BA launches ground-breaking issue

In April, British Airways launched a €300m preferred securities issue, a first for a UK corporate. Russell Maybury of Warburg Dillon Read reviews the transaction.

The ground-breaking British Airways (BA) preferred securities issue heralds a new era of balance-sheet management for UK corporates following an explosive development of preferred securities applications globally. Such 'senior equity' is no stranger to the UK markets since domestic law preference shares have had a long and illustrious history. The purely domestic nature of preference shares and the recent tax changes eroding their cost benefits have led to their demise. The new generation of tax-deductible gross paying preferred securities are their duly anointed successor. The availability of the euro market as a viable alternative to the established USD market makes preferred securities an even more attractive proposition.

In these days of shareholder value and leverage and the need for flexibility in managing the balance sheet, preferred securities have arrived at the right time. Correctly structured, they can be viewed from the corporate's standpoint as the equivalent of equity. The investment is perpetual and senior only to ordinary shares, junior to all debt. Distributions, while fixed, depend on the existence of distributable profits. Issuance does not, however, need shareholder approval and may be retired as easily as borrowings. Yet issuance is substantially cheaper than ordinary shares and non-dilutive.

This article provides a case study for the use of this exciting new instrument by a blue chip UK corporate.

Rationale

It is now a matter of public record that BA has been feeling the pressure of lower passenger yields and a lower proportion of business traffic. BA is also in the middle of a significant fleet renewal programme. It had concluded that some modest bolstering of its balance sheet would be a wise precaution. The aim therefore was to find a product that achieved some, if not all of the following aims:

1. favourable equity impact from a rating agency perspective;
2. tax-deductibility; and
3. no dilution for existing ordinary shareholders.

BA considered a number of products before coming to the conclusion that some form of preference share/preferred security would be the most likely solution. The next decision was whether this should be a USD issue in the US market – a well-established route – or the more adventurous path of a euro preferred. As a sterling-based company with assets in both US dollars and euro, this was not a straightforward decision.

On balance, BA decided in favour of the euro for several reasons. One of these was that the basic fixed-rate coupon was attractive at the time and BA wanted to diversify its capital base, recognising its significant presence in the euro-zone and the group's forthcoming investment in the Spanish airline, Iberia. Another reason was that BA considered that the transaction costs for a European-based deal would be lower than in the US.

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The structure

The bonds offered were non-voting, cumulative with a nominal value of €25 at a fixed, quarterly coupon of 6.75%. No maturity was set, but the issuer had the option to call the bonds at par at every coupon date from 2004. The securities were issued through a Jersey Limited partnership (British Airways Finance Jersey LP) and are guaranteed on a subordinated basis by British Airways Plc. They are listed on the Luxembourg Stock Exchange.

Taxation treatment

The offshore structure crystallises tax efficiency. The tax benefits of the onshore preference shares of old have now been virtually eliminated. That same tax benefit also pretty much restricted distribution to within the UK. This greatly cut down on both capacity and price transparency.

The offshore structure ensures distributions are paid gross without withholding tax, leading to a potentially global placement. The BA preferred securities were sold to investors in more than 15 countries. This not only guaranteed BA the best price but also the broadest access to a new investor base.

The offshore structure also meant that BA benefited from after-tax distributions. Consultation with the Inland Revenue (IR) meant that BA had the assurance of this advantage at the time of issue.

With the abolition of ACT and the loss of tax credits to investors, the IR is concerned about the tax deductibility of hybrid instruments and wanted to be assured that the instrument was not tax-driven. Further, in view of the international nature of the retail market for the instrument, the IR wished to be certain that there was no general lack of tax symmetry between BA and investors on a basis wider than the UK. In particular, here, the IR was a concerned that the

coupon should be taxed as interest and should not qualify for participation exemption in jurisdictions which would cause it not to be taxed.

The instrument was not marketed on any tax arbitrage basis.

Accounting treatment

The accounting treatment of capital is established under FRS4 and was reviewed by the UITF after earlier Yankee hybrid issues in the mid-1990s, notably Cadbury Schweppes and Grand Met. The BA issue follows those issues closely. The accounting treatment on a group basis is to treat the preferred securities as non-equity minority interests in accordance with FRS4.

