

Research Report: Atlantic Connection?

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07

Trade receivables securitization
– a comparison between top US
and European companies.

Key findings

- Trade receivables (TR) securitization is now a mainstream financing tool both in the US and Europe.
- TR securitization is used by top 500 non-financial companies in the US and Europe as a means of accessing greater liquidity to fund growth.
- The assumed gulf between the securitization levels in the US and Europe is far less evident between top companies in the two regions than is commonly supposed.
- 17% of US top 500 (non-financial) companies have conducted a trade receivables securitization in the last ten years, compared with just 11% who have utilised receivables financing in Europe.
- The technique is equally popular with investment grade rated companies than with sub-investment grade companies seeking reasonably priced liquidity.
- 23% of respondents are principally looking to technology to deliver economies of scale and increased profitability.
- Impending Basel II transparency requirements are expected to boost the attraction of publicly rated notes backed by trade receivables.

Note: This research report gives a relatively conservative view of TR securitization take-up, as the technique is also popular with the increasing proportion of companies that have been taken private in Leveraged Buy-Outs (LBOs), whose accounts are not publicly available. The take up of asset based lending and receivables financing is conservatively reflected.

Introduction

In its review of trade receivables activity over the previous ten years, Standard and Poors remarked at the end of 2004 that “In Europe..... companies who have trade receivables securitization programs treat them as an important source of financing. This is highlighted by the fact that the companies who went through the corporate reorganisations of the last eighteen months (for example Buhrmann N.V.) decided to retain their securitization programs as a source of alternative finance for the future.”¹

So in 2006, will the S&P prediction of TR receivables growing as a mainstream financing tool continue? Also, will the US, home to the origins of such securitization programmes, advance further than its European equivalent?

In order to bring further clarity to the issue, and to test the common preconception that the US leads Europe in the securitization field as a whole by some considerable margin, Demica commissioned research to review the history of securitization in both regions, and then specifically investigated the level to which top corporates had used trade receivables securitization over the last decade.

Before embarking on the main part of this research report it is imperative to establish a picture of the size of the ABS market backed by trade receivables, as well as the balance between methods of bringing such credit instruments to the investor. Pools of receivables (whether from one or many companies) that are isolated from the issuer and then brought to market as a term instrument (a bond), remain in the minority. Only in the most recent years have the structural and – more importantly – reporting requirements of this approach been overcome, and the market is gradually utilising these capabilities. However, the vast majority are still brought to that market through asset backed commercial paper conduits, where a bank provides backstop liquidity, assuring the paper’s high credit rating.

Standard and Poors, in another report, summarises the situation: It notes “In Europe...the total amount of outstanding rated notes has surpassed €5 billion, accounting for 2.4% of rated outstanding ABS issuance. ABS issuance backed by trade receivables is expected to grow, as we expect transactions to close in 2006. We saw an increase in term-trade receivables over 2003 and 2004 but they remain difficult transactions to execute because of some key risks, e.g., commingling, reporting, and audit requirements. Those trade receivables securitised in ABCP conduits are expected to continue to form a large part of the asset composition of such programs, currently more than 14%.”²

This management summary briefly reviews the history and drivers of securitization in the US and Europe, before moving on to look specifically at securitizations backed by trade receivables and comparing the proportion of companies utilising this financing technique on the last decade across both geographies.

Securitization in the US

The US market for securitization is relatively more mature in comparison to its European equivalent and has experienced sustained and consistent growth over the last two decades. This relatively more mature state has been the result of state sponsorship, plus the scale and ease of securitizations. It is likely that, despite the very rapid growth being experienced by European securitization markets, the USA will maintain its lead well into the next decade.

Globally, the largest market for securitised instruments is the United States where issuance accounted for 75% of the global issuance of securitized instruments in 2004, while the country accounts for just under 30% of world GDP. It is expected to attain similar proportions in 2005.

In the United States, the catalyst for securitization was the Government's drive to encourage home ownership.³ This goal was enabled by the creation of a secondary market for mortgages (i.e. the MBS market). In addition, this government sponsorship resulted in the creation of various agencies that set standards and provided credit guarantees for loans, which provided consistency in the structure and provisioning of early securitization transactions. This has proven to be invaluable in creating standardised legal and financial processes that underpin today's securitization sector in the United States.

The first securitization in the US occurred in 1970, with the market for securitised instruments growing rapidly from the 1980s onwards. The fourteen years from 1990 to 2004 saw an increase of 707 percent or an annualised rate of growth of 16%.⁴ As the market grew in size, it expanded from simply pass-through securities to more elaborate tranching pay-through structures, and from a market based on mortgage assets, to one that includes a great many diverse assets including credit card debt, manufactured housing loans, trade receivables and manufacturing inventories.

