BAe's record-breaking sterling Eurobond issue

British Aerospace recently launched the largest ever sterling-denominated Eurobond issue by a UK corporate. Gavin Brake of Goldman Sachs reviews the transaction.

At 7.30am on 22 June 1999 British Aerospace plc (BAe) surprised the market by launching a £686m bond exchangeable into approximately 5% of the issued and outstanding ordinary shares of Orange plc (Orange). To date, this transaction represents the largest ever sterling-denominated Eurobond issue by a UK corporate.

This transaction, launched and priced in one day with only a small impact on the underlying share price of Orange, offered BAe the double benefit of very low cash-cost, sterling-denominated debt, combined with the opportunity to sell its holding of Orange shares at a meaningful premium to the share price at launch.

Background on the holding

BAe's association with the mobile telephone business in the UK dates back to early 1991 when a consortium led by the company (under the name Microtel Communications Ltd) was first awarded a licence by the DTI to operate a personal communications cellular telephone network (PCN). In July 1991 Hutchinson Telecom, part of the Hong Kong-based trading group Hutchinson Whampoa, acquired Microtel Communications Ltd from BAe in exchange for a 30% stake in the resulting company. The business was subsequently renamed Orange Personal Communications Services Ltd. BAe further increased its holding in the business to 31.6% (and in Hutchinson Whampoa to 68.4%) in July 1995 when Barclays Bank plc sold its 5% equity interest to the two principal shareholders.

In March 1996, Orange underwent an initial public offering (IPO) and listing on the London Stock Exchange and NASDAQ. Following the completion of this offering, BAe's shareholding stood at 21.1%. This equity crossholding was then further reduced in a block trade of an additional 16.1% of the company in March 1998, leaving BAe with a residual holding of 59.96m shares or 5.0% of Orange.

> BAe achieved a precedent-setting sterling offering in terms of size and pricing, executed on an accelerated timetable and placed in the market with little pressure on the underlying share price of Orange

Market conditions

From an equity market perspective, the highly successful performance of Orange as a business, combined with positive market sentiment towards the telecom sector, had together driven up the share price of Orange from the IPO at a price of 205p per share in March 1996 to 908p on the day prior to launch of the exchangeable offering.


Gavin Brake

In addition, conditions in June 1999 in the convertible and fixed-income markets were favourable for new issues, with a notable lack of both high-quality sterling denominated fixed-income and convertible debt.

However, there were also concerns at that time about equity markets peaking, fixed-income spreads potentially widening and forthcoming heavy debt and equity issuance anticipated for the period from early September until mid-November 1999. Based on this understanding, BAe decided to launch, price and close the transaction on an accelerated basis prior to the summer.

Rationale and products considered

A number of different financing alternatives were open to BAe. The clear expectation of the equity market was a block trade of the remaining shares, similar to the March 1998 transaction. In addition, given the size of the remaining stake relative to the daily trading liquidity in Orange shares, BAe would also have been able to put in place a value-protecting, private, derivative transaction, such as an equity collar.

For BAe, however, the exchangeable bond disposal strategy best matched its corporate objectives and offered a number of unique advantages:

- first, the exchangeable offered the opportunity to sell the underlying shares at a premium to the Orange share price at launch;
- second, the very low, fixed-rate coupon on the bond offered BAe the opportunity to lock in highly attractive, sterling- term funding; and
- third, the exchangeable bond offered proceeds today for BAe, but without crystallising a capital gain for tax purposes until investors exchange the

bonds. This will most likely occur only at maturity of the bonds, or if BAe exercises its ability to call the bonds for early redemption (see below).

TABLE 1 Large sterling denominated corporate bonds and convertible/exchangeable bonds 1990–1999

Announced	Issuer	Size	Offering Type	Maturity
22 June 1999	British Aerospace Plc/Orange Plc	£686m	Exchangeable	21 July 2006
28 April 1999	British Telecommunications Plc	£600m	Fixed rate	7 December 2028
25 August 1993	British Telecommunications Plc	£500m	Fixed rate	5 September 2003
16 April 1991	Hanson Plc	£500m	Convertible	31 January 2006
22 April 1992	Hanson Plc	£500m	Fixed rate	20 October 1997
12 May 1995	Glaxo Welcome Plc	£500m	Fixed rate	1 December 2005
9 January 1998	National Grid Group Plc	£460m	Convertible	17 February 2008

Note: all sterling deals were issued by public and private corporates and utilities, excluding banks, other financial institutions and government/sovereign issues. Source: Euromoney Bondware

From the perspective of Orange, the exchangeable also offered a number of advantages. The potential premium on the exchangeable offered a bullish signal to the market, indicating that BAe expected further upside in the Orange share price in the future. In addition, BAe will retain legal ownership and full voting rights on the underlying Orange shares until exchange occurs.

Offering structure

Based on its corporate financing requirements, BAe decided on a seven-year, sterling denominated offering, issued and redeemed at par. The coupon range was set at 3.5–3.75% for marketing and bookbuilding, with a premium range of 27–30%. The exchangeable bond also offered investors a period of 'call protection' for the first three years, with BAe then able to call the bonds for redemption at par from the beginning of year four until maturity so long as the share price of Orange is then trading more than 115% above the exchange price of the bonds.

