Facing up to the funding

THE FUNDING METHODS TRACK AT THIS YEAR'S ACT ANNUAL CONFERENCE EXPLORED HOW TO FACE THE FUNDING CHALLENGE UNDER BOTH AN M&A AND A WHOLE BUSINESS SECURITISATION, OPPORTUNITIES IN CAPITAL MARKETS FUNDING, AND HOW TO BUILD A BULLET-PROOF FUNDING PLAN. **GRAHAM BUCK** REPORTS ON WHAT THE EXPERTS ADVISED.

WHOLE BUSINESS SECURITISATION "The story for Thames Water over the past couple of years has been one of needing to spend in order to develop our infrastructure," said Andrew Beaumont, Head of Treasury at Britain's biggest water utility.

Thames, privatised nearly 20 years ago, was acquired in October 2006 by Kemble Water, a consortium of long-term infrastructure investors led by Australia's largest securities firm, Macquarie Bank. Kemble paid £8bn for the acquisition to German utility RWE, which had acquired Thames five years previously for £5bn.

The acquisition was a prelude to further restructuring and debt financing activity for a whole business securitisation by Thames Water of the licence holder, Thames Water Utilities, last August.

"Timing is everything," said Beaumont. The finance markets are very different from those of five years, two years and even one year ago, making a different approach necessary.

When the sales process originally got under way in 2006 it was dual-track, with options for an initial public offering or a sale to financial investors. For treasury, the key challenges were to:

- re-establish and resource an independent treasury function on a "war footing" for the sale process and related refinancing activity;
- develop and deliver a refinancing strategy that would not prejudice the sales process; dubbed a "no regrets" capital structure; and
- meet the requirements for developing an IPO prospectus and the vendor due diligence process.

The "no regrets" capital structure targeted a BBB+/Baa1 rating for the regulated utility. It was also designed to move leverage to 53% through a further new debt issuance of £1.2bn, to refinance £875m of long-dated debt obligations provided by REW, and to negotiate change of control clauses in existing bank debt and finance leases. It also incorporated "flipper" language to facilitate the movement of debt into whole business securitisation, as required by new capital markets obligations (under the £5bn debt issuance programme).

Thames achieved its financing objectives for the sales process through the issue of £600m long-dated AAA wrapped and retail price index-linked private placements, rated BBB+/Baa1, and a new £600m 30-year fixed-rate bond alongside the repackage and sale of £875m Eurobonds into the sterling public bond market. A change of control covenant waiver was agreed on around £600m of bank debt and finance leases.

All this was achieved against the backdrop of an ongoing mergers and acquisition transaction and well-publicised penalties from water industry regulator Ofwat, which in July 2006 said it intended to impose a financial penalty on Thames for falling short of required customer service performance standards. It subsequently fined the utility £12.5m, although it reduced the penalty in April this year to £9.7m.

So what lessons did the group learn from the sale?

First, said Beaumont, communication and organisation were key, especially for a merger or acquisition, where relationships can be complex and things move rapidly. Second, a strategy and plan of execution were vital, and should include how you engage with key stakeholders such as the ratings agencies, capital markets and lenders. Third, a flexible approach was crucial.

The group's subsequent whole business securitisation was one of several adopted by UK water companies to deal effectively with the need to finance a highly capital-intensive sector. The Kemble consortium that acquired Thames adopted a back to basics strategy, focused on the delivery of regulatory

TO SEIZE MARKET OPPORTUNITIES, TREASURY PROCESSES REQUIRE DELEGATED AUTHORITY, SPEED IN EXECUTION, AND A TRANSPARENT AND ACKNOWLEDGED MANDATE/ EXECUTION POLICY WITH THE COMPANY'S CORE BANKS.

challenge

targets and opportunities to grow the regulated asset base. The whole business securitisation aligned the capital structure with the business strategy to provide a stable platform to finance Thames's capital expenditure.

This time, the key challenges for treasury were as follows:

- a further capital markets issuance of around £1bn at completion of the securitisation;
- a liability management exercise, involving negotiating with legacy bondholders and other existing creditors of Thames, aimed at moving all liabilities with the securitisation ringfence;
- negotiating £1bn of new committed bank facilities;
- negotiating a flexible approach to covenant compliance and business operations, so as not to hamstring everyday business; and
- introducing an effective covenant compliance process – often seen as treasury's problem.

