A different direction for acquisition financing

Securitisation is increasing in popularity in Europe as a way of raising cash to fund acquisitions and growth, as Chris Moore of Deloitte & Touche discovers.

The traditional method of funding acquisitions – a thick slice of bland debt, a thick slice of institutional equity (perhaps with an optional mezzanine layer) with the management's contribution squeezed in the middle – is still a well-trodden path to paying for the target, but it is beginning to look a little unimaginative. The smarter money is starting to come from increasingly important elements of structured finance that can add funding value to the transaction.

By structured finance, I have in mind specific asset finance: equipment leasing, appropriate where tangible assets form part of the target package and for intangibles, securitisation, appropriate where a suitable cashflow is available in the target.

Now well known in the capital markets, securitisation's curve is moving steeply upwards. ABS techniques are being used in an ever widening range of circumstances and acquisition finance is certainly one of them.

What is a 'suitable' cashflow ?

From its beginnings in the US as a finance raising exercise backed by waves of homogenous residential or commercial mortgage or credit card receivables, an increasingly wide range of cashflow generating assets is being seen as securitisable.

Assets featured in the mushrooming European ABS market cover a wide area. This widening is being driven by the smaller financial market with its smaller mass of the receivables available in the US and also by the divergent legal, accounting and tax regimes in Europe that present barriers to a seamless pan-European market.

Securitising non-performing loans sounds strange enough, but after all, cashflows, however erratic, do derive from such assets and credit enhancement techniques are available. But the latest type of cashflow to back an issue of securities – via a handy special purpose vehicle (SPV) – is a steady stream of installment payments to a contractor for work rendered – ie, liabilities. As in generating electricity from a tidal barrier, it doesn't matter whether the tide is flowing in or out as long as it keeps flowing.

Securitisation as MBI/acquisition finance

The recent acquisition of consumer credit finance provider used securitisation as part of a tailored finance provision package. The target's business generated a steady flow of cash, provided by reliable contracts with good credit customers. Prudent provisions covered the weaker aspects. Easily identifiable and ring fence-able cash inflows provided a first-class candidate for securitisation financing and, as such, an attractive proposition to a securitisation funds provider.

The securitisation bank, a well-established player in the market, carried out preliminary due diligence and was keen to do the deal. It used an established commercial paper (CP) conduit issuer to issue the asset-backed securities. As in any management buy-in (MBI), the management team was essential to the success of the venture.

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Our MBI team credentials were ideal, with its many years of experience in the consumer credit business. They also had definite plans for future growth. The underlying business was strong, with room in the market to grow, and the acquirer planned to capture this growth through further acquisitions, funded by the continuing ABS facility.

Transaction structure

The structure encompassed the sale by the consumer credit business (the originator) of current and future receivables to a trust in the form of an orphan SPV. From there, certain rights to the cashflows arising from the current and future receivables generated by the growing business were transferred to the issuer of the CP securities. The issuer took the form of a conduit company, a vehicle set up to collect cash inflows from several unrelated originators and combine their cashflow power to achieve economic critical mass.

The consideration for the transfer comes, in the case of each batch of receivables, from the proceeds of the CP issue. An arrangement can be made so that, during the period of the facility, repayments in cash of the CP principal need be made only if the rolling receivables cash balance being generated by the ongoing consumer finance contracts were to fall below the pre-agreed level, which is otherwise sufficient to keep the cash balances topped up.

Detailed due diligence, concentrating on the records of the debtors, was performed both for the acquirer and the bank, with efficient use being made of the overlap of that work. The results were then presented to the equity and mezzanine providers.

Bridge finance

Of course, you can't securitise an income flow until it is yours. So the securitsation bank provided warehouse (bridging) funding enough to finance the acquisition of the target's shares. The receivables book constituted the target's assets, with the well-known 'whitewash' procedure eliminating any potential financial assistance difficulties.

