

Research Report:

# The new voice of the invoice

issue no.

# 01

This research report by Demica examines the changing perception of Corporates towards 'trade receivables securitization'. It identifies the historical burdens associated with securitization and the market drivers that are eroding these perceptions. The report also examines predicted growth rates and the rising enthusiasm amongst European Corporates for invoice securitization.

## Key findings

- Almost a fifth of top European corporates have to date conducted a securitization.
- Invoices (trade receivables) are the most popular asset for corporate securitization.
- Access to alternative lines of credit is perceived to be a more important driver for a securitization than reduction of interest costs.
- Companies no longer believe that invoice (trade receivables) securitization is only for the largest corporates.
- Invoice securitization and asset based lending growth is expected to accelerate to the end of 2005.
- Corporates are concerned about the perceived administrative burden of securitization and maintenance, indicating a need for greater awareness of proven “securitization processing models”.

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## Introduction

Despite clear signs of economic recovery in the European Union and the US, companies remain under considerable financial stress. Since the turn of the millennium, where equity funding was readily available, a lot has changed in the world of corporate working capital finance. In most Western European states, bank finance is becoming increasingly difficult and expensive to obtain. Covenants are more strictly enforced and funding costs have increased. Numerous industry sectors have taken on large swathes of debt which, during the economic downturn, has become very burdensome to service.

That debt is the result of various factors – 3G licenses, over-optimistic retail expansion, Leveraged Buyouts, amongst others. A further result of poor trading conditions is the phenomenon of the ‘fallen angels’ – companies whose credit rating has been radically downgraded over the period, often to sub-investment grade status. Corporate bond issues have been increasingly discounted for these companies. Finally, in certain countries, structural changes in the banking system added a final blow. For instance, the post-war risk support offered by the German government to lending banks is finally being withdrawn, making it imperative that those banks lend at economic and more precisely risk-weighted rates. This, in combination with a severe economic downturn, has been a major contributory factor to Germany’s recent credit squeeze. On an international level, some pundits expect the forthcoming capital adequacy strictures of Basel II and CAD 3 to bump up the cost of borrowing for financially stretched companies.

## Attitudes to Asset Backed Finance

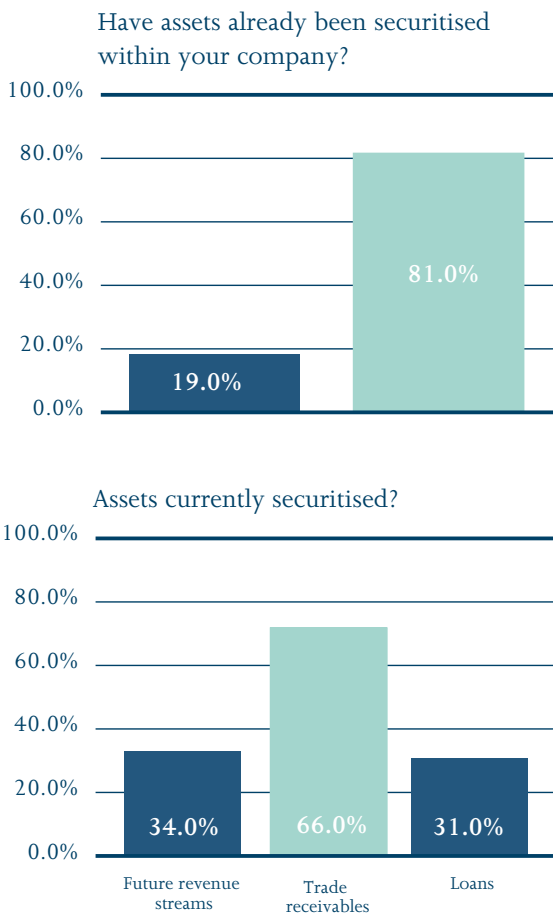
Taking the above factors into account, corporations large and small have been eagerly seeking alternative, less costly lines of working capital finance. Securitization of corporate assets, which enables better rated asset-backed finance to be raised from the capital markets, has appeared onto the radar of most financial managers. Two factors however decelerated the take-up of the securitization option. The first of these factors was the well publicised abuse of Special Purpose Vehicles (SPV’s) in recent accounting scandals, where certain mechanics of securitization were used to reengineer the balance sheet, rather than “true financing”. Secondly was the perception of securitization as complex, costly and the fact that it would tie up intolerable amounts of processing time for internal financial teams, already under pressure from current or impending financial regulatory compliance.

