INVESTMENT-GRADE BOND: TESCO

Broadening horizons

Corporate profile

UK retailer Tesco has had a busy few years. With a strong focus on growth, the business has taken off both organically and through acquisition. The group launched some high-profile acquisitions in 2002, including the HIT Hypermarket stores in Poland and the T&S chain in the UK. The group is focusing on international growth, with sales up almost 30% in international businesses over the previous year.

Principal terms of the £1bn, four-tranche, multi-currency bond

Amount €750m. £350m. £200m. £50m.
Type Fixed. Fixed. Fixed. Index-linked
Margin 42bp over mid-swaps. 86bp over Gilts. 98bp over Gilts. 95bp over Gilts.
Coupon 4.75%. 5.5%. 5.5%. 3.32%
Maturity April 2010. December 2019. January 2033. November 2025
Bookrunners Citigroup, Deutsche Bank, HSBC, The Royal Bank of Scotland

AFTER TWO ACQUISITIONS, A SUBSEQUENT DOWNGRADE, the process of integrating those groups and numerous discussions with rating agencies over where the group was headed, Tesco was ready in November 2002 to launch the multi-currency bond it had first discussed in April of that year. It was a risky choice, with markets almost closed for Christmas and a relatively rough year for bonds in general. But launch they did, to a very strong reception and at tight pricing.

The €750m bond issue launched by Tesco in November 2002 not only met the needs of the company exceptionally well – by extending the maturity of existing debt and introducing a new investor base – but it also priced well and was highly oversubscribed in a tough market.

Keith Richardson, Treasury Operations Director at Tesco, explains: "Our goal was to launch a euro benchmark transaction, continue with our long-dated sterling issuance, and to try tapping the index-linked market. We were looking to achieve funding of around £750m and to broaden our investor base. We had done some sterling issues and some smaller deals in Asia, but had not as yet tapped the liquid euro market. We knew there was a massive wealth of investors in Europe, but we were not too sure if they knew our name or would be interested in our paper, so it was certainly a question mark."

Tesco has been a relatively frequent issuer in recent years, with some high-grade issues launched predominantly in the sterling market. The group had built up a refinancing need and were looking to extend their portfolio, explains Bryony Juffkins, Managing Director in debt capital markets origination at Deutsche Bank: "They wanted to extend maturities and diversify away from the sterling market, and they had a substantial amount of fundraising to do. But at the same time it was important to retain the low cost they had achieved in the sterling market in the past. They decided to tap both the sterling and euro markets, to pull in a new investor base in the euro market and maintain their traditional great rates in sterling."

In addition, with the commercial paper (CP) markets tightening up last year, many corporates globally have been looking to move some debt into longer maturities. This presented an opportunity for Tesco to do so, retiring CP debt and replacing with longer tenors, while gaining the increased exposure in Europe to pave the way for successful future issues into the market.

Timing challenge

Richardson at Tesco says that sorting out the timing was a challenge, as the original plan was to do the deal in April 2002. "It did not launch until November because there were some discussions within Tesco about the possibility of acquisitions to come in the near future. Until we were absolutely certain what was happening with that there was no point in looking at the bond market, as it was unclear how an acquisition would affect the financial picture of the company and the credit rating. We didn't want to do a bond and then do an acquisition two months later, so we held back."

"We put together two acquisitions over the next few months, including a UK confectionery store and a Polish hypermarket. We were then were downgraded," he adds. "One of our guiding principals when we issue a bond is to have it trade a few basis points tighter in the aftermarket, to leave a little something for investors, so it is clearly a good thing that we waited."

In addition, market conditions had to be considered, explains Martin Hibbert, Managing Director at Deutsche Bank: "The market was in okay shape towards end of 2001. But at the end of June 2002 the WorldCom story broke and the market shut down completely. It came back to life a bit in September but then became quite quiet again. As there was still a lot of fear over US corporate scandals, some investors were reticent to get involved in any transactions, especially names they did not know well. It started to pick up by mid- to end-November. By then year-end was fast approaching, which meant there was really a fair element of risk for Tesco. Were people going to commit to a deal or wait until 2003?"

It turned out investors were more than willing to commit to Tesco bonds, as the euro tranche was upped from €500m to €750m on the back of very strong demand. "We were very pleased with what was achieved," says Richardson. "Even after the euro deal was increased in size, we still had a book two times oversubscribed on each tranche. Considering it was our first ever roadshow in Europe we were extremely happy with that. And the strong demand for our sterling issue really showed that this market was still willing to support us. It was very gratifying."

