Credit Research

European secondary market perspectives:

Whole business securitisation: The new corporate finance?

- Over the next 12–18 months, we foresee a marked acceleration in the use of whole business securitisation in the following industry sectors:
  - **Pubs, restaurants and hotels**
  - **Utilities**
  - **Transportation**
  - **Property**
  - **Leisure and entertainment**
- While we expect the sterling debt capital markets to remain at the forefront of this development, we project the emergence of innovative hybrid structures in the US and Continental Europe. Within this context, we rate Germany, the Netherlands and Scandinavia as the most likely candidates for product growth outside the UK.
- Overall, we believe that new supply will continue to be well absorbed and that the asset class will retain its superior ratings and spread stability relative to more traditional corporate spread products within similar credit and duration spectrums.
- In the UK, additional positive spread momentum should be created by expected reforms to the Minimum Funding Requirement (MFR) and Financial Reporting Exposure Draft 20 (FRED 20).
- We maintain our OVERWEIGHT recommendation on the asset class, reflecting our view that the sector continues to offer superior risk/return characteristics.

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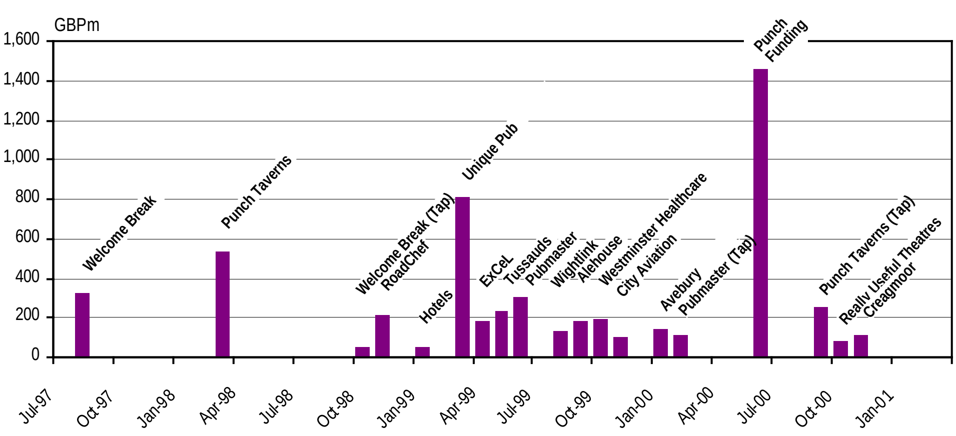
Product background

Evolving from relatively simple, inauspicious beginnings in the mid-1990s, the concept of securitising the entire spectrum of cash flows generated by a business venture has developed into one of the fastest growing and most innovative issuer segments at the long end of the sterling credit curve. The market has to date seen the successful launch of 14 'true' whole business transactions with a combined deal value of GBP5.4bn, encompassing operating assets as diverse as motorway service areas, pubs, airports, ports and ferries, care homes, hotels, exhibition centres, theatres, theme parks and wax portrait exhibitions.

Chart 1: Monthly issuance of GBP-denominated whole business securitisations



Source: Capital DATA Bondware, Euroweek, Bloomberg, Rating agencies, UBS Warburg

Structurally, the technique deviates from the standard securitisation format in several key aspects. Firstly – and most obviously – the concept does not only involve the segregation and sale of a specific pool of corporate assets and associated 'single-source' cash flows into a bankruptcy-remote special purpose vehicle (SPV), but – as mentioned above – the ring-fencing and 'fronting' of the entire business by an issuer SPV. As a result, there is no transfer of ownership or operating control, but instead the technique relies on a legal framework which provides privileged creditors with 'true control' over the income-generating assets under stressed scenarios. This mechanism is also tax-efficient, as any liabilities otherwise triggered by a transfer of assets are being avoided (eg, capital-gains tax or stamp duty).

Table 1: Whole business vs standard securitisation: The key differences

	Whole business securitisation	Standard securitisation
Nature of underlying assets?	**Entire business venture**	Segregated pool of financial assets
Sources of cash flow?	**Multi-source**	Single-source
Nature of cash flows?	**Predominantly non-contractual**	Contractual
Ownership & control over assets?	**Borrower management**	Issuer SPV
Ultimate ownership of SPV?	**Borrower parent company**	Charitable trust
Debt service funding?	**Net operating cash flows**	Contractual interest and principal re-/prepayments
Bankruptcy-remoteness?	**Yes, but only at the issuer SPV level**	Yes, subject to delinkage
Protection against external risks achieved through?	**'True control' over the income-generating assets**	'True sale' of the income-generating assets

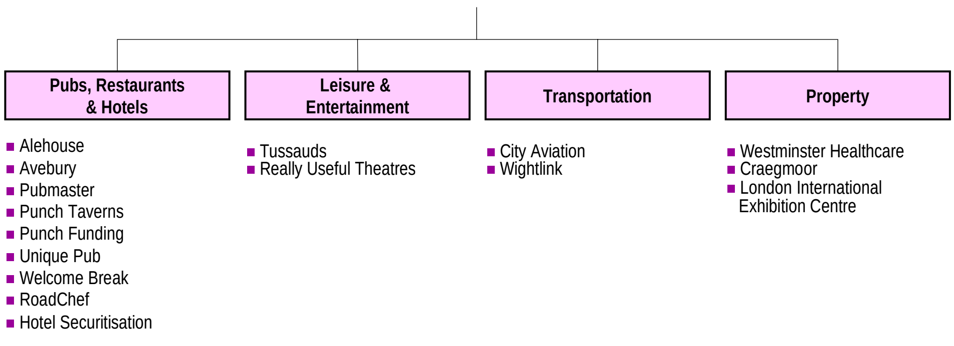
Source: UBS Warburg

Product evolution

The origins of this legal structure underpinning the whole business technique can be traced back to a relatively obscure Swedish mortgage-backed transaction called St Erik, launched in 1994. Essentially, the deal securitised rental payment flows from social housing that the municipalities as originators could, however, not sell into a bankruptcy-remote SPV under Swedish law. Also, the originators faced the additional obstacle that certain assets within the pool required active and comparatively intense management. This meant that a way had to be found around the standard 'true sale' concept typically applied in non-synthetic securitisations. Ultimately, this resulted in the development and application of what is today commonly referred to as a *secured loan structure*.

On the back of the St Erik deal, it did not take long for market participants to realise that this pushed the doors wide open for the securitisation of the entire spectrum of cash flows generated by a business venture. Taking advantage of possibly the world's most creditor-friendly insolvency regime and an acceleration in corporate restructuring, the technique was subsequently first applied in 1995 in the UK – Europe's largest single ABS market – with the successful launch of the Craegmoor Nursing Homes transaction, closely followed by the Phoenix Inn and the two Angel Trains deals. However, the ultimate breakthrough came with the launch of Investcorp's innovative Welcome Break transaction, which represented the first whole business securitisation issued in the sterling debt capital market applying the now familiar legal structure – and at the same time – brought the technique firmly into the mainstream of corporate finance.

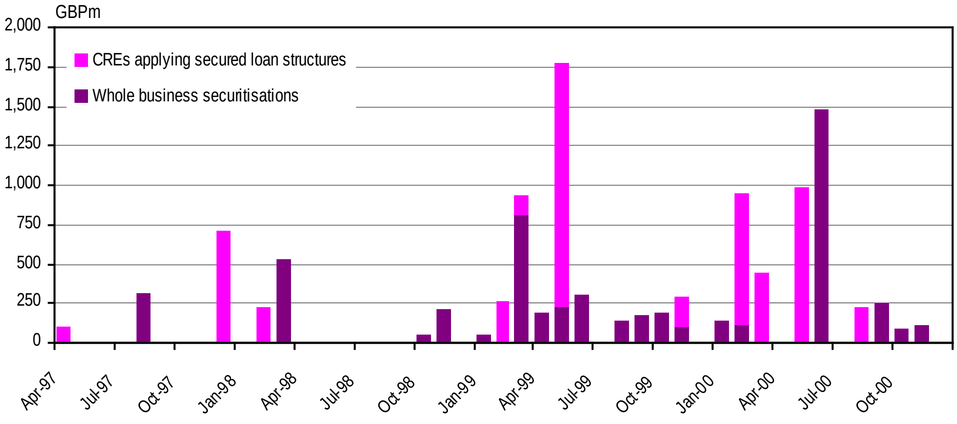
Chart 2: GBP-denominated whole business securitisations by principal industry line



Source: UBS Warburg

The development of the secured loan structure also triggered the emergence of certain derivative structures, such as the tenant lease-backed CREs product. Although not 'true' whole business securitisations *per se* due to the predominantly contractual nature of cash flows and a different set of deal rationales, the vast majority of CREs apply the secured loan principal or hybrids thereof, and the borrower entities in these deals effectively assume the role of a stand-alone property company for a segregated part of a corporate's property portfolio. Including this segment, the total value of whole business securitisations brought to the sterling market rises to over GBP11.0bn.

