MAKE MINE A CONDUIT

CONDUIT SECURITISATION WON'T BE TO EVERYBODY'S TASTE BUT FOR MANY IT COULD BE AN INTERESTING SOURCE OF NEW FUNDS, SAYS **ALEX WICKENS** OF BAYERISCHE LANDESBANK.

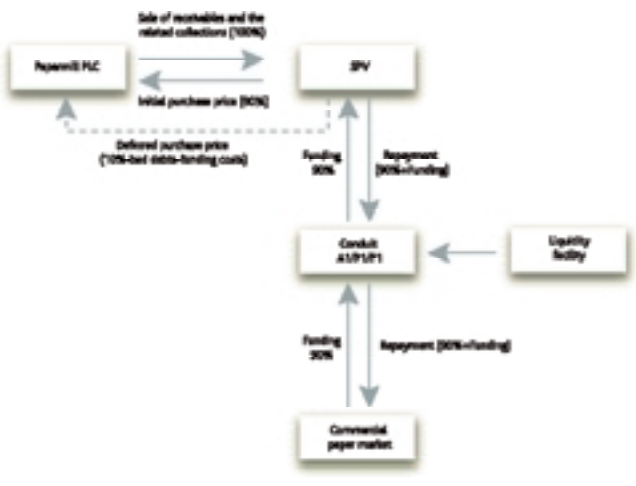
Whenever one hears about securitisation these days it is usually in the context of a jumbo deal for a multinational company, a capital relief exercise for a bank or building society, a complex whole business securitisation, or just a clever wheeze for ageing rock stars to ease their passage into retirement. So treasurers of medium-sized companies can be forgiven for thinking "very interesting, but not for me" as the process can appear complex, expensive, time-consuming and not in the least relevant. But there is a securitisation route that is available for those who do not neatly fit into any of the above categories: conduit securitisation.

BACK TO BASICS. Securitisation in general can be described as the pooling and repackaging of assets and their associated cashflows into securities funded through the capital markets. It can be subdivided into bond and conduit securitisation. The key difference between the two is that bonds are long-term instruments, listed and sold publicly, whereas conduit securitisation relies on short-term unlisted instruments which are privately placed. Conduit securitisation shares many of the techniques and characteristics of the publicly-issued, rated, asset-backed bonds which regularly fill the financial pages, but it has several key advantages over its big brother: greater flexibility, lower costs, increased confidentiality and the requirement of a smaller minimum portfolio of assets. To understand these advantages we need to look at the basic dynamics of a traditional conduit securitisation structure.

Let us assume that Papermill plc is a manufacturer of paper with sales to a large number of customers. Papermill sells/transfers its trade receivables to a special purpose vehicle (SPV). This SPV will buy the receivables at their book value, but will pay for them in a two-step process via an initial purchase price (IPP) and a deferred purchase price (DPP). The concept of the DPP is introduced to provide credit enhancement into the structure: DPP is paid to Papermill contingent upon the collection of the trade receivables, but the amount paid will be reduced by any bad debts that are incurred (the size of the DPP is primarily a function of the historic performance and composition of the receivables). The SPV finances the IPP by borrowing from the conduit which, in turn, issues asset-backed commercial paper (ABCP) into the dollar CP market – there is a growing Euro CP market, but this is small in comparison. The conduit passes its funding costs onto the SPV which, as is the case with bad debts, reduces the DPP by an equivalent amount. The conduit is already in existence and has a formal rating from the rating agencies which allows it to issue CP with a short-term rating of A1/P1/F1 or above and, as its name implies, it sits between the CP market and the SPV. Upon the conduit entering into a new transaction the rating agencies will review the size of the credit enhancement to ensure it is sufficient to absorb potential, worst case, bad debts. Bad debts that exceed the DPP will have to be borne by the conduit and ultimately the liquidity banks/CP investors.

Although the rating agencies will perform due diligence on Papermill (Papermill will still administer the sold receivables and generate new receivables), the company will not need to be rated and

FIGURE 1
STRUCTURING FINANCE



the due diligence will be more of a short visit to meet key individuals and discuss credit control/operational issues. Back to those advantages.

GREATER FLEXIBILITY. Flexibility is achieved by the revolving nature of the structure. New receivables are generated and sold to the SPV each month. Should Papermill's receivables pool increase, its funding will effectively grow. The SPV buys new receivables using collections of existing receivables and by the issuance of additional CP. Should the receivables pool fall, excess collections will be used to retire maturing CP. Additionally, your friendly relationship bank will provide a liquidity facility to the conduit that can be drawn to provide security of funding in periods of CP market disruption. As CP can have a maturity of anything between one and 270 days, a liquidity facility is necessary to provide for repayment of maturing CP in the event that no new CP can be issued – more on this later.

