Securitization: 10 lessons to remember

Dennis Vink

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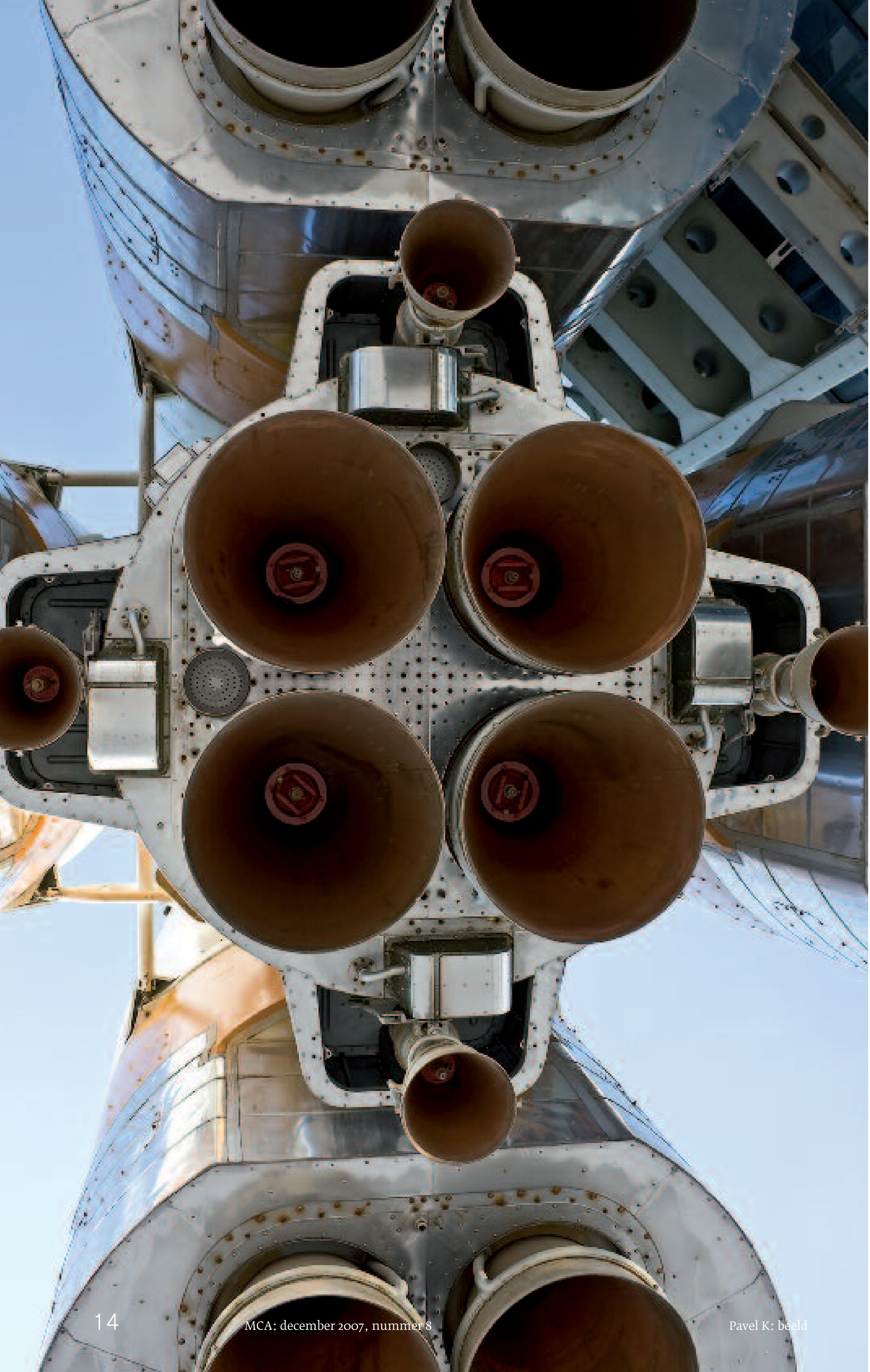

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Structured finance:

WHOLE-BUSINESS SECURITIZATION LANDS IN EUROPE

10 LESSONS TO REMEMBER

The most recent trend witnessed in the securitization markets is the application of securitization techniques to the financing of operating assets. This technique is called whole-business or operating-asset securitization. With the help of this technique, the British football club Arsenal sold its gate receipts and hospitality revenues in the largest football securitization transaction to date, in July 2006, and raised £260 million. Vodafone Japan recently securitized its assets in the largest securitization transaction ever: $12 billion. Given the generally limited level of understanding of why and how business securitization creates value, this article aims not only to inform the reader about the structural features of this new financing technique but also to answer the interesting question how whole-business securitization distinguishes itself from more traditional areas of debt financing.