Juffkins adds: "What really showed that this was a solid transaction is that the euro tranche was upped in size by a third with no increase in cost. The

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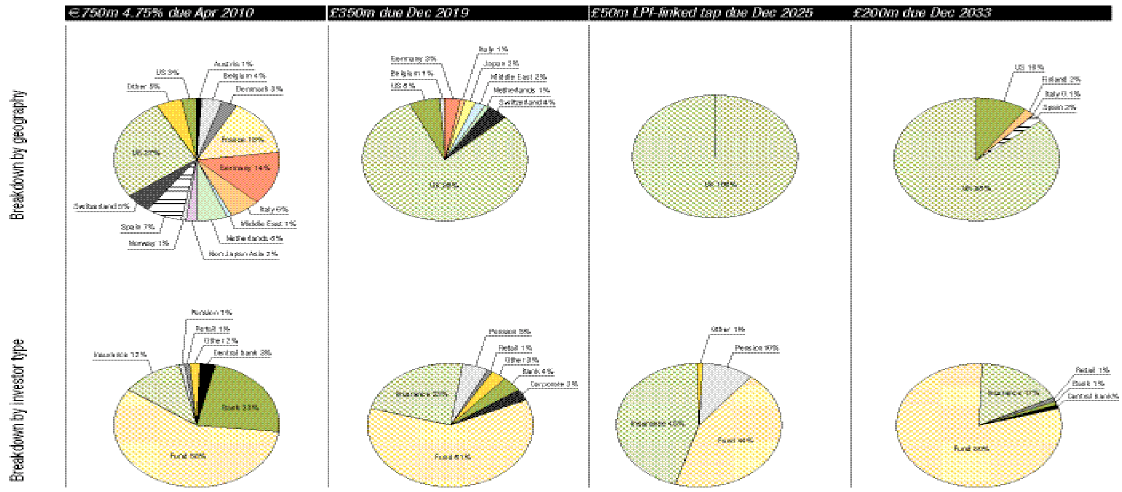

Source Citigroup

pricing and terms were coming in quite attractively, and they could easily have raised more had it been necessary, but they had no need for more funding so stopped at €750m. I think we were all pleasantly surprised, particularly with the euro tranche. Most deals at the time were requiring a premium into Europe, but there was no premium for Tesco."

Another interesting feature of the deal was the £50m index-linked sterling piece. Richardson says: "The LPI-linked issue is unique. No other retailer in Europe has issued index-linked bonds. As sales increase cashflows tend to fall in line with the retail price index, so this gives us a portion of debt that closely matches those cashflows." The LPI-linked tranche is also important in that it has a cap at 5%, so if inflation goes above 5% the group does not pay any more for the bonds.

The £200m, 31-year tranche also showed the strength of Tesco's name and the appetite of investors. "It was very comforting to know that investors are willing to take a 30-year view on Tesco as a company," says Richardson.

All in all, it was a well-executed transaction that met the needs of the group – it gave them the funding they were looking for at the price and tenor they wanted and it broadened their investor-base without increasing the cost of funding. And they achieved all this in less-than-ideal market conditions.

"I think the biggest challenge was the timing. Because we had been sitting on the deal since April and had two acquisitions and a downgrade in between, we were really not sure how market response would be. In addition we put the deal together quite quickly with four banks involved, which adds to the complexity." Pulling together the gruelling roadshow – which hit eight cities in just five days; organising the banks to work together; and getting a four-tranche multi-currency deal done effectively in just over a week is no mean feat.

RUNNER-UP. BRITISH AMERICAN TOBACCO

BRITISH AMERICAN TOBACCO

June 2003
€1bn, £350m
Mature 2013
145bp over mid-swaps,
175bp over Gilts respectively
BNP Paribas, Citigroup, HSBC

Being in the tobacco industry is not always easy going, with the US plagued by litigation and other markets tainted by association. Most tobacco bonds still require a litigation premium to get done, and finding decently-priced, long-term funding can be difficult.

But sometimes, all the elements come together, that window opens, and perfect conditions emerge. Such was the case for BAT's €1.5bn dual-tranche euro/sterling launch in June.

The months leading up to the transaction had seen several break-throughs in US litigation and much good news for tobacco industry players, particularly for BAT, with its US business usually inflicting premiums on the cost of financing versus its European compatriots.

In addition, market conditions showed an upturn in the few days prior to launch, and in particular sterling investors showed a keenness to take up BAT paper if it was well-priced. With all this in mind, BAT launched a €1bn, 10-year, and a £350m, 10-year deal.

The funding was also timely. The group had plans to enter the market within the year to refinance its €1.5bn EMTN program, which comes due in 2004. This deal took advantage of good market conditions and strong investor appetite. It gave BAT longer tenors on debt and broadened the group's investor-base in the UK and Europe.