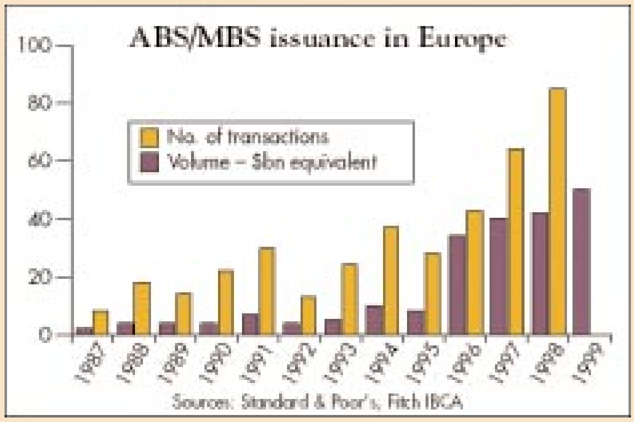
Securitisation: operating assets and corporates

Sebnem Erol of Deutsche Bank looks at securitisation for corporates, the latest financing tool that differentiates stable and not-so-stable businesses.

FIGURE 1



Securitisation is an established financing technique used to raise medium- to long-term financing at the back of a specific pool of assets. In effect, it monetises the present value of future cash flow streams generated by these assets through the issue of a debt instrument secured against these cash flows. The assets are insulated from the operating risk of the owner/seller of the assets, and hence can achieve better financing terms than the owner/seller would have achieved on its own merits.

Traditionally, securitisation issues have been backed by financial assets which enjoy a contractual right to future cash flows, such as:

- consumer loans/auto loans/credit card receivables;
- real estate/mortgage pools;
- trade receivables/inventory;
- future flows, ie workers remittances, export receivables, credit card receivables (mainly for emerging markets);
- equipment lease/aircraft finance; and
- CBO/CMO/CLO.

The rapid increase in securitisation throughout Europe is being driven by changes in regulatory environments, pressure to increase return on equity and acceptance of securitisation as a competitive financing alternative by financial institutions (see *Figure 1*), enabling them to achieve efficient use of capital, diversify funding sources and transfer risk off balance sheet.

Securitisation has grown, partly because of the introduction of new asset classes, but also as jurisdictions in Western and Central Europe align their regulatory frameworks to accommodate recent developments in the debt capital markets. Legislation has been introduced in Germany, France and Spain; proposals are pending in Italy and Portugal.

The most recent trend in the securitisation markets, however, has been the application of securitisation techniques to the financing of operating assets/corporates. This has established a financing alternative which is more attractive than traditional financing methods in many respects.

The aim of this article is to look at how the securitisation technique can be applied to operating assets and corporates, and to examine its strong growth, particularly in the UK market.

Operating asset securitisation

In the past two years, cash flows from nursing homes (Craegmoor), motorway service areas (Roadchef, Welcome Break), tenanted pubs (Punch, Premier, Wellington, Unique), transportation assets (Eurofreight, Angel Trains, etc) and in a few cases football clubs, movie libraries (FILMS) and leisure assets (Tussauds) have been securitised.

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In operating assets, securitisation is particularly attractive for financing corporate leveraged buyouts. Corporates that have used securitisation as an alternative to the leveraged loan market include: Welcome Break, Roadchef, Punch Taverns, Unique and Tussauds. Securitisation is also seen as a tool for recapitalising stable assets in order to free capital for growth businesses, as was the case at Premier and at FILMS.

The latest example is the securitisation for the Tussauds Group, the owner and operator of three theme parks and six tourist attractions in the UK and elsewhere. Earlier businesses that have been securitised were characterised by utility-like assets with low requirement for development capex and management prowess. In contrast, the leisure industry is cyclical and capex-intensive.

Clearly, the definition of businesses that can be securitised is widening. So what makes an operating asset/corporate securitisable?

Step 1: The business must be stable and generating resilient cash flows. Such industries are generally characterised by their utility-like nature and high barriers to entry. The cash flow should be achievable by any 'common sense' management as opposed to requiring specific management expertise. The business should not be prone to event risk, such as changes in technology. It is important to make sure that the cash flows are unlikely to be threatened by changing delivery methods, such as internet and digital TV. It is no coincidence that operating asset securitisations, with some exceptions, are typically real-estate based.