Although Orange is a NASDAQ-listed company, the exchangeable bonds were not offered to US investors. This resulted from both structuring issues arising from the potential affiliate status of BAe *vis-à-vis* Orange (given that it shares two board directors with Orange) and the judgement that, in any event, it would be possible successfully to place the entire deal to UK, European and other non-US investors.

Accounting and taxation

The exchangeable bond is a senior unsecured debt obligation on the balance sheet of BAe. Coupons payable on the bonds are tax-deductible. Importantly for BAe, the exchangeable raises cash proceeds today for the company, but does not result in a capital gain on the Orange shares until investors decide to exchange the bonds. Furthermore, due to the provisional call feature of the exchangeable bonds, BAe also has some control over when exchange ultimately occurs.

Timetable

BAe decided to execute the offering on an accelerated timetable. Given that the transaction was 'euro-only', no offering circular was required for investors at launch. Indeed, at launch the transaction was marketed by the syndicate on the basis of a one-page summary of the key terms and conditions of the bonds, with the full offering document being completed on 19 July 1999 in advance of settlement of the transaction on 22 July 1999.

In terms of marketing, the transaction was announced to the market at 7.30am on 22 June 1999, with bookbuilding beginning immediately. An intensive selling effort by the syndicate during the day resulted in the joint bookrunners being able to 'close the books' at 4.30pm the same day. The transaction was priced that evening, with the exchange price for the bonds based off the closing share price of the Orange ordinary shares on the London Stock Exchange that day.

Exiting or managing equity risk of corporate crossholdings is an increasing priority for treasurers, CFOs and CEOs

BAe and its joint bookrunners determined appropriate allocations for investors in the evening. The pricing terms were then communicated to the market at 7.30am on 23 June 1999, with allocations given to investors at the same time. When-issued trading in the bonds began immediately thereafter.

Syndicate

Deciding the appropriate syndicate for such an important transaction is an extremely difficult task for any issuer. Generally, syndicates on convertible and exchangeable offerings tend to be more focused than similarly sized equity offerings, recognising the specialist nature of the security and the need to ensure complete confidentiality prior to launch.

In this transaction, BAe chose to execute the offering with two joint bookrunners, Goldman Sachs and JP Morgan, and a focused syndicate of two co-managers, ABN AMRO and Dresdner Kleinwort Benson.

These four syndicate banks between them offered a strong combination of 1) product expertise, 2) prior relevant deal experience, 3) strong equity research credentials with regard to Orange, and 4) a proven long-term relationship with BAe.

Marketing and distribution

The offering was well received by the market with over 350 institutional orders received during the one day of bookbuilding. Total demand generated by the syndicate totalled £2bn, resulting in an over-subscription level of 2.9x the final deal size, in line with recent market precedent. Investor demand arose primarily from UK accounts (33%), offshore accounts (20%), Switzerland (12%), France (11%), Italy (8%) and Germany (5%).

Pricing

The offering was priced with a coupon of 3.75% and a premium of 29.4% above the closing share price of Orange (£8.84) on the day of pricing, giving an exchange price of £11.44 on the bonds.

Important lessons

As the largest-ever sterling denominated corporate Eurobond or convertible/exchangeable Eurobond, the transaction illustrates a number of important lessons:

- the exchangeable bond structure can offer an attractive, tax-efficient exit for corporates looking to sell equity holdings in other corporates. BAe achieved a coupon of 3.75% (within the marketing range of 3.50–3.75%, and despite a sell-off in the UK bond market that resulted in an 11bps increase in the underlying reference gilt yield on the day of bookbuilding and pricing), and a premium of 29.4% (towards the upper end of the marketing range of 27–30%);
- rapid execution of the transaction during one-day minimised selling pressure on the Orange share price. During the day, the price declined by only 2.6% (908p to 884p) on a day when the FTSE 100 index declined 0.9%, resulting in a relative change of only 1.7%. Furthermore, based on the historical volatility of Orange, on an average day the share price moves up or down by approximately 3%; and
- extremely tight control of information among syndicate members prevented rumours of the impending sale in the days leading up to the offering, avoiding any selling pressure being created on the Orange share price. As stated by the *Financial Times* on Wednesday 23 June 1999, “British Aerospace surprised the market yesterday by paving the way for the sale of its stake in Orange, the mobile phone group, through an offering of convertible bonds.” This helped ensure BAe achieved the highest possible exchange price (£11.44) on the bonds.

BAe was able to achieve a precedent-setting sterling offering in terms of both size and pricing, which was executed on an accelerated timetable and placed in the market with very little pressure on the underlying share price of Orange. In a climate of increasing focus by corporates on shareholder value and so-called ‘managing the equity account’, determining the most appropriate method to exit or manage the equity risk of corporate crossholdings is becoming ever higher on the priority list of corporate treasurers, CFOs and CEOs. Exchangeables are one of many solutions to consider and evaluate, as was aptly demonstrated by the record-breaking BAe offering of bonds exchangeable into ordinary shares of Orange. ■

Gavin Brake is an associate in the equity derivative capital markets group at Goldman Sachs International in London. The group specialises in convertibles and exchangeable bonds, equity derivatives and equity block trades for corporates.