EUROTUNNEL INVESTMENT CASE STUDY

Eurotunnel – Operator of the Channel Tunnel railway link between the UK and France

Eurotunnel was overleveraged from its inception. In 1998 it went through its first restructuring which created a fragmented capital structure that had the effect of deferring interest and principal payments without reducing debt. Leading up to its second restructuring in 2006 the business had not grown sufficiently in the interim period to support the maturities and cash pay interest that were imminent. This background provided the backdrop for our investments.

Eurotunnel has a 76-year lease to operate the channel tunnel rail link. Eurotunnel charges commercial trucks, passenger cars, passenger trains and freight trains for tunnel usage similar to a toll road operator. Eurotunnel moves the trucks and cars through the tunnel on its own dedicated shuttle trains. Leading up to the restructuring the passenger car business had been declining for a number of years due to the advent of low-cost airlines, but this decline was bottoming out and the businesses as a whole is a stable cash generative business.

The market was significantly discounting securities issued by Eurotunnel. This was due to four factors. The fragmented nature of the capital structure appeared to make a consensual restructuring hard to achieve. The uncertainty of how the alternative of security enforcement and formal insolvency would be applied in this unique situation where there was one asset in two jurisdictions subject to two sets of incompatible insolvency laws. The uncertainty of how the economic pie would eventually be allocated amongst the various stake holders. The relatively poor performance of the business over the previous few years.

Our investments were based on our view of the uniquely valuable nature of Eurotunnel's cash flows and the fact that it was possible to use pre-existing provisions in the inter creditor agreements to cram down the subordinated tranches of debt to achieve a consensual restructuring and therefore avoid the uncertainty of security enforcement and insolvency. Our cash flow models and legal analysis showed that the economic interest of those parties with the power to precipitate insolvency would prefer the cram down route to enforcement and formal insolvency.

The above restructuring analysis coupled with the predictable and stable nature of the overall cash flows allowed us to get comfortable with a floor on the valuation of the Tier 2 and Tier 3 debt and gave us the confidence to make substantial investments.

Why Eurotunnel's cash flows were valuable.

Approximately 35% of Eurotunnel's revenue is a liability of the French and UK governments pursuant to the Railway Usage Contract "RUC". The RUC does not expire until 2052. The RUC guarantees certain fixed maintenance payments plus a variable element with pre-agreed inflation adjusted prices per passenger and per tonne of freight carried through the tunnel. The vast majority of the variable portion of the RUC is dependent on the number of Eurostar passengers. Eurostar controls 80% of the London - Paris market because it is quicker, more reliable and more convenient than flying, effectively giving it a monopoly.

38% of Eurotunnel's revenue comes from the commercial truck shuttle business. Eurotunnel is subject to competition from the cross-channel ferry market. A significant portion of the freight that is transported across the channel is highly sensitive to the cost of delay and missed schedules. The ferries are inherently less reliable than the tunnel due to weather and other factors. Up to 2004 freight companies would take advantage of the cheapest rates during most of the year and then switch to the tunnel during those inevitable periods of ferry down time. In 2004/2005 Eurotunnel responded by requiring freight companies to commit to certain annual volumes. Freight companies that do not commit are put at the back of the queue and charged penalty rates during periods of disruption. The majority of Eurotunnel's freight customers acceded to the annual commitments. In our view the truck shuttle portion of Eurotunnel's revenue also has the advantage of certain monopolistic characteristics.

At the time of our investments the market was pricing Eurotunnel on an EV of 13 times run rate free cash flow. Given the unique and robust nature of Eurotunnel's income stream we took the view that

there was significant upside from this valuation once the uncertainty of the impending restructuring was removed. Since that time Eurotunnel's EV has traded well in excess of 20 times free cash flow.

Why Eurotunnel's restructuring appeared problematic.

The financing creditors of Eurotunnel had been granted a specially tailored collateral right by the French and UK governments called Substitution. This Substitution right in the event of a default gave the creditors the right to take the lease of the tunnel away from Eurotunnel and give it to a pre-existing shell company for the purpose of paying themselves down in strict priority pursuant to a predefined waterfall. The mechanics of exercising Substitution would automatically result in both Eurotunnel's UK and French legal entities filing for insolvency before the lease was transferred. The applicable French insolvency regime, as is usual for going concern insolvency procedures, bars the enforcement of security post filing i.e. it would bar the transfer of the lease. This was not an issue on the UK side.