Step 2: Control over the cash flows is established either through a sale of the assets, or through an adequate legal structure that ensures the continuation of cash flows in the event of the insolvency of the owner/operator. Often, the structure is enhanced by a liquidity facility to absorb temporary falls in cash flow. In the Tussauds transaction, negative cash flows are incurred between the months of October and March when the theme parks are closed. Hence the Tussauds structure, in addition to a liquidity facility, features a seasonality facility that serves to meet cash flow needs during that period.

Resilient and predictable cash flows coupled with a strong legal structure and security package that ensure control over the cash-generating assets form the building blocks of an investment-grade rating.

Step 3: The investment-grade rating allows the company to access a broader range of investors at the longer end of the yield curve at rates reflecting investment-grade pricing. As a result of both the lower cost of capital and the longer term of the debt, the company achieves a considerably higher debt quantum than it would have achieved on its corporate merits alone.

TABLE 1 The advantages of securitisation

	Stand-alone	Leveraged loan	Securitisation
Debt/equity	50 : 50	65 : 35	90 : 10
Maturity of debt	15 years	10 years	25 years
Cost of debt	6.5 %	7.5 %	6.5 %
Expected return on equity	15%	25%	35%
Debt/EBITDA	3.8 times	5.0 times	7.0 times
EBITDA/interest	4.0 times	2.7 times	2.3 times
EBITDA/interest + principal	2.6 times	1.5 times	1.8 times
Weighted cost of capital	9.6 %	11.9 %	7.3 %

Securitisation is now accepted as the principal way to finance pubs, motorway service areas and nursing homes. The fact that the cash flows of these businesses are directly attached to the real estate clearly helps in the analysis, which tries to demonstrate that the lenders will have control over the cash flows in an insolvency. That does not mean, however, that securitisation cannot be applied to businesses not backed by real estate, but by other types of assets, such as intellectual property.

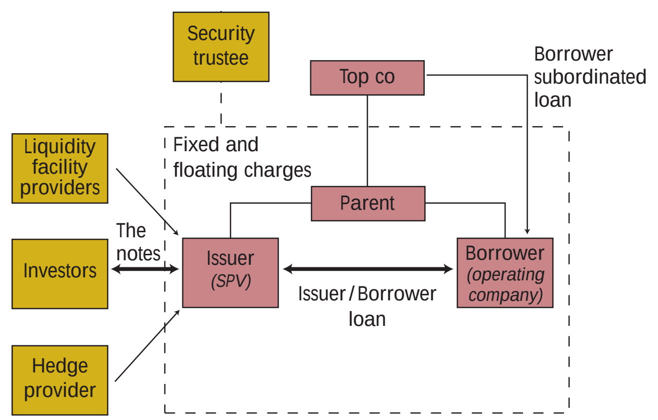
Rating analysis and legal structure

Rigorous rating analysis, together with a water-tight legal structure, allows the rating agencies to form a long-term view on the cash flows of the business.

The rating analysis for these structured transactions involve a bottom-up analysis which focuses on the individual components of the cash flow and their drivers. It is important that several factors are assessed. These include: operating risk, current and future competition, cost and income lines, capex needed to maintain steady-state cash flow, third-party liabilities and potential for event risk. The analysis relies heavily on cash flow model runs and ultimately looks at the cash flow the business would generate if it were insolvent and under sub-standard management. This is rather different from a traditional corporate rating, which tends to use a top-down approach by peer group comparisons and ratio analysis.

FIGURE 2

UK secured loan structure



Any third-party liabilities, such as tax, environmental claims, litigation claims and so on, are sized in the cash flow model or insured where appropriate. Through operational covenants, management's capacity to change the risk profile of the business over time is limited.

Liquidity, eg, a liquidity facility at issuer level, cash reserves or a seasonality facility at borrower level, largely take out seasonality and the short- to medium-term business cycle risk.

Operating asset securitisations are highly suitable for UK-based companies because of the creditor-friendly nature of the insolvency regime, which allows the senior lenders of a business (with fixed and floating charges over nearly all its assets) to take control of its management if there is an insolvency (see *Figure 2*). In many jurisdictions in Europe the insolvency process is court-led and leads to more complex challenges in structuring continental operating asset deals. Examples of transactions in continental Europe include Eurofreight and FILMS transactions where insolvency-remote special-purpose vehicles and true sales structures have been used to remove insolvency risks and permit the securitisation of operating assets.

