UK debentures – trends in financing techniques

Robert St. John of Greenwich NatWest discusses how greater choice, more flexibility and different structures are benefiting both investors and issuers.

The word debenture means different things to different people. In the US domestic bond market a debenture is defined as: 'a long-term, corporate debt instrument issued *without collateral* and secured only by the general credit of the issuer'. In the UK, a debenture is widely accepted to be a bond that is *specifically secured* by designated assets or property of the issuer, pays interest semi-annually and is in registered rather than bearer form. My focus in this article is on UK debentures.

In the days before eurobonds, the UK bond market could be divided into two sectors: loan stocks comprising unsecured issues and debentures, comprising secured issues. Debentures were (and are) favoured investments for life companies and pension funds since they provided a long-term source of interest income and, because of the security, a very low risk of loss. Hence, debenture stocks became the classic 'widows and orphans' investment.

For the issuer, pledging assets to secure its debt meant either that it could raise long-term finance, or by giving security, it could reduce the cost of its borrowing. A wide range of corporates used the debenture market to raise debt capital. Past issuers include: Delta, BET, Laporte, Albright & Wilson, Wolseley, Glynwed, Courtaulds, J Sainsbury, Tarmac, as well as others with issues still outstanding, such as Bass, Whitbread and Land Securities.

The market today

The sterling debenture market today comprises a small and much more focused segment of the overall sterling bond market. In 1998 there were 12 debenture issues with a combined value of £564m, which represented only around 1% of the total value of issuance in the sterling bond market of around £51bn. Issuers are now very largely concentrated in four market sectors: property companies, investment trusts, housing associations and brewers. *Table 1* lists some companies that have issued debentures within the past five years.

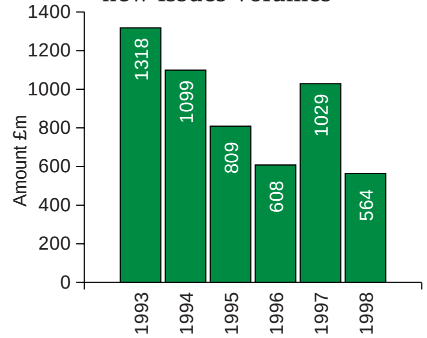
The issues were in the range of £15m–£250m, the majority being £25m–£100m. In terms of maturity, the range was 15–55 years, 20–30 years being the norm.

Invariably, the security structure is either a fixed charge on a designated portfolio of assets (nearly always property assets located in the UK) or a floating charge over all the assets of the issuer.

Fixed-charge security is most appropriate for property companies, whereas floating charges are used by investment trusts giving security over their equities portfolios and brewers giving security over their portfolios of pubs.

FIGURE 1

Sterling debenture issues – new issues volumes



Recent developments

One factor, above all, has had an increasing influence on the debenture market over the past few years – securitisation or the process of pooling assets and converting them into packages of securities.

Although both debentures and securitisations require portfolios of assets as security for debt finance, the emphasis in a securitisation is on the cash flow from those assets, whereas for a debenture it is primarily the capital value of the assets. Valuing assets for their cash-generative qualities rather than their capital values has opened the market to a wider range of asset class and security structure than is possible through a traditional debenture structure.

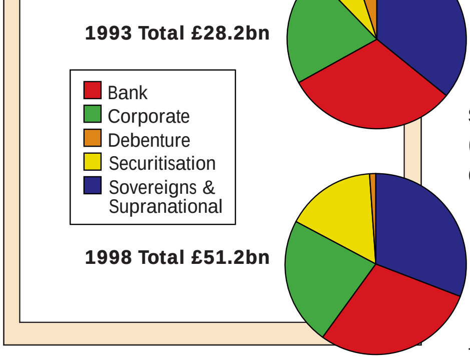
Robert St. John

The result is that many borrowers are finding they can use their assets more effectively to raise debt finance by a securitisation rather than simply giving security over a designated portfolio of assets. Over the past five years the market has seen securitisations of assets ranging from student, consumer and corporate loans to car leases and from VAT receivables to hotels.

The government's PFI initiative and project financings have spawned a series of other structures of bond issue, with some element of collateral or credit enhancement, used to finance the debt element of the project. These include power stations, waste water facilities, roads, rail links and hospitals. The security is usually provided by cash flow generated by the project, which in the case of PFI projects is often supported, albeit indirectly, by the UK government. As added protection, many of the

FIGURE 2

Sterling bond market – new issuance by issuer type



bonds are credit-enhanced by US monoline insurance companies. One recent PFI project bond, launched in 1999 by Greenwich NatWest, was the £97.19m issue for Catalyst Healthcare (Worcester) PLC with a final maturity in 2030, guaranteed by Ambac. The bond provided finance for construction of hospital facilities at Worcester.

