# Robin Hood Finance Limited

# Beat the Liquidity Crunch

It doesn’t set the pulses of hedge fund managers racing. It’s not exotic. In a way, it’s a bit old-fashioned. And it’s nothing to do with subprime! But in a market where high-quality, solid assets are in demand, trade receivables securitisation can offer tremendous value to both borrowers and lenders.

**What is it?**
In what way is TR securitisation old-fashioned? It has similarities to factoring. Factoring is the financing of amounts due & payable from one company to another, and is a STG 15bn market in the UK. (That’s amounts funded, not turnover, which would give a much larger number.) One problem with factoring is that it isn’t that cheap compared to bank funding-no big surprise when you consider that three quarters or so of UK factoring is done by the clearing banks. Another problem with factoring is that the funding is ultimately coming from those same banks, so new sources of funding aren’t being opened up to the borrower-it could be seen as new wine in old bottles.

The difference between TR securitisation and factoring is that the assets (invoices) are bundled in such a way as to attract a high rating (AAA or AA) from one or more of the rating agencies. Some older deals, often funded with commercial paper, left with the bank certain risks related to the seller. The next generation of transactions does not do this, and is therefore attractive to banks which do not have a relationship with the seller. In addition, properly structured and managed deals use less bank capital under Basel II, the new bank regulatory regime, so are more attractive as investments.

The TR securitisation market is large (around $40m funded) and well-developed, with nearly $10bn of new TR transactions going into financing vehicles sponsored by European banks in 2007. Transaction size ranged from USD 2m to USD 1.4bn equivalent.

**How can it help my company?**
The cost of credit as a whole has been rising, and there is evidence of availability of loans falling, since mid-2007. Many banks have had difficulties, and it is a prudent borrower who has at his disposal funding options in addition to that of borrowing from the usual banks, who might turn off the credit tap and/or crank up the pricing at some stage. Also, getting the assets into a highly-rated form increases the potential range of investors, and can often produce cheaper funding as well.

One more specific area is LBOs. Financing or refinancing LBOs has become more difficult and expensive in recent times, but it is quite possible to raise funding by structuring an LBO’s trade receivables to a rated standard. Demica has worked on several such transactions. It is absolutely vital to eliminate credit risk on the LBO, which needs up-to-date and robust software and transaction management.

**What's in it for banks?**
Banks exist to make returns for their owners. If they can get money to their customers by using less capital, they will-and they know that, of they don't, their competitors will! Under the Basel II banking regulatory rules, which are currently being implemented, banks will use much less capital for a AAA or AA rated TR securitisation than for a loan to a typical corporate. Consider the following:

- Loan to corporate at 0.8% margin using 8% capital* gives the bank a return on regulatory capital of 10%
- Securitisation of corporate's TRs at 0.4% margin using 1.6% capital** gives the bank a return on regulatory capital of 25%

**Regulatory capital typically required for unrated/below A- rated corporate*
*** Regulatory capital typically required for AAA/AA bond; could be lower in some cases!*

The investing bank also invariably gets a higher-quality asset than by lending directly and, in addition, new banks which do not lend to the corporate can be brought in to provide finance.

Finally, a European bank can use the rated asset as collateral with the European Central Bank for raising funding, (loans are no good for this purpose) so it is attractive to banks on yet another front.

**What are the key points?**
In order to reach the highest ratings, and hence use a low amount of bank capital and be attractive to a wide range of banks, deals have to be put together carefully. In particular, the investing bank should not have financial risks on the TR seller. This was often the case in older transactions, where various risks such as "co-mingling", which is when the TR seller collects and holds payments from debtors for a period of time, were effectively borne by the bank.

The way forward is to structure transactions to a bond standard. That means making sure that investors have risk on receivables or cash, but not the seller.The efficient way of doing this is daily settlement. Receivables are funded on a particular day in the month. On subsequent business days, cash is received and new invoices are raised. Daily settlement means that cash received is set off against new receivables. If there are more receivables than cash, they can't be bought. If there is more cash than receivables, the excess is kept in a special account with a highly-rated bank. So risk on the seller is minimised, the investor gets a highly-rated asset, and the TR seller gets maximum use of cash.

This contrasts with some offers from arrangers we have seen where all cash collected is put into a blocked account pending a weekly or fortnightly settlement-fine for the bank, but not so good for the corporate, which loses the use of this cash!

Special software is necessary to run daily settlement transactions. Demica's Citadel, for example, currently runs $10.6bn of receivables. It is important to note that the extra work required from the corporate is minimal.

It is also important to make sure that the TR seller is "securitisation ready" from a systems and procedures point of view. Demica has taken companies through this process many times in the form of a feasibility study, and improvements and efficiencies invariably result, whether or not the company decides to propceed with a transaction at that point.

Once the decision to proceed has been made in principle, it is most efficient to approach several potential arrangers witha request to quote on terms, conditions and pricing. Demica has found that the best way to do this is to produce a short outline of the desired transaction and to approach several potential arrangers.

**Conclusion**

Trade receivables securitisation is a well-established market, and has advantages for corporates and banks alike. The process is a well-established one, but it is prudent to structure and manage to a standard which meets banks' criteria, whilst making sure that the corporate is getting the best possible deal.