The right of substitution had been incorporated into French law in such a way that it was unclear if it took precedence over the bar on the enforcement of collateral post filing. The effect of transferring the lease would be to leave the shareholders of Eurotunnel with no value. French insolvency law does take into account and safeguard the interests of the shareholders. In the case of Eurotunnel, the majority of the shareholders were individual French retail holders. It was therefore likely that the French insolvency administrator would contest the exercise of Substitution. The outcome would be two separate constituencies in control of either end of the tunnel with conflicting economic aims. The result would be lengthy litigation, the freezing of cash payments and consequent negative impact on valuation.

The alternative to enforcement was a voluntary restructuring. This was problematic as there were eight separate groups of bank debt, bonds and equity that needed to consent. The voting threshold within each group varied from unanimity to 66%. At the time of our investment using the available UK or French insolvency procedures to aid the implementation of pre-packaged restructuring was not a feasible option.

The uncertainty in the outcome of enforcing collateral gave the more junior tranches considerable hold out value with respect to the more senior tranches and with respect to each other making it difficult to predict the eventual allocation of value amongst the competing constituencies.

Key analysis and conclusions regarding the restructuring

The inter-creditor agreement included a set of automatic standstill provisions designed to forestall enforcement in the event of a default. The purpose was to provide creditors with time to negotiate a restructuring. Cash flow during the standstill was allocated to the creditors pursuant to a strict waterfall priority. The effect of the waterfall was to service debt down to Tier 3 making no cash available to the more junior debt pieces ("subordinated debt") until all the principal through Tier 3 had been repaid.

Our analysis showed that where the parties with the power to exit the standstill chose not to exit then the standstill provisions could be extended until all non-subordinated debt had been paid. There were only three key parties with the ability to exit the standstill: the super Senior Debt; the Majority Co-Financiers [controlled by MBIA]; the Directors. Our analysis showed that it would not be in the economic interests of those parties to exit in the absence of a more favourable agreed restructuring. The standstill provisions effectively provided a pre-agreed restructuring (albeit sub-optimal in that there was no immediate debt reduction) and consequently a benchmark floor for valuation.
MBIA had provided the guarantee wrap for bonds issued in securitizations where the underlying assets were tranches Tier 1A to Tier 3 of Eurotunnel debt. As a result, MBIA effectively controlled the Co-Financier vote for the purposes of enforcement and was therefore a key player in the negotiations. MBIA's interest as the guarantor of the securitizations was not necessarily aligned with the interest of holders of Tier 3 debt. Our analysis showed that MBIA needed Tier 3 to be at a very minimum 50% money good to avoid any payout under its guarantees. This provided us with comfort that in the event of negotiations to agree a voluntary restructuring MBIA would not aim to settle at a lower level, subject to the value being available in the first place.

The outcome

The Directors of Eurotunnel and the other members of the ad hoc committee took on board our standstill solution as a potential back up option to the attempt to impose a more optimal restructuring. In the event a full restructuring was implemented aided by two key factors.

Firstly the market was placing a higher enterprise value on Eurotunnel as 2006 progressed which made it much easier to allocate the economic pie amongst the various constituencies. Key players had more to lose than to gain from any attempt to contest or vote down the plan eventually proposed.

Secondly at the start of 2006 a new French insolvency procedure "Sauvegarde" had been enacted that allowed the directors to remain in office while implementing a restructuring without forcing the creditors to either abandon or exercise their enforcement option. The Sauvegarde provisions had not existed when our investments were made. The Directors used the voting procedures in Sauvegarde to reduce the number of voting constituencies therefore making hold outs less likely.

The non-discounted return in this case was in excess of 100% on an approximate 350 million USD cash investment.

Commentary

Eurotunnel is an example of a complex capital structure where it is not practical for the majority of market participants to take advantage of the information on offer due to the obstacles of processing it. This is a recurring inefficiency in European and Asian restructurings albeit in respect of a limited pool of cases.

In the case of Eurotunnel, a comprehensive cash flow model was a pre-requisite to achieve a proper understanding of the negotiating position of the parties. For example, MBIA's need for Tier 3 to be 50% money good. The inter creditor agreements and the terms of the securitizations included interdependent waterfall provisions which required considerable diligence and effort to convert from the legal text into a numerical model that accurately reflected that text. The description of the capital structure included in various company accounts and bond prospectuses did not provide sufficient information from which to model out the cash flows. It was therefore necessary to go back to the original creditor agreements which ran to thousands of pages. Some of those agreements had been amended numerous times. The most recent amendments set out only the terms that had changed necessitating a review and consolidation of all documents back to inception.

The result of these obstacles meant that our fund was one of a very limited pool of investors that had a comprehensive model of Eurotunnel's cash flows and capital structure. This put us in a position to take advantage of multiple trading opportunities over an extended period of time.