Chart 3: Monthly issuance of GBP-denominated whole business securitisations, including tenant lease-backed CREs applying secured loan structures



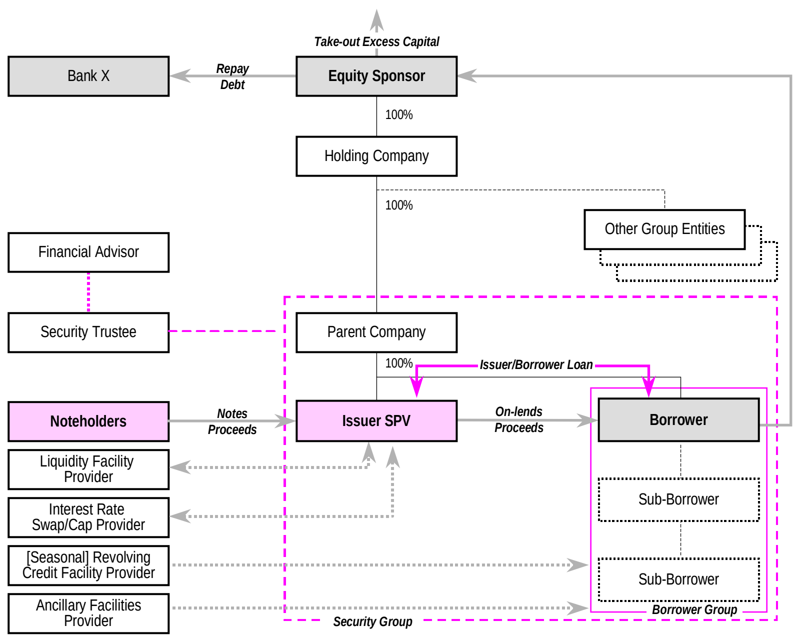
Source: Capital DATA Bondware, Euroweek, Bloomberg, Rating agencies, UBS Warburg

On the other hand, and in stark contrast to developments in the sterling debt capital market, the technique has not yet gained a foothold outside the UK. This is largely a reflection of the fact that legal frameworks on the Continent and in the US make it exceptionally difficult to structure a deal format which would provide privileged creditors with the necessary levels of 'true control' over the income-generating assets under stressed scenarios.

The underlying legal concept

The secured loan structure

Chart 4: Conceptual framework of a secured loan structure



Source: UBS Warburg

Essentially, a secured loan structure is a hybrid legal concept incorporating elements of both a standard securitisation and a senior secured corporate loan or bond. Under the structure, a bankruptcy-remote issuer SPV is set up to front the operating company and act as its financing vehicle. The notes proceeds are on-lent under an issuer/borrower loan agreement which provides for the same payment schedule as the public debt. Typically, the borrower will apply the funds to refinance indebtedness previously incurred at the borrower or group level, as well as to fund transaction costs. In most cases, the borrower will also be required to fund first loss and certain maintenance or capital expenditure accounts, while excess funds – if any – may be returned to the equity sponsor.

Nature of security

Pursuant to the issuer/borrower loan agreement, the issuer is granted first priority security interests over all the borrower's assets. In the UK, this security package typically includes – but does not necessarily need to be limited to – first ranking fixed charges over all of the borrower's assets, including property, plant and equipment and, if applicable, fixed charges over all intangible assets, such as goodwill, trade names, trademarks, contract rights, customer or subscriber lists. In addition, the issuer takes first ranking floating charges over all of the borrower's present and future assets, including cash, negotiable instruments, receivables, deposits, inventories, etc. Where the borrower group includes more than one entity, the package of fixed and floating security interests also encompass all the subsidiaries' assets and undertakings. This is further perfected by the pledge of all shares held by the borrower in the subsidiary companies as well as the cross-collateralisation of obligations and the issue of guarantees by individual borrowers in respect of each other's obligations under the loan agreement.

In turn, the issuer assigns the respective *Borrower Group Deed of Charge* and all its rights under the loan agreement to the security trustee. The security package also includes the pledge of all shares held by the parent company in the issuer and the borrower. The combined security package is held on trust for the sole benefit of the secured parties to the transaction, typically including the noteholders, the liquidity, revolving credit, seasonal and ancillary facilities and interest rate hedge providers. These parties – in turn – enter into an inter-creditor agreement that restricts their ability to act unilaterally against the issuer or, ultimately, the borrower. This structural element mitigates potential conflicts of interests among privileged creditors that could otherwise undermine the effectiveness of the security arrangement.

'True control': Legal integrity of secured loans

The UK: Provisions under the Insolvency Act 1986

Under a stressed scenario, the integrity of this legal structure hinges heavily on the wide-ranging powers granted to privileged secured creditors under British law. While it is the main purpose of all insolvency regimes to ensure that certain – if not all – creditor categories are treated 'fairly' in a company insolvency, legislative regimes vary greatly across western jurisdictions, and within this context, British law provides for probably the most creditor-friendly environment, particularly in respect of secured creditors:

- **Secured creditors have the ability to act unilaterally to initiate proceedings, without court involvement.**
- **Where secured creditors, whether fixed or floating, have security over all – or substantially all assets of the borrower – they can appoint an administrative receiver.**
- **The appointment of an administrative receiver overturns an administration order filed by a non-privileged third-party creditor.**
- **The administrative receiver – acting solely on behalf of the privileged creditors – has the option to continue the business on a 'going concern' basis or to realise the underlying assets.**
- **Secured creditors have priority in liquidation.**
- **The administrative receiver has no obligation to optimise asset realisation for all creditors, but only to "take reasonable care to get the best price available".**

The fact that the *Insolvency Act 1986* permits the holder of first priority fixed and floating charges over all – or substantially all – the assets of a company to be effectively exempt from insolvency proceedings and control the process almost as if he were the owner is one of the key elements of exercising 'true control'. Also, noteholders – acting through the security trustee – can enforce the security and appoint an administrative receiver of their choice with relative ease should either the borrower or the issuer default under any of their obligations. While non-privileged creditors have the right to apply to the court for the appointment of an administrator, they practically lose any influence as soon as an administrative receiver is appointed by the secured creditors.

The appointment of an administrative receiver results in the loss of control of the borrower's management. In contrast to other jurisdictions, a borrower cannot seek protection from creditors unilaterally. The administrative receiver would elect a qualified substitute manager who would continue to run the business on a 'going concern' basis for the sole interest of the privileged creditors, but may alternatively elect to liquidate the collateral if this should be deemed more favourable to the privileged creditors. This ability to replace the borrower's management by a substitute manager is to some degree comparable to the concept of a back-up servicer in a standard securitisation. In a liquidation, there is no obligation for the administrative receiver to optimise asset realisation for the non-privileged creditors, but only to "take reasonable care to get the best price available". Furthermore, the administrative receiver can commence to realise assets without the need for a formal restructuring, with secured creditors able to rely on the availability of insolvency set-off and netting.

Table 2: Position of secured creditors in major western jurisdictions (I)

	Formal stay period	Management retains position	Scope for major restructuring	Priority upon liquidation	Ability to enforce security unilaterally	Ability to control the process	Ability to ignore/overrule other creditors
UK	Very limited	No	No	Yes	Yes	Yes	Yes
US	Yes	Yes	Yes	Yes	Yes	No	No
France	Yes	Yes	Yes	No	No	No	No
Germany	Yes	Yes	Yes	Yes	Yes	No	Yes

Source: Moody's Special Report: *Bankruptcy & Ratings: A Leverage Finance Approach for Europe*, UBS Warburg

Clearly, secured creditors in the UK – particularly if holding properly perfected security interests – are in a fundamentally stronger position relative to secured creditors in other major jurisdictions, such as the US, France or Germany. The extent to which a secured creditor can ignore other categories of creditors when deciding to enforce security and the ability to control proceedings with very little involvement by the courts are two of the key strengths of this structure under the UK regime. In contrast to other major jurisdictions, secured creditors have also priority on liquidation proceeds, putting them into a much stronger position than for example under French law, where much greater priority is given to 'social claims', such as employee claims or tax liabilities.

