The second coming of US whole business securitisation

Whole business securitisation is growing in popularity and offers an innovative way for strong brands to segregate valuable intellectual property and other intangible assets from the parent company's operating risks, and thus effectuate cheaper debt financing

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Whole business securitisation first appeared in the United States in the early 2000s, with some relatively small securitisations of franchise fees and trademark royalties of the Arby's fast-food restaurant chain, the Athlete's Foot Group of athletic shoe stores and the Guess? trademark portfolio. The first marquee whole business securitisation in the United States occurred in 2006, when Dunkin' Brands sponsored a $1.7 billion franchise and trademark royalty securitisation.

While there had been some prior forerunners in the United Kingdom, the legal and structural challenges for whole business securitisation under English law were much less daunting than those under US law. English insolvency law assures holders of fixed and floating charges an absolute priority over all or substantially all of the borrower's assets in favour of a secured creditor. Further, secured creditors with a security interest in substantially all of a bankrupt company's assets generally have an unfettered right to appoint an administrative receiver to run the company for the benefit of the secured creditors. This means that securitisations can be structured by allowing the income-producing assets to remain within the operating company, as the bond holders can be protected from insolvency risks through iron-clad control agreements. Whole business securitisation transactions taking advantage of this feature of English insolvency law began to be closed in the late 1990s and involved various types of business, including securitisations of pub revenues, Madame Tussaud's museum revenues and Formula 1 racing revenues.

Unlike English insolvency laws, the US bankruptcy system presents serious barriers to whole business securitisation because of the power of the US bankruptcy courts to override the primacy of the secured creditor's position through automatic stays, substitution of collateral, cram-downs and other equitable remedies that benefit junior classes of debt as well as equity holders. As discussed below, the Dunkin' Brands transaction used a fundamentally different structure from those used in the United Kingdom and created a template which continues to be used in US whole business securitisation transactions, with minor variations. While highly original in its structure and in the rating methodology applied to it, the Dunkin' Brands transaction could not have taken place had it not been for the convergence of several developments in the US financial markets.

First, significant breakthroughs in rating methodologies opened new pathways for issuing asset-backed securities that were rated several places above the rating of the sponsoring company, even though cash flow still depended on the sponsor's operational performance. Before whole business securitisation, the exclusive fodder for the US asset-backed security (ABS) market was self-liquidating financial assets. Although such assets required varying degrees of management and servicing, the dependency on the management services of the operating company of the assets securitised in the Dunkin' Brands transaction was qualitatively and quantitatively different. Without a properly functioning franchise company to manage the geographically

dispersed franchisees, revenues could not be reliably generated. Such management dependency posed the conundrum of how to achieve a rating above that of the operating company where the revenues to be generated from the assets relied heavily on the company's operations. Only if the rating agencies could get comfortable assigning ratings that were higher than the operating company's ratings could the Dunkin' Brands securitisation and its progeny become a meaningful sector of the ABS market, since the sponsors were uniformly rated sub-investment grade or were unrated.

A second development was the growing prominence of intellectual property and other intangible assets in the value proposition of operating companies and the growing recognition of how these intangibles contribute to operating revenues. Only if the revenue-generating potential of these intangibles could be recognised and quantified could a transaction involving the segregation of these assets from the operating risks of the company be executed.

A third factor was the surge in corporate M&A activity driven by private equity funds in the early 2000s, with a significant portion of the liquidity for such activities provided by acquisition or bridge financings issued by large banks. The debt component of these acquisitions was high yield, based on the high leverage and the low or non-existent rating of the acquisition target. The high cost of acquisition debt used in these transactions was itself a strong incentive for the private equity funds to refinance such debt at the earliest possible opportunity with cheaper debt. This in turn created a strong incentive for financial engineers to invent low-cost debt to refinance the more expensive debt and thus free up profits.

Thus, while the Dunkin' Brands whole business securitisation was a seminal transaction in the purest sense, it was the most prominent in a series of securitised leveraged buy-outs which, in a relatively short period, was becoming the new paradigm in M&A transactions in the United States. 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 in the form of whole business securitisation.

Although quick service restaurant systems were – and still are – the low-hanging fruit for whole business securitisation, because of their need for growth capital and the low or non-existent ratings of the franchisor companies, other types of business executed whole business securitisations before 2008. These included a $547 million securitisation of cash flows generated by print directories and internet-based search services and a $1 billion-plus securitisation of intercompany licensing revenues from consumer goods trademarks.