Dr. Dennis Vink: The asset-backed market has grown to become one of the largest capital markets in the world in terms of size and volume. Since 1998, companies have increasingly often used whole-business securitization to refinance whole lines of businesses that frequently form a substantial portion of the assets of the parent company. 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. Transactions in this asset class have primarily focused on the intellectual property arena, including fast food, licensing, music, and film and drug royalties. More recently, a broader area of transactions – including London Heathrow, Gatwick and other airports – has been securitized with the help of newly created whole-business or operating-assets techniques.

Because securitization – in principle – has many advantages, many (Dutch) firms seek my advice in their attempts to answer the question whether or not they would act sensibly if they refinanced all or part of their business activities through this type of securitization. If I then ask them why they should consider this type of financing, I often receive answers related to increasing (irrelevant) accounting ratios, attracting more money, and most of all doing all this at a lower price. This may be true to a certain extent, but of course there is no such thing as a 'free ride' or a 'free lunch' in the financial market. In short, it is assumed that some sort of advantage must be gained somewhere by means of securitization compared with the more traditional alternatives that are available, such as financing through a common (bank) loan or a loan backed by a collateral (secured loan).

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 inform the reader about the structural features of whole-business securitization by discussing 10 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.

Asset-backed securitization

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, since usage is not entirely consistent. Asset-backed securitization first appeared in bank funding. Hess and Smith (1988), for example, explained asset-backed securitization in the context of financial intermediaries to manage interest rate exposure. The authors 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 third-party investors. So, asset-backed securitization can best be defined *as the process in which assets are refinanced in the market by issuing securities sold to capital investors by a bankruptcy-remote special purpose vehicle*. This definition comprises the fundamentals of asset securitization and is visualized in figure 1.

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

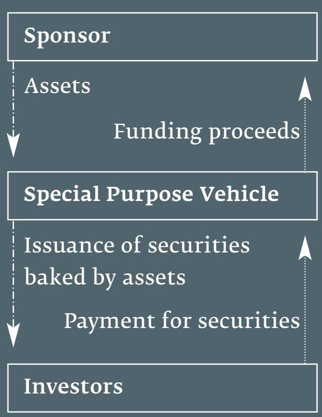

Figure 1. Basic asset-backed securitization transaction model

‘Only SPV-investors will have a claim against the securitized assets when seller goes bankrupt’

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.

Whole-business securitization

Lesson 3: 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 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[1]) 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.[2]

One of the great challenges lies in defining the difference between operating asset securitization and the more common forms witnessed in 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.

Lesson 4: The receiver has the 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 a loan secured by a pledge on a specific set of 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 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 from 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 the authorization to seize control

Notes

1 Securitization vehicle, also called a special purpose vehicle, established only for the purpose of a specific securitization and legally different and independent from the original owner of the assets. The securitization vehicle has a different governance structure than the originating firm. In particular, its specific structure restricts any chance of a standard bankruptcy procedure.

2 It is essential that the SPV receive the strongest possible rights over all the assets needed to operate (or sell) the business, should a default arise.

over the assets of the securitized business at the loss of any other creditor. Also, the receiver eliminates the risk of external activities of management decisions reducing the return to bondholders. 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 UK-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). This was rejected by the bondholders. 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 finally agreed to pay all classes of bondholders back at par by selling nine service stations.

Lesson 5: It is hard – but not impossible – to separate the assets legally while the sponsor still retains operating control and services these assets.

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. 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 UK 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.[3] Unfortunately, in the Netherlands no whole-business deals have so far been finalized that could act as an example. One of the reasons for this is presented by the role played – and the responsibilities held – by the receiver in a bankruptcy case. If it involves a bankruptcy situation, the receiver has extra powers. He may, for instance, in certain situations nullify specific obligatory juristic acts: for example if both the debtor and the third party involved knew that a bankruptcy petition had already been filed, or if the case involved collusion between the creditor and the debtor to the detriment of the other creditors. Does this imply that such things could not occur in the Netherlands? On the contrary: France, Belgium and Germany have encountered similar problems. In these countries, a series of large transactions has recently been witnessed in which the role of the receiver and securing the pledge in default cases have been adequately and appropriately dealt with.

Lesson 6: The holder of an asset-backed bond is not affected by the non-performance of the sponsor's other assets; an ordinary secured bondholder is.

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.

