

# Can Whole Business Securitization *re-emerge*



Prior to the subprime meltdown, whole business securitization was on a modest upward trajectory in the United States. By providing favorable rates compared with more costly leveraged financing, it was becoming an attractive tool for refinancing private equity acquisitions of public companies like Dunkin' Brands. And the structure was also gaining popularity more generally as a way to reduce interest expense and to fund stock buy-backs, as in the IHOP, Sonic and Domino's Pizza transactions.

The rate differential was the result of ratings methodologies that facilitated multi-notch shadow rating uplifts above a company's debt ratings, and these in turn qualified the bonds for a triple-A wrap by a monoline insurer. In the Dunkin' deal, that allowed the firm to shave two-and-a-third percentage points off its annual interest payments, or \$35 million.

The current credit market turmoil has made whole business securitization even more challenging than before while at the same time creating increased demand for its resurgence.

The leveraged buyout sector is already under substantial pressure. Major banks' exposure to LBO debt, much of it underwater, still runs at over \$100 billion, leading to some to devise ways to reduce the pressure on their balance sheets, even if that means selling at a loss. Some even face the prospect of lawsuits from LBO firms over alleged unfunded commitments.

This pressure will only increase as leveraged loans closed several years ago hit their bullet maturities at a time when replacement credit, if available at all, will come at a much higher price and with much less favorable terms.

All this could create enough demand for whole business ABS to come to the rescue. Of course, demand alone does not a market make. A number of potentially conflicting factors will help determine when this funding tool returns to favor.

Chief among these: investors returning to asset-focused fundamentals. Income-generating assets and businesses have consistently been the centerpiece for esoteric asset securitiza-

By Ronald S. Borod

It's certainly a challenge. The structure is hard to sell in a market that's currently shunning complexity and leverage. But if investors and issuers can overcome these hurdles, there's a future yet for this cost-effective financing tool.



*Is it time to come back out yet?*

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tions generally and whole business securitizations in particular. The agencies have applied uniformly stringent stress cases and structural requirements when rating these transactions. As a result, ratings downgrades, defaults and rapid amortization events in this sector have been a rarity.

If inattention to asset quality is perceived as the principal failure contributing to the current meltdown, it would be logical to expect the lights to come back on first in the esoteric sector before power is restored to the rest of the securitization grid.

Aligned with this factor is a general flight from complexity. Whole business securitizations, like other esoteric securitizations, are of course complex. But that is derived from the nature of the assets being securitized — not from the use of derivatives or multi-layered asset structures in the often impenetrable web of derivative products imbedded in CDO and SIV transactions. Unlike with CDOs of ABS, CDOs-squared, and other multi-layered securitizations, investors in a whole business securitization do not need to drill down several layers to identify the assets and the obligors on which cash flow depends.

### **Big challenge: the monoline meltdown**

If the only take-away from the current crisis is that complexity is bad and simplicity is good, then the future of all forms of securitization except the most plain vanilla will be bleak indeed.

Just as there was a stigma attached to the SPE in the immediate aftermath of the Enron scandal, there is likely to be a stigma attached to complexity in the immediate wake of the current crisis. However, institutional investors are sophisticated enough to differentiate among different types of complexity, and any generic flight from organic complexity should be short-lived.

The meltdown of monoline insurers poses another big challenge. Whole business transactions relied heavily on monoline wraps, and the primary rating challenge has been to achieve the rating elevation to investment grade necessary to qualify for the guaranty policy. Most businesses for which ABS pricing is attractive — and particularly those which have been acquired in a leveraged buy-out — have junk ratings and are seeking significant debt service savings through refinancing their acquisition debt in the ABS market. For many, it is a stretch to reach investment grade on an unwrapped basis. If the monoline industry is not restored to its prior health, it will be difficult to issue large tranches of whole business deals with triple-A ratings, thus substantially reducing the investor base. If the senior tranches of whole business transactions are rated at the lower range of investment grade it will be difficult to meet the large funding requirements of these deals. If the monolines are not successful in recapitalizing themselves back to health, new third party enhancers or new structural enhancements will be needed.

In addition, those investors who relied on bond insurance and did not analyze the complexity underneath the wrap will need to analyze the underlying complexity of the deal. This will add to the difficulties of filling out large order books.

Leverage also plays a major role in the attractiveness of whole business securitization. The ratios achieved by whole business transactions are not always transparent. Total rated debt in each of the Dunkin' Brands, Sonic and Domino's securitizations was just under seven times securitized cash flows, whereas the corresponding ratio for the first IHOP transaction was just above two times. Another key variable is leverage ratio triggers, which generally correlate to the leverage permitted at initial issuance. In the most recent publicly rated transaction, Local Insight Media Finance, which was wrapped by Ambac, the leverage ratio (partial amortization) trigger was set at eight-and-a-quarter times securitized cash flows for the first year, declining thereafter by 25 basis points each year. For new deals to achieve ratings between single- to triple-A on an unwrapped basis, the leverage on the higher-rated tranches will have to be reduced sufficiently to meet the stress tests and simulations for those rating levels. The challenge will be to achieve an all-in advance rate sufficient to meet the requirements of the sponsor while at the same time achieving the required rating and investor acceptance.

Another problem to be solved in the wake of the monoline crisis is the absence of the monoline insurer to make decisions on an expedited basis in the event of a default or a trigger event. The presence of a monoline insurer assured a timely and in-

formed response during the transition between the sponsor-servicer regime and the regime of the back-up servicer; and also assured proper oversight of the activities of the servicer and the back-up servicer. The absence of a monoline insurer will require the creation of a new role within the securitization structure to perform this function. One possibility would be to include a designated bondholder representative or special servicer when the bonds are issued, empowered to act on behalf of the bondholders upon the occurrence of certain enumerated events.

The final possible by-product of the subprime meltdown is investors' and ratings agencies' heightened risk aversion and the resulting need to create deal structures that offer better protection. Because most whole business transactions involve the transfer of substantially all of the cash-generating assets from the sponsor to the SPV, there is increased risk that a bankruptcy judge would, in the case of a bankruptcy filing against the sponsor, be tempted to rule that the debtor company needs the assets

previously transferred to the SPV in order to be successfully reorganized. This was the basis for the "core asset" doctrine enunciated in the Days Inn and LTV Steel cases, where the Bankruptcy Court came dangerously close to disregarding the

true sale of the company's assets to the SPV and consolidating the SPV with the bankrupt estate. To obtain a significant ratings elevation above the rating of the sponsor company, it may be necessary to provide added comfort that this is unlikely to occur.

One method for doing so, which is already common practice in whole business securitizations, is to require that the proceeds of the whole business transaction be used to retire the secured debt facility of the company and to require the company to covenant that it will not incur additional long-term debt, thus removing the possibility of an involuntary filing by a secured lender and thus a challenge on the basis of the core asset doctrine. However, trade creditors and other general unsecured creditors can also pose a threat of an involuntary bankruptcy filing against the sponsor company. Therefore, other structural features may be necessary in certain circumstances to insulate the sponsor from the incurrence of trade claims and other liabilities which could trigger bankruptcy filings by or against the company. One structural feature to be considered is to ring-fence the operating company by creating a NewCo to perform the operating functions of the sponsor company post-securitization.

If these hurdles can be cleared, and whole business securitization deal flow can be restored, the applications of whole business technology are limited only by one's imagination — and by the restrictions imposed by a newly chastened market. ▼

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