

Accounts Receivable Securitization

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By various estimates, a tally of accounts receivable as reflected in the financial statements of U.S. companies would total approximately \$10 trillion, with a comparable amount outstanding in Europe and more in the rest of the world. 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 accounts receivable). Accounts receivable 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 and asset-based loans, accounts receivable have been securitized since the 1980s, with an estimate of approximately \$60 billion outstanding in the U.S.

PROBLEM

Notwithstanding the history and breadth of funding techniques, it is this author's opinion that accounts receivable are generally inefficiently funded despite their typical characteristics as one of the most creditworthy and liquid financial assets on a corporate balance sheet. This discussion will focus solely on commercial accounts receivable, which may also be referred to as receivables.

Various cash-flow-generating assets, such as mortgages, automobile loans and credit card receivables, have been successfully securitized on a broad scale. Despite the well-publicized problems with residential lending, a new home mortgage is more likely than not of to be included in a securitization pool. However, by stark contrast, securitization of receivables represents less than 1% 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 historically companies generally have required both significant size and credit quality to successfully fund through receivables securitization.

SOLUTION

Today, a wide range of companies can work with financial institutions to address the barriers to entry noted above and access reliable and cost efficient funding through accounts receivable securitization. The hurdles to be addressed include: reduction of fixed costs, conformity and reliability of credit underwriting, credit enhancement (as appropriate), conformity and credibility of servicing and reporting, and accommodating

the increasing globalization of companies' sales. Unlike consumer finance receivables, most commercial accounts receivable are not originated by companies that would naturally be frequent securitization issuers. As such, Finacity, a finance company specializing in accounts receivable securitization, provides a more templated process to clients, thereby giving them the effective benefits of Finacity's own frequent issuances. Leveraging off the disciplines and processes developed in connection with prior issuances ameliorates fixed costs for new issuers. 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 can reduce credit performance uncertainty, mitigate catastrophic risk and enhance cash flow. Vigorous invoice verification, collections and comprehensive reporting address the combined risks of fraud, seller-servicer effectiveness, and seller default risk. Transactions designed to finance receivables from multiple jurisdictions in multiple currencies can help maximize liquidity from global working capital.

RECEIVABLES SECURITIZATION

Receivables are typically 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 term commitments usually of up to 364 days, relatively quick access to funding and anonymity. CP conduits are generally bank sponsored, rated at least A1/P1, and require collateral deemed at least A/A2 rated. Purchase amounts usually exceed \$100 million. An example of a CP conduit-funded transaction Finacity facilitated is a €1.2 billion securitization on behalf of INEOS Group Ltd. Customer access to CP conduits 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 floating rates. An example of a term transaction Finacity facilitated is a 2.2 billion Mexican peso securitization on behalf of Cemex.

Pricing for receivables funding varies. CP conduits typically provide their customers pricing that ranges from CP + 50 bps to CP + 300 bps. CP has varied over time but generally tracks with LIBOR. Pricing depends on the credit quality of the seller, the attributes of the receivables portfolio, jurisdictions, currencies, structural features, explicit or implied ratings, etc. The pricing available through CP conduits is usually superior to traditional asset-based lending and factoring. Factoring arrangements are often priced relative to prevailing commercial lending rates, invariably much higher than capital market CP conduit rates. For most issuers, the construct of multi-year funding available through term securitizations provides cheaper funding versus unsecured term debt alternatives.

Traditional securitizations typically involve the formation of a special purpose vehicle ("SPV"). The SPV is usually bankruptcy remote from the seller and in compliance with

legal true sale requirements. Receivables are transferred via a sale agreement into the SPV with servicing generally retained by the seller. Thereafter, receivables usually represent the primary collateral for notes issued by the SPV. Cash received from obligors over time is then available for purchases of additional receivables and thus, in a revolving manner, notes are usually longer in duration than the underlying receivables. The notes issued are mostly purchased by CP conduits or traditional fixed-income investors. While the issuance of notes by the SPV remains the most common construct, in order to achieve sale treatment under FAS 166 and 167, issued in 2009 and effective for 2010 financial statements, it has been necessary to have the receivables sold onwards from the SPV instead of issuing the notes. Under the old accounting rules, a SPV consolidation exemption was available for so-called qualified special purpose entities (“QSPEs”). Under the new accounting rules the QSPE exemption has been eliminated and there is a focus on a traditional control-based approach with respect to determining who owns the receivables.

Corporations generally stand to benefit from new approaches to the securitization structure. For example, Finacity offers a construct that differs from the typical arrangements in certain key respects. First, the SPV can be created and owned by Finacity and not the seller, such that the sale of the receivables involves a conveyance to an unrelated third party, rather than to a wholly owned SPV subsidiary of the seller. This feature is especially comforting in an environment where seller-sponsored SPVs are under intense scrutiny. Secondly, in the Finacity construct, the receivables are usually sold with servicing retained. An important consequence to Finacity’s approach is simplicity: the seller is not responsible for the securitization and credit enhancement process as the seller is essentially only involved in the sale of the assets and ongoing servicing of the assets.

UNDERWRITING

While the securitization market is sometimes comfortable with the credit underwriting performed by larger companies, the market views the credit quality of the receivables of smaller or weaker credit companies with more skepticism. Arguably it is merely discernment and not reality, but it is generally perceived that mid-sized or weaker credit 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. In some instances, 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 or weaker credit companies perform an inferior job of credit management than their larger and higher-rated brethren. Credit disciplines and comprehensive due diligence can provide investors with a more confident assessment of risks and future performance.