Table 3: Position of secured creditors in other western jurisdictions (II)

UK	US	France	Germany
Costs of proceedings	Post-petition financing (super priority)	Employees, in respect of their super priority	Administrative costs of proceedings
Holders of fixed charges, incl accrued interest	Costs of proceedings, incl administrative fees & claims, counsel	Costs of proceedings, tax & social security	Secured creditors, less fees
Preferential creditors, incl tax, social security, & wages	Priority claims, incl tax, social security, & wages	Observation period creditors, i.e. post-insolvency creditors	Unsecured creditors (there are no preferential classes of unsecured creditors)
Holders of floating charges, incl accrued interest	Secured creditors	Secured creditors	
Unsecured creditors	Unsecured creditors	Unsecured creditors	

Source: Moody's Special Report: *Bankruptcy & Ratings: A Leverage Finance Approach for Europe*, UBS Warburg

The procedures under the UK regime also mitigate the potential risks otherwise associated with the absence of bankruptcy-remoteness at the borrower level. In principal, the borrower is free to enter into any third-party transaction subject to the restrictions under the legal documentation. Therefore, in the event of the borrower failing to meet its third-party obligations, the respective creditor could attempt to place the company into administration by seeking a court order. However, as this would trigger the enforcement of security by the privileged creditors security trustee and the appointment of an administrative receiver, this would effectively overturn the administrative order granted to the non-privileged party. Nevertheless, there is a minor risk of a delay in the flow of payments if the court proceedings should coincide with the payment schedule under the loan agreement, a risk which should, however, be more than adequately mitigated through the financing structure typically applied in whole business securitisations.

Within this context, investors should, however, note that the government has been looking at possible changes to insolvency proceedings for some time and certain changes have already been implemented. For instance, small businesses are now able to obtain a moratorium on creditor action for a period of up to 28 days, with a view towards putting forward a rescue plan for approval (*Insolvency Bill*, February 2000). Despite these recent developments, we believe that changes that would effectively abolish a secured creditor's right to overturn an administration by putting the borrower into receivership are highly unlikely to materialise within the foreseeable future.

Leveraging 'true control': Financial and restrictive covenants

Financial covenants

The legal documentation in a whole business securitisation will also provide noteholders with a covenants package enabling them to intervene well in advance of an actual insolvency should the borrower's financial performance decline below certain minimum levels. One of the most efficient and often used 'early intervention tools' are financial covenants setting a certain minimum debt service coverage (DSCR), defined as the ratio of adjusted EBITDA over debt service. DSCRs are typically calculated on a 4-quarter rolling average basis – forward and/or backward-looking – to account for income/cost seasonalities. EBITDA is usually adjusted for non-cash and exceptional items, but does not include any cash balances brought forward at the issuer or the borrower level.

The minimum DSCR covenant represents the default trigger and is typically set at around 1.25–1.35x dependent on the intrinsic risk profile of a transaction. The setting of minimum DSCRs above 1.0x takes into account cash items excluded from the formal calculation, namely strategic capital expenditure or taxes. Additional DSCR covenants may also be set above this default trigger, usually at around 1.35–1.45x, with a breach usually resulting in the appointment of an external advisor to management on behalf of the noteholders. Other financial covenants may include provisions in regards to a minimum maintainable tangible net worth of the borrower group or minimum funding requirements of reserve accounts.

Restrictive covenants

In contrast to financial covenants, restrictive covenants are designed to limit the nature of third-party transactions a borrower can enter into. The rationale behind this is to ensure that the integrity of the underlying business is not distorted by third-party transactions, ie, it remains fundamentally similar over the life of a transaction. Restrictive covenants cover the scope of business activities a borrower can engage in, and the ability to acquire or dispose of assets, while prohibiting the incurrance of additional indebtedness, the issue of additional shares, an engagement in a consolidation or merger, or the creation or permission of any security or security interests over any charged assets, undertakings, or revenues. In order to retain certain minimum levels of funds within the business and accrue the business' cash position over time, the covenants package will also include restrictions on the cash distributable to the equity sponsor in the form of dividends or subordinated loans. Such cash sweeps are typically set at a DSCR trigger of around 1.5–1.65x.

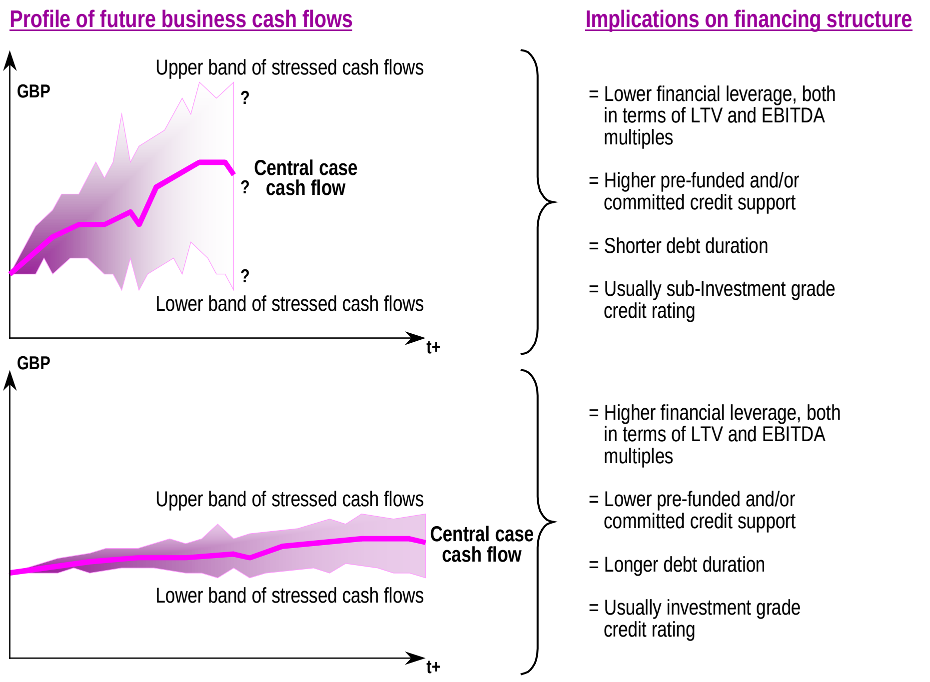
In combination with the powers granted to privileged creditors under the *Insolvency Act 1986*, this framework of financial and restrictive covenants effectively transforms the otherwise binary nature of credit – the company either defaults under its financial obligations or not – into a framework which provides noteholders with a comprehensive set of control and early intervention tools.

The underlying financing concept

Underlying business cash flows, not sponsor credit

Given the absence of legal recourse towards the equity sponsor, the financing structure and ability of timely and full repayment hinges on the stand-alone future cash flows generated by the operating companies and not the credit quality of the equity sponsor. Within a somewhat simplified equation, it therefore follows that (A) the lower the implied volatility of future cash flows and (B) the longer the duration of such cash flows; (a) the higher the level of financial leverage achievable; (b) the longer the weighted average duration of debt; (c) the more 'aggressively' structured the scheduled debt service relative to projected cash flows; (d) the lower the requirement for external or internal liquidity or credit support; and (e) the higher the weighted average credit rating achievable.

Chart 5: The underlying financing concept of whole business securitisation



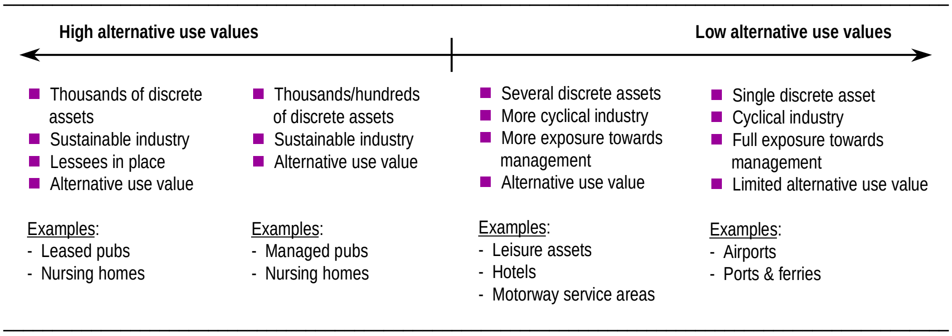
Source: UBS Warburg

Structural support

Overcollateralisation

In addition to the characteristics of the business' cash flow profile, consideration is given to assumed loss severities under a scenario of default and liquidation on day one post-launch, taking into account alternative use values, the ability to find a substitute manager and the likely timeframe of a liquidation. Certain rating agencies will also look at the business' intrinsic or sustainable value over time and the equity component relative to that. The resulting overcollateralisation, which will typically range between 15–30% depending on the risk profile of the underlying business, in turn represents the first layer of structural support in a whole business securitisation.

Chart 6: Potential alternative use values



Source: UBS Warburg

Subordination

The second layer of structural support is provided through the subordination of notes classes among each other as a result of ‘tranching’, a process that is largely driven by certain maximum levels of leverage tolerated per ratings category by the agencies for certain underlying risk profiles, but also takes into account the level of structural support made available to the structure. The effect of subordination is usually further optimised by applying certain pass-through provisions for certain notes classes, typically at the most junior-rated level (typically Baa2/BBB level).

