows how the market views the stability and track record of Northumbrian."

Pricing the deal or raising the money could have led to difficulties, according to Smith. "But I think those elements worked out well. When we first started market conditions were poor – it was late January," he says. "By the time we got to May the market conditions had improved significantly. But that did not really help because this is a water business, so it is a very defensive business, which actually made it more difficult to sell. People were looking beyond defensive to more risky ventures at that point."

But even so it was well received, explains David Martin: "The market ended up liking the transaction, as was

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evidenced by the 30 initial investors – including Suez. Shares since launch have traded up, and the acquisition loan was oversubscribed."

Adds Green: "It really met the needs of company from our perspective. Public equity is a different thing than private, as you have continuous access to equity. With a private placement they may or may not provide more equity than you would get from a public deal, but usually they are looking for an exit, as well."

DAVID MARTIN
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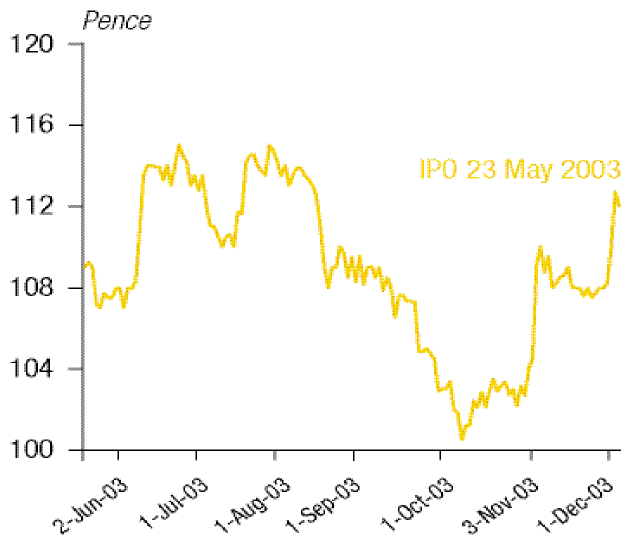
Smith says: "When private equity is looking for an exit, they are not always thinking about what is best for the company, rather how to maximise the value they can extract." With the public placement Northumbrian avoids that and ends with shareholders that better mesh with the long-term nature of the company.

The deal is a benchmark in that it opens the equity market to a brand new structure – the ready-made IPO. It is certainly something that could be used again, according to Smith at Collins Stewart: "We have actually just completed another deal with this structure, and we do believe that interest is growing." But the structure of the water business did lend itself particularly to the structure. Because of the ability to pay such a high dividend yield, it could attract investors looking for that type of stability and interested in a defensive play. In addition, at the moment no competitors are likely to enter a bid process, as consolidation is not allowed within the water industry at the moment. Thus conditions were ideal for Northumbrian to use the unique structure and go to market with a highly successful IPO.

Historical Prices Northumbrian Water.
23 May – 3 Dec 03



RUNNER-UP. YELL GROUP

YELL

July 2003
£1.31bn IPO including greenshoe
400m shares at 285p plus 60m greenshoe
Goldman Sachs, Merrill Lynch

It may have been a long time coming, but when UK directories group Yell went to market with its IPO, it went in with a bang. The deal, launched in July 2003, raised £1.31bn including greenshoe. It was a partial exit for private equity investors Apax Partners and Hicks Muse Tate & Furst. It was postponed last year as a result of the bear market conditions and held off until some recovery had occurred in the middle of this year.

The group timed the deal well to take advantage of the improving market but also beat the summer slowdown. From the company's perspective, it was a great deal. It was negotiated quite quickly – to hit a window of opportunity in the market, and it was six times covered and upsized on such strong demand – to 400m shares before greenshoe.

Investors were happy to have it upsized as it would give the company a 50% freefloat, which is key for index reasons. The decision to increase size came gradually during the roadshow, as it became clear that the deal would be highly oversubscribed.

In terms of pricing, it came in at mid-range of premarketing – the deal priced at 285p on price talk of between 250p and 300p.

The company was happy with the deal as it priced where they wanted it to and reached target investors – namely US and UK institutions, along with some German accounts. The IPO also launched simultaneously with the group's £1.225bn syndicated facility.