Note

3 These privileges are based on the very favorable insolvency regime operated in the UK which allows the so-called fixed and floating charges of a corporate to be passed over to a specific creditor. This passing of the fixed and floating charges can be identified as the main value drivers in a business securitization transaction.

Credit rating improvement

Lesson 7: The credit rating of a security is based on the company’s unsecured rating, but is notched up or down depending on its seniority of claim.

The rating of a company is known as its senior implied rating, or unsecured credit rating (comparable with a credit rating without any collateral). This rating reflects the corporate-wide default risk and the estimation of the firm-wide possibility to pay its obligations aggregate. This rating focuses on the company in general in its industry context, such as the strength of its management, consolidated balance sheet positions, competitive position, market prospects, and how these may change. Rating agency Moody’s, for example, generally notches (numerical rating category) securities based on the average historical loss severity rates – given their priority of claim in default of the company. Table 1 is a classification scheme consisting of 21 rating scales for three rating agencies: Moody’s, Standard & Poor’s and Fitch. A word of caution is needed here, as it is important to remember that the rating scales are inverse scales, so that spread increases as rating decreases.

Each security’s rating is based on the company’s unsecured rating, but is notched up or down depending on its seniority of claim. As expressed in table 2, secured bonds (high seniority) historically demonstrate a 30% lower loss severity upon default than the unsecured corporate bond, resulting in a favorable (higher) credit rating (and lower spreads).[4] Senior subordinated bonds have experienced a 40% higher loss severity, subordinated bonds 52% higher, and junior subordinated bonds (with the lowest possible seniority) show a 62% higher loss severity, all indicating a lower credit rating (and higher spreads) in comparison with the unsecured corporate bond.

Note

4 Credit ratings and credit risk have an inverse relationship, implying that higher credit ratings result in lower credit risk and vice versa.

Lesson 8: Standard debt is rated a maximum one or two notches above the corporate rating, whereas whole-business securitization debt-like features could realize one to six notches above the corporate rating.

Moody’s approach to rating whole-business securitization transactions is based on the same expected loss methodology it applies to evaluating the credit risk of any structured security: cumulative expected loss equals the product of default probability and loss severity, summed over all possible scenarios.[5] To date, credit rating agencies have assigned ratings in whole-business securitizations between two and six notches above the unsecured corporate rating of the sponsor. The key driver of an increase in credit rating for whole-business securitization versus ordinary debt is the fact that the value of the assets in a securitization transaction is much better preserved, thanks to bankruptcy remoteness, in comparison with the value of the assets in an ordinary debt contract. This will be illustrated by the following example. The unsecured credit ra-

Note

5 The probability of default is determined through an analysis of sector-specific and transaction-specific risks. The severity of loss is determined by assessing the ease of finding and installing a replacement operator in case of default as well as the alternative use of value of assets.

ting of a corporate is Baa3 (value 10 in Table 1). If this company issues $75 million of debt secured by a $100 million of Baa3-rated of the company's operating assets, the debt would be rated Baa1 (collateral as security qualifies for two notches of credit). But the credit rating agencies would rate a $50 million issuance secured by the same $100 million of assets Baal as well, despite it having a substantially lower leverage. Thus, if the $100 million of assets degrades to $60 million, investors in a $75 million issuance lose $15 million. However, had the issuance been $50 million, the investors would have received all the required principal and interest fully guaranteed. Giving the same rating – Baal – to both issuances ($75 million versus $50 million) would not seem logical given the fact that the $50 million could withstand much more asset deterioration than the $75 million issuance. In a whole-business securitization transaction, it is in fact possible to grant the $50 million issuance a more favorable rating, for example an A1-rating. This is in contrast with a standard debt contract, in which a more favorable rating is not likely to be granted.6 This can be explained by the fact that bankruptcy remoteness eliminates certain relevant business risks from the sponsor's other activities: risks that cannot be completely covered in a standard debt contract.

Lesson 9: A whole-business securitization structure tends to carry a lower average cost of debt and it usually issues debt with a longer maturity, which reduces pressure on the corporate issuer to place refinancing.

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. According to Moody's Investor Service (2002), it may be possible to achieve a rating substantially above the corporate's unsecured rating by issuing senior classes that have significantly

Note

6 Sponsors should be aware that an operating company securitization transaction may cause a downgrade of the sponsor's other ratings. This will depend, among other things, on the sponsor's use of the securitization proceeds and on its overall competitive position after selling the securitized assets.