Internal and external liquidity support

While such credit enhancement – ie, overcollateralisation and subordination – takes a more static approach, the concept of internal and external liquidity support is dynamic. In principal, the need for external liquidity arises from the fact that delays may occur under a stressed scenario, eg, while taking control over the assets of the borrower, appointing a substitute manager or liquidating assets. Also, it is likely that the borrower would already have generated poor cash flows prior to a trigger event, which may not be sufficient to service debt.

Therefore, and in order to avoid a default under the rated notes, potential cash shortfalls relative to scheduled debt service are to be recovered through externally provided liquidity support at the issuer, and potentially, the borrower level. The level of liquidity in a whole business securitisation will typically cover up to 15–18+ months of scheduled debt service, but ultimately hinges again on the intrinsic risk profile of the underlying business, as well as the weighted average rating desired by the originator of a transaction. Additional liquidity will usually also be required at the borrower level to fund net working capital requirements, certain non-strategic capital expenditure or other corporate purposes, dependent on the maturity and seasonality of the securitised business.

Amortisation

Debt in a whole business securitisation is fully amortising; typically i) directly, ii) in sequential order, and iii) excluding major ‘bullet’ risk. This is an important factor, as it reduces the noteholders’ exposure towards asset values and the borrower group over time, thus enhancing – in principal – potential recovery values under stressed scenarios, ie, insolvency or liquidation.

Product application: What business?

Considering the conceptual framework of whole business securitisation and as exemplified by the kind of assets brought to the market to date, the profile of businesses which lend themselves towards the concept is somewhat limited, and can essentially be narrowed down to assets that generate very stable and sustainable cash flows over a series of economic cycles, ie, cash flow characteristics typically found in 'old economy' business franchises. In turn, this tends to reflect that they:

- **operate in industries with utility or utility-like characteristics;**
- **operate in industries with relatively high barriers to entry, either due to regulatory and/or initial capital expenditure requirements;**
- **operate in industries in which fundamental changes are expected to be limited and only very gradual;**
- **are mature and highly cash-generative in nature and – by definition – have only moderate net working capital requirements;**
- **have a narrow business mix, which makes the projection of future cash flows comparatively easy; and**
- **have a strong underlying 'hard' assets element, essentially in the form of real estate and other fixed assets, which are comparatively easy to value and can be charged as security.**

Table 4: Key characteristics of GBP-denominated whole business securitisations

Issuer	Deal size	Underlying assets as of launch	Deal rationale	Equity sponsor
Alehouse	183.0	809 leased pubs	Refinance LBO debt	Alchemy Partners
Avebury	134.0	686 leased pubs	Refinance LBO debt	Cabot Square Capital
Pubmaster	305.0	1,485 leased pubs	Refinance MBO debt	Bridgepoint Capital PPM Ventures
	+109.0	Tap issue to partially refinance acquisition of 662 leased pubs		BC Partners
Punch Taverns	535.0	1,428 leased pubs	Refinance LBO debt	Texas Pacific
	+250.0	Tap issue to partially refinance acquisition of 754 leased pubs		Colony Capital
Punch Funding	1,484.0	2,844 leased & managed pubs	Refinance LBO debt	Texas Pacific & Management
Unique Pub	810.0	2,614 leased pubs	Refinance LBO debt	Nomura
Welcome Break	321.0	21 motorway service areas & 17 adjacent roadside travel lounges	Refinance LBO debt	Investcorp
	+55.0	Tap issue to partially refinance post-acquisition capital investment programme, incl. Addition of 2 further MSAs and adjacent roadside travel lounges		
RoadChef	210.0	17 motorway service areas & 10 adjacent roadside travel lounges	Refinance LBO/MBO debt	Nikko, Credit Suisse & Management
Hotel Securitisation	52.0	8 regional hotels across the UK	Refinance LBO/MBO debt	Management & Alchemy Partners
Tussauds	230.0	City centre attractions & 3 theme parks	Refinance LBO debt	Charterhouse Capital
Really Useful Theatres	84.0	13 theatres in London's West End	Refinance LBO debt	Andrew Lloyd-Webber & Bridgepoint Capital
City Aviation	100.0	London City Airport	Refinance debt/fund expansion	Dermot Desmond
Wightlink	135.0	Ferries & port operations on the British mainland and the Isle of Wight.	Refinance MBO debt	CinVen & Management
Westminster Healthcare	195.0	84 specialist care homes & care homes for the elderly	Partially refinance public-to-private MBO debt	Chai Patel & US venture capital firms
Craegmoor	110.5	Specialist care homes & care homes for the elderly	Refinance original securitisation (called)	Craegmoor Group
ExCeL	183.6	Exhibition centre, located on a 85-acre site formerly comprising the Royal Victoria Docks in London's Docklands area	Finance design, construction & operation (project finance)	Miller Freeman, Reed, Robert McAlpine, Best Golden, Government & Management

Source: Offering circulars, Capital DATA Bondware, Euroweek, Bloomberg, Rating agencies, UBS Warburg

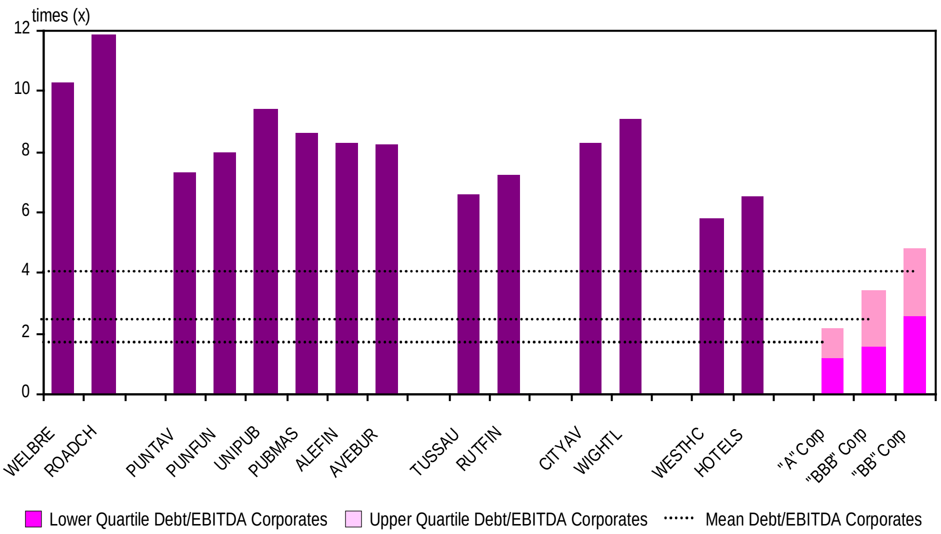
Economic benefits of whole business securitisation

The economic benefits to an equity sponsor of financing such ‘defensive’ business franchises on the basis of the whole business concept are essentially threefold:

- **High financial leverage**

Firstly, an originator will usually achieve considerably higher financial leverage multiples than otherwise achievable through traditional forms of debt financing. Using the whole business securitisations brought to the market to date as benchmark, equity sponsors usually achieved leverage multiples in the region of 7–10x EBITDA and LTVs of up to 90%, while the traditional format of acquisition finance (modelled around senior/mezzanine/high yield), usually only achieves EBITDA multiples of 4–5x and LTVs in the region of 50–70%.

Chart 7: Financial leverage of GBP-denominated whole business securitisations based on EBITDA multiple at launch, relative to corporates (total debt toEBITDA)

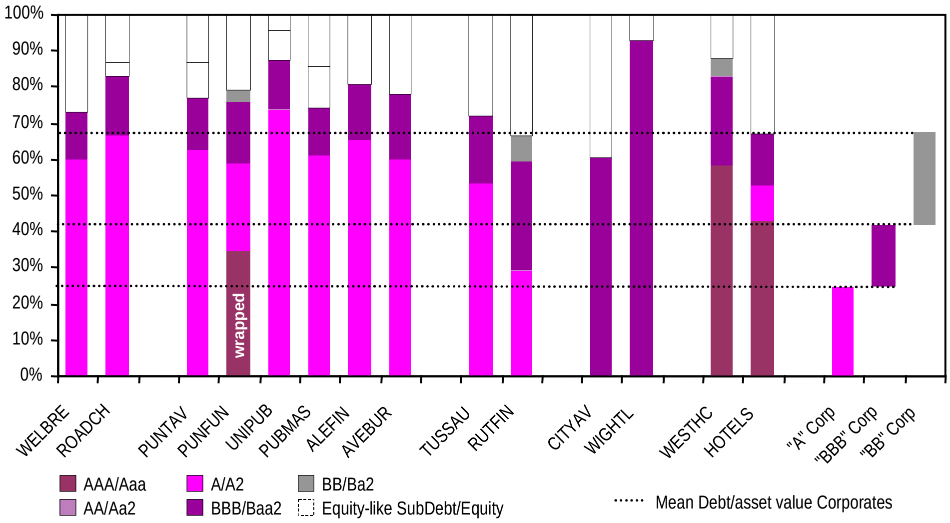


Note: WBS ratios as of launch; Corporate ratios per ratings category based on S&P "CreditStats: Industrial Comparative Ratio Analysis – Long-term Debt (1999); Source: Offering circulars, S&P, UBS Warburg

- **Low cost of capital**

Secondly, an originator will usually achieve a considerably lower ‘all-in’ cost of capital, based on the fact that by achieving a higher financial leverage, debt replaces a substantial amount of equity – by definition the most expensive form of capital – and that whole business securitisation, dependent on the intrinsic risk profile of the underlying business, will usually achieve weighted average credit ratings within the A- to BBB bracket. In comparison, such business franchises would not attract investment-grade ratings if funded on the basis of traditional forms of acquisition finance and applying similar levels of leverage.

