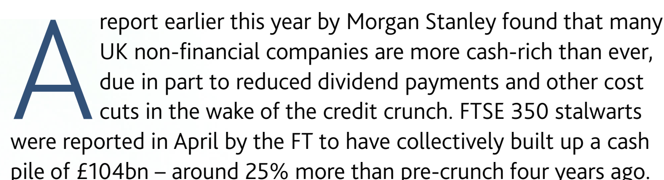
Green light for debt buybacks

MANY CASH-RICH COMPANIES HAVE DECIDED THAT CURRENT CONDITIONS ARE RIPE FOR REDUCING THEIR PUBLIC DEBT LOAD. **GRAHAM BUCK** REPORTS.



A report earlier this year by Morgan Stanley found that many UK non-financial companies are more cash-rich than ever, due in part to reduced dividend payments and other cost cuts in the wake of the credit crunch. FTSE 350 stalwarts were reported in April by the FT to have collectively built up a cash pile of £104bn – around 25% more than pre-crunch four years ago.

But rather than hit the acquisition trail, many companies have used the cash to buy back shares, restore dividends and cut debt. Although the banks have been criticised for not lending, it appears that many companies are not seeking fresh credit but are reducing debt loads.

Excluding companies in the financial sector, there is, says the FT, "a cache of potential firepower", with 101 FTSE 350 firms announcing reduced debt levels over the previous year and 69 reporting net cash. "That will improve company cashflows in coming years as interest bills fall, or even turn into interest receipts, leaving management teams with money to spend," the newspaper observed.

While net debt at Vodafone, Royal Dutch Shell and BP rose over the last reporting year, the combined total for the remaining members of the FTSE 350 was put at £234bn, a 15% reduction from the 2008/09 figure of £275bn and similar to the level of 2007/08. The figure is expected to fall further in 2010/11 as companies continue to pay down debt and further bolster their cash piles against the backdrop of an uncertain economic outlook.

The trend continued over the summer months, as BAT, Land Securities and Tesco announced buybacks of either short-term or longer-term debt, and in each case won the City's approval.

Land Securities, the UK's largest commercial property group, successfully bought back £254m of bonds to reorganise its debt and benefit from poor liquidity for corporate notes. The bonds, due 2013, were originally issued in February 2006 when the UK commercial property market was nearing its peak. The group offered a repurchase price of £1,017.96 for each £1,000, which was accepted by more than 80% of the holders.

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It was the latest phase of a buyback policy initiated last September when the Land Securities group paid back £1.5bn from a total debt load of just under £4.5bn and raised a further £210m from the sale of its stake in Birmingham's Bullring development. As reports noted, the buyback "helped Land Securities to eliminate a sizeable chunk of corporate debt… freeing up resources to renegotiate a key £1.5bn revolving credit facility which matures in July 2013."

When Tesco announced full-year results in April it revealed net debt of £7.9bn; lower than the expected figure of £8.5bn, thanks to property disposals and working capital inflows. In June, it announced plans to trim a further £1bn. A Tesco statement said: "The company now has a surplus level of cash, and is in a position to retire a proportion of senior debt and, therefore, improve net finance costs on an ongoing basis." The Tesco buyback, described as an "invitation for offers to sell notes for cash in a modified Dutch auction", was spread over nine separate bonds – with various maturity dates as late as 2057 – of which £6.22bn is outstanding debt. The group will invite bondholders to tender at or above a price that it sets, and its savings will reflect which bonds are tendered and at which price.

LONGER-TERM PROGRAMME BAT had approached the market last November when it repurchased £350m of 5.75% notes and €1bn of 5.125% securities, due 2013. The group followed up in June with an invitation to holders of its outstanding €750m notes, due in 2012 with an annual rate of 3.6%. It purchased an aggregate principal amount of €412m of the notes, which were offered for sale at a mid-swap rate of 1.3% and purchase yield of 1.6%.

Neil Wadey, treasurer for corporate and financial risk at BAT, says the two buybacks were part of the group's £10bn ongoing funding programme, of which around 80% is in bonds that regularly come up for renewal. "We always review best execution and whether or not we should await the bonds' maturity," he says. "With the bond buyback in 2007 we decided it was too big for us to wait, but the two more recent ones resulted from the cost of carry debate.

"We liked the market conditions in terms of issuance and, as interest rates remain very low, buybacks continue to look attractive. So it was more a case of looking at the options of tenders or exchanges. We also consider what the group's objectives are; sometimes these may be structural rather than financial."

The late June timing of the most recent buyback was determined by BAT's close period beginning in July and because conditions were less favourable earlier due to concerns over Greece's economic situation. "Although we were happy with our timing, the logic has in fact improved even further since as gilts and credit spreads have tightened," says Wadey. "The June buyback was certainly the most opportunistic, as while we liked the look of 30 years sterling we didn't like the cost of carry."

With consumers under pressure and a rise in VAT to 20% scheduled for next January, conditions in the retail sector are likely to get even tougher. Marks & Spencer and Next are among the major high-street names that have joined Tesco in reducing their debt. Last November M&S announced a buyback of up to £225m on its 6.375% bonds, due 2011, and 5.875% 2012 notes through a modified Dutch auction. The group cited favourable market conditions and said it had around £1.2bn of bonds maturing over the next five years and wanted to refinance some of that while demand remained strong.

"In terms of motive this had nothing to do with using surplus cash," says Michael Wallace, M&S's group treasurer. "It was all to do with extending our average debt maturity and managing our refinancing risk for upcoming bond maturities, while mitigating the cost of carry at the same time."

He adds that, from a liquidity point of view, what stood the group in good stead during the financial crisis was the lack of any need to refinance bonds in the short term supported by a large, long-term bank facility. "It made sense to take the opportunity to implement some liability management on our 2011 and 2012 bond maturities while market conditions were good."

Fashion rival Next has also been reducing net debt. The total was cut from £629m to £400m in its most recent financial year, although group finance director David Keens says that the policy is not a reflection of the anticipated squeeze on consumer spending. "This is emphatically not the case," he stresses. "To the contrary, Next has consistently been returning capital to shareholders via higher dividends and share buybacks for over a decade, made possible by strong cash generation from operations. This has resulted in surplus capital over and above that required for investment in the business, which is always our first-choice use of capital."

The group confirmed, when it reported its first-half figures last month, that it had continued the policy of using surplus cash to buy back shares over the first half of 2010. Next believes that the policy translates into earnings per share rising 6% faster than profits. Cash will primarily be used to invest in the business, with £135m pencilled in for capital expenditure in the current year and an increase of at least 10% in the annual dividend. Once these requirements have been met, any surplus cash will be used for buybacks.

ALIGN BOARD WITH TREASURY Wallace suggests that companies contemplating a buyback need to be ready to exploit windows of opportunity, which requires the board to be aligned with treasury. "Conditions are still good, with an improvement in underlying yields and no material widening in credit spreads," he notes. "It looks unlikely that this will fundamentally change for the time being. The story for treasurers is that the bank debt market has changed. In the past large, long-dated facilities were easily available, but corporations need to reassess what they use their bank facilities for. For those with facilities that don't expire until 2013 there is no immediate pressure to refinance, but treasurers need to anticipate tougher discussions in the future and take this into account when considering bond refinancing."

And with reports suggesting that a "big wall of refinancing" lies ahead in 2012, it is likely that banks will be keen to get in on the act.

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