Advantages

The advantages of corporate securitisation include:

- investment-grade cost of debt, which results in a lower weighted cost of capital (see *Table 1*);
- higher debt quantum than that offered by leveraged loan markets;
- lower debt service per annum due to stretched maturity, which means that there will be more cash flow in the business for capex, acquisitions or dividend payments;
- customised operational covenants

- that allow disposals and acquisitions (some trade-off between flexibility and debt quantum);
- ability to make dividend payments, subject to meeting cash flow criteria;
- no change of control provision, allowing the debt package to stay with the business on exit of current shareholders;
- reasonable financial covenants, typically EBITDA to debt service (interest and principal) test set in the range of 1.0–1.35 times; and
- access to a diversified investor base – there is potential for 144A issues to enable access to US investors.

Investors

Investors are more willing to consider complicated credit stories with the securitisation of operating assets given the rigorous rating analysis and the structural enhancements. Securitisations are structured products and price at a premium to non-structured, but similarly rated corporate paper. They allow investors to diversify portfolios into new asset classes, while improving yield within the same rating categories.

The investor base has started to broaden through the introduction of US and other long-term institutional investors. Demand for securitisations is expected to grow, enabling further liquidity as issuance volume increases.

Conclusion

The introduction of new asset classes is expected to be spearheaded by the UK market and aided by its creditor-friendly insolvency regime. New transactions may emerge from the infrastructure, leisure and intellectual property sectors.

Substitution of high-yield products by securitisation for stable businesses has already begun. In the past two years, securitisation has become accepted as a mainstream financing tool for pubs, nursing homes, motorway service areas and leisure assets, which were before considered as new asset types. Good examples of this are: Welcome Break, Roadchef, Punch Taverns, Premier, Unique. The significant advantage in the cost of capital means that businesses in securitisable and consolidating sectors must be financed through securitisation, or perish while competitors reap the benefits.

The next step is to educate the equity markets on the advantages of securitisation. This should be seen in the next two years as the securitised businesses seek public offerings.

Securitisation is not a magic trick, but a financing tool that differentiates stable businesses from the not-so-stable ones, pricing them efficiently and giving due credit to their inherent resilience.

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EXAMPLES OF OPERATING ASSET SECURITISATION

Type of borrower **Borrower**	**Date**	**Rating**	**Amount (£m)**	**Term (Yrs)**	**Type**	**Lead**	**Features**
Nursing homes:							
Craegmoor	December 1996	AA A BBB	51.2 11.2 17.6	12 12 12	FRN FRN FRN	UBS	One of the first examples of the UK secured loan structure
Motorway service areas:							
Welcome Break	August 1997	A A A BBB	42 85 127 67	10 14 18 20	FRN FRN Fixed rate bond Fixed rate bond	BT Alex.Brown (Deutsche Bank)	First securitisation used to refinance an LBO
Welcome Break - Tap issue	October 1998	A A	30 25	10 14	FRN FRN	BT Alex.Brown (Deutsche Bank)	First tap issue for an operating asset securitisation
Roadchef	November 1998	A A BBB	35 133 42	9 24 27	FRN Fixed rate bond Fixed rate bond	Barclays	
Pubs:							
Punch Taverns	March 1998	A/A2 A/A2 A/A2 A/A2 BBB/Baa2	120 60 80 175 100	10 13 18 24 28	FRN FRN FRN Fixed rate bond Fixed rate bond	BT Alex.Brown (Deutsche Bank)	First securitisation of a tenanted pub portfolio First securitisation to finance an acquisition directly
Premier	November 1998	A A BBB	40 80 35	10 2 28	FRN Fixed rate bond Fixed rate bond	Nomura	Launched but not closed
Unique	March 1999	A A A BBB	285 150 250 125	10 15 22 25	FRN FRN Fixed rate bond Fixed rate bond	Nomura	
Intellectual property:							
FILMS	March 1998	A	ITL475bn	13	FRN	Merrill Lynch	Securitisation of Italian exploitation rights of a movie library
Leisure assets:							
Tussauds	May 1999	A2 A2 A2 Baa2	50 20 100 60	10 12.5 21 25	FRN FRN Fixed rate bond Fixed rate bond	BT Alex.Brown (Deutsche Bank)	Securitisation extended to leisure assets. First use of . seasonality facility
Transportation assets:							
Eurofreight	June 1998	AA AA A	EUR90 EUR130 EUR35	18 18 18	FRN FRN FRN	BT Alex.Brown (Deutsche Bank)	First securitisation of operating railcar leases in Europe involving multiple jurisdictions