There have also been bond issues to finance pub portfolios, which were sold by the major brewers in response to the Beer Orders legislation. Over the past four years bond issues for Phoenix Inns, Punch Taverns and Unique Pub Co, have raised nearly £1.6bn through bond issues securitising pub portfolios.

Often, the securitisations are structured as long-term fixed-rate issues with security provided by fixed charges over portfolios of properties. In this sense they are the same as debentures and the bonds are placed with the same group of UK institutional investors which buy traditional debentures. However, in many cases these transactions are structured as a number of different tranches with different amounts and maturities – some tranches fixed rate, others floating rate. For example, the recent £1.54bn securitisation of British Land's Broadgate properties comprised seven issues ranging in maturity from 2014 to 2038. Of these tranches, three were floating- and four were fixed-rate.

One advantage of structuring issues with fixed and floating rate bonds is that it is possible to tap a much wider range of investor since those in floating rate notes are very different to traditional UK life and pension fund investors.

Most securitisation issues have at least one external credit rating. Because the transactions often involve complex structures, often with different tranches (of size and maturity) carrying different credit risks investors expect ratings to help in their own assessment of the risks involved and to provide a yardstick for pricing. By comparison it is rare for debentures to be rated since the buyers of these issues are more familiar with the security structures and are therefore comfortable making their own assessment of the risks.

As regards price, debentures generally trade at a tighter spread than securitisation transactions of an equivalent risk. This is partly because of the relative scarcity of debenture issues and partly because investors are more comfortable with security structures of debentures which are perceived as tried and tested.

However, despite the advantages of debentures, the additional flexibility provided by some securitisation structures has led to a rapid increase in this type of financing at the expense, to some extent, of traditional debenture finance. *Figure 2* shows the growth in securitisation transactions and decline in debentures between 1993 and 1998.

Emerging patterns

The pattern of the past few years in the sterling bond market has been the growth in size, structure and complexity of bond issues which utilise security. Gone are the days when the market divided into eurobonds, loan stock and debentures. There is now a seamless spectrum of unsecured eurobonds, secured bonds structured as traditional domestic debentures, securitisations in eurobond format and eurobonds secured on designated assets.

The major UK institutional investors are indifferent. They have an ongoing (and increasing) appetite for high-quality, long-dated income streams providing a better yield than gilts to meet their pension and annuity liabilities. So long as the security is robust, maturity long enough and return competitive, they will invest regardless of the transaction structure.

In view of this it is likely that traditional debentures will continue to decline as a market sector whereas securitisation will continue its recent rapid growth. However, while the largest transactions are likely to be structured as securitisations, there will be a place for traditional sterling debentures particularly for issue sizes of less than £100m.

Borrowers looking for long-term debt capital now have more choice than ever before. Clearly it is important they consider all the options and choose the structure best suited to their own constraints and the security they can offer. Two recent transactions illustrate this.

In March 1999, Burtonwood brewery raised £25m through a 25-year debenture issue. It would have been possible for Burtonwood to raise these funds through a securitisation of part of its pub portfolio, but this would have had several disadvantages. By contrast, Paramount Hotels, which owns a portfolio of eight hotels, decided on a securitisation rather than a debenture partly because it enabled it to achieve a higher loan to value on its assets and partly because it did not want to be tied to some of the restrictions of a debenture structure. As a result, in March 1999 a £52m issue was launched for Hotel Securitisation No.1 – the first hotel securitisation transaction in Europe.

There is every reason to believe this trend of greater choice, more flexibility and different structures will continue to the advantage of both issuers, which are able to select the best alternative for them and investors, which will be offered a wider spectrum of investment opportunity. ■

Robert St. John is director, Capital Markets, at Greenwich NatWest.

TABLE 1 Selected debenture issues in the past 5 years

Investment trusts	Brewers	Housing associations	Property companies
Dunedin Smaller Companies Investment Trust	Burtonwood Brewery	North British HA	Asda Property
Edinburgh Investment Trust	Eldridge Pope	Northern Counties HA	British Land
Invesco English & Intl. Trust	Fuller, Smith & Turner	Peabody Trust	Eskmuir
Monk Investment Trust	Marston, Thompson & Evershed	Sanctuary HA	Great Portland Estate
	Whitbread	The Housing Finance Corporation (THFC)	Hemingway Property
			J. Saville Gordon