SECURITISATION IS DEVELOPING INTO A MORE MAINSTREAM FINANCING TECHNIQUE FOR MANY CORPORATE TREASURERS. INVOICES HAVE EMERGED AS A VIABLE AND COST-EFFECTIVE ASSET TO SECURITISE, PARTICULARLY FOR POST-LBO COMPANIES. **DECLAN LYNCH** REPORTS.

A secure opportunity

Until recently, securitisation was perceived as applying to the largest European corporates only. Two factors have hindered its take-up. Firstly, the well-publicised abuse of Special Purpose Vehicles (SPVs) in recent accounting scandals, where the mechanics of securitisation focused simply on balance sheet engineering rather than true financing, have been a setback. Secondly, there has been a perception that securitisation is complex, costly and ties up insupportable amounts of processing time for internal financial teams, already under pressure from compliance with current or impending financial regulation.

These perceived problems have been largely overcome in the minds of corporate financial managers, who now view securitisation as a mainstream financing tool. Statistics from the European Securitisation Forum, held in July, indicated that non-mortgage-backed issuance in the European securitisation market increased to over €55.5bn in the first half of 2004, up 56.8% on the same period last year.

Earlier this year, a research report entitled *The New Voice of the Invoice*, confirmed that securitisation is past the 'pioneer' stage and is becoming accepted as a mainstream financing method. Nineeteen per cent of top European companies stated that they have securitised assets within their companies. The first choice was trade receivables (invoices) securitisation (66%), with future revenue streams (34%) and loans (31%) trailing behind.

Executive summary

- Lack of up-to-date technology and complexity are the main reasons why securitisation has been considered the domain of large corporates.
- Recent reports indicate that securitisation is past the 'pioneer' stage and is growing rapidly, with nearly 20% of top European companies stating that they have securitised assets within their companies.
- The five types of securitisation used by corporate treasurers are trade receivables, whole company, vendor finance, future flows and property.
- Invoice securitisation is expected to emerge as a frontrunner over the next few years, especially for post-LBO/MBO companies.

INVOICE SECURITISATION. There are five main types of securitisation relevant to the corporate treasurer – trade receivables, whole company, vendor finance, future flows and property. The cashflows generated by invoices represent a simple solution to the assets required for a securitisation. Payment performance is straightforward to monitor and allows the capital markets a transparent window on credit quality.

Typically, transactions achieve a funding cost in the region of 0.5-1.5% above London Interbank Offered Rate (Libor). Such securitisations can deliver financing with a higher rating than that of the corporate itself. One recent transaction saw a European blue chip corporation rated BB- execute an AAA-rated securitisation. This saved it more than €5m per annum in interest costs, equating to a net present value saving of €30m over the term of the deal.

In the recent research, respondents quoted "access to finance from a source other than your relationship banks" as a greater motivation (64.7%) behind invoice securitisation than "access to cheaper finance" (57.7%). While a prime objective of invoice securitisation is evidently to reduce interest cost, widening the range of credit lines available is regarded as even more critical. Emphasising the credit rating advantages of this financing technique, "separation of the asset from the corporate credit rating" was deemed the third most important advantage of invoice securitisation (55.1%).

When asked about the perceived negative aspects of invoice securitisation, treasurers said that it is "expensive to set up and administer" (74.3%) and "time consuming" (68.3%). One possible explanation is that the combination of compliance with new financial regulations, plus concerns over increasing interest cover, are so time consuming for financial managers, that they have little time to actively seek alternative lines of credit. Nevertheless, the research did reveal that the notion of "securitisation only applying to large corporates" is evidently declining – a sign that former perceptions are changing.

Invoice securitisation is seen as an appropriate post-Managed Buyout (MBO)/Leveraged Buyout (LBO) method of financing. This year, around €150bn (in equity) of LBOs will be concluded in western Europe. But cost of debt is expensive for post-LBO companies as they are often subject to a downgrade in credit rating to sub-investment grade because of their high leverage.

Many private equity houses have turned to invoice securitisation as a means to free up development capital as soon as possible after an LBO. They are interested in this financing tool because it releases working capital which can be invested in marketing, product development, channel development, sales incentives and other initiatives. This enables them to grow the acquired company

more rapidly, reduce the period it takes to divest it and realise the return on investment for investors. Furthermore, the typical length of an invoice securitisation deal of five to seven years is a very good fit with the exit strategy of many private equity houses.