Value	Rating agency		
	Moody's	Standard & Poor's	Fitch
1	Aaa	AAA	AAA
2	Aa1	AA+	AA+
3	Aa2	AA	AA
4	Aa3	AA-	AA-
5	A1	A+	A+
6	A2	A	A
7	A3	A-	A-
8	Baa1	BBB+	BBB+
9	Baa2	BBB	BBB
10	Baa3	BBB-	BBB-
11	Ba1	BB+	BB+
12	Ba2	BB	BB
13	Ba3	BB-	BB-
14	B1	B+	B+
15	B2	B	B
16	B3	B-	B-
17	Caa1	CCC+	CCC+
18	Caa2	CCC	CCC
19	Caa3	CCC-	CCC-
20	-	CC	CC
21	-	D	D

Table 1. Credit rating scales

Average Loss Severity Rates for Various Debt Classes (relative to the historical loss severity on the same issuer's senior unsecured bonds)	
Secured bonds	-30%
Senior unsecured bonds	n/a
Senior subordinated bonds	40%
Subordinated bonds	52%
Junior subordinated bonds	62%

Table 2. Average loss severity rates

‘Higher credit ratings result in lower credit risk and vice versa’

lower leverage than the corporate bonds of the sponsor. Standard & Poor’s (2001) states that the business securitization structure tends to carry an average lower cost of debt in comparison with ordinary debt, thanks to higher credit ratings, and it usually issues debt with a longer maturity, which reduces pressure on the corporate issuer to place refinancing.

Lesson 10: Certain kinds of business are unlikely to benefit from a business securitization transaction.

According to Standard & Poor’s (2001), borrowers whose business risk corresponds to a rating below ‘BB’ are unlikely to benefit from whole-business securitization. This is because their future cash flows are, by definition of the rating, so uncertain that in the opinion of the rating agency they cannot justify stretching the maturity of the debt and are not likely to support a substantial decrease in credit risk. Furthermore, certain kinds of business 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. Also, all these companies have a well-defined source of income: rent income, for example, or contracted beer sales, catering sales on specific locations, mobile phone revenues, restaurant loyalties, clothing licenses, music royalties or gate ticket sales for popular entertainment attractions.

Conclusions

Whole-business securitization is a form of financing in the early stages of development. It 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 subsequently be limited. Without a doubt, this represents the largest innovation in comparison with familiar standard debt contracts such as common (bank) loans with or without collaterals. 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. Still, many enterprises have so far been eager to use the whole-business securitization technique in order to enjoy the advantages offered by cheaper financing in combination with longer terms.

The structure discussed here will undoubtedly evolve over time and adapt to changing market conditions. Many Dutch firms could definitely benefit from repaying their perhaps needlessly complex, but certainly expensive bank loans taken out with various lenders and from replacing them by a transparent and straightforward securitization transaction structure - witness the highly innovative and successful transactions that have so far taken place in neighboring countries. Think about airports, for example, or hospitals, motorway restaurants, entertainment parks, movie theatres or royalties paid to famous Dutch artists. And how about revenues generated by the many major football clubs operating in our country?

Research into the possibilities of setting up securitization structures, into the opportunities that will be generated and into calculating the profits to be gained by individual businesses will have to demonstrate whether this techniqe is worth applying.

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Dr. Dennis Vink lectures Corporate Finance in the MSc, MBA and executive education programs at Nyenrode Business Universiteit, Breukelen. In addition, Dennis acts as an independent business advisor, covering a wide range of disciplines in the field of structured finance.

APPENDIX

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Specialised courses Dr. Dennis Vink

Dennis Vink lectures Corporate Finance in the MSc, MBA and executive education programs at Nyenrode Business Universiteit in Breukelen, the Netherlands. His ten years of practical and academic experience reflect his interest in corporate finance, structured finance and risk management. With an average rating of 4.3 out of 5 in the MBA program, Dr. Vink qualifies as an excellent lecturer. Next to his work for Nyenrode he has also acted as a visiting professor at the VU University in Amsterdam.

Dennis Vink received a Master of Science degree in Financial Management from Nyenrode Business Universiteit (1999), where he also obtained his PhD degree (2007) with a thesis on Asset Securitization. Additional training was followed through the Tilburg PhD Program in Finance. His academic work deals with empirical research in the field of corporate finance, with a particular focus on structured finance.

Dr. Vink acts as an independent business advisor covering a wide range of disciplines in the world of structured finance. Not only is he the author of over ten articles in this field but he has also participated in the supervision of a number of finance projects. These included asset-backed securitization issues, value-based management and cost of capital issues, to name but a few, carried out for the benefit of multinational corporations and financial institutions.

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The Netherlands

Dennis Vink
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Website: www.dennisvinkonline.nl
Tel: +31 346 291 211