Securitisation – a safe bet for your assets

The securitisation market has grown rapidly in recent years, affecting everything from London City Airport to Newcastle United, says Stephen Moller of Simmons & Simmons.

The European securitisation market is in a period of very rapid development. According to Moody's, the outstanding volume in the market grew by 84% to $83bn last year. The United Kingdom continues to be the single most important source of issuance in Europe with about 40% of the market.

The more established part of the market is playing its part in that growth with mortgage-backed securitisation in the UK more than doubling to £5bn. Equally significant has been the application of securitisation to a new range of assets. Securitisation is becoming a mainstream source of finance for both financial institutions and other corporates.

This article focuses on the new types of asset being securitised and examines the motives of some of the issuers in the market. What emerges is that the term 'securitisation' now encompasses a number of very different transactions which are being undertaken for different reasons.

What assets are being securitised?

When securitisation began in the UK in the 1980s, the assets being securitised – residential mortgages and trade receivables, for example – were homogeneous debt obligations subject to relatively simple terms and conditions. These assets remain ideal for securitisation, but some assets now being securitised – shopping centre leases, football ground and airport revenues, for instance – are more diverse.

There are now new types of transaction, such as real estate lease securitisation and whole business securitisation, together with an increasing number of transactions which do not fit established categories. Innovations have also taken place in more established asset classes such as commercial and personal loans and mortgages and trade receivables.

Real estate leases

To date the most significant real estate securitisations have involved the Canary Wharf development and the Broadgate estate. The Broadgate securitisation of properties in the Broadgate estate, near Liverpool Street in the City, by British Land in May last year raised £1.54bn, making the transaction the largest ever sterling denominated asset-backed securitisation and the world's largest securitisation of any single piece of real estate.

The Canary Wharf development was the subject of securitisations in 1997 and again this year. Like Broadgate, it is a prestigious development with good credit quality tenants (including domestic and international banks) occupying high quality office space in an excellent location. These factors helped assure the rating agencies that not only is the likelihood of tenant default relatively low, but also the prospects of re-letting in a short period of time, should a default occur or lease expire, are good.

This made the assets particularly suitable for securitisation, which concentrates more on the predictability and sustainability of adequate cashflow rather than the asset's loan to value ratio.

Stephen Moller

The Broadgate securitisation demonstrated the ability of securitisation to deal with particular goals of the originator. The transaction resulted in only £100m worth of secured debt appearing on British Land's balance sheet, but achieved substantially the same legal effect and the same pricing as if security for the whole debt had been granted.

Other real estate assets can also be securitised provided that the requisite sustainability of cashflow can be demonstrated. Notably, providers of lease finance have undertaken several securitisations of nursing homes over the last few years. Here the sustainability of cashflow is based on the demographics of the UK's ageing population, the statutory obligation of local authorities to fund provision and the barrier to competitive entry resulting from licensing requirements. Pubs have also been securitised in large numbers, proving attractive due to customer loyalty and the restrictions on new competition placed by planning and licensing requirements.

The ability of securitisation to deal with new assets was illustrated by the securitisation of the Trafford Centre in Manchester which was the first securitisation of a shopping centre in the UK. A further securitisation of retail property followed this year with Sainsbury entering into a sale and leaseback of 16 supermarkets securitising the lease rental. The terms of the leases were more attractive than those generally available in the sale and leaseback market as they did not contain upwards only rent reviews and gave Sainsbury an option to buy back the properties on maturity.

Also early this year, Owengate Keele plc issued the first securitised bonds in the UK secured on student accommodation rental. The transaction achieved fixed rate funding at about 6.7%, although unusually it was necessary to 'credit wrap' the deal through a financial guarantee provided by an insurance company. Owengate Keele was possibly the most prominent of a number of recent securitisations in the public sector and/or involving PFI projects.

Whole business securitisation

The structure of a whole business securitisation involves the issue of bonds by a special purpose company which then on-lends the proceeds on a secured basis to the operating company which holds the business assets. This enables the operating company to access a wider group of potential investors than would otherwise be available to it.

Deals completed in the last year include the securitisation of revenues from London City Airport. Like other operating business securitisations, the transaction involved a debt service-to-EBITDA ratio covenant (again emphasising the importance of sustainable cashflow). In London City Airport's case, the ratio was set at 1:25; a breach of the covenant can trigger the appointment of an independent financial advisor. The security for the transaction then becomes enforceable if the breach is not remedied. The appointment of a financial advisor is a halfway-house between management having unrestricted control over the business and the appointment of a receiver, and it represents a sophisticated approach to potential default.

Also in the transport sector was the Wightlink securitisation of revenues from ferry routes to the Isle of Wight. Like London City Airport, the business benefits from high barriers to competitive entry, as Wightlink's position is protected by its control of port facilities.

The existence of high barriers to competitive entry is a common theme. The Tussauds transaction last year involved the securitisation of Madame Tussauds and certain theme parks. Although there is nothing to prevent a similar attraction being established in close proximity, it is considered that Madam Tussauds' global reputation would prevent a rival from offering effective competition.

Similarly, the securitisation last year of Newcastle United's ticket sale and corporate hospitality receipts depended to a large extent on the loyalty of the club's supporters. It is said that an analysis of attendance records at St James's Park over a 100-year period concluded that only during world war had attendances been insufficient to cover the bond covenants.