Chart 8: Financial leverage of GBP-denominated whole business securitisations based on pool valuation at launch and relative to corporates (total debt to assets)

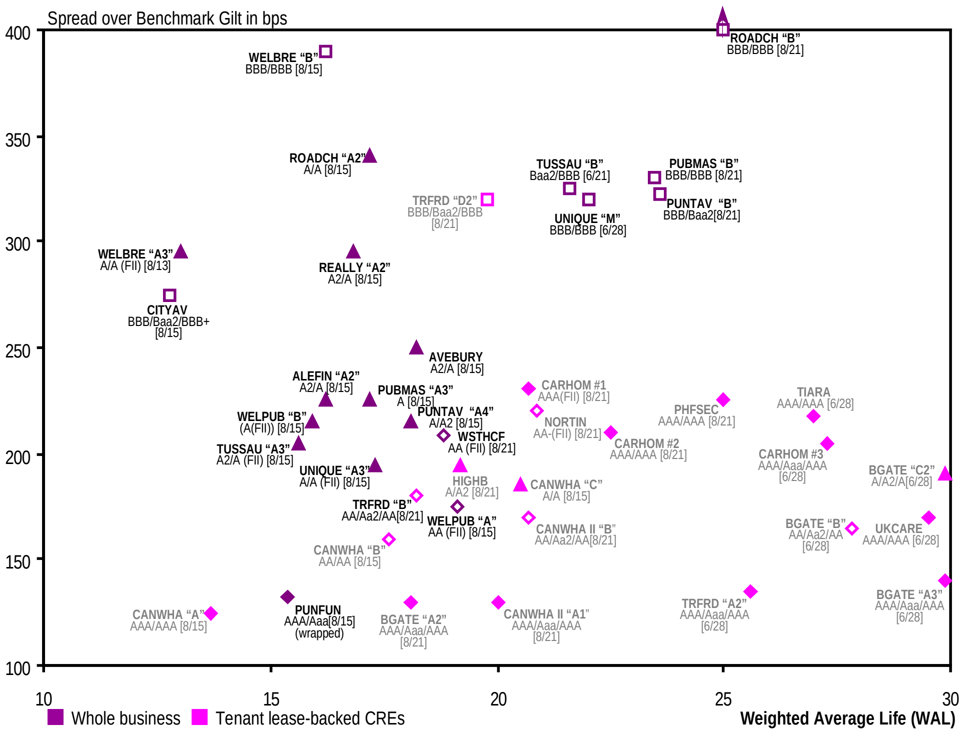


Note: WBS ratios as of launch; Corporate ratios per ratings category based on S&P "CreditStats: Industrial Comparative Ratio Analysis – Long-term Debt (1999), equity at market values; Source: Offering circulars, S&P, UBS Warburg

Long debt duration

Finally, an originator will usually achieve a considerably longer weighted average debt duration, typically up to 20–25 years. Traditional acquisition finance will generally not provide for terms longer than 7–10 years.

Chart 9: Indicative mid-spread levels for GBP-denominated fixed-rate whole business securitisation paper vs tenant lease-backed CREs (as of 7 December 2000)



Source: UBS Warburg

Scope of application

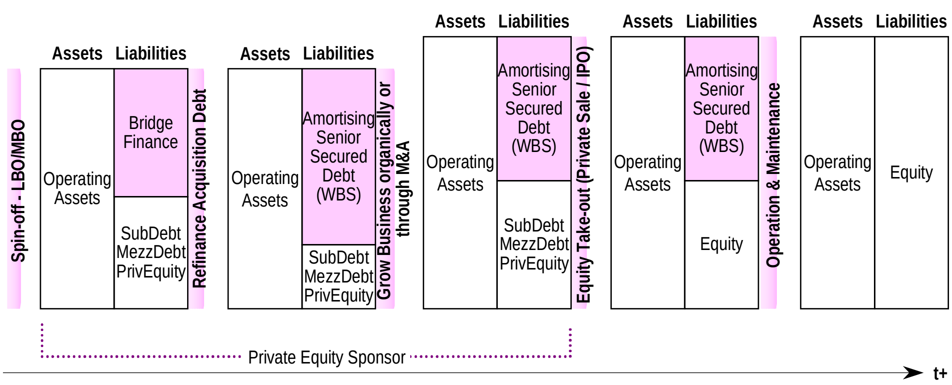
To date, the vast majority of 'true' whole business securitisations brought to the market to date refinanced changes in ownership (LBOs/MBOs), but the concept has since also migrated into other areas of corporate finance, for example the financing of public-to-private transactions and, within a wider context, project finance and leveraged on-balance-sheet financing.

Whole business securitisation in LBO/MBO finance

Although equity investors' perception of 'old economy' franchises has undergone some changes over recent weeks and months, today's equity market-driven environment still attributes little value to assets with stable cash flows but low future growth potential. Instead, they are seen by the majority of the investment community as assets locking up a corporate's scarce resources at the expense of activities potentially yielding higher growth and effectively attracting higher valuation multiples. As a result, many of these business franchises have declined to a peripheral status with listed corporates, which in turn have actively been looking at divestment opportunities to bolster their share prices.

On the other hand, by being able to refinance the initial acquisition debt through a whole business securitisation, a growing number of leveraged buyout firms have become eager buyers of such 'unloved' business franchises. Additional upside to the equity sponsor's investment returns is usually also created by the fact that purchase prices for such assets have historically tended to come in below 'intrinsic values'. This reflects the situation that once such business franchises come up for sale, the seller will typically already have been under mounting pressure from investors to divest, and will, therefore, be looking at completing a deal within a short timeframe rather than going through a lengthy competitive tender process. Also, many of these businesses carry a considerable 'hidden intrinsic value' upside potential, reflecting the fact that the vast majority of businesses coming up for sale will typically have under-performed for quite some time relative to their performance potential, either due to persistent under-management and/or under-investment.

Chart 10: Whole business securitisation as an integral part of an LBO/MBO cycle



Source: UBS Warburg

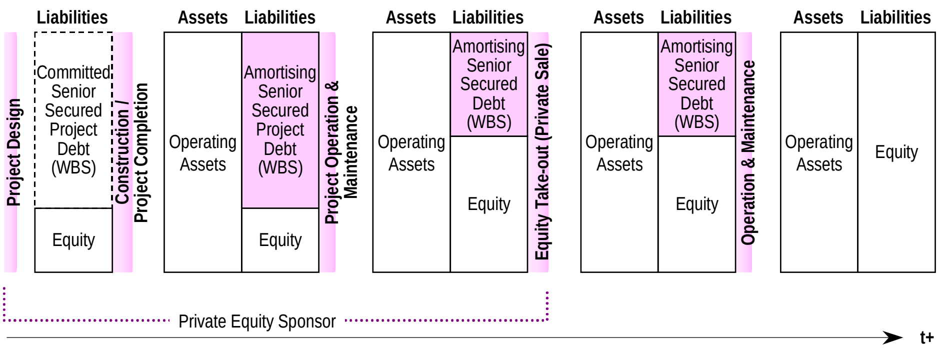
Whole business securitisation in recapitalisations

The concept is also increasingly considered as a financing tool for taking listed companies private. Such public-to-private deals would take advantage of low equity-valuation multiples for old economy assets and/or act as a defensive mechanism to shareholder pressures or the possibility of falling prey to an unfriendly take-over. The likely candidates for refinancing debt related to public-to-private deal through a whole business securitisation are principally smaller or medium-sized franchises with settled, highly cash-generative asset bases. We understand that a number of deals are currently in the structuring phase, which could bring such public companies back into private ownership.

