Understanding the value of securitisation

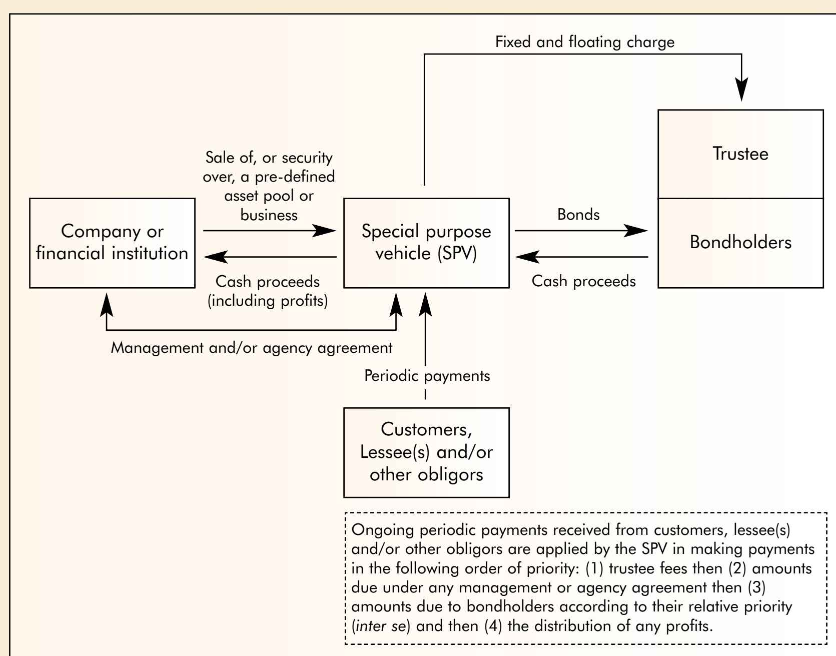
Steve Din of Morgan Stanley provides a helping hand for those companies interested in reaping the benefits of securitisation.

Securitisation has been most closely associated with mainly US financial institutions that have funded pools of financial assets, for example, mortgage loans, by issuing bonds typically rated as high as AAA in order that both the assets and related funding remain off balance sheet.

In this case, the financial institution incorporates a new insolvency-remote special purpose vehicle (SPV) that issues the bonds and applies the proceeds towards acquiring a pool of, say, mortgage loans whereupon amounts received by the SPV in relation to these loans are passed onto bondholders in the form of principal and interest payments. While profits of the SPV are ultimately paid to the financial institution, it should not be liable to the bondholders should they ever suffer a shortfall. This arrangement is illustrated in *Figure 1*.

FIGURE 1

Typical securitisation structure



The recent renaissance in highly leveraged, and occasionally hostile, acquisitions of undervalued companies, and the subsequent securitisation of these companies' businesses, principally by financial buyers, has demonstrated that securitisation is not limited to either financial institutions or financial assets. Instead, the use of securitisation as an acquisition tool has led to a growing awareness among treasurers that the securitisation of businesses now deserves very careful attention.

Here, we will describe the value of securitisation and how such value might be measured and realised to the benefit of a company's own shareholders.

What is securitisation?

Securitisation is the financing in the international bond markets of an asset pool or individual business where the source of any payment due to bondholders is limited to the prospective cashflow from such asset pool or business. Securitisation is best understood from a geographic perspective. In the case of the US, such assets generally comprise the benefit of one or more contracts, for example, a pool of mortgage loans, while in the UK, additionally it is a business that can be securitised. In either case, it is the cashflow from a pre-defined asset pool or business that is applied towards redeeming a bond issue.

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The reason businesses, as well as contracts, can be securitised in the UK is related to English insolvency law. Bondholders having, *inter alia*, fixed and floating security over a business can frequently avoid the effects of an administration order and continue to control these assets and their cashflow whenever necessary[1]. It is this element of control that is required before secured bonds can be rated higher than their unsecured equivalent.

Why securitise?

