

Introduction to Receivable Securitization



BY JIM LEONARD

While portfolio factoring and receivable securitization are both corporate funding constructs based on the true sale of a company's trade accounts receivable, there are also significant differences between the two products. Unfortunately, many receivable finance practitioners have only a vague idea on how the other's product actually works. This article is intended as a primer to help bridge the gap.

It has been almost 30 years now since the first securitizations of trade accounts receivable were structured and placed with investors in the U.S. financial markets. Since that time, these financings have grown to constitute an important part of the capital structure of many large, well-known companies around the world. At the same time, it is clear to us at Finacity from the types of questions we routinely field at trade conferences and industry events that this important corporate funding mechanism remains at best only vaguely understood by many otherwise sophisticated CFOs and treasurers in corporate America. When pressed, finance professionals at companies large and small often speak of it as no more than a variant of factoring. However, while there are indeed some superficial similarities between receivables securitization and portfolio factoring, there are also quite a few very basic and important differences. Given the pervasive confusion that exists, this author's goal herein is to try to demystify the subject of receivable securitization by, among other things, comparing and contrasting it with the more traditional factoring products with which many *TSL* readers may be more familiar.

Non-Recourse sale of receivables / balance sheet treatment

Like portfolio factoring, a receivable securitization is predicated on the legal true sale of a company's trade accounts receivable to a third-party funding source. However, while a factoring of receivables may be accomplished either with or without recourse to the corporate seller, securitization is always done on a non-recourse basis. Both factoring and securitization thus stand in contrast to an asset-based lending or borrowing-base approach in which funds are advanced as a loan against the collateral value of accounts receivables (and often other corporate assets), rather than as proceeds of an actual sale of the receivables, and thus such ABLs always provide full recourse to the underlying company.

An important distinction to make at this point is that the legal true sale of a company's receivables (i.e., a legal concept) does not necessarily mean that those receivables may then be removed from the selling com-

pany's balance sheet (an accounting concept). Given the various legal, financial and technical complexities surrounding this topic, interested companies would be well-advised to consult their auditors before getting too far into the process. Suffice to say that, when properly structured, either portfolio factoring or receivables securitization funding structures may in many cases be used by a company selling its receivables on a revolving basis to facilitate off-balance sheet treatment. This can be accomplished under both U.S. GAAP and IFRS accounting regimes.

Portfolio valuation vs. individual obligor underwriting

A fundamental difference between receivables securitization and factoring is the way in which the receivables portfolio being sold is valued. In a factoring construct, the credit strength of each account debtor must be evaluated and underwritten before receivables due from that account debtor are deemed "eligible" for inclusion in the factoring program. This credit underwriting is sometimes done directly by the factor itself, though in practice many factors effectively outsource it to a highly rated third-party trade credit insurance company, which then bears the majority of the default risk on the insured receivable portfolio. When this is the case, the factor may either be named as a direct beneficiary of the insurance policy or, alternatively, may become an assignee of an insurance policy that is already held by the company being funded. In either case, the factor relies primarily on the credit strength of the insurer rather than that of the individual obligors in the program. The key point, however, is that someone – either the factor or the insurer – must assess the creditworthiness of each obligor before receivables due from that obligor are deemed eligible for advance value under the facility.

In contrast, the valuation of receivables in a securitization is not accomplished by analyzing historical financials or other backward-looking credit metrics related to individual obligors. It is, instead, a portfolio-based statistical approach that tracks the ongoing real-time performance of a large, diversified pool of receivables as a whole.

For this reason, while factoring facilities often set static or semi-static advance rates against net eligible receivables based on traditional credit analysis, receivable securitizations permit the application of dynamic advance rates – most commonly recalculated monthly—based on the actual portfolio performance during the preceding month. If collections slow or if payment defaults or dilution rise in a given month, then the advance rate will automatically decrease the following month to reflect the deterioration in performance. On the other hand, if collections or portfolio performance improve, then the advance rate will rise accordingly. In this way, a receivable securitization continuously self-adjusts to maintain a uniform credit quality of the program over time. In practice, the monthly advance rate changes in a securitization are smoothed out somewhat through the use of rolling averages for various key performance metrics, which tends to minimize potentially erratic movements in the advance rate that might be caused by a one-time anomalous event in a particular month.

