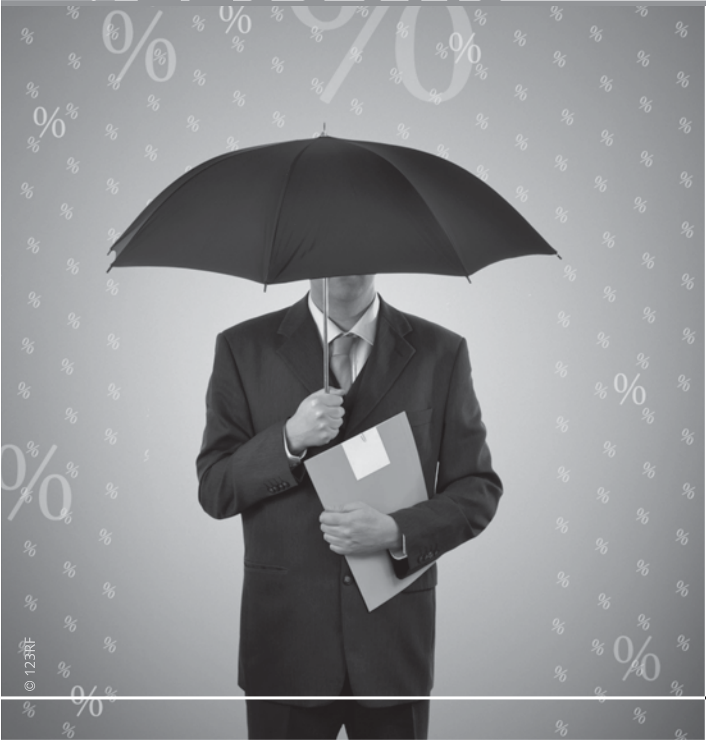

Corporate Securitization:

Seven Lessons for a CFO

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Before the subprime meltdown the asset-backed market had grown to become one of the largest capital markets in the world in terms of size and volume. The market was not only accessed by financial institutions, but also by corporates. Corporates increasingly often used securitization techniques to refinance whole lines of businesses by issuing asset-backed debt that was rated multiple notches above the rating of the parent company. One of these instruments that were used is whole-business securitization, also defined as operating-asset or corporate securitization. [1] The overall issuance has continued in Europe and the United States despite the crisis, albeit at lower levels. [2] An interesting example of a recent transaction done in the market is that of Church's Chicken.

In February 2011, Church's Chicken issued secured bonds in the aggregate principal amount of $245 million. The new credit facility is the first whole-business securitization completed in the restaurant sector since 2007. The bonds are backed by the franchise revenues of the nearly 1,450 franchised Church's Chicken-branded and Texas Chicken-branded restaurants in operation both domestically and internationally and substantially all of the tangible and intangible assets of the approximately 230 company-owned Church's Chicken-branded restaurants in operation in the United States. The new credit facility is the first whole-business securitization completed in the restaurant sector since 2007.

> "The performance of whole business securitizations backed by restaurant franchise payments, such as the Church's Chicken bond, has been «stable,» note Moody's Investors Service analysts. These haven't suffered during the economic downturn because they experienced «milder customer traffic declines than did the more expensive fine dining and casual dining industry segments,» the analysts note. [3]

[1] In one year's time, both the Dunkin Brands transaction (May 2006) and the Domino's Pizza deal (April 2007) pushed about $3.5 billion of asset-backed papers onto the market.

[2] See report "Recent Developments in Securitization", published by the European Central Bank in February 2011.

[3] http://www.dowjones.de/site/2011/02/churchs-chicken-puts-franchise-fees-on-abs-menu.html.

The decision to use whole-business securitization involves an explicit choice regarding the financial structure concerned as well as managerial involvement and control. This article aims to introduce the reader to the structural features of whole-business securitization by discussing 7 important lessons.

First, the general concept of asset-backed securitization will be discussed. Next, the reader will be introduced to the terminology framework for whole-business securitization. Finally, an answer will be presented to the question how whole- business securitization distinguishes itself from more traditional areas of corporate finance.

Lesson 1:

The definition of asset-backed securitization refers to the issuance of tradable debt papers, which are guaranteed based on a well-defined collection of assets.
Unfortunately, the term 'asset-backed securitization' is used differently by many, and the usage is not necessarily comparable. Asset-backed securitization first appeared in bank funding. Hess and Smith (1988), for example, defined asset-backed securitization as a financial intermediation process, which re-bundles individual principal and interest payments of existing loans to create new securities. More recently, the term 'asset-backed securitization' has come to be used to refer to so-called 'structured finance', the general process by which illiquid assets are pooled, repackaged and sold to investors. So, asset-backed securitization can best be defined as the process in which assets are refinanced in the capital market by issuing securities sold to investors by a bankruptcy-remote special purpose vehicle. This definition comprises the fundamentals of asset securitization.