There is, unfortunately, no single reason why a company should securitise a pool of financial agreements or a business. The most common reason is that it lowers its weighted average cost

of capital and, therefore, improves shareholder returns. In turn, any surplus capital arising out of a securitisation can be redeployed more effectively elsewhere. We will look at more specific, yet related, reasons below.

Lower funding cost

Unless they already enjoy a AA or AAA credit rating, companies that own unencumbered assets, such as real estate, trade receivables (debtors), etc that are not the subject of negative pledge, can simply borrow funds that are secured over such assets at a significantly lower interest rate. Essentially, a firm's funding cost is, in this case, being lowered merely by reference to the security being taken over its assets.

Recently, the inverted government yield curve has led many companies to combine the issue of long-dated bonds with security to achieve funding at record-low interest rates.

Example 1: Canary Wharf Group

In 1997, Canary Wharf Group began a programme of securitising recently-built prime office properties leased to a number of blue chip tenants. Not only was Canary Wharf Group able to secure mainly AAA funding, but most of its debt was priced off long-dated gilts when investors were suffering from a shortage of supply in the gilts market and, as a result, yields were at their lowest for many years.

Higher operational gearing

Occasionally, companies wish to substitute financial gearing with operational gearing. Depending on local GAAP, this can be accomplished, for instance, where a company sells its real estate to an SPV and then leases it back. The SPV pays for the real estate out of the proceeds of a fixed rate or index-linked bond issue[2], which is redeemed over its term out of the lease payments it in turn receives from the company.

The firm is free to apply the cash it receives towards an acquisition, share buy back or debt refinancing. In the meantime, it begins paying rent for the properties it occupies – typically at a rate lower than it would have paid for borrowing the equivalent cash amount.

Example 2: Sainsbury's

In 2000, Sainsbury's entered into the sale-and-leaseback of several supermarket stores. The stores were funded by two bond issues priced to reflect the value of the property owned by the SPV as well as the leaseback to Sainsbury's. After taking into account the associated tax planning, the post-tax cost of financing was particularly attractive to Sainsbury's.

The SPV financed the acquisition of these stores by issuing bonds secured over them.

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Defensive value

Financial buyers, in particular, may carefully compare the market value (the market cap) of a target with its borrowing capacity. If the two converge, an opportunistic bidder may seek to raise acquisition financing prospectively secured over the assets of the target. From the target's perspective, this situation might be avoidable. Once a potential target has already secured its assets as part of a securitisation, it may no longer be of interest to potential bidders. In this regard, securitisation can benefit from significant defensive value.

Source of acquisition funding

Companies may wish to use the proceeds from a securitisation to make an acquisition. One practical difficulty is that it usually takes longer to complete a securitisation than an acquisition. Rather than raise the cash proceeds out of a securitisation at the very outset without having identified a target, a bank will perform all the relevant securitisation analysis at the very outset with a view to executing a committed standby facility that can be drawn upon only when the funds are actually required, which will be subsequently refinanced out of a securitisation. The facility might be arranged in relation to either a bidder's assets, a target's assets or both. This structure gives companies the certainty they need to mount a bid, yet avoids the difficulties associated with funding a war-chest with debt.

Example 3: Punch Taverns

In the summer of 1999, rather than enter into an auction, Allied Domecq entered into an exclusivity agreement with Whitbread to sell it a portfolio of public houses for a fixed purchase price. Punch Taverns considered that, by relying on securitisation, it could afford to pay a higher price. After launching a hostile and high profile bid for this chain of pubs and after securing acquisition financing from Morgan Stanley, Punch Taverns successfully outbid Whitbread and eventually acquired the chain in September that year. The pubs were subsequently securitised.

Public-to-private

The recent downward pressure on share prices, let alone interest rates, has led to renewed interest on the part of existing management groups to take public companies private. While a number of UK property companies have already used securitisation to go private, it is now being studied by other industries such as the retail sector. Management might raise debt secured over, and equal to about 80% of the value of, a retailer's real estate leaving a relatively small equity contribution, which might be sourced from a private equity firm, to take their company private.

