THE HYBRID RATING PROCESS

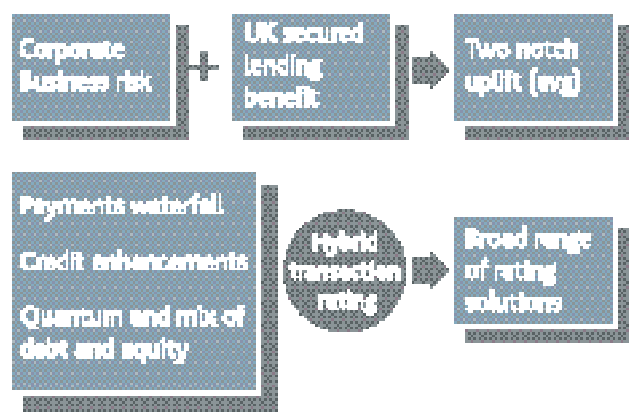
ELENA FOLKERTS-LANDAU OF STANDARD & POOR'S EXPLAINS THE RISK PROFILE ASSESSMENT PROCESS FOR COMPANIES ENTERING THE WORLD OF HYBRID SECURITISATIONS, COMBINING CORPORATE BUSINESS RISK WITH STRUCTURED FINANCE ANALYSIS.

Hybrid securitisations involve a blend of techniques from structured finance and other disciplines and include whole business or corporate securitisations. Such transactions have a risk profile that is a hybrid between pure corporate risk and the risk associated with traditional securitisations backed by financial assets or diversified pools of debt. In rating this type of transaction, Standard & Poor's (S&P) applies a blend of corporate business risk and structured finance analysis. Ultimately, though, the key requirement is a legal framework that allows true control by bondholders of any relevant cash-generating assets in the event of an insolvency of the originator of the assets.

To date, investment grade ratings for corporate securitisations have been attained by operating companies in the UK having business risk scores in the BB to BBB range, stable or predictable cashflow generating characteristics and debt funding structures employing a range of risk mitigants.

BENEFITS AND LIMITATIONS. Assuming a basis for efficient structuring and favourable underlying business risk characteristics, corporate securitisation transactions can offer a number of benefits to borrowers over standard corporate secured financing. These include a lower-weighted average cost of debt due to higher ratings being achieved and greater debt leverage. The latter is partly due to structural support of debt tranches over their respective lives, which can enhance the financial ability of underlying cashflows to service an aggregate level of debt. Typically, debt has tended to be fully amortising, rather than bullet, to provide a continuous signal to bondholders of the transaction's satisfactory financial performance and to drive de-leveraging of the transactions during the periods of greatest certainty in underlying cashflow assumptions. Ultimately, rating levels and the debt volume of a new hybrid transaction are largely determined by the business risk of the underlying assets and the operating company's incentives to abide by risk-mitigating covenants and other structural enhancements, as well as the investors' tolerance and realistic pricing of such risks.

FIGURE 1
ASSESSMENT PROCESS.



Source: S&P

CORPORATE SECURITISATIONS VERSUS SECURED DEBT. Two key elements borrowed from the structured finance analytical approach to ratings distinguish corporate securitisations from more conventional secured debt are: the analytical assumption that the operator (or servicer) of the business may default and that an alternative operator exists that can either restructure or liquidate the assets to service or repay the debt; and the legal certainty that the bondholders will maintain control over the assets during insolvency proceedings and that the bankruptcy of the operator will not compromise the cashflow generating capacity of the assets.

KEY INPUTS INTO THE RATINGS ANALYSIS. The hybrid rating process is a blending of corporate business risk and structured finance analysis. The ultimate goal is to maximise bondholders' control over the cash-generating assets. To this end, S&P conducts its analysis on the basis of the following information:

- business risk score;
- assessment of management and operations;

- alternative operator/servicer;
- cashflow structure and modelling;
- legal and tax structure;
- credit enhancements and other structural supports; and
- effectiveness and/or enforceability of mitigants in the form of covenants and third-party activities, such as asset valuation, servicing and audits.

BUSINESS RISK, THE FIRST BUILDING BLOCK. The business risk score comprises an analysis of industry characteristics and how the company is positioned to succeed in that environment, a judgment about the company's competitive position and evaluation of management. In the UK, the first fixed and floating charge structure of a hybrid transaction may isolate the operating company's business risk from financial risks such as its level of indebtedness.

Business risk arises because the collateral's cashflow-generating characteristics are aligned closely with the operating company's own performance and with that of the servicer. For this reason the rating of a corporate securitisation generally depends on the continued strong performance of the operating company and the continued mitigation of risks related to the collateral. This is the case whether the collateral is a complex, vertically integrated set of operating assets or an operating company's revolving stock of inventory.

