Securitisation: music to Chrysalis' ears

Rob Horowitz of The Royal Bank of Scotland sets out the procedures that enabled the bank to complete a music rights-backed securitisation for Chrysalis.

In March, Chrysalis Group plc completed a £60m securitisation of the global catalogue of their music publishing rights. The transaction represents the largest ever music rights-backed securitisation, and the first for an international music publisher.

The transaction involves a sterling loan being extended to Chrysalis Music Ltd in the UK by Music Finance Corporation, a special purpose vehicle which is funded by a commercial paper (CP) conduit, whose dollar CP issuance is supported by the underlying transaction structure and rating, and a 100% liquidity facility arranged by Royal Bank of Scotland. The copyright assets from Chrysalis' music operations in the UK, the US, Germany, Sweden and the Netherlands and the multi-currency cashflows deriving from this are the sole security and source of repayment for the securitisation.

Since the transaction is non-recourse to the rest of the Chrysalis Group, the leverage provided is incremental, and, as we will discuss below, competitive in terms of cost, tenor and flexibility.

The transaction allowed Chrysalis to release the value in their intellectual property assets, which had not been possible through traditional bank borrowing. The transaction is by its nature complex, dealing with multiple jurisdictions and their varying currencies, tax, bankruptcy and accounting rules, as well as the generally difficult nature of intellectual property assets. This article highlights some of the key characteristics of this unique transaction.

The assets

The assets which form the basis of the security for the transaction are Chrysalis' rights as publisher of a catalogue of some 50,000 copyrights owned and administered in the UK, the US, Germany, Sweden and the Netherlands. In addition to the music publishing rights, the Chrysalis catalogue includes various rights to interests in several vintage record catalogues, including Tom Jones, Engelbert Humperdink and the Beatles. A music publisher typically owns the copyright in a musical composition written by a songwriter under contract for a predetermined period of time, during which the publisher exploits and protects the copyright and earns a share of all royalties earned by the copyright, known as the net publisher's share (NPS). As will be explained further, it is the NPS that both determines the amount available under the facility and provides debt service.

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Due diligence

As with all securitisations, it is necessary to ensure access to the underlying assets so that in the unlikely event of default, the secured parties will be able to enforce against the underlying collateral.

In the case of copyrights and writer agreements, the task included a detailed analysis of the terms and conditions of a majority of the writer agreements (eg, term, assignability provisions) as well as a thorough chain of title examination in the case of acquired rights.

Since the collateral includes copyrights from various jurisdictions, each sub-catalogue needed to be examined with an understanding of local copyright law. For example, German copyright law provides for notice conditions more stringent than other jurisdictions, while only the US provides for a central copyright registration mechanism.

Valuation process

An essential element of the securitisation process when dealing with assets that do not have a face value is an understanding of the value of such assets. Commercial aircraft, for example, which, along with related leases have been securitised frequently, have a fairly liquid and transparent secondary market, with several well established valuation companies providing valuation advice to these securitisations based on recent asset sales and lease transactions.

The concept extends to intellectual property. In this case, the valuation performed by Houlihan, Lokey, Howard & Zukin focuses on both market value and discounted cashflow analyses. While the former method operates in an environment that is significantly more opaque than for commercial aircraft, the same principle is applied. What will a willing third-party buyer pay for a particular asset under a given set of circumstances, based on sales of a similar nature?

Discounted cashflow valuation is more complex. It requires an analysis of not only the contractual and statutory mortality of the asset (while also considering external factors that may truncate asset life) but also a projection of future revenue streams based on historic catalogue performance and expected future performance. This analysis must also consider external factors (for example, the impact of the internet on the recorded music market) as well as determine an appropriate discount rate given the likely cost of capital of a buyer and any possible tax and depreciation issues.

Debt structure
The transaction is at the same time both a cashflow-based and a value-based securitisation. NPS (cashflow) determines the borrowing capacity but also provides the debt service. Movements in NPS effectively provide a built-in debt service trigger and loan-to-value policing mechanism.

Revolving period
The transaction provides for a three-year revolving period, during which time (subject to borrowing base requirements) Chrysalis may add additional copyrights to the transaction through new deliveries under existing writer agreements, the signing of new talent or catalogue acquisitions. In effect, the facility provides a revolving credit facility for Chrysalis, who have the ability to draw as much, or as little, as it needs during the initial three years.

Amortisation period
At the end of the revolving period, the transaction enters a 12-year amortisation period, during which, again subject to borrowing base requirements, the facility will amortise on a straight line basis down to a residual amount at maturity.

Certainty of leverage
The main difference between this transaction and a majority of the copyright transactions completed to date is that it does not require continuous third-party valuations. Such requirements expose the borrower to the uncertainty of valuation decisions made beyond their control. By basing borrowings on actual achieved cashflow, the debt structure provides more certainty of leverage, which is particularly important given the 15-year tenor of the financing.