Disposals of non-core businesses

For strategic reasons, a company may wish to dispose of a non-core business yet presently be unable to secure an attractive price from a trade buyer or flotation. As I allude to below, the cash associated with the securitisation of a business might be close to that available from, for instance, a trade sale. A securitisation should permit the company to raise cash from the disposal of the business to a SPV while continuing to retain a token, albeit 100%, equity interest (in the SPV) that could be sold, possibly to a financial buyer, at a later date.

Here, special care must be taken to protect the transferor from crystallising any liability to capital gains tax by, for instance, incorporating into any securitisation a scheme of reconstruction.

Lower weighted average cost of capital and redeployment of capital

This is the single most common reason companies will securitise some or all of

their business. The rationale is very straightforward. A securitisation of a pool of contracts or a business that enjoys strong barriers to entry (for new competition) and a robust, if unexciting, earnings profile might support investment grade debt equal to between 7x and more than 9x net operating cashflow, being EBITDA less maintenance capex.

These multiples are significantly higher than the equivalent that has traditionally been available from the corporate bond, bank and high yield markets. Securitised businesses can, therefore, be capitalised with relatively little equity or, in the case of a bank, regulatory capital.

Such equity is often protected against the effects of default because as with preferred shares, unpaid interest on the securitised bonds typically accrues when there is insufficient cashflow to pay interest in full.

UK companies can, therefore, use securitisation to reduce their weighted average cost of capital and, in turn, improve shareholder returns. The equity or regulatory capital that is released by a securitisation might then, inter alia, support an acquisition, be re-invested in the company's core business or otherwise returned to shareholders.

What can be securitised?

This question is best answered according to whether a pool of contracts or a business is being considered. In the case of the former, the contracts should ideally be executed (as opposed to executory) in form, for example, trade receivables.

Special attention should be paid to the early termination, assignment and any confidentiality provisions, the drafting of which might eventually affect the shape and cost of any securitisation. Executory contracts have been securitised in the past, for instance, property leases, off-take agreements, private finance initiative (PFI) concessions, but this can be difficult where, in particular, there is a reasonable prospect that such contracts might be terminated early and the company does not own the reversionary interest associated with, for example, the asset or service being supplied, leased or licensed.

In practice, the detailed terms of these contracts should be considered together with an investment bank and specialist law firm before a conclusion is reached on whether a particular pool of agreements can or cannot be securitised.

In the case of businesses, it is impossible to be definitive. Generally, a UK business which enjoys a history of predictable operating cashflows, strong barriers to entry and limited protection against mismanagement might be well-suited to securitisation.

Examples of businesses that have been securitised in the past include airports, amusement parks and attractions, conference facilities, ferry companies, hotels, motor racing, motorway service areas, ports, pubs, record and CD libraries, restaurants, shipping containers and theatres.

Business securitisation is also being presently pursued by several UK companies operating in the energy, utility, transportation and real estate sectors.

Who should securitise?

By now, it should be possible to understand whether, as a company, you have one or more businesses or other assets that could be securitised. More importantly, though, is to gain an understanding as to what economic and other benefits – if any – a securitisation might create.

Depending on which reason (or reasons) might prompt possible interest in securitisation it should, for instance, be possible to compare the net present value of a securitisation with alternative forms of capital structure.

In any event, only if it creates shareholder value, should it be pursued. Companies should also consider the effects of securitisation, such as:

- how will any existing company rating be affected;
- how will earnings be affected;
- will future operational flexibility be compromised; and
- what control will bondholders want over their security?

The eventual securitisation of an asset can be expensive and difficult to reverse. Therefore, it is a decision that cannot be entered into lightly and should only be made after a company has properly considered the matter with its advisers.

In many cases, decisions are properly taken by companies not to securitise. Treasurers will always be thanked for creating value for their own shareholders rather than leaving it to others. ■

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Notes

[1] *For a more detailed description, please see Understanding Securitisation in the context of Corporate Recapitalisations and Acquisitions [2000] J.I.B.L 128 and Non-Bankruptcy-Remote Issuers in Asset Securitisation [2001] published by Moody's Investors Service.*

[2] *The provisions of certain GAAP, for example, US GAAP, may lead to a more complex legal structure if the debt created by such a bond issue is to remain off balance sheet.*