Ratings benefit

Achieving some support for senior credit ratings through the preferred securities issue was a major driver of the transaction. The ratings agencies have for years acknowledged that there is much benefit to be derived from the use of hybrid instruments in managing the balance sheet. BA would not have proceeded with the transaction if the major ratings agencies had not confirmed expressly that the issue would have a favourable effect on the airline's ratings profile.

BA made focused presentations to the ratings agencies and engaged them in specific discourse as to the structure and perceived benefits. It chose to proceed with the 'Rolls-Royce' version of non-dilutive hybrid: the straight perpetual. Although more costly than others, it also potentially afforded more benefit. The sought-after assurances from the ratings agencies were forthcoming and this driver was in place.

Timetable

As a strategic capital markets project, preferred securities issuance, particularly the first transaction for a new issuer, is a time-consuming and relatively intense undertaking. From the mandate in early February 1999 to the launch some two months later in April, BA officials, WDR experts and their advisers worked together to a demanding timetable to sort out all the tax, accounting, legal and market issues. As structuring obstacles were overcome and documentation started to take shape, the team turned its attention to defining the best strategy for entering the market and achieving best execution.

> Ratings agencies have long said that there is benefit from using hybrid instruments to manage balance sheets

Marketing approach and distribution

One of the principal aims of the sales process was to make full use of the international recognition of the BA brand to achieve the broadest possible retail distribution. In particular, many of the preceding bank capital issues in euro had leaned heavily on Iberia for sales. A key to success, therefore, was to allow plenty of time for the book-building process to develop. Retail investors also need a lot of care and attention as well as time before they are able to make a decision.

The first part of this process was to brief sales professionals and private bankers on this new product before they in turn went out to their clients. This is a specialised process which demands a strong understanding of the likely buyers of the product by the lead manager. The number of potential small-ticket investors is so great that a 'blunderbuss' approach would make the book-building process interminable. Only a well-informed, targeted effort is likely to reduce the time required to a manageable period.

The great advantage of a retail deal in Europe is that once the process has been started, it is difficult to turn it off, since retail enquiry will continue long after the pay date. The strategy throughout therefore was to launch a successful deal, albeit in a smaller size, certain in the knowledge that in a matter of months, or even weeks, it would be possible to re-open and increase the size of the transaction.

Syndicate

One of the most difficult challenges for treasurers is choosing the right syndicate group. The balance between rewarding relationships and ensuring the deal's success is always a difficult one to strike. This is made even more complicated when the issue is a ground-breaking transaction for a highly prestigious borrower with many strong relationships, in a market where track records are difficult to judge.

In the end, the syndicate group included banks with proven capabilities in the European retail market and some with balance sheet exposure to BA's aircraft loans. "…the syndicate group in this type of transaction can never be big enough to recognise all of BA's important relationships", said BA group treasurer, Chris Willford. "Inevitably there were some very disappointed people, but no bank should expect to be part of every deal we do".

Lessons to be learned

The tax-deductible preferred securities market in Europe is new and complex, so a few cautionary tips are useful:

- allow plenty of time, particularly in the structuring phase, for all your advisers and, where appropriate, the IR and any relevant regulatory body, to have a good look at the transaction. Do not assume that advice that may have worked for a previous transaction will necessarily work for you;
- make sure that the key people in your advisory team are the best available and are personally committed to the transaction. In a complex transaction it is very easy to lose the thread and regular changes of personnel will exacerbate this; and
- retail marketing is very different from institutional and it is not open to everyone (for the time being). Good name recognition and respectable ratings are important factors. Allow plenty of time and take into account the impact of the many holidays in Europe if you are working to a tight timetable.

The euro preferred market is growing fast. On a cost basis it provides a very attractive alternative to the established US market. The quality of distribution achievable is superb and well worth the effort. For those companies who fit the criteria and are considering putting their balance sheets under pressure through expansion or acquisition and do not wish to issue straight equity, it is a must for the shopping list. ■

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