Another important implication of securitization's statistical valuation methodology is that all of a selling company's currently performing open account trade receivables can potentially be included and funded in the program, rather than just whatever subset may have been approved in advance by the nominated funding institution. For example, there is no reason in a securitization to exclude receivables due from small or ostensibly "less creditworthy" buyers, since it is the actual performance of the portfolio – rather than the expected performance of individual obligors—that is paramount. In fact, the robustness of securitization is enhanced by the greater diversification resulting from inclusion of a larger universe of account debtors. Not only does it result in more obligors that are included (and thus more receivables against which advances can be made), but it can also lead to a higher advance rate on the portfolio as a whole.

Credit ratings

Still another difference between factoring and receivable securitization is that the latter is designed to produce a financial instrument with either an explicit or implicit

credit rating. Various established international credit rating agencies have developed and promulgated clearly articulated structuring guidelines that can be followed to produce specific targeted rating levels for each transaction. These standardized guidelines provide for analytic uniformity across industries and geographies, and have held up well over many years, including during the most recent global financial crisis.

Most receivable securitizations have traditionally been structured to achieve fairly high investment grade ratings – at least single-A and quite often as high as triple-A. This is partly a function of the target investor audience for most such issuances. The lion's share of these deals are still purchased by asset-backed commercial paper conduits administered by large international banks. Such conduits normally fund themselves through the issuance of A1/P1-rated commercial paper, which in turn generally requires them to hold assets with a minimum equivalent long-term credit rating of single-A.

On the other hand, receivable securitizations that are executed in many emerging markets are more commonly structured as term transactions for placement into those countries' domestic bond markets. Such bond issuances are frequently structured to attract the interest of local institutional investors like pension funds and insurance companies that are required by law or regulation to invest only in highly rated financial instruments. For example, in 2009, Finacity arranged a securitization for the large global cement producer Cemex, which at the time was rated single-B minus. However, because we structured our securitization transaction to a triple-A local rating, it was placed with Mexican pension funds and insurance companies that most likely wouldn't have invested in the company's unenhanced corporate debt. This diversification of funding sources was actually a strong driver for the company's decision to do the deal.

Finally, a growing number of big banks have in recent years started to purchase trade receivable securitizations directly onto their balance sheets. While this strategy may in theory provide banks with somewhat greater flexibility to invest in se-

curitizations that have been structured according to somewhat lower rating criteria, in practice most such banks have continued to target deals with at least single-A equivalent ratings, given the positive regulatory capital implications of doing so.

Use of SPECIAL-PURPOSE VEHICLES

Another basic difference between factoring and securitization is that, while a factor typically purchases receivables directly onto its book, a receivable securitization generally employs a 2-step sale methodology wherein the receivables portfolio is first sold into a separately capitalized bankruptcy-remote, special-purpose vehicle (or "SPV") in order to legally isolate the receivables from a potential bankruptcy of the selling company. The SPV may then, in turn, either (a) execute a second-step sale of the receivables to the ultimate funding source or (b) issue notes to the funding source collateralized by the receivables held by the SPV.

Collections

Another frequent difference between these two instruments has to do with the collections process. In almost all securitizations, the funding institution delegates to the selling company the right to continue servicing/collecting—on an agency basis rather than as a principal—the receivables that it sells into the program. While there are also typically pre-set program triggers that, if and when violated, may cause the servicing role to revert to the funding institution or a designated third-party agent, the selling company is otherwise permitted to continue servicing its receivables just as it has always done. On the other hand, most U.S. factoring facilities require that the selling company abdicate the servicing/ collections function to the factor. This is a structural feature that is intended to give the funding institution greater control over the cash that will be needed to extinguish the financing. It is not necessarily a requirement of factoring, as so-called "agency factoring" (which applies a more securitization-like collection methodology) is relatively common in much of Europe. Still, in the United States and many other countries, agency factoring remains much more the exception than the rule.