TECHNOLOGICAL DEVELOPMENTS. The lack of sophisticated technology has always posed a barrier to securitisation. As European corporates tend to operate on a decentralised basis, with operating companies in each country running their own books with a great deal of independence, securitisation has proved difficult for the typical multi-national or regional group. A consolidated and centralised systems infrastructure used to be a fundamental requirement of any securitisation.

‘THE COMBINATION OF DEBT LEGACY, SLOW TRADING CONDITIONS, THE UPSWING IN LBO ACTIVITY AND RECENT TECHNOLOGICAL DEVELOPMENTS HAVE MEANT THAT MANY COMPANIES ARE NOW CONSIDERING INVOICE SECURITISATION’

However, online reporting services are now available, providing the necessary consolidation without disrupting existing IT infrastructure or interfering in local operational matters. Such services are automated, secure and can deliver the necessary securitisation tracking and reporting no matter how many systems, operating companies and business processes are involved. One recent transaction involved processing over three million invoices, making a robust processing infrastructure critical. Key additional benefits to this sophisticated technology are that there is no requirement for additional hardware, local systems or to hire new people.

In the past, structuring technology did not effectively insulate the debtor book from the creditworthiness of the originator. Consequently, securitisation funding was really restricted to companies rated A and better. This has changed as a result of the new rating and financing technologies recently pioneered that have allowed effective legal and practical isolation of the debtor book from the parent company’s balance sheet. The successful legal separation of a securitised invoice pool from the issuing company releases that debt-asset from the millstone of the company’s credit rating. In short, the debt is rated according to the credit quality of the debtor, not of the issuer.

The combination of debt legacy, slow trading conditions, the upswing in LBO activity and recent technological developments have meant that many companies are now considering invoice securitisation. For companies conducting such transactions, it is critical that the sub-investment grade credit rating is due to high balance sheet leverage and not poor business performance. Companies must also demonstrate strong historical sales growth and have a strong management team and business model in place. Proceeds from the proposed securitisation transaction should only represent a minority proportion (less than 35%) of the overall debt financing of the company.

Due to the nature of such transactions, originating companies tend to be characterised by high volume, low-value product lines and have high debtor diversification. By definition, this achieves a more even spread of risk. Companies usually have an outstanding debtor book of at least €100m. These characteristics make industrial sectors (i.e. distributions firms), as opposed to service industries, particularly suitable candidates. In many cases, treasurers of such companies are finding that it is sufficient to include 33-50% of a debtor portfolio in a securitisation transaction.

Trends in financial stress

Securitisation has only recently featured on the radar for financial managers because pressure to find alternatives to traditional bank finance have only become apparent since the late 1990s. However, the breakdown in relationship banking and the faltering economic recovery in Western Europe has increased financial pressure on European companies and led to a subsequent focus on lower-cost alternative financing methods.

Recent research examining trends into the current state of financial stress amongst non-financial European companies in various rating bands measured the change in financial stress for companies in different credit rating classes.

European companies – financial stress trends

CREDIT STATUS	FINANCIAL STRESS INDEX (100 = Average)	PROFITABILITY INDEX (100 = Average)
All rated companies	112	108
A rated companies	103	126
B rated companies	136	85
Sub-investment grade companies (below BBB-)	149	44

The picture that emerged was one of polarisation. Financial stress has increased for all rated companies in Europe. However, the increase has been absolutely marginal for A-rated companies (3%), substantial for B-rated companies (36%) and punishing for sub-investment grade companies (49%). The sound corporates appear to be getting sounder, but the highly indebted, with some notable exceptions, are in danger of becoming terminal.

The research highlighted the importance and urgency for sub-investment grade companies to reduce their weighted average cost of capital (see *A balancing act*, page 20) through lower cost alternative finance such as securitisation. This alternative financing method also has economic importance in that further company failure, or just severe difficulty, could dent the confidence of the current recovery in continental Europe.

Declan Lynch is Executive Vice President at Demica.
declan.lynch@demica.com
www.demica.com