Shortly after the acquisition, the securitisation bank refinance the receivables book, and because asset-backed finance has been committed for the expansion of the consumer finance book through further acquisitions, the process is smoothly repeated as future acquisition targets present themselves. This string of transactions makes the aggregate deal size worthwhile from the securitisation bank's point of view and helps keep costs to the minimum.

Credit rating

The example of securitisation we used here was through a well-established CP issuer whose securities were already rated. Consequently, no dedicated ratings agency credit rating (which usually requires detailed and expensive legal, accounting and tax opinions of the transaction) was required for this transaction – although a credit rating type of review was performed by the securitisation bank as part of its own due diligence procedure.

Detailed testing of the underlying customer contracts is the most critical of the asset due diligence, as is scrutiny of the business cashflow projections supporting the securitisation element of the company's financing. In this case, the legal integrity, Consumer Credit Act compliance, enforceability of the customer contracts, testing of credit controls, collection procedures, provisioning and bad debt experience, accounting systems and cash collection and bank account arrangements were all looked at in detail.

Post-transaction reporting

The post-transaction information required by the securitisation bank is detailed and frequent. However, it is no more burdensome than that demanded by any financier, and involves cash management reporting that should be available to the directors of any business with a large volume of cash movement.

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The transaction could have tripped up over a couple of issues

The quality of the underlying records is always a top priority for finance providers of any acquisition, and, where the debt economics depend solely on the customer cashflows, it is of even greater importance to the securitisation provider. Archaeological techniques can sometimes be necessary where accounting records or the underlying contracts are not readily to hand or where a non-standard debtor status reporting system has been set up. This review is particularly important where a client perhaps displays an erratic payment history or where contracts are found to bear technical legal flaws.

Stamp duty

It pays to be wary of tax issues in any financial transaction. Particular care should be taken with Stamp Duty – now potentially a deal-stopping 4% of the consideration for many types of financial asset other than shares. It might be possible for the transaction documents to be organised so as to obviate the incidence of the duty. If any earlier transactions of the target have taken place in which Stamp Duty might have impinged, a cash reserve might be required to be established for a specified period of time to meet possible future liabilities.

Tax deducted from interest

Withholding tax, or tax deducted at source from cash receipts, has to be treated with great care where loan interest payments are made and foreign countries are involved, especially where individuals are paying the interest and/or none of the very useful withholding tax exemptions can apply. A bare trust can come to the rescue here when the beneficial ownership of the interest can be demonstrated as accruing to a UK taxable person, although a more comprehensive solution is to organise the transaction's SPV so that interest is paid both to and for the direct benefit of a UK entity with no intervening non-UK entities in the interest payment chain.

Often, though by no means always, the natural home for a securitisation SPV is a low tax area such as the Channel Islands, Cayman Islands or Ireland, but the threat of the deduction of 20% tax from the cash receipts is enough to bring the SPV onto the UK mainland, foregoing any VAT advantage planning that might otherwise have been possible.

Target a member of a group tax payment arrangement?

Beware also where the target has participated in group tax payment arrangements. Legally, the liability is still that of each individual company within the arrangement, therefore take care not to be caught for interest and penalties, or even for tax payments you thought had been dealt with by a fellow group member (and paid for by your target) if the target company is set adrift from its vendor group by the taxpaying parent.

No equity dilution

Securitisation refinance is very attractive to the MBI purchaser because it does not have to involve equity dilution. It is a straightforward, generally lower-cost debt source, with no demands by way of shareholding. A form of finance that is now a familiar feature in the capital markets, it is focused on the underlying assets in the acquisition, extracting value from the assets being acquired and putting that value to good use in supporting the acquisition effort.

A happy ending

When all the issues have been settled by advisers and consensus reached, a successful acquisition should have been made. A finance providing team will have been established which will accommodate continuing acquisitions to the business with the minimum of fuss and complication, and achieved at an acceptable overall cost. The foundation for this is that the value inherent in the assets being acquired will have been put to work at the earliest stage and for maximum reward. ■

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