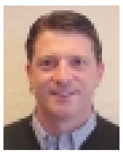
FINANCING WORKING CAPITAL



ASSET-BACKED COMMERCIAL PAPER PROGRAMMES ARE BECOMING INCREASINGLY ATTRACTIVE TO FIRMS LOOKING FOR SOLID RETURNS. **DAVID DE MILT** OF GOLDMAN SACHS EXPLAINS.

In an era of tough shareholder demands, increased regulatory and rating agency scrutiny, and the current low growth, if not recessionary environment, the pressure to produce solid return on capital and consistent performance is greater than ever. Efficiently financing your company's operations has never been more critical. Even with a low rate environment, the need to be creative and think 'outside the box' is crucial. For many companies, financing working capital through an asset-backed commercial paper (ABCP) programme can provide several benefits, only one of which is an inexpensive source of funds.

ABCP conduits are special purpose off-balance sheet vehicles. In most cases, they are administered by banks but may also be sponsored by companies and other non-bank groups. They are broadly categorised as multi-seller, single-seller, securities-backed and structured investment vehicles (SIVs). The latter two provide capital relief to banks and serve as a proprietary fixed income investment fund, respectively. This article will focus on the first two types, as they are the most relevant to financing a company's working capital.

ELIGIBLE RECEIVABLES. Multi-seller ABCP conduits are administered or managed by commercial banks and provide an alternative to traditional lending facilities for banks' customers. Rather than lend money in the traditional sense, ABCP vehicles raise money in the commercial paper (CP) market and then buy accounts receivable from companies. The oldest and most common type of financing through these vehicles are trade receivables programmes.

A company sells 'eligible' receivables to the conduit, over-collateralises the sale with excess eligible receivables, and then acts as a servicer, collecting payments and handling any delinquent accounts. Eligible receivables are defined by the programme's legal documentation, and generally define age, type and concentrations allowable for each sale. Eligibility definitions also incorporate the following factors: delinquencies, defaults, dilution and yield. The sales are usually done on a monthly basis (although weekly and daily are possible) and the level of over-collateralisation is based on the previous months' performance. A single-seller vehicle is one sponsored by a non-bank company, which only buys assets from itself.

With their quick turnover, consistent performance and generally high credit quality, trade receivables represent the most popular types of assets sold to conduits. However, finance companies and other firms with longer-dated types of receivable are also able to use ABCP vehicles for financing. Whether using conduits as a warehouse facility with monthly sales in advance of a term bond deal or as a source of financing at the ends of quarters and fiscal years, all different types of companies may find ABCP conduits useful.

HOW DO THEY WORK? ABCP conduits are thinly capitalised off-balance sheet special purpose vehicles with independent directors, and owned by a party other than the sponsoring group. They achieve Tier 1 short-term (and in a few cases long-term) ratings from the ratings agencies based on the protections to investors that these vehicles offer. They benefit from two levels of credit enhancement, one at the asset level and the second at the programme level, in the event of a default in any asset. Backstop liquidity support (like that for a traditional non-ABCP programme) serves as a repayment source during market disruptions or other events that may render a conduit unable to roll CP and pay note holders. While the level of credit enhancement varies from vehicle to vehicle, it is sized to meet between an 'A' or 'AA-' level for assets. Liquidity support is always 100%, with the exception of only a few highly specialised cases.

Because of the high investment grade level of these programmes, they are able to finance themselves at extremely attractive levels. As a result, companies that sell assets to these vehicles enjoy a high investment grade cost of funds, regardless of their own debt ratings.

Another feature that appeals to many corporate sellers is the anonymity of the funding source. Conduit administrators, for competitive reasons, do not reveal who the sellers to their conduit are. What they will provide is a generic description of the company, by industry type, the performance of the purchased receivables, the maximum size and utilisation programme, and some other items. However, the name of the company is not released. This allows companies to be more selective in the use of these facilities and not worry about public scrutiny of how they choose to finance themselves.

On the rating agency front, there are two clear examples of how an ABCP programme may be beneficial. First, since it serves as

‘A FEATURE THAT APPEALS TO MANY CORPORATE SELLERS IS THE ANONYMITY OF THE FUNDING SOURCE. CONDUIT ADMINISTRATORS, FOR COMPETITIVE REASONS, DO NOT REVEAL WHO THE SELLERS TO THEIR CONDUIT ARE’

diversification from traditional funding sources, the agencies tend to look favourably on companies that use ABCP facilities to help meet their working capital needs. Second, since the seller of receivables is not directly facing the investor, it is effectively a ‘downgrade-proof’ method of achieving consistent financing. So long as the receivables continue to perform, the sales to conduits may continue. If there is an extreme ratings change in the seller of receivables (as servicer), a back-up servicer or collections agency may be necessary.

For companies with a significant investment in their collections and tracking platforms, engaging in receivables sales to a conduit allows for greater flow through of receivables through your existing platform, which generates a higher level of efficiency for your assets. By realising the cash sooner and speeding up the collection cycle, a company may increase its turnover on its existing platform allowing for greater economies of scale.

IS IT TOO GOOD TO BE TRUE? No, but there are important pieces of the puzzle to keep in mind. First and foremost are costs. While most ABCP vehicles fund as well as (or better than) the highest rated corporate programmes, fees to sellers will incorporate a 15bp to 20bp premium for the cost of a committed backstop liquidity facility. This liquidity fee is then coupled with a programme fee based on the quality of receivables pool that is sold. Clearly, the better the portfolio, the lower the costs.

Another important consideration is the strength of your company’s receivables monitoring systems. Since the rating agencies need to evaluate each portfolio a conduit purchases, they will need to see three to five years’ worth of historical data in order to assess the credit strength of underlying receivables. In addition, you will need to produce fairly detailed information on a monthly basis for the conduit administrator to efficiently assess the amount of receivables you may sell, and for them to properly report to investors the pool’s performance on a timely basis.

While this seems daunting, most computer systems are capable of tracking the pertinent information, it just may require the manpower to ensure the information is configured in a timely fashion.

This article is designed simply to scratch the surface of what is possible in the world of ABCP finance and securitisation in general. If you think there is anything on your balance sheet at all that can be financed through ABCP, it is worth exploring. To date, everything from charged-off credit cards, to music royalty receivables, to auto rental fleets to name but a few, have found their way into conduits. Even the well-publicised pub deals in Europe have flowed through to the once vanilla world of conduit finance. The better mousetrap has already been built – simply find the right type of cheese to put on the spring.

David De Milt is Executive Director at Goldman Sachs.
dave.demilt@gs.com

See also the article by Permjit Singh, The Treasurer, July/August 2002.