Securitising UK DESTINATIONS

Securitisation has been employed to great effect in the United States. In the UK, meanwhile, it is still very far from being an obvious choice to destination planners and stakeholders. Arvind Bajaj is an Executive Director at Morgan Stanley, where he advises major clients on securitisation issues. Here, he offers some guidance to prospective property professionals and corporates considering securitisation as a possible way of financing development, and explains how it helped three of his UK clients in the sectors of property, retail and hospitality: Canary Wharf Group, Sainsbury's and Punch Taverns.

Traditionally, securitisation has been regarded as the preserve of the great American financial institutions, and as something which only ever involves financial assets. But today, the increasing use of securitisation as an acquisition tool has led to a growing awareness among financial managers that the securitisation of *businesses* now deserves very careful attention. The destination sector is full of businesses (aquariums, hotels, pubs) for whom securitisation may prove to be a valuable tool, both via project and business-level securitisation.

What is securitisation?

Securitisation is the financing in the international bond markets of an asset pool or individual business where the source of any payment due to bondholders is limited to the prospective cashflow from such asset pool or business. In the US, securitisation has been most closely associated with financial institutions, which have funded pools of financial assets such as mortgage loans by issuing bonds, typically rated as high as AAA, in order that both the assets and related funding remain off the balance sheet. The financial institution incorporates a new insolvency-remote special purpose vehicle (SPV), which issues the bonds and applies the proceeds towards acquiring a pool of assets, whereupon the amounts received by the SPV in relation to the assets are passed on to bondholders in the form of principal and interest payments. While profits of the SPV are ultimately paid to the financial institution, it should not be liable to the bondholders should they ever suffer a shortfall. This arrangement is illustrated in the Figure opposite.

In the UK, meanwhile, a business can also be securitised, thanks to English insolvency law. (Bondholders having, *inter alia*, fixed and floating security over a business can frequently avoid the effects of an administration order and continue to control these assets and their cashflow whenever necessary. It is this element of control that is required before secured bonds can be rated higher than their unsecured equivalent.) Whether it is a pre-defined financial asset pool or a business

that is securitised, the cashflow generated is applied towards redeeming a bond issue.

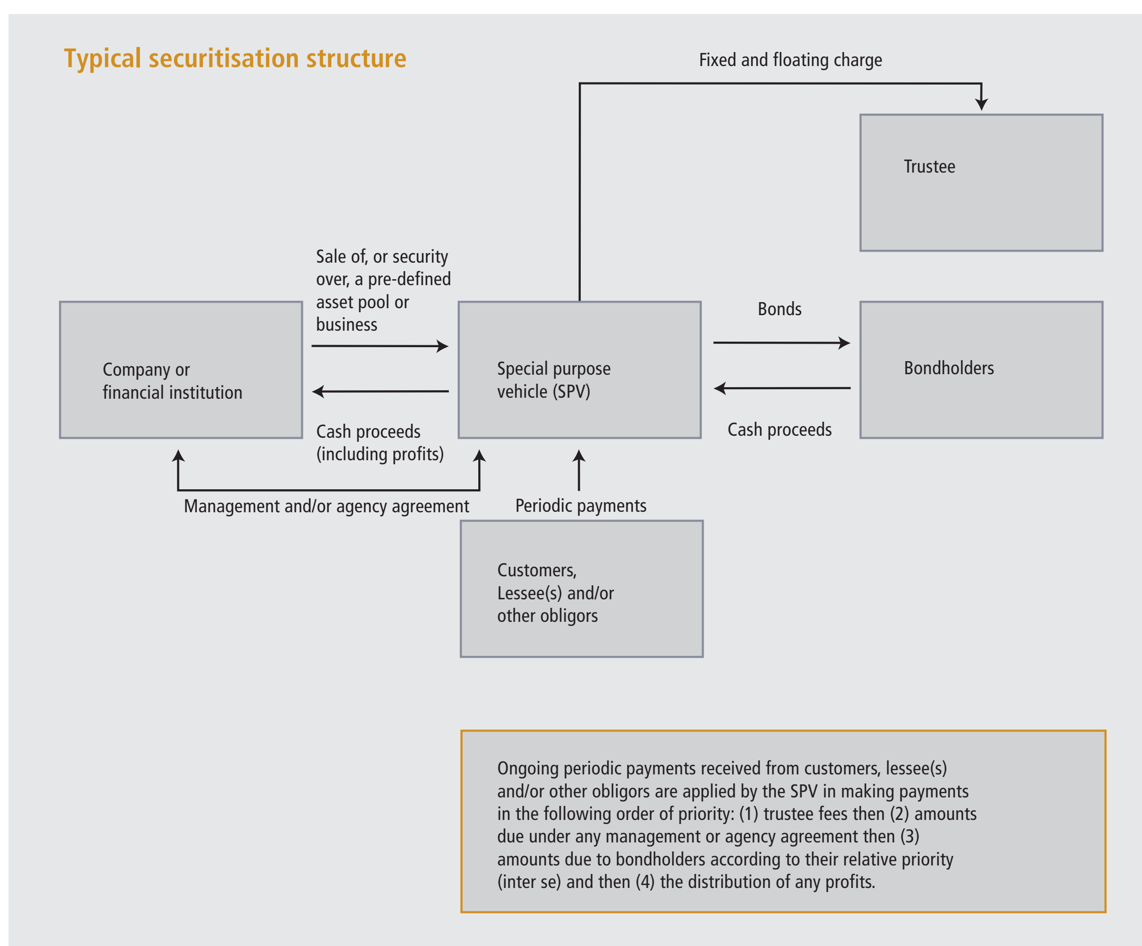
Why securitise?