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Other obstacles

In addition to the challenge of obtaining a rating elevated above that of the sponsor when the assets being securitised depend on the sponsor's performance to produce revenue, early US whole business securitisation transactions had other challenges to overcome. One of the most serious of these was the core asset doctrine. This was first applied in a securitisation context in the 1991 *Days Inn* bankruptcy case. Although the $155 million securitisation of the trademark and franchise assets of the motel franchisor Days Inn was performing well, its sponsor nevertheless declared bankruptcy and caused the special purpose vehicle (SPV) issuer which had issued the securities backed by the trademark and franchise assets to file a petition as well. The debtor prevailed upon the bankruptcy court to issue a preliminary ruling that it would substantively consolidate the assets of the SPV with the assets of the bankrupt parent. This preliminary ruling was based on the reasoning that the trademark and franchise agreements which had been assigned to the SPV in connection with the securitisation were considered to be core assets of the bankrupt parent and thus necessary for its successful reorganisation. Although this ruling was subsequently withdrawn and the securitisation was spared the fate of substantive consolidation, this close call had a sobering effect on the rating agencies. For a number of years, several reviewed each securitisation transaction that they were asked to rate in order to determine whether it was vulnerable to a core asset challenge.

The Guess? transaction – which involved the securitisation of the iconic clothing retailer's trademark licence revenues and which closed several years after the *Days Inn* case – adopted a structural feature that elegantly side-stepped the core asset issue. The corporate sponsor, Guess? Inc, transferred all of its material trademarks, licence agreements and related receivables to a bankruptcy-remote SPV, IP Holder LP, in a transfer that qualified as a true sale for bankruptcy purposes. IP Holder in turn contributed all receivables generated by the licence agreements and contributed IP Holder to another bankruptcy-remote SPV, with the exception of the trademarks. IP Holder also provided a guarantee of the principal due on the notes on their legal final maturity, which was secured by a first-priority security interest in the related trademarks and licence agreements retained by it.

PICTURE:

By assigning only the receivables generated by the licence agreements to the issuer SPV, and by pledging the licence agreements and the trademarks to secure only the final maturity guarantee, the core asset issue was avoided because the holders of the rated securities issued by the SPV were given no rights to the trademarks and licences held by IP Holder before the final maturity of the securities. In fact, those marks were relicensed by IP Holder to the parent company, in order to permit its core licensing activities to continue. Thus, the sole collateral for the scheduled principal and interest payments on the notes was the cash payable under the licensing agreements. The fact that the trademarks and licences collateralised IP Holder's maturity guarantee did not pose a core asset issue because the maturity guarantee would, by definition, not be subject to the claims of the note holders until the final maturity of the notes. In rating the transaction, Standard & Poor's reasoned that the presence of the core asset issue at the time of final maturity implied no incremental risk to the transaction, since this risk was already factored into the credit analysis on which the rating of the final maturity was based.

For a decade after *Days Inn*, those wishing to securitise operating assets in the United States faced a Hobson's choice between leaving the assets in the operating company (and thus subject to bankruptcy risk) or transferring them out of the operating company and risking the application of the core asset doctrine. Moreover, where the operating assets are transferred to the SPV, an operating infrastructure is still required in order to generate the cash flow on which the securitisation is based. Thus, overheads and other operating expenses will be incurred in the course of operating those assets and the cash-flow waterfall will require the application of revenues to pay those operating expenses before funds are available for debt service. Thus, in order to obtain a rating for the whole business structure, it is necessary to satisfy the rating agencies as to the reliability and predictability of earnings before interest, taxes, depreciation and amortisation (EBITDA). This creates a far more complex and layered rating analysis than merely stressing the cash flows of self-liquidating financial assets.

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In response to the core asset issue, whole business securitisations were structured to require the use of proceeds to pay off all existing long-term debt facilities of the operating company and covenants were imposed that prohibited any future incurrence of debt other than payables incurred in the ordinary course of business. If long-term debt at the operating company level is prevented, then the risk of a bankruptcy filing and the resulting invocation of the core asset doctrine is remote.

The responses to the EBITDA-based cash-flow modelling for whole business securitisation was to require sufficient over-collateralisation in order to permit the payment of higher-priority operating costs in the waterfall and to include a smaller variable funding note tranche as part of the whole business securitisation structure to fund temporary fluctuations in operating costs. An additional result was to permit only 'best of class' business concepts to enter the whole business securitisation market, on the basis that the stronger the business model of the sponsor, the more predictable EBITDA would be.

Another problem at the heart of whole business securitisation – indeed, the elephant in the room – is the dependency of the cash flow on the sponsoring company's operating performance, which is typically unrated or rated below investment grade. The response to this inherent weakness within whole business securitisations is best examined in the context of the Dunkin' Brands transaction.

Dunkin' Brands

Key features of the transaction include the following:

- All of the trademarks and franchises – as well as

the royalty payments and leases generated by the Dunkin' Donuts, Baskin-Robbins and Togo's fast-food franchises – owned by Dunkin' Brands Inc were transferred to SPVs and were used to secure the issuer's full debt service payments.