Use of CP
The asset-backed CP market is ideal for this type of transaction for three main reasons, as follows:

- it is inexpensive, given that the base interest cost is A1/P1 CP giving an all-in cost of funds proving very competitive for a long-term underlying financing;
- since the underlying debt instruments are short term, the CP market provides the greatest funding and repayment flexibility. The facility can be used as and when needed and cancelled in part or in its entirety, with little incremental cost or modification; and
- as the funding is by way of a multi-seller conduit, the particulars of the transaction, and more importantly of the underlying assets, are not required to be disclosed beyond the conduit level.

Legal issues
Multi-jurisdictional deals are always legally complex, and Chrysalis' catalogue of copyrights proved no exception.

Asset isolation
The key issues that needed to be addressed included isolating the copyrights from the underlying corporate credit in ways appropriate to each jurisdiction while preserving the integrity of the underlying writer/publisher arrangements. A number of techniques were used to transfer security over the assets, including true sales, secured loans and other bespoke methods appropriate for particular jurisdictions. These methods had to take into account not only the usual bankruptcy considerations but also ensure compliance with the vagaries of the different rules of local rights societies (groups of which both writers and publishers are members and which provide various collecting and monitoring services).

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Depending on the jurisdiction, as part of the process it was necessary to register transfers/security interests with a central registration authority, notify certain affected parties and in some cases take physical possession of various instruments.

Addressing tax issues
The transaction legal structure needed to look at Chrysalis' specific tax issues. In particular, it needed to ensure that any asset transfers did not constitute taxable events and that ongoing NPS and royalty receipts would not be subject to taxation at the transaction level. Again, in each jurisdiction the structure was tailored to meet the requirements of the tax regime and tax structure of the Chrysalis companies in that country.

Complexities of accounting
Since the transaction provides for a single loan to a central borrower, with security provided by multiple charging companies, the accounting analysis also proved complex, with various up and downstream loans funding the multiple intermediary special purpose firms established to effect the security mechanics.

Administration arrangements
The transaction suits the group's needs in that it allows Chrysalis to operate as administrator without the need for a pre-agreed back-up. Such arrangements are often required when the issuer is new to the market or is of a significantly lower rating than that desired for the issued securities. This is certainly the case here, but given Chrysalis' experience in managing this catalogue and the desire for a 'business as usual' operation (from both the writers' and publishers' points of view) the transaction employs only Chrysalis (and its local subsidiaries) as administrator. Specifically, Chrysalis will continue to manage, exploit, administer and originate copyrights as it has historically.

Meeting hedging needs
The transaction funds itself in the dollar asset-backed CP market, and extends a single sterling loan to a central borrower. Ongoing receipts are in multiple currencies (sterling, dollars, euros and

Swedish krona). This combination provided three separate hedging needs:

- **dollar CP to sterling:** An arrangement was entered into with the commercial paper issuing vehicle to swap (using spots and forwards) the dollar CP proceeds into sterling to fund the loan extended to Chrysalis and to exchange the sterling loan repayments made by Chrysalis back into dollars to retire maturing CP.

- **currency hedges:** More complex was the arrangement by which future currency receipts are to be converted into sterling to meet the repayment requirements of the loan. Non-performance-related movements in exchange rates could adversely effect borrowing base calculations (in sterling) that would be further compounded by a related reduction in converted sterling cashflow in a period of increased debt repayment requirements resulting from the reduced borrowing base. A complication was the desire to not structure a hedge so restrictive as to risk the possibility that, while aggregate sterling cashflow (post-conversion) may be sufficient to meet the required debt service in a particular period, a shortfall of a particular currency as against the required hedge delivery could cause an early default of the entire transaction. The solution was a rolling series of currency forwards with deliveries sized to simultaneously ensure sufficient sterling cashflow to service the debt, yet small enough to minimise the risk of non-delivery defaults.

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- **interest rate hedges:** Since copyright-related cashflows are fixed rate as related to interest rates (since changes in rates hardly affect NPS) and CP is floating rate (at the A1/P1 level trading closely to Libor), the rating of the transaction required that an interest rate cap be put in place to allow for an assumed maximum cost of debt. Given, however, that the transaction has a 15-year tenor, and a possibly uncertain amortisation schedule, such a cap can be costly. The solution was to sell a corresponding interest rate floor, the proceeds from which were used to purchase the cap. In effect, a 'zero cost' collar, locking rates for the life of the transaction into a predetermined band.

Overcoming difficulties

While the above discussion is clearly not exhaustive, it hopefully provides an outline of some of the main issues that arose in structuring what was always going to be a complicated transaction.

This securitisation transaction demonstrates that even faced with complex assets, multi-jurisdictional legal and tax regimes and challenging administrative issues, it is still possible to structure a robust, cost effective, long-term funding solution to meet a company's financial goals. ■

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