Despite these two perceived ‘problems’, securitization is, in fact, growing steadily. Statistics from the European Securitisation Forum show that the European securitization market is expected to grow by 19% in 2004. Evidently, corporate financial managers are overcoming their uncertainties and discovering securitization solutions/models that are not so burdensome.

Demica decided to commission a research project that focused on three key areas: what proportion of top European companies had actually started to use securitization; what did they perceive as the main benefits of (and obstacles to) securitization; and how did they expect it to grow through to the end of 2005.

## Current use of Securitization

Use of securitization was revealed to be past the ‘pioneer’ stage, but with very substantial potential for future take-up. To date, some 19% of top European companies have securitised assets within their company. Of course, there are a number of different assets that can be securitised, so our research also asked respondents about the nature of the assets employed. Overwhelmingly, the first choice was trade receivables (invoices) securitization (66%), with future revenue streams (34%) and loans (31%) trailing at some distance behind. Given the views received during this research exercise, the authors of this report expect the gap to widen, with invoice securitization becoming even more of a distinct front runner.



## Why Invoice Securitization?

Anecdotal feedback suggests two distinct reasons for this favouring the securitization of invoices. The first of these reasons is geographical. The UK has an established “invoice discounting” industry, where invoice debt is bought from the invoice issuer, but the responsibility for collecting that debt remains with the issuer rather than passing to the invoice discounter. This contrasts with factoring – a Europe-wide industry – where the purchaser of the debt also collects the monies. The attraction of invoice discounting for corporates is that the sale of invoice debt is never divulged to its customers, but the working capital finance is nevertheless available. Until recently, invoice discounting has not been possible in civil code jurisdictions in continental Europe. This was due to the fact that it was difficult to prove the legal separation of invoice debt purchased from a third party from the company that originally issued those invoices. Recently, however, the stringent reporting requirements of a securitization (combined with technology that facilitates the reporting process for the issuing company) have been accepted as legally robust proof of ownership of an invoice pool in Germany, France, Italy, Spain and other European countries. As a result, invoice discounting has now become an available working capital finance product in continental Europe, and its growth is rapid.

The latter reason for the enthusiasm to securitise invoices is simply a matter of credit rating. We have remarked that over the last four years, many companies have come under greatly increased financial pressure. In some cases, debt has risen, while revenues have stagnated, making the burden of servicing that debt progressively more difficult. The post millennial trend of debt-financed takeovers (known as leveraged buyouts, LBOs) has also created additional interest exposure for many firms. Even if a large amount of debt has not been accumulated, the cycle of market change and the ease of entry for competitors in many industries have both continued to grow, affecting cash

flow and margins, therefore driving the need to find alternative working capital finance options.

We have outlined the fact that many companies have seen their credit rating downgraded as a result of this mounting financial pressure. The legal separation of a securitised invoice pool from the issuing company has the advantage of releasing that debt-asset from the millstone of the company's credit rating. In short, the debt is rated according to the credit quality of the debtors, not of the issuer, with the consequence that the finance is AA or AAA rated.

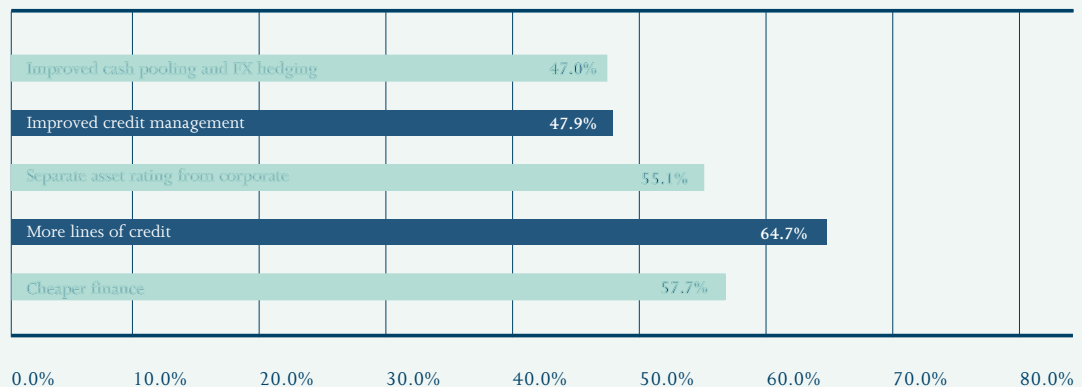
## Advantages and Disadvantages of Invoice Securitization

