monitor
LEASING & FINANCIAL SERVICES
monitordaily.com
Reprinted from the July/August 2002 Issue

Mid-Sized Companies:
Breaking the Funding Barrier Through Account Receivables Financing

Account receivables financing is a highly efficient means of satisfying many financial demands and has been employed in various forms for centuries. Notwithstanding the history and breadth of funding techniques, receivables are generally inefficiently funded despite their characteristics as one of the most creditworthy and liquid assets on a balance sheet.

By Adrian Katz

By various estimates, a tally of account receivables as reflected in the financial statements of U.S. companies would total approximately $6 trillion. In order to bridge the typical timing gap of cash inflows and outflows, companies frequently seek funding from lenders, factors, and the capital markets (via pledges or sales of account receivables). Account receivables financing is a highly efficient means of satisfying many financial demands and it has been employed in various forms for centuries. In addition to the older methods of factoring (estimated outstandings of $85 billion) and asset-based loans (estimated oustandings of $800 billion), account receivables have been securitized (estimated outstandings of $230 billion) since about 1985. Notwithstanding the history and breadth of funding techniques, it is this author's opinion that account receivables are generally inefficiently funded despite their typical characteristics as one of the most creditworthy and liquid financial assets on a balance sheet. This discussion will focus solely on commercial trade account receivable and these will be referred to as receivables.

Various cash flowing assets, such as mortgages, automobile loans and credit card receivables, have been successfully securitized on a broad scale. A new home mortgage probably has a ninety plus percent chance of being included in a securitization pool. However, by stark contrast, securitization of receivables represents less than 4% of the market size. Traditional wisdom and experience suggest that the pricing, transparency and structuring disciplines of the capital markets (per the requirements of the securitization process), should result in the best possible all-in-cost and most reliable funding for companies. However, significant barriers to entry exist and to date companies generally require both significant size and credit quality to successfully fund through receivables securitization.

While the securitization market has become comfortable with the credit underwriting performed by larger companies, the market views the credit quality of the receivables of smaller companies with more skepticism. Arguably it is merely discernment and not reality, but it is generally perceived that mid-sized companies do not have sufficient infrastructure to support comprehensive credit underwriting of obligor risks.

Hurdles

The hurdles include: reduction of fixed costs, conformity and reliability of credit underwriting, credit enhancement, and conformity and credibility of servicing and reporting. Aggregation of multiple sellers ameliorates fixed costs. Robust due diligence with respect to sellers and credit scoring across industries and countries with respect to obligors provides consistent and reliable metrics for credit risk assessment. Receivables insurance reduces credit performance uncertainty, mitigates catastrophic risk and enhances cash flow. Vigorous invoice verification, collections and comprehensive reporting, address the combined risks of fraud, seller servicer effectiveness and seller default risk.

Receivables Securitization

Receivables are securitized in two formats. The vast majority of receivables securitized to date have been funded through commercial paper conduits (CP conduits). Invariably, CP conduits provide sellers floating rates of interest, funding terms up to 364 days, relatively quick access to funding and anonymity. CP conduits are generally bank sponsored (ABN AMRO and Bank of America, are large sponsors of CP conduits), rated A1/P1, require collateral deemed at least A/a rated and purchase amounts usually exceed $100 million. Customer access has been historically limited to large companies with good creditworthiness. Aside from conduits, multi-year stand-alone term securitizations have been completed for companies in industries as diverse as healthcare, airlines, manufacturing and advertising. Such stand-alone term issuances are usually significant in size to support the associated fixed costs and generally pay fixed rates.

Recent events in the markets suggest the importance of servicing outsourcing to facilitate access to receivables securitization for a broader range of companies. Recent press reports regarding Allied Deals and the allegations of fraud through grand scale hypothecation have drawn attention to the perils of leaving the fox in the henhouse.

Pricing for receivables funding varies by product. CP conduits typically provide their customers pricing that ranges from LIBOR + 25 BPs to LIBOR + 200 BPs. The pricing available through CP conduits is usually superior to traditional asset-based lending and factoring. Factoring arrangements are often priced relative to the prime rate, an index that is currently almost 300 BPs higher than LIBOR. For most issuers, the construct of multi-year funding available through term securitizations provides cheaper funding versus unsecured debt alternatives.

Traditional securitizations typically involve the formation of a special purpose vehicle (SPV). The SPV is usually formed by a seller, such that it is bankruptcy remote from the seller and in various ways it is designed to be in compliance with FASB 140. Receivables are transferred via a sale agreement into the SPV with servicing generally retained by the seller. Thereafter, receivables represent the primary collateral for notes issued by the SPV. Cash received from obligors over time is then available for additional purchases of receivables and thus in a revolving manner notes are usually longer in duration than the underlying receivables. The notes issued are purchased by CP conduits or traditional fixed income investors.

New Approaches to Securitization

Corporations generally, and mid-market companies in particular, stand to benefit from new approaches to the securitization structure. Finacity offers a construct that differs from the typical arrangements in certain key respects. First, the SPV is created by Finacity and not the seller such that FASB 140 does not even apply. This feature is especially useful in an environment where seller sponsored SPVs are under intense scrutiny. Secondly, in the Finacity construct, the receivables are sold with servicing released. An important consequence to their approach is simplicity: the seller is not responsible for the securitization and credit enhancement process as the seller essentially is only involved in the sale of the assets.