Whole business securitisation in project finance

The first transaction that was structured more closely along the lines of a whole business securitisation rather than traditional project finance is the GBP183.6m ExCeL deal brought to the market in April 1999. Essentially, the project involved the design, construction, operation and maintenance of a 90,000 square metre exhibition and conference centre and the development of a surrounding 85-acre site situated in London's Docklands area. While applying a broadly traditional project finance contractual framework for the design and construction phase, the transaction broke new ground by securitising future exhibition revenues as principal source of debt service rather than requiring full long-term offtake/supply/O&M contracts or utilisation histories.

Chart 11: Whole business securitisation as an integral part of a project finance cycle



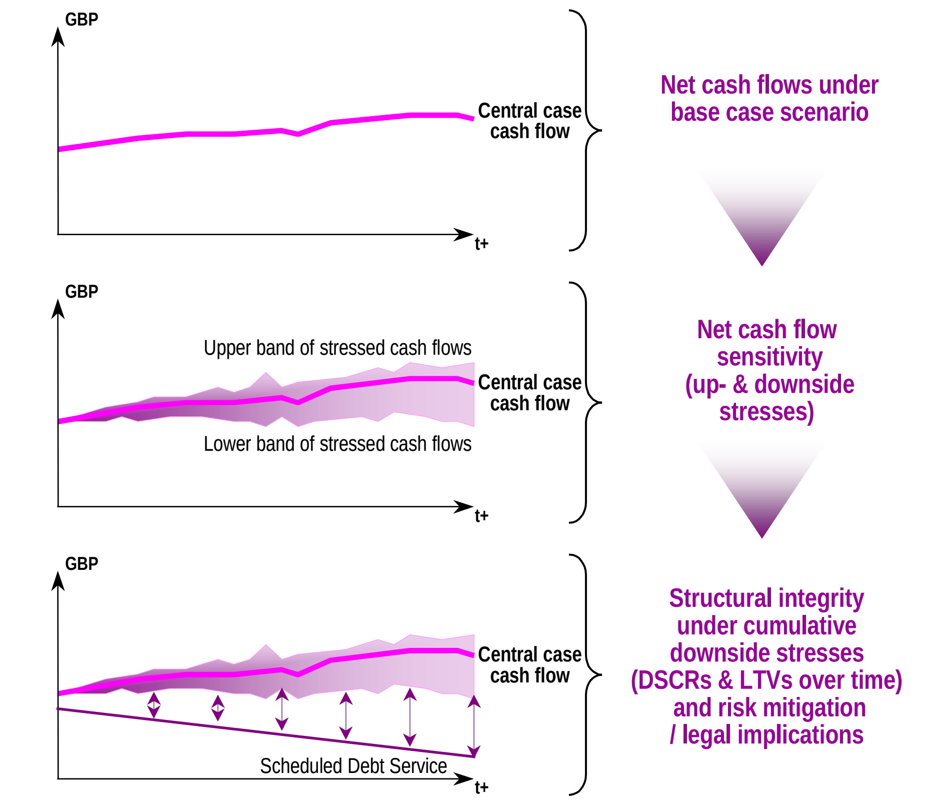
Source: UBS Warburg

The analytical perspective

Structured products force investors to take a different analytical approach relative to corporate paper. However, investing into whole business paper – at least within a wider context – does not require a 'revolutionary' different perspective. The key variables driving the operating and financial performance of a whole business transaction are broadly similar as for a corporate credit, ie, i) the state and future direction of underlying sector fundamentals; ii) the quality of management and management strategy (tap risk!); and iii) the diversification of operating, legal, regulatory and financial risks. On the other hand, given the maturity of underlying assets, the focus of the credit analysis in a whole business deal shifts from a top line growth-centred perspective to a view on the stability of the top line over time and management's ability and incentives to control operating and capital costs effectively over time.

Also, it is crucial that investors look through to the legal integrity of a structure: i) The 'conservativness' of debt service relative to projected net cash generation over the life of a deal; as well as ii) the level of credit enhancement and support provided to a transaction. These factors have – in combination – the potential to transform a positive underlying credit story into a negative one, or vice versa.

Chart 12: UBS Warburg's basic quantitative and qualitative concept for analysing the relative fundamental credit strength of whole business securitisations (bottom-up)



Source: UBS Warburg

Despite the absence of legal recourse towards the equity sponsor in principal, investors should also give consideration to the quality and integrity of the equity sponsor. A strong and committed sponsor will support a deal through a period of under-performance and will remedy a breach of a financial covenant by injecting additional equity or using certain defeasances, or providing a deeply subordinated loan to a deal.

Furthermore, corporate event risk, which usually forms a considerable part of a traditional fundamental risk assessment, tends to be a lesser issue in analysing structured paper. At the micro level, corporate event risk is typically fully mitigated through the restrictions imposed on management under the covenants package. On the other hand, there is some exposure towards counterparty event risk, ie, a up/downgrade of a liquidity or hedge provider may trigger a up/downgrade depending on the ratings methodology applied by the agencies rating the deal. Investors should therefore give consideration to the quality and ratings stability of the external parties to a transaction.

Product and market outlook

Over the next 12–18 months, we foresee a marked acceleration in the use of whole business securitisation in the following industry sectors.

- **Pubs, restaurants and hotels**
- **Leisure and entertainment**
- **Utilities**
- **Transportation**
- **Property**

While we expect the sterling debt capital markets to remain at the forefront of this development, we project the emergence of innovative hybrid structures in the US and Continental Europe. Within this context, we rate Germany, the Netherlands and Scandinavia as the most likely candidates for product growth outside the UK.

Sterling market perspectives

Pubs, restaurants and hotels

Pubs are already the largest sector of the UK whole business securitisation market, but 2001 issuance may break all records as the country’s brewers plan to dispose of pubs worth some GBP3.5bn. In late November this year, Whitbread issued an information memorandum to potential buyers for the previously announced sale of its 3,000 tenanted and managed pubs, valued at around GBP1.5bn. The sites, which include the Hogshead and Dome chains, are likely to attract a good deal of interest from both trade and financial bidders.

Enterprise and Fuller, Smith & Turner have already publicly expressed their interest in some segments of the portfolio, while the likes of Punch and Pubmaster are sure to be interested. WestLB Panmure, Alchemy Partners and Greene King are also sighted as interested parties. Given that some 1,700 of the Whitbread pubs are leased premises with the rest managed, this makes a format of at least two buyers very likely, unless a buyer would apply a similar structure to Punch Funding, which securitised both leased and managed pubs.

Bass also plans to sell some 900 pubs valued at around GBP0.6bn, although some of the branded pubs may be too expensive for a principal finance buyer. Legal & General Ventures (L&GV) working in conjunction with fellow venture capital firm Candover, is believed to be the frontrunner. Greene King – the brewer and traditional pubs group – is also thought to have expressed interest in part of the portfolio. On the other hand, Nomura's interest in the deal is said to have cooled over recent weeks. Alchemy Partners are understood to have submitted a bid for part of the portfolio but are reported to have dropped out of the running. L&GV is believed to be supporting the management team which runs the unbranded estate, but industry observers take the view that it is likely to bring in some external resources, too.

Scottish & Newcastle is thought to have some 700–900 of its 2,300 managed pubs up for sale, possibly worth in the region of GBP0.6–0.8bn. The group is currently in the final stages of a major strategic review of its estate and a disposal of a significant number of under-performing outlets, particularly in the 'locals' category, is likely. Although S&N has not yet given precise indications (announcement due in January 2001) as to the number of disposals planned, the fact that the group's four core business segment are expected to include an eventual 1,500-strong estate gives an indication as to the scale of a potential sale. On the other hand, Wolverhampton & Dudley – the UK's largest regional brewer and owner of the Pitcher & Piano franchise – has already sold some 480 pubs over the course of 2000 and is understood to be looking for a buyer, either for its 850 pubs valued at around GBP0.4bn or – and possibly more likely – for the entire franchise.

Meanwhile, pub company Pubmaster itself is finally set to change hands this week after weeks of tortuous negotiations. The group – owner of some 1,975 tenanted pubs – is being sold from its three venture capital owners Bridgepoint Capital, PPM Ventures – the private equity unit of Prudential – and BC Partners to a consortium led by WestLB Panmure and Rotch Property Group. The business is expected to be sold for GBP550m, including assumed debt. The buyer is likely to retain the current management, which is eager to further expand the franchise. A likely format of a buyout transaction would most likely take the form of a new company called 'Pubmistress' being set up to hold the acquired business and act as the vehicle for further acquisitions. In addition to the Pubmaster buyout, there is also speculation linking sponsor Cabot Square with a potential sale of its interest in Avebury.