Emphasising the extent of the credit squeeze that European corporates have been experiencing, our survey found that “access to finance from a source other than your relationship banks” achieved an even greater importance score (64.7%) amongst senior financial managers than “access to cheaper finance” (57.7%). In other words, while a prime objective of invoice securitization is evidently to reduce interest cost, widening the range of credit lines available was even more important. In line with our observations

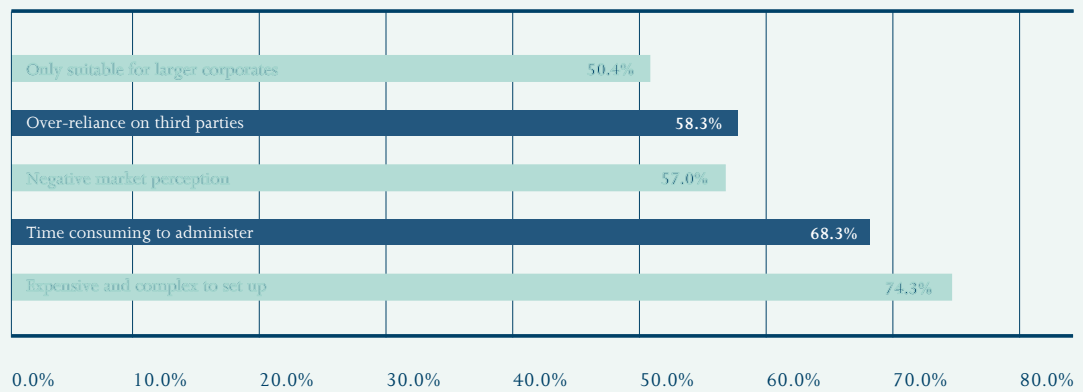
above on the credit rating issue, “separation of the asset from the corporate credit rating” was deemed the third most important advantage of invoice securitization (55.1%) according to our respondents.

Our research also tested the level of the perceived negatives of invoice securitization amongst corporate financial managers. Overwhelmingly in the lead were “expensive and time consuming to set up and administer” (74.3%) and “time consuming” (68.3%). This perception in itself is intriguing, given the number of well publicised cases in the UK and Germany where the only pressure on the internal finance team was to deliver a daily text file of the sales ledger. The authors of this report surmise that the combination of compliance with new financial regulations, plus concerns over increasing interest cover, are so time consuming for financial managers, that they have little time to actively seek alternative lines of credit. Therefore both vendors and the corporates own industry associations bear a considerable responsibility to make companies more aware of the various alternative working capital solutions (including invoice securitization) available. Nevertheless, our research did reveal that the notion that “securitization only applies to large corporates” is already on the decline – a positive sign that former receivables financing perceptions are changing.

Advantages of invoice securitization



Disadvantages of invoice securitization



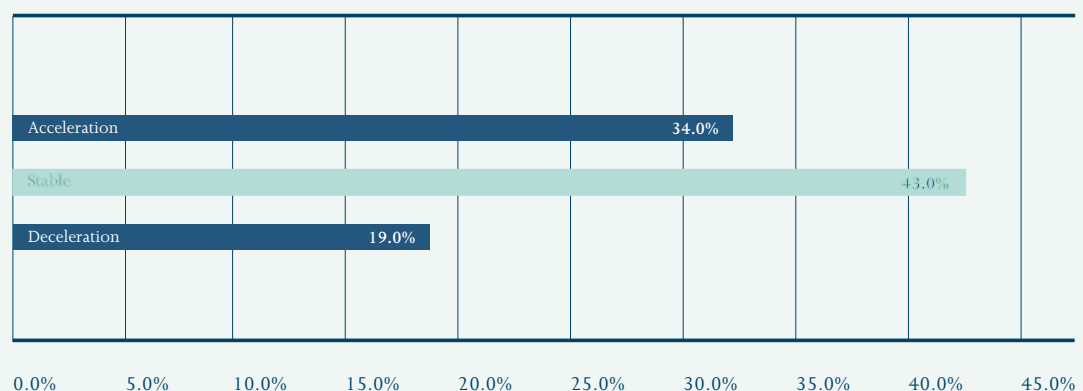
## The Future of Invoice Securitization in Europe

Invoice securitization is set to grow substantially over the next two years. Just over a third of our respondents saw growth rates increasing, two fifths thought they would hold at current levels, and only a fifth saw any deceleration. Interestingly, a number of our respondents who had already conducted an invoice securitization reported that they had stopped some way short of securitising the whole of their eligible book, choosing

to retain the flexibility to increase this line of finance in the future – in some cases by up to 50%.