Lesson 2:

The objective is that only the investors in the SPV will have a claim against the securitized assets in the event of the seller's bankruptcy: not the seller or the seller's creditors.
Legal concepts in the area of securitization often differ, and thus have specific accounting and tax rules, including tax consequences for both sellers and investors. Common-law countries (such as Australia, the United Kingdom and the United States) for example, follow different legal rules in comparison with civil countries (most other countries). Despite fundamental differences in the legal environment, the primary objective of the SPV is to facilitate the securitization of the assets and to ensure that the SPV is established for bankruptcy purposes as a legal entity separate from the seller. In other words, the objective is that only the investors in the SPV will have a claim against the securitized assets in the event of the seller's bankruptcy: not the seller or the seller's creditors. Because the pool of assets is insulated from the operating risk of the seller, the SPV in itself may achieve better financing terms than the seller would have received on the basis of his own merits. This is the key driver for reducing financing costs by securitization in comparison with alternative forms of financing.

Lesson 3:

Asset-backed securities are not the same as covered bonds.
The objective of securitization is that the investors in the SPV will have a claim against the securitized assets in the event of the seller's bankruptcy: investors do not have recourse on the seller. That makes securitization different than covered bonds, because covered bonds do not allow for risk transfer in the same way as securitized products. In the event of default, asset-backed securities have recourse only on the pre-defined pool of assets in the SPV, while covered bonds have recourse on both the SPV and the seller of the assets. So one distinct feature from securitized products is the liability of the seller in the event of default. Note that covered bonds are frequently used as an alternative for residential mortgage-backed securities (RMBS).

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Lesson 4:

The element of future exploitation of the asset is a key distinction between standard securitization and whole-business securitization.
Whole-business securitization uses securitization techniques for refinancing a whole business or operating assets. You may wonder what exactly is meant by 'whole business', and where precisely the difference lies compared with the

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more usual types of collateral used in securitization transactions: credit cards or mortgages, for example. In order to make you understand whole-business securitization, its definition will be presented first. Next, the difference will briefly be explained between whole-business securitization and the more common forms of securitization, as we know them today: for example the use of mortgages and credit cards. Whole-business securitization can be defined as a form of asset-backed financing in which operating assets are financed in the bond market via a bankruptcy-remote vehicle (hereafter: SPV) and in which the operating company keeps complete control over the assets securitized. In case of default, control is handed over to the security trustee for the benefit of the note holders for the remaining term of financing. One of the great challenges lies in defining the difference between operating asset securitization and the more common forms of securitization transactions. Consider for instance a mortgage pool. If the mortgages have been securitized, the seller (sponsor) has no further obligations towards the consumer. The mortgage has been closed and stipulations concerning future payments – to be made by the consumer – have been laid down in a contract. Simply stated, the financial institution then collects payments from the consumer for the balance of the life of the loan. In effect, the traditional classes of securitization assets are self-liquidating. By contrast, in the example in which claims on the basis of operating assets are securitized, the sponsor has an obligation to exploit the underlying assets. To offer an illustration: when a football club securitizes its revenues from the sale of tickets, the sponsor must continue to render services that allow football fans to buy their tickets at the box office. Thus, the securitization process requires permanent managerial involvement on the part of the original owner in order to generate revenues. The element of future exploitation of the asset is a key distinction between standard securitization and operating-asset securitization. Control over the cash flows of the securitized business is established either through a sale of the assets, or through an adequate legal structure that ensures continuation of cash flows in the event of the insolvency of the borrower. [4]

Lesson 5:

The receiver has authorization to seize control over the assets of the securitized business at the loss of any other creditor.

In a standard 'whole-business securitization' transaction, a financial institution grants the sponsor (or originator) a loan secured by a pledge on the assets. This secured loan is then transferred to a bankruptcy-remote special purpose vehicle, which issues the notes. The security attached to the loan is also transferred to

5 This feature makes it difficult in some countries to structure a business securitization deal. In fact, it has been proven to be hard to separate the assets legally while the sponsor still retains operating control and services these assets. Under U.K. law, this difficulty has almost been eliminated by the 1986 Insolvency Act, which permits the holder of a charge over substantially all of the assets of a corporate to control the insolvency proceeds of that corporate through an administrative receiver.

the SPV. Thus, ownership and control of the assets remain with the sponsor, and bondholders are only granted charge over those assets. Control is required because the owner of the assets should exploit the assets for the full term of financing. Also, the sponsor intends to repay the loan out of the cash flows generated from its business. In case of default of the sponsor, the SPV receives complete control over the securitized assets by appointing a receiver for the full term of financing. The receiver has authorization to seize control over the assets of the securitized business at the loss of any other creditor. This is called bankruptcy remoteness. The SPV increases the likelihood of the business being able to continue as a going concern rather than being forced to have a 'fire sale" of the individual assets. This preserves the value of the assets securitized, which is of great importance to the investors. Whole-business securitization therefore efficiently uses the privileges of bankruptcy law offering bondholders extensive security in case of default.