- The securitisation was used to repay a $1.5 billion acquisition debt incurred in a leveraged buy-out of Dunkin' Brands several months earlier by a consortium of private equity firms.
- The two senior Dunkin' Brands debt tranches achieved a shadow investment grade rating (enabling the issuer to obtain a AAA-rated monoline wrap), even though the parent company had only a B-rating due to the substantial leverage resulting from the leveraged buy-out.
- The notes were issued by Dunkin' Brands Master Finance LLC (a bankruptcy-remote subsidiary of the operating company), which was a parent of the three separate SPVs which owned the three classes of operating assets. The generation of revenue from all of the underlying assets was materially dependent on the operational function to be performed by Dunkin' Brands under a master management agreement.
- Standard & Poor's was able to reach a rating (unenhanced) of investment grade to the senior notes issued by the issuer SPV – a rating elevation of six notches above the rating of the operating company. Standard & Poor's had previously refused to give rating elevations more than three notches above the sponsor's rating where the performance of the securitised assets was dependent on the performance of the sponsor, but it achieved a higher elevation in the Dunkin' Brands transaction through the use of its newly published corporate securitisation criteria. The essence of Standard & Poor's rating methodology requires that the following factors be present in order to achieve comparable rating elevations:
  - Recapitalisation of corporate debt structure – a key fact that facilitated the rating elevations achieved in the Dunkin' Brands transaction was the use of securitisation proceeds to pay off third-party debt and the prohibition of incurring new debt at the operating company level.
  - Compelling business case – the business being securitised must have a dominant market position. This is necessary in order to support the conclusion that the sponsor company has the necessary incentives to affirm the master management agreement in the event of a bankruptcy filing and to support the projected EBITDA on which debt service will be based.
  - Strong back-up servicer – the rating agencies have taken comfort from a strong back-up servicer able to take over the management responsibilities in the event of the bankruptcy or default by the sponsor. This means that any company wishing to use whole business securitisation must be able to find a competent back-up servicer to sign on for these responsibilities and such company must be willing to share normally confidential client lists and proprietary products and business processes with the back-up servicer.

Fall and rebirth of whole business securitisation

With the financial collapse of 2008, whole business securitisations – along with securitisations of all other types – came to an abrupt halt, although the whole business transactions which closed prior to the financial collapse generally performed on schedule throughout the darkest days of 2008 to 2010. However, one casualty of the meltdown was the collapse and downgrade of the monoline insurance industry, with the result that there were commensurate downgrades of the whole business securitisation notes outstanding which had been wrapped by the monolines (usually the senior notes in multi-tranche structures). Additionally, because of the constrained secondary market, secondary market liquidity in whole business securitisation notes was non-existent or limited.

As the securitisation market began to re-emerge slowly in 2010 and 2011, whole business securitisations were among the first to re-enter the market. Although the essential structures for whole business securitisations post-meltdown remained basically the same, there were also some important differences.

Institutional investors are looking for yield and safety, and are finding both in whole business securitisation issuances

Since there are no monoline insurance companies left to wrap the senior notes, post-crisis whole business securitisation notes are being issued unenhanced. This means that AAA/Aaa ratings cannot be achieved and the senior tranche must be sold unenhanced with low to mid-investment grade ratings.

Due to the lack of monoline guarantees, investors interested in exposure to whole business securitisations must have the resources to understand the intricacies of the securities that they are buying rather than relying on the wrap. This can result in increased marketing periods. The absence of AAA/Aaa ratings has also reduced the investor base for whole business securitisations. This was expected to result in smaller deal sizes, although larger deals are possible for the strongest credits.

Another paradigm shift post-financial crisis is that since the monolines are no longer available to take the first-loss position on the senior tranche – which afforded them decision-making rights when deals moved sideways – the new whole business deals generally have third-party servicers charged with working with note holders and, in certain cases, taking action to address problematic situations where investors fail to give the trustee direction within a specified timeframe.

Drivers of growth

Structural innovation and breakthrough rating methodologies cannot by themselves drive issuance volume in any sector of the ABS market. What is required is a confluence of demand on the buy and sell sides of the market. From the issuer side, whole business securitisation

is attracting growing numbers of two different types of sponsor. The first are large public companies that are interested in converting floating-rate term debt to fixed-rate longer-term ABS financing as a defensive measure against rate increases by the Federal Reserve. Examples of this type of issuer include the following:

- The $1.15 billion securitisation sponsored by CKE Restaurants for its Hardee's and Karl's Jr franchise subsidiaries, which closed in April 2013 – proceeds were used to repay all existing debt facilities, with the balance of the proceeds to be used to pay transaction costs and to fund shareholder distribution. The transaction consisted of $1.05 billion of notes rated BBB- by Standard & Poor's and $100 million of variable funding notes, due September 2018. (To illustrate the benefits of whole business securitisation, CKE itself was rated B- by Standard & Poor's. Thus, the whole business securitisation achieved a six-notch rating elevation.)
- The $1.4 billion whole business securitisation for DineEquity, the owner of the Applebee's and IHOP brands, which closed in September 2014 – the transaction consisted of $1.3 billion of senior notes rated BBB by Standard and Poor's and up to $100 million of variable funding notes. Proceeds of the transaction were used to repay existing debt facilities, to pay the securitisation transaction costs and for general corporate purposes.
- The $2.6 billion securitisation sponsored by Dunkin' Brands, which closed in January 2015 – in a reprise of the seminal 2006 Dunkin' Brands transaction, Dunkin' Brands refinanced the earlier securitisation with bank debt and then went public in 2012. The 2015 whole business securitisation was issued in three tranches, with each tranche rated BBB(sf) by Standard & Poor's. The 2015 transaction differed from the 2006 transaction in several respects:
  - The SPV issuer owned the membership interests in various subsidiary SPVs, which in turn owned franchise agreements for the United States, the United Kingdom and Mexico, as well as real estate assets and intellectual property.
  - As a response to the absence of a monoline insurer to take action in the event of deficiencies in the performance of the manager, an independent third-party servicer was appointed to assume responsibility for instructing the trustee to take action upon certain occurrences. In the event of a manager default, the servicer as control party – acting at the controlling class representative's direction – may direct the trustee to remove the manager and replace it with a successor manager. The controlling class representative is elected by the controlling class note holders.

Traditional bank and high-yield financings are generally simpler and have a reduced timeline to execution than whole business securitisation

The second category are first-time or repeat issuers – generally smaller middle-market franchise companies seeking to lower the cost of their debt and to optimise their capital structure. A recent example of this type of issuer is the restaurant network, which sponsored a $300 million whole business securitisation, which closed in Summer 2014. This issue, which was rated solely by Kroll Bond Rating Agency, involved a similar structure to the Dunkin' Brands transaction, in that the operating company pledged nearly all of its revenue-generating assets to several bankruptcy-remote SPVs as collateral for the offered notes. The collateral, as in the Dunkin' Brands transaction, consisted of all existing and future franchise agreements and related intellectual property, as well as company-operated restaurants. The proceeds of this transaction were used to refinance the company's existing debt, significantly strengthening the company's coverage ratios and cost of funds, while also funding a distribution to shareholders. The notes were issued in two tranches, each of which was assigned a BBB rating by Kroll. The governance provisions of the transaction were similar to those of the 2015 Dunkin' Brands transaction, including an independent servicer which was authorised to take steps to install a successor manager in the event of specified manager defaults.

Other examples of whole business securitisation transactions closed post-meltdown (including some involving sponsors other than quick service restaurant companies) include the Sonic franchise securitisation, a timber asset securitisation managed by RLC Industries, the securitisation of Adams Outdoor Advertising's billboard revenues and the securitisation of Iconix Brand Group's copyright licensing revenues.

In addition to the lower cost of funds made available to the corporate sponsors by whole business securitisation as compared to regular bank financing, other advantages of whole business securitisation include:

- greater flexibility with respect to dividends and share repurchases;
- higher advance rate on a first-lien basis; and

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The Hooters restaurant network sponsored a $300 million whole business securitisation, which closed in Summer 2014 and used as collateral all existing and future franchise agreements and related intellectual property, as well as company-operated restaurants

- more flexibility regarding change of control.

However, the advantages do not run in only one direction; traditional bank and high-yield financings are generally simpler and have a reduced timeline to execution than whole business securitisation, except in the case of repeat issuers. Bank financing structures are also often pre-payable at par, whereas yield protection is built into securitisation structures. It is also possible that the change of control flexibility normally associated with whole business securitisation may come under increased scrutiny as a result of the acquisition of control of CKE restaurants from the prior owner by Roark Capital in late 2013, after the CKE securitisation was closed. This acquisition was made subject to the securitisation and left the securitisation intact, raising questions among some investors as to the risks associated with change of control as private equity funds buy and sell their positions.

From the buy side, whole business securitisation has become an equally compelling story. As the low-interest rate environment continues as of the time of writing, institutional investors are looking for yield and safety, and are finding both in whole business securitisation issuances. Many of the securitisations mentioned in this article which were issued over the past three years met strong demand in the institutional investor market and were oversubscribed by between two and four times. The strong performance of whole business securitisations during the financial meltdown provides strong support for this investment thesis. In the secondary market these securities have also performed well. As an example, between 2012 and 2013, yields on whole business securitisation paper in the secondary market experienced a sustained rally, with trading yields falling from an initial yield at closing of 4.5% to between 2.5% and 3% in the secondary market on some whole business securitisation paper.

As the structural features of whole business securitisations have solidified and market conditions are strong, whole business securitisations should be an attractive financing option for operating companies in other market sectors. **WTR**

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