Relative pricing

A well-structured receivables securitization can frequently represent the lowest cost component of a company's capital structure, especially for relatively large unrated or sub-investment grade corporations. Notably, through the securitization architecture, it is quite possible for a low or unrated company selling products mostly to other low and unrated companies to nonetheless achieve a high investment-grade funding execution, thereby offering a tremendous cost arbitrage in comparison to the same company's unsecured debt. Likewise, receivable securitizations can typically be placed at lower yields than could be achieved through factoring, ABLs or other forms of secured debt as well. Though the upfront costs of arranging a securitization may sometimes be higher than might be expected on a standard factoring facility, the difference is often more than offset by the lower interest margin that can be obtained. Moreover, a new "small securitization" model being pioneered by companies like Finacity aims to increase usage by relatively smaller companies through innovative reductions of the fixed-cost component of such deals. Finally, the self-adjusting nature of such securitizations allows these programs to maintain their high equivalent credit ratings – and thus the low all-in cost of funds they provide—even under seriously adverse conditions.

One compelling example of this was a securitization arranged in 2005 for the Mexican glass container company Vitro Envases Norteamerica S.A. de C.V. ("VENA"). At the time of the initial execution, though Moody's international rating on VENA was just "B2", our securitization was structured to achieve an in-country triple-A rating. In 2009, Vitro defaulted on its direct senior debt obligations. However, the securitization facilitated by Finacity—with its cash redirection and bankruptcy remote, true sale structure—continued to perform smoothly and maintained its triple-A rating. The company's stand-alone problems continued in 2011 when Vitro entered the Mexican equivalent of US Chapter 11 bankruptcy proceedings. Even at this darkest of times, Finacity was able to roll and even upsize the existing securitization with no

credit rating impairment, thereby providing Vitro with continued working capital at a time when it was otherwise locked out of both public and private financing markets. This achievement demonstrated clearly the ability of a well-structured securitization, when supported by detailed daily tracking and reporting, to protect investor interests under even the most difficult of circumstances.

Cross-Border and multi-country receivables

As many users and practitioners of factoring are likely aware, portfolio factoring, as it is practiced in the United States, is a primarily domestic funding instrument. While a few specialist financial institutions in North America may offer some advance value against their clients' export receivables, the great majority prefer not to. The same is true in much of the rest of the world, including Latin America, Asia and the MENA region, where portfolio factoring remains by and large a mostly domestic affair. On the other hand, it is true that a number of big multi-country, bank-owned factoring groups in Western Europe do offer factoring services in multiple European Union countries. Many of these may also factor export receivables as long as they are due from obligor companies based in the EU. However, even these big multi-country factoring groups still have limited appetite for extra-regional receivables. Additionally, while they may happily provide factoring to a large multinational company's subsidiaries in multiple European locations, there is generally little ability to offer a single integrated multi-country funding solution. Instead, each individual country facility still functions largely as a stand-alone domestic financing program.

In contrast, the receivables securitization framework can flexibly support a truly integrated multi-country funding approach. A single bankruptcy remote SPV can make daily purchases of trade accounts receivable as they are originated by multiple selling subsidiaries in multiple countries of a single multinational company. The same structure can also accommodate multiple currencies, both in terms of the currencies of receivables being purchased as well as

the currencies of funds being disbursed. One good example is a \$700 million receivable securitization currently administered for a large international trading company. That deal includes receivables originated by ten different selling subsidiaries in eight different countries, and involves invoices denominated in four different currencies due from over 4,000 obligors in more than 30 different countries. This is just the type of structurally complex, data-intensive financing transaction that can be ideally served by the trade receivables securitization structure.

In conclusion, while market understanding and usage of the trade receivables securitization paradigm have certainly expanded greatly over the years, there remains significant scope for further growth. The potential advantages offered by this flexible product are considerable and clear, including an ability to maximize corporate liquidity while leaving other corporate assets unencumbered; minimal need for financial covenants; improvement of balance sheet metrics; ability to accommodate very complicated multi-country, multicurrency transactions; the potential to achieve off-balance sheet treatment under U.S. GAAP or IFRS; and, of course, the significant cost savings that may be realized. Looking ahead, both the domestic and international landscapes are ripe for additional growth over the coming years **TSL**

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