In the hotels sector, Granada Compass – the foodservice and hospitality company formed in July 2000 – announced in mid-September 2000 that it was conducting a strategic review of the hotels division and was holding exploratory discussions. In the light of the strength of interest shown in the business, the board decided that the interests of shareholders would be best served by establishing a formal process for the disposal of the Forte hotel division, comprising the Le Meridien, Posthouse and Heritage hotel brands as well as the London Signature hotels. The group also separately earmarked the Cavendish Hotel – a 251-room 4-star hotel situated in the heart of London's West End – for sale, which was completed in early December to the De Vere Group for a consideration in cash of GBP60.0m. Bass, Sol Melia, Hilton, Marriott and leveraged buyers Nomura and Doughty Hanson are all thought to be among the likely bidders for all or part of the hotel franchise.

Utilities

There has been a lot of speculation recently suggesting a radical restructuring of the UK water industry through securitisation. In principal, such utility assets would lend themselves very well towards the whole business concept given the overall stability of sales volumes, high barriers to entry, a narrow business mix and the availability of 'hard' assets. On the other hand, political sensitivities as well as uncertainties in respect of the regulator's price regime (Office of Water Services (OFWAT)) make securitisation a concept that may be difficult to apply in its purest form. In terms of the whole business technique, possibly an even bigger obstacle is the fact that under UK legislation, no security can be taken over certain regulated assets, given concerns over the maintenance of a safe and efficient water supply under an operator insolvency.

Proposals which have to date been put forward to find a way around these constraints include a sale of the water company's core regulated assets and licences to a third party to create a separate regulated water company. In turn, such a company would be set up as a non-profit entity taking the form of a community-owned mutual company or a company limited by guarantee. In essence, such a structure would rely on the support of the regulatory and legal framework that currently exists in the UK to provide legal protection to noteholders in order to offset the risks associated with higher levels of debt leverage. Kelda, the owner of Yorkshire Water, and one of the utilities looking at securitisation, proposed the set-up of a mutual structure some months back, which would have turned the water company into a non-profit entity owned by its customers. However, OFWAT turned this down, arguing – among other factors – that such a structure failed to show how it would sufficiently benefit existing customers of Kelda.

On the other hand, Glas Cymru – the bidder for Hyder's Welsh Water – has put forward a proposal that would see ownership pass to a company limited by guarantee, owned and controlled by some 50 members. The entity would own the water assets and retain an administrative staff of about 150, but contract out its operations, including day-to-day management and operational services, under a competitive tender.

On the bottom-line, whether securitisation will or will not play a key role in the expected financial and sectoral restructuring of the water industry is yet unclear. Based on the indicators we have, we believe that 'true' whole business securitisations are very unlikely to emerge in the context of the water sector, but we certainly would not rule out the application of hybrid structures if economically feasible, incorporating many securitisation techniques but not representing securitisations per se.

Within this context, we understand that at least three law firms are currently exploring the potential of such hybrid structures on behalf of water companies, with certain market commentators suggesting that the first deal may be brought to the market as early as the first quarter of 2001. Names of potential originators repeatedly mentioned within this context, include Welsh Water (Hyder), Yorkshire Water (Kelda), Anglian Water and Severn Trent Water. Other segments of the utilities sector that may also increasingly consider whole business securitisation are power generation and distribution.

Transportation

Nikko Principal Investment, the European private equity arm of Nikko Securities, submitted an offer for Powell Duffryn – the listed UK ports and engineering company – which has since been approved by shareholders and the OFT, and valued the company at around GBP550m. Senior debt and bridging facilities are understood to be provided by Deutsche Bank, and are set to be taken out during 2001 through a whole business securitisation. The basic plan is to split the business into two – ports and engineering – and to sell off the engineering franchise at a later stage. Meanwhile, the assets and revenues of the port division would underpin the structure. Other UK port companies have also been approached by private equity firms. In May 2000, Associated British Ports shrugged off a GBP1bn bid from Nomura, while Forth Ports snubbed a GBP540m offer from Duke Street Capital. Regardless of this, we take the view that the ports and ferries sector will remain a hot spot for LBO/MBO activity over the next 2–3 years and we project that at least two whole business securitisations will materialise from this over the next 12–18 months.

In the airports segment, transportation group First Group announced in mid-May 2000 that it intends to divest its 51% stake in Bristol International Airport (remaining shareholding with Bristol City Council). The competitive tender process is already at an advanced stage and we expect an announcement over the next 1–2 months. In addition, the National Express Group confirmed in early September 2000 that it intends to dispose of its UK airports division, involving the sale of its 100% stakes in East Midlands Airport and Bournemouth Airport, a process which is already at an advanced stage. All these potential transactions are likely to be refinanced using whole business securitisation.

Property

Although not falling – per se – into the whole business securitisation mould, we expect the commercial property sector to remain an important source of supply at the long end of the sterling curve. With some GBP240bn of commercial property in the UK – of which around GBP140bn is owner-occupied – forming the underlying potential, we believe that issuance coming form the segment will become more constant into 2001, but is set to remain limited to a relatively narrow range of property classes, namely in the form of trophy office developments and retail property. We also foresee an acceleration in the use of sale-and-lease-back structures in the owner-occupied area along the lines of Sainsbury's *Highbury* and *Dragon* transactions. Likely candidates in this category are corporate HQs, retail portfolios or branch networks. On the other hand, we expect the care homes sector to remain subdued. In mid-August 2000, Westminster Healthcare was forced to postpone a GBP115m securitisation refinancing its acquisition of Priory Healthcare psychiatric care homes indefinitely on the back of negative investor sentiment. While the company has 10-year committed bank financing available and is not believed to be under immediate pressure to refinance, we would certainly not rule out another attempt to tap the market over the next 6–12 months should sentiment improve.

Other industries

Nomura is currently in the process of structuring the third securitisation of assets from Thorn – the UK-based consumer goods rental company it bought in October 1998 – refinancing its GBP980m public-to-private acquisition. When Nomura bought Thorn, it had about GBP280m of cash from the sale of its US operations, so the bank paid for GBP700m of value. The cost was met with GBP275m of equity and GBP425m of debt. The first GBP309m 5-year securitisation, brought to the market in June 1999, was backed by virtually all the assets of Radio Rentals, the main business of Thorn UK. Nomura used most of the proceeds to retire some of the original acquisition debt. The second EUR250m deal, launched in August 2000, parcelled rental and hire purchase contracts from Thorn's subsidiaries in Denmark, Norway and Sweden. The capital raised redeemed all the remaining acquisition debt. In June 2000, Nomura spun-off Thorn UK into a new company, Box Clever, which simultaneously acquired the UK consumer rental business of Granada Media. WestLB underwrote some GBP860m of bridge debt to finance the double buyout. Of that, some GBP330m went to Nomura and GBP530m to Granada. Thorn and Granada Media now each hold half the equity in Box Clever. We understand that the company intends to refinance the bridge facilities through a securitisation, possibly combined with a high yield bond, which is expected to come to the market during the first quarter of 2001.

Also, it is now increasingly clear that Doughty Hanson's impending buy-out of UK food manufacturer Rank Hovis McDougall (RHM) from conglomerate Tomkins may be refinanced partly through a large deal worth perhaps GBP700m. To gain comfort that RHM would be able to generate stable revenues over a long-term period, rating agencies and investors would have to rely on the strength of RHM's manufacturing base (it owns several flour mills in the UK), its brands (Hovis and Granary), and on an assessment on the potential for the company's market share to be eroded by competition. The rating process could provide another illuminating case study of how such operational factors may add up to a higher rating in the context of a securitisation than when viewed through the lens of an ordinary corporate rating.

What future outside the UK?

The principal obstacles

The absence of a legal framework outside of the UK providing noteholders with effective ‘true control’ has to date been the major obstacle for the application of ‘true’ whole business securitisations in any major jurisdiction outside the UK.

Obstacle 1: Ability to take security

In Spain, for example, there is great difficulty in achieving true perfected security, and the only way in which this can be achieved is through share ownership in the borrower company. Also, in regards to cross-jurisdictional transactions, such securitisations would end up with an horrendously unwieldy security package, required to address the particular mechanisms and legal regulations which apply to the jurisdictions involved. Certain recent deals have been flagged as ground-breaking cross-jurisdictional treatments of security, but the ratings effectively did not rely on the security package and the treatment by the various jurisdictions in the same way as for a domestic UK whole business securitisation deal. For example, a credit default swap embedded in a deal structure and certain sorts of safety nets may stand instead of the same degree of reliance on the security package and control over the assets, but such structures really become a different ‘animal’ altogether.