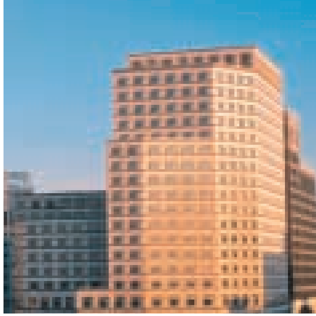
There is no single reason why a company should securitise a pool of financial agreements or a business. The most *common* reason, however, is that it lowers its weighted average cost of capital - and therefore improves shareholder returns. In turn, any surplus capital arising out of a securitisation can be redeployed more effectively elsewhere. More specific, yet related, reasons are outlined below.

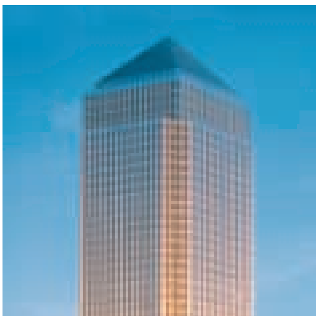
- While a number of UK property companies have already used securitisation **to go private**, it is now being studied by other industries such as the retail sector. Management might raise debt secured over (and equal to about 80 per cent of the value of) retailer's real estate, leaving a relatively small equity contribution, which might be sourced from a private equity firm, to take their company private.
- For strategic reasons, a company may wish **to dispose of a non-core business** yet presently be unable to secure an attractive price from a trade buyer or flotation. The cash associated with the securitisation of a business might be close to that available from, for instance, a trade sale. A securitisation should permit the company to raise cash from the disposal of the business to a SPV while continuing to retain a token, albeit 100 per cent, equity interest (in the SPV) that could be sold, possibly to a financial buyer, at a later date. Here, special care must be taken to protect the transferor from crystallising any liability to capital gains tax by, for instance, incorporating into any securitisation a scheme of reconstruction. Such equity is often protected against the effects of default because, as with preferred shares, unpaid interest on the securitised bonds typically accrues when there is insufficient cashflow to pay interest in full.
- UK companies can, therefore, use securitisation t**o reduce their weighted average cost of capital** and, in turn, improve shareholder returns. Securitised businesses can, therefore, be capitalised with relatively little equity or, in the case of a bank, regulatory capital. The equity or regulatory capital that is released by a securitisation might then, *inter alia*, support an acquisition, be re-invested in the company's core business or otherwise returned to shareholders.

What can be securitised?

This question is best answered according to whether a pool of contracts or a business is being considered. In the case of the former, the contracts shoul ideally be executed (as opposed to executory) in form, for example, trade receivables.







Special attention should be paid to the early termination, assignment and any confidentiality provisions, the drafting of which might eventually affect the shape and cost of any securitisation. Executory contracts have been securitised in the past, for instance, property leases, off-take agreements, private finance initiative (PFI) concessions, but this can be difficult where, in particular, there is a reasonable prospect that such contracts might be terminated early and the company does not own the reversionary interest associated with, for example, the asset or service being supplied, leased or licensed.

In practice, the detailed terms of these contracts should be considered together with an investment bank and specialist law firm before a conclusion is reached on whether a particular pool of agreements can or cannot be securitised.

In the case of businesses, it is impossible to be definitive. Generally, a UK business which enjoys a history of predictable operating cashflows, strong barriers to entry and limited protection against mismanagement might be well suited to securitisation. In addition to the destination sector businesses mentioned at the outset, commercial operations that have been securitised in the past include conference facilities, ferry companies, motor racing, motorway service areas, ports and pubs. Business securitisation is also being presently pursued by several UK companies operating in the energy, utility, transportation and real estate sectors.

Who should securitise?

By now, it should be possible to understand whether, as a company, you have one or more businesses or other assets that could be securitised. More importantl, though, is to gain an understanding as to what economic and other benefits - if any - a securitisation might create.

Depending on which reason (or reasons) might prompt possible interest in securitisation it should, for instance, be possible to compare the net present value of a securitisation with alternative forms of capital structure.

The eventual securitisation of an asset can also be expensive and difficult to reverse. Securitising your business or assets is a decision that should not be entered into lightly. No business manager, in the destination sector or otherwise, would be thanked for creating value for others rather than their own shareholders. Companies should therefore ask themselves a series of questions at the outset of the process:

- How will any existing company rating be affected?
- How will earnings be affected?
- Will future operational flexibility be compromised?
- What control will bondholders want over their security?

Canary Wharf Group

In 1997, Canary Wharf Group began a programme of securitising recently-built prime office properties leased to a number of blue chip tenants. Not only was Canary Wharf Group able to secure mainly AAA funding, but most of its debt was priced off long-dated gilts when investors were suffering from a shortage of supply in the gilts market and, as a result, yields were at their lowest for many years.

Sainsbury's

In 2000, Sainsbury's entered into the sale-and-leaseback of several supermarket stores. The stores were funded by two bond issues priced to reflect the value of the property owned by the SPV as well as the leaseback to Sainsbury's. After taking into account the associated tax planning, the post-tax cost of financing was particularly attractive to Sainsbury's. The SPV financed the acquisition of these stores by issuing bonds secured over them.

Punch Taverns

In the summer of 1999, rather than enter into an auction, Allied Domecq entered into an exclusivity agreement with Whitbread to sell it a portfolio of public houses for a fixed purchase price. Punch Taverns considered that, by relying on securitisation, it could afford to pay a higher price. After launching a hostile and high-profile bid for this chain of pubs, and after securing acquisition financing from Morgan Stanley, Punch Taverns successfully outbid Whitbread and eventually acquired the chain in September that year. The pubs were subsequently securitised.

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