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Whole Business Securitization After the Sub-Prime Meltdown: What Next?

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Prior to the sub-prime meltdown this summer, whole business securitization was on an upward trajectory in the United States. This was due to the convergence of three trends in the U.S. financial markets: first, some breakthroughs in rating methodologies that opened new pathways for issuing asset-backed debt rated multiple notches above the rating of the sponsoring company despite the dependency of the cash flows on the operating performance of the sponsor; secondly, the growing prominence of intellectual property and other intangible assets in the value chain of operating companies; and thirdly, the surge in merger and acquisition activities of private equity funds, with a significant portion of the liquidity provided by acquisition or bridge financings of the large banks. What emerged from the confluence of these three trends was a new template which was becoming the standard in M&A transactions.

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Danger and Opportunity:
The Effect of the Credit Squeeze on Hedge Funds and Structured Investment Vehicles (SIVs)

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Few of us would have predicted that difficulties in the US sub prime mortgage market would cause such a significant reverberation around the financial markets. Loss of investor confidence seems to have caused a lack of liquidity. Institutions are wary of lending to each other as it is not clear who is holding the most "toxic" US sub-prime mortgage investments. Participants in credit markets, particularly those exposed to any form of asset backed securities, have been most affected. Whilst the credit squeeze has thrown up a large number of issues, this article focuses on some of the legal issues facing hedge funds and structured investment vehicles (SIVs). As is perhaps inevitable behind the gloomy headlines, the credit squeeze presents opportunities for distressed debt investors.

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Under this template, acquisitions were funded with a mix of equity and high-yield acquisition debt, followed by a refinancing into lower-yielding highly-rated debt through the issuance of ABS. Because many of the target companies were rich in IP and other intangibles, these assets were frequently used in the securitization; and because the performance of these assets was in many cases heavily dependent upon the operations of the target company, whole business securitization technology was used to achieve the desired rating elevation.

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U.S.-based private equity firms invested over 421 billion USD worldwide in acquisitions in 2006, and raised 156 billion USD in new money during the same year. Institutional forward loan commitments by late July of 2007 were estimated at approximately 250 billion USD, much of this attributed to LBO activity, and other estimates of unfunded bridge commitments by mid-summer were at almost twice this amount.

The most highly publicized exemplar of this new template was the $1.7 billion franchise and trademark royalty securitization—DB Master Finance, LLC—closed in 2006. This transaction securitized the revenues generated by trademark licenses, franchise agreements and real estate leases created by the Dunkin' Donuts, Baskin-Robbins and Togo's fast food franchises owned by Dunkin' Brands, Inc. ("DBI"). The securities issued by DB Master Finance, LLC achieved a shadow investment grade rating which enabled the issuer to obtain a monoline wrap on most of its bonds so that they were rated AAA/Aaa when sold to investors. The proceeds of the transaction were used in part to repay a 1.5 billion USD acquisition loan incurred only a few months before in a leveraged buyout of DBI by three private equity firms. The corporate debt of DBI at the time had a B- rating due to the substantial leverage (8.5 times) resulting from the LBO.

In granting the rating elevation to DB Master Finance, S&P and Moody's relied heavily upon the strength of the respective brands owned by DBI's three fast food franchises, their prior revenue history and the brands' strong market position, which together enabled the rating agencies to conclude that DBI would remain as a viable going concern. Furthermore, the agencies found that, were DBI to file for bankruptcy, it would be economically motivated to seek to reorganize under Chapter 11 rather than to liquidate. S&P's rating analysis concluded that in the event of a reorganization, DBI, acting as servicer, would most likely affirm the master servicing agreement under which it was obligated to continue managing the trademarks and the franchise agreements of the three restaurant chains, even though such an agreement could be rejected in bankruptcy as an executory contract. This reasoning was based on the view that affirmation of such contract would be beneficial to the bankruptcy estate of DBI by enabling it to continue to receive the servicing fees (in its role as servicer) and to manage the assets for future growth (in its role as residual equity holder). Finally, additional comfort was provided by the fact that a backup manager could be readily identified to step in and provide the servicing functions needed to ensure the continuation of the cash flows in the event that, contrary to the foregoing analysis, a bankrupt DBI chose to reject the master servicing agreement.

By analyzing these factors, the agencies were able to rate the transaction "through" the bankruptcy of the operating company; that is, they were able to de-link the rating on the securitized debt from the sponsor's debt rating, despite the fact that there was a significant degree of dependency on the continued business operation of DBI.

Other franchise and trademark securitizations (including deals by Arby's, The Athlete's Foot, Sonic and IHOP) similar to the Dunkin' Brands securitization have also been closed using similar structures and achieving similar rating elevations. Each of these transactions had not only the cash flows of a well-established national franchise system to securitize, but also a strong business case for accessing the ABS market for liquidity. Businesses with ample liquidity and high credit ratings generally do not turn to the securitization market, absent special strategic reasons. The ABS market provides attractive financing terms, however, to companies subject to capital constraints and in need of liquidity. However, for a capital-constrained company to access the ABS market using the whole business model, that company's business must be

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of sufficient quality and sustainability to allow rating agencies to rate cash flows generated by the business *after* taking into account operating expenses which must be incurred in order to generate these revenues. In other words, whole business securitization—unlike the securitization of self-liquidating financial assets which are not dependant upon an operating company to generate cash flow—relies upon EBITDA rather than gross revenues to pay debt service on the bonds. Consequently, for businesses to achieve favorable results under this model, the businesses themselves must be in a strong competitive position with a long-term favorable outlook. For companies meeting these criteria, whole business securitization was rapidly becoming the vehicle of choice for taking out high-yield LBO debt and thus a potentially important source of liquidity for the heated M&A market.

But "That Was Then...This is Now." At this writing, the contagion of the sub-prime mortgage meltdown has spread to most corners of the capital markets, including structured debt and acquisition and bridge loans. The sudden loss of liquidity and the precipitously widening spreads on even highly-rated asset-backed securities have, at least temporarily, wreaked havoc with the acquisition financing template described previously. The liquidity crunch has forced private equity firms to take down their bridge loans to fund their acquisitions. Bridge lenders are struggling to fill out their syndicates and in many cases are left to fund the bridge alone. Covenant-free or covenant-lite financings are meeting increased resistance from lenders; and this, combined with increased spread requirements, has left many financial institutions with substantial underwater positions on their bridges. Meanwhile (again at this writing), new issuance volume in the ABS market (whether conventional ABS or whole business ABS) is in a state of suspended animation, while investors wait for pricing levels to settle and are licking their wounds over losses in their portfolio due to massive rating downgrades.

It would be foolish to speculate how this will all shake out. However, a few things are reasonably clear:

- Investment opportunities will be created for those with liquidity as SIVs and other asset aggregators are forced to unwind their positions.
- Unless ABS spreads return to their pre-meltdown levels, larger equity or quasi-equity tranches, with equity-type yields, will be necessary to liquefy the collateral pools and achieve off-book treatment for the portfolio owners.
- Assuming that the ABS market recovers more quickly than the institutional whole loan market, the demand for the use of whole business securitization to take out or reduce acquisition or bridge debt will be greater than ever. ❑

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