> The fact securitisation is being used by an increasing range of issuers for a variety of purposes means its growth is set to continue

A further significant development came with the issue of \$1.4bn worth of bonds, which securitised the income from television rights, promotion and merchandising in relation to motor racing's Formula 1 Championship. In this case, the company's principal asset was its contractual right to receive a percentage of those revenues throughout the lifetime of the bonds.

Trade receivables and stock securitisation

Trade receivables are an established class of securitisation asset. Being straightforward debt obligations they are comparatively easy to securitise, particularly if the obligors are highly-rated. The prevalence of trade receivable securitisation can sometimes be obscured because issues are often completed through an asset backed commercial paper conduit set up by an investment bank, rather than through a stand-alone issue.

One recent exception was a \$700m securitisation of commodity trade receivables by Glencore (a company involved in the trading of metals, energy products and agricultural goods). The bonds have an expected life of about five years and lock in spreads for a considerably longer period than is possible in the commercial paper market.

A similar new asset has emerged in the last two years in the form of inventory securitisation. This technique involves the sale of stock to a special purpose company. The technique allows a supplier to raise securitisation finance when inventory is produced rather than waiting until a sale to a trade customer. Inventory securitisations have tended to be completed through commercial paper conduits and so have been unpublicised.

A public securitisation of champagne stocks was, however, completed by Marne et Champagne, France's second largest champagne producer. Champagne proved to be perfect for securitisation as there is a perennially strong demand for the product and supply is limited by law.

Commercial and personal loans and mortgages

Financial institutions continue to securitise, both for regulatory purposes and to diversify funding sources. Recently, Barclays launched the Gracechurch credit card securitisation raising \$1bn.

Some leading players in the residential mortgage market have also turned to securitisation as a mainstream funding source. Competition for retail funds has intensified, resulting in the disappearance of the relative cost disadvantage of securitisation for mainstream lenders.

Outside the UK, a significant development in the commercial mortgage-backed market was Rheinhyp's Europa 1 transaction which securitised mortgages in Austria, France, Germany, the Netherlands and Spain. The introduction of the euro has removed the currency exchange risk which previously inhibited pan-European securitisation, but differences in legal systems can still make the transfer of assets located in different jurisdictions a relatively complicated process. Europa 1 overcame this hurdle through the use of a synthetic structure where the credit risk in the assets is passed to the vehicle, but legal ownership of the assets remains with Rheinhyp.

Other assets

Equipment leases continue to be securitised with a number of deals relating to railway rolling stock and aircraft leases completed this year and last. In relation to personal rental contracts and equipment, the securitisation of lease payments by Radio Rentals, part of Thorn plc, demonstrated the ability of securitisation to raise more debt than conventional bank finance. £309m of securitised bonds were issued, whereas £205m of the overall acquisition financing less than a year earlier is said to have been allocated to the business.

Motives for securitisation

The motive behind many securitisations remains regulatory relief. By putting assets off-balance sheet, financial institutions regulated under the Basle Accord avoid maintaining regulatory capital against those assets. It is, however, clear from the above examples that many securitisations are now being completed by corporates which do not have capital adequacy requirements.

What motivates the new issuers?

For many the attraction is that securitisation can often raise more debt than conventional financing, reducing the amount of equity required and leading to an improved return on equity. The overall cost of debt can also often be reduced. In one of the major real estate lease securitisations, the originator's cost of funds is said to have reduced by 90 basis points per annum.

The relative cost of securitisation depends, of course, on several factors including the asset class and the originator's ability to demonstrate the sustainability of cashflow from historical data and other sources. For highly rated originators, securitisation can prove more expensive than other funding sources. However, recent securitisations by banks such as Barclays, Abbey National and Northern Rock shows that, even for highly rated originators, securitisation is becoming more cost competitive.

Diversity of funding is a further motive. The end product of securitisation is debt issued in the international capital markets which provides direct access to potential groups of investors such as life assurance companies and pension funds, both in the UK and abroad.

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Once an issuer has completed one securitisation, it will be much quicker and cheaper for it to access these markets a second time should it ever need to.

Securitisation can also offer a range of maturities matched to the maturities of the underlying assets, ranging from the very short maturities available in the asset backed commercial paper market to maturities of 30 years or more in commercial real estate transactions.

Linked to the long-term nature of many securitisations is the covenant package expected. Generally, securitisations will involve the transfer of the securitised assets to one or more special purpose companies whose activities will be limited to holding those assets and, possibly, assets of a similar type. This reflects the financial analysis of securitisation which concentrates on the ability of particular assets to generate cashflow rather than the ability of management to undertake different types of business in the future.

However, within those parameters, the terms of a securitisation tend to allow a great deal of flexibility in managing the assets without the complicated package of financial and other covenants often required by bank lenders.

Future development

The ability of securitisation to raise large amounts of debt on certain types of assets, such as pubs and lease receivables is well documented. Those who extend securitisation to new types of asset may well see the amount of debt which can be supported by those assets, and ultimately their value, improve as a result. Certainly the innovation which has extended securitisation to so many new asset classes shows little sign of abating.

The most significant trend in the next couple of years, however, may be the continued overall growth in issuance. Recent transactions have shown that it is possible to securitise assets as diverse as hotels, shopping centres, transport infrastructure, theme parks and receipts from sporting events. However, the penetration of securitisation into these markets for debt finance is still very limited. We can expect more types of transaction to become standardised as has happened to residential mortgage transactions.

As this process continues, the cost of securitisation will fall and the awareness of the technique on the part of borrowers will increase. Allied to the fact that securitisation is now being used by an increasing range of issuers for a variety of different purposes, the growth in securitisation is set to continue. ■

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