A clear case of effective receivership in default is that presented by Welcome Break, the U.K.-based motorway service area operator and the first whole-business securitization operation in its segment. When Welcome Break was no longer able to meet its obligations following its weaker-than-expected operating performance in 2002, the owner was in danger - if the economy continued to slide – of landing in a situation in which the company would not be able to meet its debt obligations. The owner then made an offer to the bondholders: Class A's were to be repaid at par (£309 million par value), and Class B's at 55% (£67 million par value). The bondholders rejected this proposal. Subsequently, after Welcome Break failed to make full payment on its loan, it was put into receivership. Deloitte was appointed administrative receiver. A few days later, the owner and the administrative receiver finally organized a solution; the owner agreed to pay all classes of bondholders back at par by selling nine service stations.

Lesson 6:

A whole-business securitization structure tends to carry a lower average cost of debt compared to ordinary debt, and it usually issues debt with a longer maturity, which reduces pressure on the corporate issuer to place refinancing.

The result of bankruptcy remoteness is that the SPV generally issues securities that are rated higher (and in many cases significantly higher) in comparison with other alternatives, such as the issuance of ordinary secured debt by the company. This is the result of the risk mitigation generated by isolating the assets from the bankruptcy and other risks of the parent company through the whole-business securitization structure. Hence, the holder of an asset-backed bond is in a position similar to that held by the holder of an ordinary secured bond with regard to the sponsor, because repayment of the bonds takes place from a defined pool of assets. The difference is that the holder of an asset-backed bond is not affected by the non-performance of the sponsor's other assets, whereas the ordinary bondholder is.

Furthermore, structural features in whole-business securitization are designed to decrease the moral hazard of the borrower, and to decrease potential investment conflicts between borrower and bondholder. In other words, these features mitigate the risk that the strength of the business will be impaired through mismanagement. Also, the structure is secured by the entire set of cash flows generated by the assets, as well as the value of the underlying assets. As a result, the structure tends to carry an average lower cost of debt in comparison with ordinary secured debt, thanks to restrictive covenants on both the asset and liability side of the company. It usually issues debt with a longer maturity, which reduces pressure on the corporate issuer to place refinancing.

Lesson 7:

Post-meltdown whole business securitizations are similar to the whole business deals that were closed prior to the meltdown, but….

The credit crisis had revealed several shortcomings in the securitization

structure that includes: lack of transparency regarding collateral, failing monoline insurance companies, and the recognition that financial engineering cannot offset the risk related to the fundamentals of the operational business . Although we expect post-meltdown whole business securitizations to be similar to the whole business deals that were closed prior to the meltdown, we expect investors to favor simple and transparent structures so that investors can now scrutinize the product more carefully. Without a doubt less financial engineering is possible since we know now that credit enhancement by monoline insurers is not very popular among investors these days. That would probably result in less triple-A rated tranches in the structure. Tranches would reflect their real risk according to the cash flow waterfall and subordination levels. Also, originators are expected to have more skin in the game that requires them to retain some of the junior tranches in the structure.

Conclusions

Whole-business securitization enables a business to set up a structure in which business and financial risks can be managed and in which the level of credit risk for the investor can be substantially reduced. It could be a good alternative as opposed to a more traditional secured loan or collateralized mortgage-backed securities (CMBS), because of the limited amount of debt capacity available to companies.

Corporate securitizations have primarily focused on the intellectual property arena, including fast food, licensing, music, film and drug royalties. But certain kinds of businesses are not likely to benefit from a business securitization transaction. These include businesses that are capital intensive, are reliant on unique management skills, or are evolving rapidly. All of the business securitization transactions executed were business activities of which the cash flows could be accurately estimated thanks to long-term contracts and a well-documented history of stable cash flows through which the business and financial risks were considered low, or could be significantly mitigated by structural features.

Applying such structures, however, is not without risks: witness the problems encountered in the Welcome Break transaction. A combination of too little return on investment and too high leverage damaged the sponsor to such an extent that it was ultimately forced to make repayments to the investors by winding up the business.