Taking securitisation to a brand new level

Jonathan Laredo of JPMorgan takes us behind the scenes of the first securitisation of a UK food firm and the largest true operating firm transaction

Mergers and acquisitions are among the most testing experiences for any finance director. But few have faced a greater set of challenges than those confronted by Ranks Hovis McDougall's (RHM) Finance Director Michael Schurch.

A year ago his firm did not exist, except as a division of Tomkins. Since then, he and his colleagues have worked with private equity firm Doughty Hanson as it bought RHM out of Tomkins. They had to create not one but two treasury functions for the new company. As if that was not enough, they then refinanced the buy out with a groundbreaking securitisation deal.

"A lot of our managers have spent the best part of two years working on either the sale process or the refinancing deal," says Schurch. "It has been hard work, but we are all delighted at how much we have achieved."

Doughty Hanson bought RHM, one of the UK's best-known food businesses, in July 2000 after Tomkins decided to concentrate on its engineering concerns. As with any such buy-out, one of the biggest problems facing the private equity firm was how to finance the purchase in order to leverage its investment. The RHM acquisition was one of the largest European LBOs ever and Doughty Hanson was focused on optimising the standard bank and high yield financing market terms applied to a fairly broad range of transactions in the European LBO market.

The solution, which was engineered by Doughty Hanson and JPMorgan, was a 'whole business' securitisation. This is different from a traditional securitisation where bonds are secured on a pool of financial assets such as mortgages or credit card loans. A whole business securitisation involves issuing bonds backed by all the assets and cashflows of a single business or operating division.

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Such deals have been completed before in the UK. Securitisation has become the preferred method of financing the buy out of pubs, for example. It allows buyers to leverage their acquisition up to eight times, compared with typical multiples of no more than four or five times equity for acquisitions financed by bank loans.

A new level

But RHM has taken whole business securitisation to a new level. Unlike a pub company, RHM does not own a large portfolio of property. Nor are its cashflows guaranteed by long-term contracts. Rather, it is a conventional operating business whose value is based on its ability to sell products to customers. What makes RHM a suitable candidate for securitisation, however, is the great stability of many of its cashflows. Nevertheless, securitising a whole business is more complex than issuing credit card or mortgage-backed bonds. The cashflows from mortgages or credit cards are predictable, with a wealth of historical data to show how they are likely to perform in the future. For RHM's deal, by contrast, JPMorgan needed to carry out detailed analysis of RHM's fundamental business.

This was the first securitisation of a UK food company and the largest true operating company securitisation to date. As a result, the deal's arrangers spent a great deal of time working with Moody's, the rating agency that would give the deal a credit rating. The arrangers needed to explain to the agency the strengths of RHM's business and the financial structure of the deal.

But the hard work paid off. The bonds were rated and sold successfully to a broad range of UK investors when the deal was launched in February this year. JPMorgan acted as lead manager and bookrunner on the bond issue, with Royal Bank of Scotland as co-manager. The bond issue, comprising a total of £650m, was divided into five tranches (see *Table 1*). The three senior tranches were rated Baa2 by Moody's, while the two junior ones carried a Ba3 rating.

By securing the bonds on the future cashflows of the business, RHM was able to achieve financing on far better terms than alternatives such as conventional high-yield bonds or mezzanine loans. Furthermore, it secured funding with a much longer term. RHM's bonds have legal maturities ranging from three to 21 years. The bulk of the bond debt will not need to be refinanced until well into the next decade.

A valuable financing tool

This structure may not be the ideal solution for every company. But securitisation is likely to become an ever more valuable weapon in the finance director's armoury. Although whole business securitisation has so far been used mainly as an acquisition finance tool, this may soon change. Securitisation is likely to be used increasingly as simply an alternative method of raising cash. It can be applied to any business with stable and predictable cashflows. Promising sectors include utilities, chemicals and engineering.

As the RHM deal demonstrates that while this technique is called whole business securitisation, a firm can use this tool to securitise only part of its operations. RHM's businesses fall into two broad categories, only one of which was suitable for securitisation. As a result, it was divided into RHM Food Solutions and RHM Foodbrands+.

RHM Food Solutions consists of three divisions involved in either food technology or servicing large customers. RHM's Partnership division, for example, supplies food to restaurant chains such as McDonalds and Pizza Hut. Because of the nature of these businesses, the bank market was their most appropriate source of financing. As part of the refinancing package, RHM raised a £220m senior bank loan secured on its Food Solutions group of businesses.

