Case Studies

- Finance Company Ltd (Malaysia)
- Fannie Mae Guaranteed REMIC Pass-Through Certificates
- Sears Credit Account Master Trust II
- Ford Credit Auto Owner Trust 1998-B
- Trains I PLC
- Belenus Securities
- Advanta Equipment Receivables
- Atherton Franchisee Loan Funding
- FILMS (Finance for an Italian Library of Movies plc)
- Hong Kong Card Master Trust
- Ras Laffan LNG

Example: Formula One Bond

- In May 1999, Morgan Stanley Dean Witter and WestLB led a $1.4 billion F1 Eurobond issue.
- The bond was backed by TV rights and revenues from the exclusive contract between Bernie Ecclestone’s F1 company and broadcasters for Grand Prix racing coverage.
**First Principles**

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
- The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt).
- Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
- The form of returns - dividends and stock buybacks - will depend upon the stockholders' characteristics.
- Minimize unnecessary financial risks.

**Objective:** Maximize the Value of the Firm

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**Corporate Financing Choices**

- Do financing choices matter?
- Debt or equity?
- What kind of debt?

Certain kinds of market imperfections allow corporations to reduce costs by improving the financing mix.

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**Is There an Optimal Capital Structure?**

\[
\text{Value of the firm} = \text{PV}(\text{Cash Flows}) = D + E
\]

**Does Capital Structure Matter?**

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You cannot change the value of the real business just by shuffling paper - Modigliani-Miller

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**Does Capital Structure Matter?**

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\text{Value of the firm} = \text{PV}(\text{Cash Flows}) = D + E
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The “Conservation of Risk” argument

You cannot change the risk of the business just by shuffling paper - Modigliani-Miller

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**The Financing Side: Is There an Optimal Capital Structure?**

\[
\text{Value of the firm} = \text{PV}(\text{Cash Flows}) = D + E
\]

Optimal debt ratio?
When Debt and Equity are Not Enough

Value of future cash flows

Claims on the cash flows

Assets

Liabilities

When Debt and Equity are Not Enough

Value of future cash flows

Claims on the cash flows

Assets

Liabilities

Debt
  - Contractual int. & principal
  - No upside
  - Senior claims
  - Control via restrictions

Equity
  - Residual payments
  - Upside and downside
  - Residual claims
  - Voting control rights

What if...

Claims are inadequate?

Returns are inadequate?

What Kind of Debt?

Some Considerations

- Fixed/floating:
  - How certain are the cash flows? Are operating profits linked to interest rates or inflation?
- Maturity or availability:
  - Are the assets short term or long term? Should the firm assume ease of refinancing, or buy an option on access to financing?
- Currency:
  - Consider currency of the assets: currency of location vs. currency of denomination vs. currency of determination.

Alternatives

- Collateralized
- Asset-securitized
- Project financing
- Preferred
- Warrants
- Convertible

FINANCING ALTERNATIVES AVAILABLE TO MAJOR CORPORATIONS

Debt
  - Subsidized funds
  - Private placement
  - Public offering
  - Revolving facility
  - Term loan
  - Real estate leasing
  - Asset-backed unsecured domestic eurobond
  - Fixed floating long term short term US CP Euro CP bank debt MTN ARP FRN VRN straight hybrid callable index-linked convertible with warrants restricted full rights private sale public offering domestic international equity options stripped unstripped project finance bank debt
Application

- How should Spanish oil company Repsol finance its $13.4 billion acquisition of Argentina’s YPF? (Fixed/floating; Maturity or availability; Currency?)
- Originally planned to finance it entirely with long-term US debt. But the falling Euro with a lower interest rate led the company to finance 30%-40% in Euros.

Guidelines for Financing

- Liabilities to match assets: economic exposure of the firm determines base financing choices.
- Decision on whether or not to fully match depends on company’s view relative to the view implied by market prices.
- When strategy is chosen, use the financing/hedging techniques that offer the lowest effective cost.

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Financing Choices and Asset-Backed Securities

- ABS are complex and expensive to structure. Hence in a perfect market with no informational inefficiencies, no need for ABS
- Use of ABS may make sense when there are
  - Subsidies, guarantees or regulatory incentives
  - Information-based value added

Information-Based Value Added

- Information about a company’s receivables is improved
- Specialization in risk-bearing is achieved
- ABS has positive “signalling effect,” especially when residual rights retained by company

Beyond Modigliani-Miller’s “Conservation of Risk” Argument

- Securitization creates assets with less risk and greater liquidity, hence a lower cost of financing
- But can the higher quality be achieved without a commensurate decrease in the quality of the remainder of the company?
- Yes -- if securitization sweetens a lemon!
- Reason: when a company faces uncertainties, investors demand a premium. But investor concerns about receivables can be dispelled at far lower cost than other concerns about the company and its overall performance.
Asset-Backed Securities: Summary

- Asset-backed securities can create value for investors and issuers if:
  - The assets are for some reason worth more off the balance sheet than on
  - The right legal framework is in place
  - The costs do not exceed the benefits
- Sometimes they do not work...because you cannot make money by cutting up a dog