

In Practice

Authors Tom Cochran, partner, and Boin Cheong, associate, Latham & Watkins

Finding room for asset-backed financings alongside high yield and leveraged loan transactions

In the current environment of inflation and higher interest rates, securitisations may play an increasingly prominent role in offering access to cheaper and diversified funding. In this article, the authors explain why a corporate group may wish to consider exploring whether a securitisation would be available to it – and permitted under any existing high yield and/or leveraged loan documentation.

There has been a meaningful slowdown in capital markets and syndicated lending activity worldwide as central banks continue to raise interest rates to levels not seen in a decade amid significant inflationary pressure. If a corporate group has previously relied on corporate-backed debt issuance – including leveraged loans and/or high yield bond issuances – an asset-backed or receivables financing, particularly in the form of a private securitisation, may make sense under current market conditions. Such structures may offer opportunities to diversify funding and the investor base, optimise and strengthen the balance sheet and/or access cheaper funding. A securitisation can vary in size and complexity, with the smallest being in the tens of millions of pounds/euros/dollars and the largest in the billions. The opportunity is not limited to receivables and may be a solution for inventory, real estate and other hard assets, which is a trend we have seen in recent years.

What does an asset-backed financing or securitisation involve?

Although securitisations can involve public issuance of debt securities, a significant proportion of issuance is in the private markets. A securitisation typically involves establishing a special purpose vehicle (SPV) that purchases receivables or other assets, funded by way of a loan advanced by, or notes issued to, one or more financiers (which may include banks, private credit funds, asset managers, etc). More often than not, such SPV is an orphan vehicle and outside of the corporate structure, but for tax and non-tax reasons, the SPV may be incorporated as a wholly-owned subsidiary of the corporate group. Even in the latter structure, recourse to the corporate group is limited and generally the corporate is not required to grant security or quasi-security over its assets (other than in relation to collection accounts relating to the receivables (if any) and/or any nominal shareholding it holds in the SPV). The SPV's assets are limited to the receivables/assets and the account(s) into which collections from the receivables are paid; security will be granted over such assets in favour of the financiers. There is no requirement to produce an offering circular or obtain a rating of, or publicly list, the debt in a private transaction, although the financiers may request that a rating or listing be obtained in certain circumstances.

Why is a cheaper cost of funds achievable?

A non-recourse asset-backed financing, as the name suggests, is not priced or structured on the basis of ultimate recourse to the corporate group. Although there may be limited recourse to the corporate for specific matters

(such as ordinary course transaction indemnities) and the corporate may continue to act as “servicer” of the receivables/assets to manage outward-facing client/customer relationships, the financiers ultimately provide funds to an insolvency remote SPV to finance the purchase of receivables/assets from the corporate. The SPV will have no other activities, liabilities, assets or even employees, so the financiers' primary exposure is to the credit risk of the receivables/assets. Financiers may view the credit quality of the receivables/assets to be higher than that of the corporate group and, as a result, be able to offer much more competitive financing rates.

Are asset-backed financings permitted under customary leveraged loan agreements or high yield indentures?

If a high yield indenture or a leveraged loan facility is already in place at the corporate group level, the existing documentation should be reviewed to assess whether a securitisation is permitted. High yield and/or leveraged loan documentation have varying levels of complexity in terms of permissions – some include extensive and explicit language that permits receivables financings/securitisations, whilst others are more restrictive (although this does not mean such financings are prohibited). The more permissive frameworks may include key concepts and related definitions, such as “Qualified Receivables Financing”, “Receivables”, “Receivables Assets” and “Receivables Subsidiary”. Consequently, a Qualified Receivables Financing involving a sale, assignment or transfer (whether in law or equity) of Receivables and/or Receivables Assets which meet certain eligibility criteria to a Receivables Subsidiary, should be permitted. However, even in a permissive framework, it is important to consider what the framework actually allows when structuring the transaction. For instance, the definition of “Receivables Subsidiary” may be limited to corporate subsidiaries of the borrower/issuer, rather than permitting an orphan SPV. The definition of Qualified Receivables Financing may also have a requirement that the securitisation is entered into “on market terms” and having regard to this principle is important when agreeing any financing terms.

Other considerations

Securitisations can span multiple jurisdictions, which would be especially beneficial for any corporates with cross-border assets; for ease of execution, only a few select jurisdictions may be included as part of initial closing. Such financings often require a good understanding of treasury operations and functions (eg any existing cash pooling arrangements), reporting capabilities, as well as local legal and regulatory considerations, including the status of local subsidiaries and a review of local legal documentation/terms and conditions. The inventory/hard asset backed financings may also have particular tax and logistical considerations and we have seen increasing use of off-balance sheet structures, which require significant engagement from the corporate group's auditors/tax advisors. ■