Whilst suggesting that financial regulation may be taking up much of the financial manager's attention, our respondents firmly told us that there was no causal link between compliance and securitization growth. This remains firmly the province of reducing interest cost and widening the lines of credit available to a company.

Change in current invoice securitization growth rate to 2005



## Conclusion

This report strongly highlights the growing enthusiasm amongst European corporates for invoice securitization, employed as a true finding tool rather than balance sheet engineering. Asset-backed working capital finance is focusing on the invoice as the most effective security to employ to reduce interest costs. Growth is predicted to be strong. This growth however has the potential to accelerate dramatically if entrenched views on the “perceived” complexity and administrative burden of invoice securitization are reversed. In the light of recent case study, examples demonstrate these perceptions are unfounded. Market drivers of securitization are various, ranging from sheer debt burden, to market downturn, to realising value from LBOs. Finally, it is just an important for the corporates to increase their lines of credit, as it is to reduce their overall cost of borrowing.

## Methodology

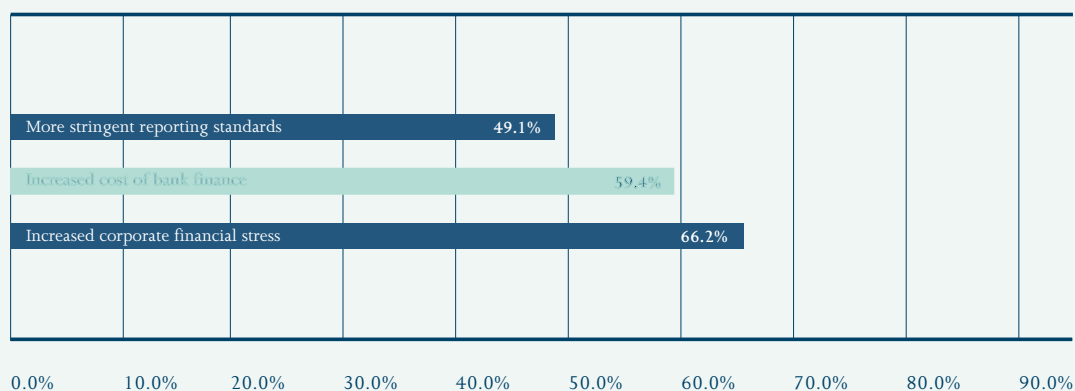
The methodology deployed for this study embraced both primary and secondary market research and included telephone and email interviews. The survey period ran from January to February 2004 and was carried out by MarketingUK.

- Primary research was conducted amongst European top 1000 companies in order to ascertain:-
  - Percentage of companies that had conducted a securitization (receivables financing)
  - Types of asset securitized
  - Perceived advantages and disadvantages of securitization (asset based lending)
  - Securitization market growth expectations
  - Drivers of securitization (sales of receivables)

### Third party research sources included:

- The International Securitisation Forum
- The International Federation of Stock Exchanges
- The Chartered Institute of Management Accountants
- Association of Corporate Treasurers
- AMR Research
- The Bank for International Settlements
- Central banks in major European countries
- KPMG -
- PricewaterhouseCoopers
- TowerGroup -
- Bloomberg -
- Standard and Poors
- Moodys

Drivers of invoice securitization to 2005



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Demica are leading specialists in trade receivables securitization factoring and global credit management. We provide expert consultancy and technology solutions to an international client base comprising major banks, corporations and financiers. Demica's intelligent working capital management solutions, enable clients to arrange and execute optimal financing structures based on real-time reporting of trade receivables data. Demica has consulted with and deployed its technology in many of the leading European and US investment banks, and currently runs several billion of rated transactions for blue chip institutions on its Citadel® platform. Demica is a wholly owned subsidiary of the J.M. Huber Corporation, one of the largest privately held companies in the United States. Demica currently has offices in London, Dublin and Tokyo.



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