Papermill retains the originating and servicing functions of the receivables, the ultimate debtor is not made aware of the transaction, and cash management processes can be adapted to ensure the collections are readily available for the company to use as it would usually do.

LOWER COSTS. Set up costs will inevitably be higher than for a bi-lateral or syndicated loan facility, but will be much less than for a public bond transaction. Rating agency and legal fees will be reduced because the conduit has already been established and the costs relating to that already borne. A structuring fee will be payable but this can be charged to the P&L over the life of the transaction.

Continuing costs include the funding cost (sterling equivalent of the dollar CP rate), a liquidity fee to the liquidity facility provider and an administration fee to the conduit. Although there are three components to the finance charge, all-in costs are often lower then companies are used to paying. Why? Because banks have a much reduced capital requirement compared to a fully-drawn loan and CP investors are buying short-dated, highly-rated liquid paper. Historically, CP rates have been comparable to Libor rates. This relationship is still intact, even after the events of 11 September.

INCREASED CONFIDENTIALITY. The CP market is a private market. Investors buy rated paper issued in the name of the conduit and they have no idea of the identity of the originators of the underlying assets. Periodic performance data relating to the securitised portfolio will have to be produced by the company, but this is strictly for the eyes of the rating agencies and the conduit/liquidity provider only and will be similar to the information which the company already produces for its own internal management reporting purposes. Clearly, however, if the company wished to publicise the transaction, few banks would discourage this.

LOWER MINIMUM SIZE. The minimum size is effectively determined by economics. CP can be issued in very small denominations but the economic sense of embarking on a structure such as this only really kicks in for transactions of more than £50m (those upfront costs have to be spread over something). The maximum size is limited by the availability of suitable banks to provide liquidity and the existence of the assets themselves.

Hopefully, we can begin to see that conduit securitisation has a much wider potential audience than bond securitisation, but we haven't finished yet.

Apart from being inexpensive, flexible, confidential and suitable for companies with smaller balance sheets, what has conduit securitisation ever done for us? Well, the structure is also non-recourse to Papermill. If losses exceed the deferred purchase price, the conduit/CP holders/liquidity providers will bear the loss and not Papermill. This allows Papermill to achieve linked presentation under UK GAAP on its balance sheet and derive all the benefits that this entails for gearing measurements.

'THE ABCP MARKET CURRENTLY STANDS AT ABOUT $690BN – THIS IS NOT A MARKET THAT IS SUDDENLY GOING TO DISAPPEAR COMPLETELY'

NOW, WHERE DID I PUT THAT LIQUIDITY FACILITY? One of the perceived disadvantages of conduit securitisation is that it is extremely reliant upon the dollar ABCP market. Where is the certainty of funding when the funding base is dependent upon a single market? The ABCP market currently stands at about $690bn – this is not a market that is suddenly going to disappear completely. There may be temporary disruptions for a period of days but that's why there are liquidity facilities.

In the immediate aftermath of the tragic events in New York and Washington there was effectively no CP market for a period of time. Any conduit which had CP maturing on the 11/12 September had three options: (i) attempt to place CP but recognise that settlement would be extremely difficult and pricing high; (ii) extend the CP daily until the market properly re-opened; or (iii) remove the liquidity facility from the bottom drawer and drawdown under it.

In a survey carried out by rating agency Fitch[1], 12 % of those with CP maturing on the 11/12 September pursued the third option, and every facility worked as intended. It is worth quoting directly from the survey: "The effectiveness of these liquidity facilities, an integral structural feature of ABCP programmes, sent a reassuring message to the market that even under stressful market conditions, ABCP vehicles operated as expected. Moreover, with the US Federal Reserve's timely injection of liquidity into the capital markets, all liquidity banks were able to honour their funding obligations when called upon to do so." To misquote a well-known television advert, "liquidity facilities do exactly what they say on the cover".

MAKE MINE A CONDUIT. If conduit securitisation were to be marketed as a drink it would be called Securitisation Lite. It should be viewed as a hybrid between syndicated/bi-lateral bank lines and a full asset-backed bond, incorporating attractive elements of each. It will not be suitable for everyone, but for many it could be an interesting new source of funds. The range of suitable assets extends far beyond traditional trade receivables to incorporate assets such as physical stock, government/quasi-government obligations, and even future income streams. Something to think about when refinancing time comes round again.

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NOTE: [1] *ABCP Market Shows True Colors – Fitch, 26 September 2001*