RHM Foodbrands+ consists of RHM's other five divisions. These are mass-market businesses underpinned by some of the UK's strongest brands, that sell through supermarkets in all parts of the UK. These businesses have several qualities that make them suitable for securitisation. First, while they may never enjoy rapid growth, their cash-flows are stable. RHM Foodbrands+ operates mainly in mature markets such as bread, cakes and flour. Second, the market-leading position of brands such as Hovis, Mr Kipling and Bisto helps to protect their sales from new competitors. Barriers to entry in these markets are high and new competitors, such as supermarket own-label products, are likely to take greatest market share from brands ranked two or three in the market rather than the market leader.

Robust structure

The mechanism that pledges Foodbrands' cashflows to service the bonds is a secured loan. Unlike in some securitisations, Foodbrands+ continues to own the assets after the transaction has been completed. A special purpose vehicle (SPV), RHM Finance, issues the bonds and in turn makes a loan to RHM. The loan is secured with a fixed and floating charge on the Foodbrands business, which also incorporates a covenant package.

The treasury activities of RHM's two sub-groups, Foodbrands and Food Solutions, are ring-fenced. There are separate pooling arrangements to ensure that cash cannot leak from one to the other. Since RHM as a group includes more than 25 trading firms and some 130 active bank accounts, this separation involved considerable work for Schurch and his team.

TABLE 1

Terms of the bond issue

	Amount	Maturity	Rating	Price/coupon
Class A1 floating rate notes	£50m	2004	Baa2	Libor+135bp
Class A2 floating rate notes	£200m	2013	Baa2	Libor+300bp
Class A3 fixed rate notes	£240m	2019	Baa2	Gilts+400bp
Class B1 fixed rate notes	£135m	2022	Ba3	11.5%
Class B2 floating rate notes	£25m	2022	Ba3	Libor+575bp

Clearly, it is vital that a deal of this nature has the correct legal structure. For Schurch, one ingredient in the success of the deal was that JPMorgan and the legal advisers worked efficiently together. It is also important to have the right level of legal expertise within the company. His advice to others embarking on whole business securitisation is to set up an in-house team dedicated to carrying out the transaction. It should include accounting and legal specialists, as well as benefiting from the close involvement of the company secretary. Clear leadership of the project is also essential. In RHM's case, Schurch led the project and until recently had few operational responsibilities other than the buy out and refinancing.

This is probably just as well. A great deal of work went into establishing RHM as a separate firm. At the time of the buy out, for example, RHM had no head office. For the first six months of its existence as a newly independent firm, RHM continued to use Tomkins' services for many head office functions. The first task was to put staff in place at the new head office in Marlow and to draw up accounts for the new company. "The biggest challenge we faced was not simply to set up a new corporate infrastructure, but to set up an infrastructure capable of dealing with two separate subgroups," says Schurch.

Such corporate restructuring can be distracting for managers. One factor that helped with the changeover, says Schurch, was the willingness of the arranger to explain the new structure. "Doughty Hanson and JPMorgan were prepared to work with managers throughout the RHM group and to help them to understand the steps we needed to go through," he says. "This was vital for a large company such as ours. The financing strategy was consistent with the focused business strategy on the different characteristics of the RHM Foodbrands + and Food Solutions businesses."

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Obtaining a credit rating was another part of RHM's learning experience. Working with the rating agencies is an increasingly valuable skill for finance officials. In the past three years, so-called 'relationship' lending has begun to dry up throughout Europe. Banks are cutting credit lines as they seek to improve their return on capital. As a result, European firms have begun to turn to the capital markets, financing themselves through securitisation and plain-vanilla bond issuance.

"We all have a lot of experience of working with banks," says Schurch. "But as the market moves from bank financing to bond financing, it becomes increasingly important to understand how the rating agencies work. We were fortunate that JPMorgan has a good understanding of the rating process."

Securitisation looks set to become an ever more important feature of the corporate finance landscape. RHM's success suggests a number of lessons for other firms hoping to emulate it. Leadership from within the firm is vital, as is the ability to work with experienced and capable financial and legal advisers.

And, as Schurch discovered, a deal of this kind requires a great deal of commitment. "This is not a nine-to-five process," he says. ■

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