# Securitisation of trade receivables: an alternate source of corporate liquidity

Arnold Alpert, director – deal origination, Finacity, examines how securitisation programmes can assist corporates in raising liquidity.

**Overview**

Securitisation is a powerful technique for deriving flexible and efficient liquidity from a corporation's trade accounts receivables. It can provide committed, revolving funding on a non-recourse basis at a low 'all-in' cost, with the possibility for accounting sale treatment, term placement, or other useful features. Once the providence of large multinationals, advances in technology and the emergence of third-party specialists, like Finacity, have empowered corporates of many sizes and market sectors to take advantage of the benefits of securitisation.

**Reasons to securitise**

Raising cash efficiently is the most common reason to securitise receivables. An ability to convert what is typically the largest asset on a company's balance sheet into cost-effective financing represents an important enhancement in the field of working capital management. That the resulting instrument can be better-rated than the issuing company also presents a unique opportunity for credit arbitrage. A securitisation platform (and the capital markets access it provides) can grow and change over time, presenting a flexible financing path and durable source of funding diversification.

Balance sheet management objectives may also be achieved via securitisation, with international financial reporting standards (IFRS) or US generally accepted accounting principles (GAAP) sale treatment providing an opportunity to buy-back shares or deleverage. Debt-to-equity, return on assets, days sales outstanding, and the 'quick' ratio can each experience improvement and foster compliance with loan covenants or lower costs on existing grid-priced credit facilities.

**Securitisation structure**

Securitisation is essentially a legal construct. A company sells its trade receivables on a legal true sale basis to a bankruptcy-remote special purpose vehicle (SPV) established especially for the transaction. The SPV's security over customer collections creates a 'closed loop' between invoicing and payment. New receivables are purchased each day with retired receivables' cash in a revolving cycle that supports an extended funding duration.

Analysis of historic patterns in the creation and retirement of customer obligations determines the advance rate against the receivables collateral. This advance rate can be maximised with insight into industry dynamics and precision control over ledger data. Structures are predi-

cated on the performance and diversity of the receivables pool, and there is little emphasis on the credit quality of any individual customer.

Securitisations function as an 'overlay' on existing systems, preserving a company's control over processes, customer relationships, and servicing. Properly structured and implemented, a securitisation provides revolving funding, insight into working capital dynamics, and opportunities for efficiency improvements in treasury operations.

**Capital markets construct**

Securitisation fashions a company's book of commercial accounts receivables into investment-grade and non-investment grade securities. The relative proportion of these 'senior' and 'junior' notes is a function of the desired attachment point and underlying performance of the receivables pool. Published rating agency criteria describe the quantitative bases for structuring AAA, AA, A, and BBB notes. Higher attachment points usually result in better pricing, but less overall liquidity.

Pricing varies according to a company's credit quality, note tenor, complexity of the receivables pool, structural features, and macroeconomic factors. Banks and their asset-backed commercial paper conduits (CP conduits) are the usual investors in this structured paper, though standalone term issuance to traditional fixed-income investors is also possible. In a typical situation, the senior note is sold to an investor and the company retains the junior note. Customer defaults (up to the value of the junior 'first loss' note) are borne by the company absent mitigants like trade credit insurance or letters of credit, precisely as would be the case without a securitisation.

CP conduits fund senior notes on a floating rate basis – CP cost of funds generally tracks Libor and spreads currently range from 40 basis points (bp) to 240bp. Financing levels are variable and can be

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adjusted by the company as frequently as weekly. Conduit funding commitments can be three-year, though one-year annually renewing programmes are the norm in periods of stress and five-year commitments are achievable exceptionally. Fixed-rate and longer-termed issuance outside the bank market is possible and, indeed, may represent an attractive alternative to high-yield bonds. Securitisation limits investors' recourse to the receivables collateral – there are no financial guarantees made by the company.

**A flexible funding platform**

A company's investment in securitisation creates a durable, flexible, investment-grade funding platform. Once the receivables collateral is properly analysed and understood, it can be fashioned into a variety of notes to suit the company's instant funding needs or longer-term goals. AAA notes can be issued to minimise cost of funds or A notes can be created to prioritise liquidity – one client of Finacity sells both AAA and BBB tranches to balance quantum and quality of funding. Notes and their underlying investor commitments

can repeatedly be created, retired, or expired under a single platform. The composition of investors and specific terms of their funding are evolved over time.

Multiple (pari passu) notes within an individual tranche are also possible, each with different investors, pricing, tenor, term or variable funding basis. Concomitant issuance of one-year variable and three-year term notes in a benevolent pricing environment could represent a strategic balance between cost and commitment. The company can command its platform to issue additional series of notes, provided there is sufficient collateral and investor support.

The life of a securitisation platform is not limited in time and programmes may continue for 10 or more years, growing and changing with a company over cycles of investment, acquisition, and divestiture. Natural sales growth results in more receivables collateral, providing the platform scope to issue additional notes. The inclusion of additional company subsidiaries into an existing securitisation programme can likewise add to the available receivables pool and facilitate additional funding.

One Finacity client recently took advantage of the currency crisis abatement to add its Spanish and Italian subsidiaries to an existing programme, generating $250 million of additional liquidity. Acquisitive companies with an existing securitisation can quickly fold a target's accounts receivable into their platform, creating efficient purchase financing. Subsidiaries may also be removed from a company's securitisation, as may be necessitated by divestiture or other activity.