Obstacle 2: Restrictions on the ability to enforce security

Although English law allows companies to avail themselves to a moratorium, ie, through administration, the *Insolvency Act 1986* provides that secured creditors holding charges over all – or substantially all – of the assets of a company are excluded from the effects of administration, and continue to have full rights under their security. In addition, there are no mechanics that would allow a defaulting borrower to seek protection from creditors unilaterally. In contrast, many countries have decided as a matter of public policy that companies should have the right to prevent creditors from enforcing security if there exists the possibility of the company being able to continue trading through a period of financial constraint. Such workout moratoria give a company a period of time to re-establish their business without the need to be concerned about sometimes over-anxious secured creditors enforcing their security ‘unnecessarily’ and thereby collapsing a company. Therefore – and even if informal restructurings are possible in many jurisdictions – court-assisted and formal restructurings are much more common, with defaulting borrowers able to seek protection unilaterally. In France, for example, a moratorium can last as long as 20 months. In the US, *Chapter 11 of the Bankruptcy Code* makes this moratorium automatic and absolute, regardless of the nature of the security held by creditors, and may typically last for 9–12 months, although in strongly disputed cases, this may take several years. During a moratorium, creditors are usually prevented from enforcing their security or payment under their security. In certain jurisdictions, a judge can, however, decide to exempt certain assets from a moratorium and allow secured creditors to enforce certain security interest. For example, Spanish law allows the mortgagee a preferential right to enforce its mortgage outside the creditors’ universal proceedings.

Obstacle 3: Ability to influence continuation or liquidation

At the end of the observation period, a court would usually decide whether to set up a continuation plan or liquidate the assets. If the affected company obtains continuance, the management of the company would generally stay in place and continue to run the business under the control of a party appointed by the court. Creditors' influence over that process will vary among jurisdictions, but major creditors generally tend to play a key role in the restructuring of insolvent companies. In some jurisdictions, the court may also impose some kind of debt rescheduling on creditors. In France, for example, this may include delays in payment for up to ten years.

Contrary to the UK, where the secured creditor has priority upon liquidation, other jurisdictions may also give certain unsecured claims preferential rights over secured creditors. In many jurisdictions, for instance, it also appears difficult to assume with reasonable certainty that the borrower will continue to manage the securitised assets on a 'going concern' basis over such periods. Most likely, secured creditors would therefore end up being forced to liquidate to recover value, thus exposing themselves to the price uncertainty way ahead in the future.

Obstacle 4: Length of proceedings

Insolvency processes can be more or less lengthy and uncertain in terms of recovery depending on the jurisdiction, asset and security considered. The potential for such long-lasting enforcement processes and uncertainties over eventual recovery values represents a major hurdle. Because US-style moratoria are absolute, and because the rating agencies would take very conservative views on the length of such a process, there is no way to structure around the possibility of moratoria without the provision of very substantial amounts of liquidity support, which in turn would push the concept beyond the prospects of an economically rationale financing option.

The possible solutions

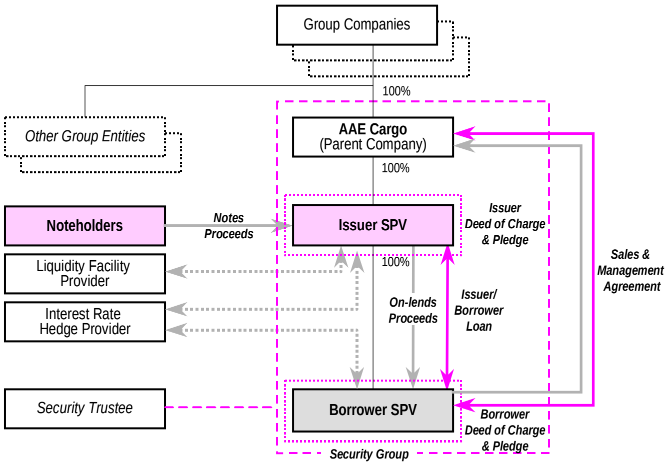
While it is clear that the whole business securitisation format applied in the UK – at least at this point in time – is not replicable in any other major jurisdiction outside the UK, several alternative structures combining elements of whole business securitisations and standard securitisations have been and are being developed to adapt the concept to other legal frameworks, including a combination of a true sale and a secured loan structure, recourse lending secured by identifiable assets, or trust structures.

Option 1: Combining 'true sale' and secured loan

The structure involves the isolation of the operating company's income-generating assets from the operations of that company. The assets to be securitised are sold by the operating company into a bankruptcy-remote entity forming part of the security group. In turn, the issuer SPV on-lends the proceeds to a second SPV, which applies the funds to purchase the assets from the operating company and at the same time, retains the operating company as the operator of the assets.

The legal integrity of this structure hinges on the bankruptcy-remoteness of the borrower SPV from the operating company. This, in turn, can only be achieved if the respective courts would not consolidate a bankrupt operator with its subsidiary. It also requires the existence of potential alternative servicers to take over the operation of the assets under a stressed scenario.

Chart 13: Deal example – EuroFreight



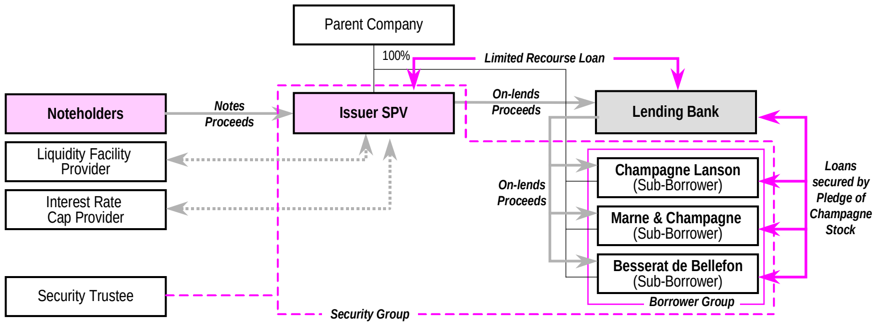
Source: Rating agencies, Offering circular, UBS Warburg

Elements of this structure can be observed in the *EuroFreight* securitisation – effectively the only deal of this type completed in Europe to date – and could potentially be considered for structures based on US legislation. Under the EuroFreight structure, the securitised assets (ie, railcars) were first sold into a bankruptcy-remote SPV on a 'true sale' basis, thus isolating them from the claims of creditors of the seller, AAE, a Swiss railcar company. In turn, the issuer SPV on-lent the proceeds to the borrower SPV. The management of the borrower as the rolling stock owner leasing them to train operators across Europe was left with AAE. That control, usually taken in a whole business securitisation by security, was rather ingeniously effected through restrictive covenants imposed on the borrower, and security in the form of the borrower's shares. There would not be a need to enforce any security as the assets were segregated (through ownership by the issuer SPV) from an insolvency of the originator.

Option 2: Secured limited recourse structure

Within this framework, an issuer SPV on-lends the proceeds to a borrower, with debt repayment directly linked to the operating and financial performance of the borrower. Noteholders would have security over the core assets owned by the operating company, particularly assets that benefit from relative price stability over a series of economic cycles. These assets would have to remain unaffected in terms of their value characteristics over the course of a moratorium, while scheduled debt service is covered by external liquidity support. In addition, the structure has to be largely insensitive to an insolvency of the operating company, even in an adverse legal environment. Within a narrow definition of whole business securitisation, such a structure would not necessarily fall within the category given that such a structure would in most cases not encompass the entire business.

Chart 14: Deal example – Marne et Champagne



Source: Rating agencies, Offering circular, UBS Warburg

In the EUR396m *Marne et Champagne* transaction designed to finance loans to champagne companies, the notes were effectively secured by inventories of unmatured champagne. The integrity of the structure relies on a *gage avec dépossession*, where in the event of a default, the area where the stock is held for the benefit of the noteholders is actually cut off from insolvency proceedings of a French court. Also, the lending bank as the financing intermediary has the option to start wind-down if, for example, under scenarios of non-payment under the secured loan agreements with the sub-borrowers or if the price of champagne falls below a certain floor. If the borrower group defaults, wind-down occurs. Under the assumption that the *administrateur judiciaire* would decide that the group should continue its business until the whole stock has been sold, the main risks in this transaction effectively relate to the price of champagne, its production and distribution costs and production timing.

Option 3: Trust structure

The trust structure involves the sale of income-generating assets by an operating company to a trust. The trust is set up for the benefit of noteholders over the life of the transaction, and for the benefit of the seller thereafter. The operating company would act as servicer. As owner of the assets, the trust has full power to terminate the servicing agreement upon the breach of certain performance triggers or upon insolvency of the servicer. Again, the structure requires the existence of potential alternative servicers to take over the operation of the assets in a bankruptcy scenario. However, the risk of consolidation of the trust's assets with the seller's estate in a bankruptcy of the seller is usually limited. This type of structure has been used in a number of Japanese securitisations. Nevertheless, this structure also deviates from the whole business concept, unless the entire venture would be sold into the SPV, which is an unlikely scenario.

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