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 sometimes perceive available receivables insurance policies as not sufficiently comprehensive and certain to pay claims. Most property and casualty policies, for example, have many conditionalities in contrast to monoline insurance guarantee constructs, which have very few. In most instances, the foremost investor issue is not the ability but rather the willingness of an insurer to pay claims. Any utilization of a trade credit insurance policy requires appropriately worded agreements, reflecting reduced conditionalities, to avoid unnecessary claim denials.

Trade credit insurance policies are often especially helpful with navigating transactions with high obligor concentrations or in situations where a securitization can benefit from political risk insurance (in addition to the obligor risk cover). About 75% of Finacity's revenue is generated from non-U.S. receivables with obligors in over 80 countries, more than half of which are non-OECD, presenting opportunities to enhance securitizations with trade credit insurance.

BOND ADMINISTRATION/SERVICING

A lack of transparency as to the underlying assets in securitizations is sometimes considered one of the key causes of the credit crisis. As a consequence, reporting requirements have appropriately become more rigorous. Corporations considering a trade receivable securitization are often first-time issuers. Considerable know-how and resources are required to facilitate the ongoing reporting necessary for investors and rating agencies. The extent to which a contemplated transaction involves multiple countries, multiple currencies, and multiple selling entities that may be operating on autonomous software platforms drives the level of reporting complexity. Companies contemplating a transaction should either determine that in-house capabilities are sufficient to support the requirements or consider the engagement of a professional administrator, such as Finacity.

Over the past few years, certain alleged fraud events and the credit crisis have suggested the importance of enhanced and independent investor-reporting transparency to facilitate access to receivables securitization for a broader range of companies. For example, press reports regarding Allied Deals Inc. 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." Allied Deals was a purported non-ferrous metals broker that financed its metal sales with bank loans collateralized with accounts receivable that were determined to be bogus and then, in an apparent Ponzi scheme, used loan proceeds from one victim bank to make loan payments required by another victim bank. There is non-trivial risk when the very party responsible for servicing and bond administration with respect to the receivables is also the entity borrowing against or selling the receivables. The perceived fraud risks of the traditional arrangement in which

a seller is also the bond administrator / servicer are magnified for weaker credit and/or mid-sized companies. Also, it is an empirically observed phenomenon that in the circumstances where sellers file for bankruptcy, their ability to perform as bond administrator / servicer is substantially impaired. Also, obligors have a tendency to take advantage of a seller's bankruptcy with accompanying disruptions in servicing and payments being 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. Finacity, for example, generally requires that bond administration be outsourced to its platform, thereby mitigating capital market concerns with respect to servicing.

REASONS TO SECURITIZE RECEIVABLES

Probably the most common reason to securitize receivables is to raise cash efficiently. 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, they are a natural choice for monetization. The securitization process generally provides small and medium-sized companies broader access to capital at a lower all-in-cost of funds. This is especially true for companies that have weaker creditworthiness than their customers do and/or companies with very well diversified customer bases. In such instances there is opportunity for 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 enhancement, and appropriate structuring, Finacity broadens the opportunities for weaker credit and/or more complex companies to bootstrap their access to capital and resulting efficiencies.

Achieving balance sheet management objectives can be an additional reason for a company to securitize its receivables. Pursuant to certain financial engineering, sale treatment / deconsolidation can be achieved with the resulting opportunity to de-leverage through the use of proceeds to redeem outstanding debt. Achieving GAAP sale treatment, per FAS 166 and 167, requires careful and deliberate structuring, but is achievable without undue adverse economic consequence. IFRS de-recognition, per IAS 27 and SIC 12, is much more difficult to accomplish and success typically involves a higher all-in-cost. Compliance with debt or loan covenants can be fostered through improvements in certain balance sheet ratios and metrics, including: days sales outstanding ("DSO"), the "quick" ratio, return-on-assets ("ROA") and the debt-to-equity ratio.

Sellers can choose to remain anonymous or they can raise their profile in the capital markets by participating in an investment-grade issuance. Finally, due to the international strengths of Finacity's solutions and partners, cross-border receivables are eligible for securitizations, further expanding the amount of potential monetization. While Finacity is headquartered in the United States, approximately 75% of the obligors that it touches are located in countries outside of the United States.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

Risk retention associated with Section 15G of the Dodd-Frank Act is a new consideration for all securitizations, including trade receivables. In general, the new rules require a minimum 5% risk retention in deals. In most typical trade receivable securitization structures the corporate originator of the receivables is expected to retain sufficient reserves to accommodate loss, dilution, obligor concentrations, interest, and fees. Generally, published Standard & Poor's rating criteria offer the best roadmap for how deals are structured. The reserve level of risk retention invariably exceeds 5%, usually ranging from about 15% to 35%. While under the new rules securitization issuers/sponsors are supposed to retain a minimum of 5% risk, the new rules permit such risk retention to be allocated to the originator. So while not mentioning the new risk retention rules would make this author remiss, it should be noted that the new rules should not adversely impact or meaningfully change the way typical deals will be executed in the future.

CONCLUSION

Recently, an increasingly broad range of companies, including companies that may be weaker credits, mid-sized, involved in cross-border trade and/or have more complex operations, have been able to access the cost efficiencies and disciplines of the capital markets. 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 robust servicing and reporting capabilities. Accounts receivable securitization remains a viable and often compelling source of working capital financing for companies across the globe.

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