In order to ensure maximum flexibility, it is important for a company to take ownership over its securitisation platform. Third-party specialists like Finacity can support this by providing the necessary structuring experience, infrastructure, transparent reporting, and market guidance. Relying upon a relationship lender to establish and maintain a company's securitisation is a common option, but results in the platform being captive to the bank and obliged to incentives potentially different from those of the company.

**Perceived complexity**

All major ratings agencies have developed sales-based criteria for trade receivables securitisations that determine advance rate on a given pool by deducting ineligible receivables and then projecting loss and dilution rates to the desired level of credit enhancement. Smaller 're-

serves' for bond yield, fees, currency fluctuations, or other factors may also be assessed. Securitisations need not be formally rated by an agency, but public and private ratings are available at a cost if required by the investor. The maths behind these methodologies is penetrable, but a learning curve exists.

Qualitative considerations can also shape the advance rate. 'Unbilled' receivables that result from goods issued but not yet invoiced, for example, are valid collateral in many jurisdictions and can be included within a securitisation if properly tracked. Differentiating between 'contractual' dilution elements known at the time of invoicing (volume rebates, tolling, good customer credits, etc.) and 'non-contractual' dilution (short shipments, non-conforming goods, pricing errors, etc.) can also serve to increase the amount of liquidity derived from the receivables pool. Such elements can be identified by a sufficiently experienced treasury professional, but require knowledge of receivables securitisation frameworks to properly analyse.

Investing market norms also influence the funding outcome of a receivables securitisation. Certain investors may not accept trade credit insurance as enhancement on a portfolio; others may require an agency's private rating for regulatory capital purposes; some may insist on cross-default clauses in securitisation legal documentation; a few might have unusually high CP cost of funds. In this opaque matter, an advisor with sufficient breadth of market knowledge is an advantage.

**Role of a securitisation specialist**

A third-party expert can reduce complexity, increase funding efficiency, and slash securitisation's barriers to entry. Finacity, for example, essentially acts as our clients' in-house securitisation department. We perform quantitative and qualitative assessments of the receivables pool, leveraging our extensive experience, treasury knowledge, and advanced analytics; assist clients in understanding market norms to identify the most appropriate funding source (facilitating offering circulars and road shows on term deals); structure the securitisation to maximise liquidity in concert with investors' credit requirements; and manage the programme throughout its life (including a proprietary IT platform that automates the production of detailed daily securitisation reporting). Our involvement results in a strict and advantageous application of securitisation criteria, maximising liquidity and providing investors with transparent and accurate reporting.

**Challenges and solutions**

Specialist infrastructure and a template-process can facilitate companies' origination and maintenance of accounts receivables securitisation platforms, overcoming historical challenges in the space:

- **Industry:** receivables securitisation is applicable wherever there exists a non-interest bearing timing mismatch between a customer's obligation and

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payment. Areas as diverse as healthcare, commodities trading, telecommunications, energy distribution, transportation, freight, media, and manufacturing have successfully applied such structures. Precise control and reporting of ledger data is the common theme.

- **Reporting:** securitisation reporting is ultimately the company's responsibility. Organising and maintaining a basic level of reporting can require significant FTE commitment from a treasury department and still deliver suboptimal funding results. In particularly complex cases, it may be determined that the number of subsidiaries and systems make securitisation prohibitive. Finacity has delivered outstanding results in these instances, shouldering the workload and maximising liquidity through daily reporting.
- **Size:** up-front investment in a securitisation platform drives the minimum programme level required for funding to be efficient. Multiple subsidiaries, jurisdictions, and currencies increase complexity and cost. Finacity has facilitated securitisations as small as $35 million and $25 million should be viable by properly leveraging our infrastructure and templated approach. $100 million is the typical minimum for a Conduit-funded transaction and higher receivables levels can facilitate additional structuring options. Finacity's largest securitisation has been $1.7 billion and larger programmes exist in the market.
- **Off-balance sheet treatment:** sale treatment for receivables securitisation is possible under both US GAAP and IFRS. A more complex approach is required under IFRS and typically involves trade credit insurance, which increases costs and reduces flexibility. Finacity has successfully applied a volatility-based approach to achieve off-balance sheet treatment without need for insurance.
- **Credit underwriting:** smaller or financially weaker companies may (rightly or wrongly) be perceived by the capital markets to have lower customer underwriting standards or higher fraud risk. Finacity's rigorous and transparent approach to reporting provides confidence to investors, helping facilitate programme placement.
- **Performance volatility and customer concentrations:** extreme seasonality, performance volatility, and high customer concentrations in the receivables pool may make securitisation less efficient. Finacity has implemented specialised trade credit insurance and hybrid securitisation/factoring structures in certain cases to mitigate these effects. Our €100 million ($130 million) securitisation for Sonae Industria, for example, bootstrapped a €5 million factoring programme to fund otherwise ineligible receivables collateral. Smaller programmes also remain a possibility.
- **Cross-border receivables:** it is not uncommon in the increasingly globalised economy for a company to have receivables originated in multiple jurisdictions and currencies. Proper structuring and reporting can facilitate funding for most of these receivables within a single platform in constituent currencies or a single currency, as required. Where law or currency controls may present an issue (China, India, Brazil, etc.), a separate platform and funding source may be a solution. Finacity has successfully facilitated such local placements in Mexico and Colombia and is pursuing transactions in India, Turkey, Brazil, China, and elsewhere.

Securitisation remains a uniquely effective option for funding trade receivables, whose efficiency and applicability continues to evolve through improvements in structuring, technology, and capital markets. ■