There is a higher level of business risk in hybrid transactions than in traditional asset-backed securities (ABS) transactions because the operating companies entire base is often securitised or the operating firm can alternatively require specialised management skills. There is also a big element of business risk when securitising distinct assets such as inventories. To assess the degree of separation between the collateral and the operating company's performance, we determine whether the operating company has full use in practice of the stock of collateral, notwithstanding any 'structured' written rules to the contrary. We also evaluate the collateral's own distinguishing characteristics, which may be quite risky. For example, the collateral may be undiversified or homogeneous (such as foods inventory or bulk products), perishable (such as date-sensitive inventory) and/or highly mobile (such as containers and gems).

A collateral stock may need to be actively managed to generate cashflows, highlighting the importance of the operating company's management skills and its commitment (backed by commercial incentives) and, ultimately, the skills and commitment of the back-up servicer, if any. Where no back-up servicer has been engaged, S&P evaluates the availability of alternative operators or servicers, and analyses the likelihood that such alternative operators would be able to service the assets effectively.

OPERATIONAL RISK RELATED TO THE LINE OF BUSINESS. S&P assesses the operating firm's inherent susceptibility to operational risks, including risks to the operating company's reputation, those arising during the processing of goods and services, hazards, as well as the risks of theft and fraud. Structural features can mitigate such risks, including insurance policies, company procedures and processes and on-site surveillance by expert third parties whose impartiality can be enhanced through the structure of their remuneration.

OPERATIONAL RISKS RELATED TO THE STRUCTURE. Covenants can have a number of functions, including preservation of repayment capacity, protection of the integrity of the assets and business position, early warning signals of credit deterioration, placement of the bond trustee in a position of influence should deterioration occur, and other purposes that are standard in asset-backed securitisation (ABS) transactions. They can impose discipline on the operator, prevent leakage of cash, or trigger early termination of the debt and/or of the secured loan to allow enforcement of the underlying security when negative signals occur about the business's future cash-generating prospects. Therefore, covenants can mitigate operational risks by motivating the company to implement adequate tracking, monitoring, compliance and procedures for remedial action. A credible mechanism also needs to be in place to respond to any breach in the covenants.

A variety of structural features can improve the risk profile of the securitised debt. In addition to covenants, such features include the final maturity of the debt, the average life of individual debt tranches, their respective ranking within the payment waterfall and the degree of debt leverage. Indeed, the scope for leverage and, ultimately, the quantum of total debt that can be raised in a hybrid transaction are positively influenced by the size of the equity contribution, dividend restrictions, provisions for cash reserves and/or dedicated liquidity facilities, and the senior/subordination structure. Subordinated debt can take the form of traditional securitised debt tranches and preferred stock.

LEGAL RISKS. The absence of a binding legal precedent to test the structure may pose more risk. For example, there may be ambiguity about the 'true sale' or true control of collateral in situations in which the operating company can freely deal with the collateral. Likewise, there may be ambiguity about whether inventory collateral is the issuer's property or the operating company's when transaction assets are commingled with similar assets, or when surplus cash (profit) goes back to the operating company in a sale of revolving collateral stock by the issuer to pay off the purchase price. In such circumstances, S&P takes the view that the structure could attract legal challenge by third-party creditors of the operator, as well as heightened judicial scrutiny. In the absence of cases validating the analysis, there may be doubt as to how the courts would react to an arguably aggressive structure.

POTENTIAL IMPACT ON CORPORATE CREDIT RATINGS. The effect of a hybrid transaction is reviewed on the credit profile of a firm in much the same way as it treats off-balance-sheet financings. Debt contracted in the context of a securitisation may be added back to the balance sheet along with underlying assets for the purpose of ratio calculations. This permits a better comparison across firms regardless of their choice of financing. The decision whether to consolidate the securitised debt into the operating company's balance sheet depends on the hybrid transaction's strategic and economic importance to the rest of the company, and in particular whether the firm would likely support the transaction financially and/or operationally under stress.

The effect of a corporate securitisation on a firm's business profile would be negative to neutral, depending on the quality and importance of the assets securitised, and whether the issuance proceeds would be invested in riskier assets. There can be a positive implication for the firm's credit profile if the hybrid transaction results in overall debt reduction or improved financial flexibility.

Elena Folkerts-Landau is a Director of Standard & Poor's Structured Finance (Ratings) Group Europe.
elena_folkerts@standardandpoors.com
www.standardandpoors.com
www.ratingsdirect.com