Underwriting

While the securitization market has become comfortable with the credit underwriting performed by larger companies, the market views the credit quality of the receivables of smaller companies with more skepticism. Arguably it is merely discernment and not reality, but it is generally perceived that mid-sized companies do not have sufficient infrastructure to support comprehensive credit underwriting of obligor risks. Terms of sale (often an effective form of customer financing) are sometimes not adjusted to accommodate for credit differences in obligors. Frequently, sales people enter into sales contracts with customers on behalf of their companies without ever consulting credit professionals on the rationale of the terms of sale. Important clients as measured by sales volume are too often treated with kid gloves and permitted uncontrolled terms of sale resulting in irresponsible exposures. Inconsistencies across a seller's customer base add further confusion. Unfairly or not, it is the perception of capital market participants that mid-sized companies perform a weaker job of credit management than their larger brethren. Credit scoring conformity and credit insurance provide overarching risk mitigation and easier assessment.

Credit Insurance

The capital markets have expressed great interest in reliable insurance coverage for receivables. Currently, there are relatively few insurance companies that provide receivables insurance and even fewer that appropriately specialize. The relevant players are highly rated. However, the capital markets perceive the majority of available receivables insurance policies as not comprehensive and sufficiently certain to pay claims. Conditionalities common to most property and casualty policies are contrasted with monoline insurance guarantees and the typical discrepancies are tangible. In most instances, the issue is not the ability but rather the willingness to pay claims. Finacity has crafted a unique insurance policy with Euler American Credit Indemnity to substantially reduce the scenarios under which coverage could be denied.

Servicing

Recent events in the markets suggest the importance of servicing outsourcing to facilitate access to receivables securitization for a broader range of companies. Recent press reports regarding Allied Deals and the allegations of fraud through grand scale hypothecation (estimates range from $600 million to $1 billion) have drawn attention to the perils of leaving the fox in the henhouse. There is non-trivial

risk in having the very party responsible for servicing and reporting on the receivables also being the entity borrowing against or selling the receivables. The perceived fraud risks of the traditional arrangement in which a seller is also the servicer are magnified for lesser-known mid-sized companies. Also, it is an empirically observed phenomenon that in the circumstances where sellers file for bankruptcy, their ability to perform as servicer is substantially impaired. Also, obligors have a tendency to take advantage of a seller's bankruptcy with accompanying disruptions in servicing and payments are often delayed and/or diminished. Finally, sufficient transparency of the ongoing performance metrics of a receivables portfolio, achieved through comprehensive investor reporting, is important to optimal capital market interest and support. Our firm generally requires that servicing be outsourced to its platform, thereby mitigating capital market concerns with respect to servicing.

The securitization process generally provides companies broader access to capital at a lower all-in-cost of funds. This is especially true for companies whose creditworthiness is weaker than their customers. In such instances there exists a credit arbitrage. A well-structured securitization can achieve an investment grade rating even for a selling company that is not investment grade rated.

Reasons to Securitize Receivables

Probably the most common reason to securitize receivables is to efficiently raise cash. Enhancing working capital is especially important for companies with long sales cycles and terms of sale. Given that receivables are typically the largest single asset category on the balance sheet, it is a natural choice for monetization. The securitization process generally provides companies broader access to capital at a lower all-in-cost of funds. This is especially true for companies whose creditworthiness is weaker than their customers. In such instances there exists a credit arbitrage. A well-structured securitization can achieve an investment grade rating even for a selling company that is not investment grade rated. Through standardized underwriting, robust servicing, credit insurance and appropriate structuring, a company can intends to further broaden the opportunities for mid-sized companies to bootstrap their access and resulting efficiencies.

Achieving balance sheet management objectives can be an additional reason a company chooses to securitize their receivables. Sale treatment can be achieved with the resulting opportunity to de-leverage through the use of proceeds to redeem outstanding debt. Compliance with debt or loan covenants can be fostered through improvements in certain balance sheet ratios and metrics, including: days sales outstanding (DSO), "quick" ratio, return-on-assets (ROA) and debt-to-equity ratio.

Conclusion

The ability for mid-sized companies to access the cost efficiencies and disciplines of the capital markets is now more broadly available. However, discipline is required and deliberate procedures should be followed to address issuance considerations, such as, amelioration of transaction costs, application of quality underwriting and standards, and implementation of servicing capabilities and independence.

ADRIAN KATZ *has been involved in the asset-backed securitization industry for 17 years, working in both the investment banking and specialty finance industries. Currently, Katz serves as CEO and Director of Finacity Corporation, a company that purchases, credit enhances, securitizes and services account receivables. As an investment banker, Katz was a Managing Director at Smith Barney responsible for issuance of new asset-backed and mortgage-backed securities. Subsequent to Smith Barney, Katz worked for Prudential Securities where he was a Managing Director and Co-Head of the Mortgage and Asset Capital Division. More recently, Katz was the Chief Operating Officer, Chief Financial Officer and Vice Chairman of AutoBond Acceptance Corporation.*

Katz is a frequent speaker at conferences and has testified before Congress regarding commercial real estate finance on behalf of the Public Securities Association (now the Bond Market Association).