Tapping a revenue stream

IN THE THIRD AND FINAL PART OF OUR SERIES ON SECURITISATION, **JAMES DOUGLAS** AND **SIMON STEPHENS** OF DELOITTE LOOK AT THE BENEFITS AND PITFALLS OF WHOLE BUSINESS SECURITISATION.

There will be more money generated by corporate securitisation deals this year than ever before – more than £18bn worth, according to a Standard & Poor's global credit survey. For certain types of business, raising funds against the future revenues of various operating assets can be an efficient means of value creation for shareholders.

But there are a number of issues that management needs to consider before doing such a deal, not least of which is giving up a certain amount of control over the assets securitised. But there could also be negative consequences in not considering a whole business securitisation, including higher funding costs.

APPLICATION What sort of company can this financing technique be applied to? The main areas where these techniques can be best applied involve industries with stable and predictable revenue streams. Sectors such as water and electricity utilities or large infrastructure assets such as toll roads or airports are ripe for securitisation, but the technique has been extended to other more surprising areas such as FA Premiership football clubs.

The financing techniques that have been developed by banks and private equity companies, some of which involve or come close to whole business securitisation, allow them to reach valuations for a buy-out of a company that can prove surprisingly high to management and investors.

Both stock and bond investors in UK airports operator BAA were surprised last year when a takeover bid arrived from Spanish construction company Ferrovial and private equity investors. It had been thought that the airports operator was too indebted and had too heavy a capital expenditure programme to be taken over – so much so that a bond issue from the group did not include any change of control clauses, although they were hurriedly inserted before the bonds were delivered to meet the demands of investors following the bid from Ferrovial.

WHY DOES SECURITISATION WORK? The use of long-term secured funding – through the securitisation of steady, visible revenue streams from landing slots and retail outlet rentals – allowed Ferrovial, the predator in the BAA deal, to come up with a very attractive valuation based on relatively cheap funding levels.

Likewise, the use of securitisation allowed the Macquarie-led Kemble Water consortium to beat off stiff competition from private equity to acquire Thames Water. Australian investment fund Macquarie has made a highly successful speciality of developing cheap long-term financing for infrastructure and utility assets, which allowed it to put together a compelling bid.

The large number of infrastructure and utilities deals over the past two years shows just how much these industries have become an identifiable asset class in themselves, with very specific investment and reward profiles that suit both the equity investors and buyers of the resulting debt.

Modern infrastructure structured finance is generally agreed to have been developed by banks in Canada and Australia in the mid-1990s during a period of transport sector business sales. Banks and other longer-term investors, particularly pension funds, have the jump on private equity in this area because of the nature of the cashflows from such businesses.

What these banks realised was that with large, often monopolistic concessions that can also have inflation-proof guarantees on revenue increases from domestic governments, financing these businesses with cheap long-term secured debt meant they could be left with a long-term cashflow dividend that had a better yield than that available on bonds of similar tenors.

Executive summary

- Securitisation raises finance secured on the back of identifiable and predictable cashflows derived from a particular set of assets. Almost any assets that generate a stable, predictable income stream can be securitised.
- A 'whole business securitisation' describes a securitisation where the cashflows derive from the entire range of operating revenues generated by a whole business (or a segregated part of a larger business). The key to the suitability of a business for securitisation is the stability of the cashflows.
- To protect the quality of the assets in the business, a securitised company generally agrees or 'covenants' to maintain the assets to a certain standard, and not to sell the assets without consent. In addition, the company usually agrees to use the cashflows generated by the assets in the first instance to pay the interest on the debt as well as to meet the repayment obligations.

For pension funds particularly, this enables good matching with long-term liabilities, hence the rapid growth in infrastructure funds. The present firepower of financial buyers in the form of private equity firms, banks and infrastructure funds, which are awash with cash, and of trade buyers who are skilled at securitisation techniques should give the treasurer cause for thought.

The cost of such long-term secured funding is also significantly less than that available to private equity, with the spread over Libor on senior debt sometimes less than a quarter that paid for senior leveraged buy-out financing debt.

As the market develops and infrastructure-style funds increase in size and number, more work is being done to identify other types of operating assets – either parts of companies, or whole businesses – that show similar stable, predictable and even protected cashflows. Some doubt whether the techniques are realistically usable beyond true infrastructure and utilities businesses, and companies have to invest large amounts of time and money to ensure they can not only model the predictability of cashflows, but also have the kind of clean, complete and reliable data that will give those models integrity.

But securitisations have been pursued successfully in some surprising areas and when an idea is hot it is likely to be pushed beyond the point where it works.

For incumbent management, examining such techniques is not just a case of defending a company against a potential bid, but also about ensuring they explore all routes to create the best value for shareholders possible through the use of modern financing and fundraising techniques.

ISSUES TO CONSIDER Securitisation involves structuring the operating assets so that they are ringfenced from the rest of the business. This protects the cashflows on the securitised asset from the parent group, which is a crucial factor in lowering the cost of funds raised. While the assets can continue to be used by the business as a whole, it necessarily involves some loss of management control and some restrictions on how they can be used.

For a business running daily ferries across a stretch of water, where the frequency of large investment and changes in cashflows is low, this may not matter. But with an intensely competitive business, where management needs to be nimble and to splash out at times to guard against a dip in performance, it is a different story.

Premiership football club Arsenal recently pulled off a large securitisation of ticket sales to refinance the cost of building a new stadium. The revenue generated by the larger stadium has also given the club greater spending power for player signings.

For other business types, where giving up any control is too difficult to contemplate, the route to cheaper fundraising may lie instead in identifying operating assets that do not necessarily require day-to-day management oversight.

For many businesses, this asset is property – and here there is a market of willing investors ready to help out. A number of retailers as well as government departments have pursued sale and lease-back strategies, which takes the business's property away from management for good.

But properties do not have to be sold and leased back. One UK supermarket chain, Sainsbury's, this year securitised the leases on a number of its own supermarkets while maintaining ownership. The cheap funding raised was used to buy back outstanding unsecured bonds, saving the company a significant amount in annual interest costs on its debt.

This strategy is also common in chains of public houses, where the business is split into an operating company and a property company. In these so-called opco/propco deals, both parts can then securitise future cashflows specific to each operating asset and gain more efficient funding than if the whole were securitised as a single entity.

However, from the property investment side at least, there may begin to be some push back from investors on some of these deals. If a property asset is highly specific to a particular business, then the future cashflows from the property can be so dependent on the ongoing success of the occupying business that it becomes akin to a whole business securitisation by another name – although at cheaper rates and with the investors exerting less control over the business than they might like.

SOPHISTICATED WAYS… The lesson for the treasurer at this point in the business cycle where attention is focused more on improving returns to shareholders is that there are increasingly sophisticated ways in which a business can be releveraged to lower the cost of capital. There is, however, always a balance to be struck between cost of funding, operating freedom and fear of predators.

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