Although market conditions were fast deteriorating at the time, Thames had completed the financing objectives of the whole business securitisation by August 2007. It issued £900m of long-dated AAA wrapped and retail price index-linked private placements, rated BBB+/AS, with £1bn of new three-year and 364-day securitisation-specific committed bank facilities in place with a group of nine banks. All legacy bank debt and finance leases migrated to the securitisation structure.

Beaumont said Thames assured its bondholders it wasn't "cutting them off and would come back and talk to them". This resulted in a follow-up event in February this year, with completion of the consent solicitation process to move £705m of existing listed debt obligations into the securitisation.

"This time around, Thames was able to draw on the experiences of the previous year's sales process in project planning, effective communication, organisation and flexibility of approach," he added.

And the other lessons of the whole business securitisation?

"Keep in mind the perspective of your counterparties. They will not always be able to work to your timetable and this will impact strategy. And focus on the critical path. As market conditions deteriorated last summer, the focus needed to be on the route to market and the key deliverables."

COMMERCIAL PAPER The commercial paper market has seen significant volatility in recent months, with most delegates at this year's ACT Annual Conference reporting a fall in the volume of outstanding corporate commercial paper since last autumn.

But while access to longer commercial paper tenors has been intermittent for many borrowers, pricing for the best-rated corporates has been historically tight and is attractive versus longer-term options. This raised several questions, said Russell Schofield-Bezer, European Head of Corporate Debt Capital Markets and Derivatives at HSBC:

- Is an A1-P1 short-term rating more valuable than ever?
- Has the credit crunch affected corporates' views on the level of commercial paper balances they are prepared to run on a consistent basis?
- Should all commercial paper balances be backed by credit facilities or are bank bridges to future debt capital management takeout the best way forward?

"In response to the first question, BP, like other strong industrials, has continued to see demand for its commercial paper in the short-term markets," said Gary Admans, Manager of Debt Capital Markets at BP International. At the end of 2007, BP had $5.9bn in outstanding commercial paper – a higher level than in previous years.

He added that commercial paper pricing showed Libor had ceased to be a good indicator of BP's short-term funding, which is at Libor less 40/50bp but pricing is unchanged versus Fed Funds.

For corporates needing to access longer-dated maturities, it is sometimes unclear which transactions offer best value. Libor spreads based on credit default swaps (CDS) now look unattractive against fixed-rate opportunities, which have been supported by historically low underlying rates.

In the long-term markets, BP has felt the impact of the widening in credit spreads and has minimised it by reducing issue sizes and seeking alternative funding sources.

"The key at all times was BP's ability to react quickly to market opportunities, including those in the alternative market," said Admans. BP's CDS levels have moved with the market and correlated to iTraxx Europe.

In response to the wider pricing in the G3 currencies of the yen, euro and US dollar, BP also sought to issue into alternative markets to fulfill its funding requirements. These include currencies such as the Swiss franc (a traditional retail market for BP), as well as the Canadian maple, Australian kangaroo, Japanese samurai, euro-yen and euro-Mexican peso.

What is the best treasury strategy for being able to access the market opportunistically? Admans said that suitable, as opposed to optimal, execution windows within the G3 currency markets were becoming condensed within any one week, so opportunities within them are "increasingly transient".

This means that treasury processes must be ready to move quickly so that market opportunities can be seized. To cope with this need requires delegated authority, the maintenance of an available documents platform, speed in execution and a transparent and acknowledged mandate/execution policy with the company's core banks.

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FUNDING METHODS

DELEGATES AT THIS YEAR'S ACT CONFERENCE WHO ATTENDED THE SESSION ON FUNDING METHODS WERE ALSO CANVASSED FOR THEIR VIEWS ON THE IMPACT OF THE CREDIT CRUNCH. THE RESULTS WERE AS FOLLOWS:

How do you think the volume of outstanding commercial paper has changed in the past six months?	
Increased	14.5%
Remained broadly stable	21.8%
Decreased	63.7%

What has been the most significant change in your long-term funding strategy in the past six months?	
No change in strategy	6.4%
Increased focus on bank market opportunities	22.0%
Increased focus on commercial paper market	5.5%
Increased focus on alternative funding ideas	66.1%

Do you think corporate credit spreads will be wider, tighter, or remain broadly stable at the end of the year?	
Wider	36.0%
Remain broadly stable	34.4%
Tighter	29.6%