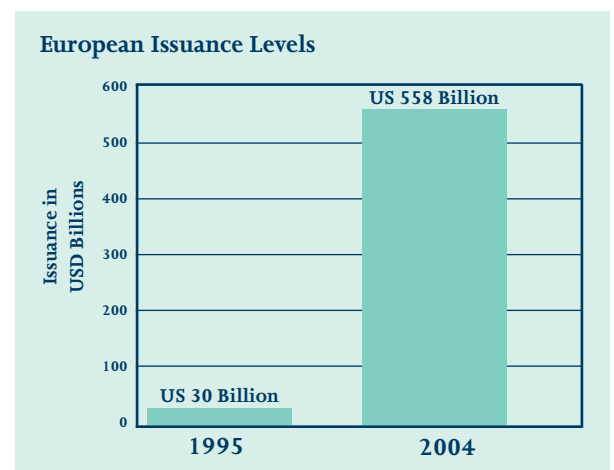
Latest analysis from Thomson Financial reveals that the U.S. asset-backed securities market in 2005 swelled to a record \$1.1 trillion of issuance - exceeding analyst expectations from last year and for the first time reaching into the trillion dollar range. Many firms had felt 2004s then record-breaking \$873 billion of issuance would be unbeatable last year, but major issuers such as Countrywide Financial Corp., which brought more than \$93 billion to the market in 2005 and underwriters such as Citigroup, which sold \$98.5 billion, helped push the bar even higher.

³ Andrew Davidson, *Securitisation: Structuring and Investment Analysis* (2003).
⁴ Milken Institute, 2005 Capital Access Index, October 2005. ⁵ Milken Institute, 2005 Capital Access Index, October 2005. ⁶ An Analysis of the Treatment of Securitisation under the Proposed Basel Accord, April K. Rinne, April 2004.
⁷ Annualised estimate based on data from the European Securitisation Forum, ESF Securitisation Data Report, Autumn 2005. ⁸ Milken Institute, 2005 Capital Access Index, October 2005.

Securitization in Europe

The importance of securitization as an indicator of economic vibrancy is well argued in a paper from the Milken Institute⁵ which points out that access to capital is significantly higher in countries which are most active in the issuance of securitised instruments. The US and the UK have both achieved top ranking for capital access in the last three years, the former being the global focus of the securitization market, and the latter in Europe. Other authorities have stated that "one result of the fact that securitization furthers the development of disintermediation by making financial flows less dependent on specialised lenders is the enhanced adaptability of the economy during periods of stress."⁶

In contrast, European ABS issuance in 2005 is expected to be in the region of €136 billion⁷ (\$164 billion), just 15% of the US equivalent, however exhibiting even stronger growth rates. Western Europe accounts for 32 percent of 2004 GDP but 20 percent of 2004 issuance of securitised instruments (ABS and mortgage-backed securities). The first securitizations to occur were the 1980s issuance of mortgage-backed bonds in the United Kingdom. From 1995 to 2004, new issuance rose from \$30 billion to \$588 billion, representing 24 percent annualised growth and an overall increase of 1,860 percent.⁸



Source: Milken Institute, 2005 Capital Access Index, October 2005

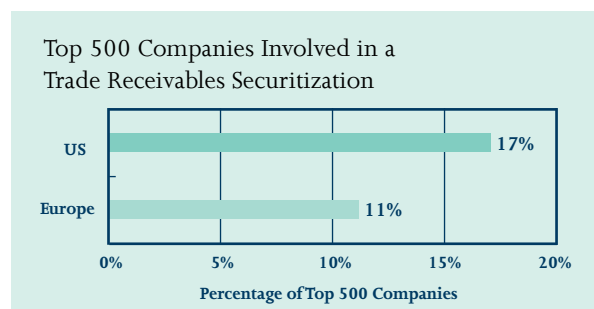
This period also saw the development of a number of innovations in the Western European market, including whole business securitization and the creation of credit derivatives. New issuance of securitised instruments is concentrated in four countries in the region – the United Kingdom, Germany, Switzerland and France – which together accounted for an average of 72 percent of new issues from 1990 to 2004, yet represented 59 percent of real GDP for the region over the same period.⁹

According to a survey by Barclays Capital¹⁰, a broadening of the investor base has coincided with the phenomenal growth in European ABS volumes and that volume is set to grow even bigger on the back of new participants gaining a foothold in European issuance. According to the survey results, the average expectation of growth over the next 12 months is approximately 40%, with the weighted average growth at the lower rate of 21%. The same industry commentator commented recently that, "Some of the smaller and newer players expect to double their business but for the larger more established buyers it is a bit more difficult to achieve that type of growth".

Comparing the US and Europe - Gulf or Proximity?

The gulf between ABS volumes in the US and in Europe narrows considerably when we take the more specific area of trade receivables securitizations. This report from Demica has revealed that trade receivables (TR) securitization has matured into a mainstream financing tool for top US and European corporates. In terms of the number of leading firms that have utilised this financing technique over the last decade, Europe is not as far behind the US as is commonly assumed. Moreover, this report was confined to publicly quoted companies only, and hence resulting figures represent a somewhat conservative view of the market as they exclude the increasing number of private equity-backed companies, who are increasingly turning to TR securitization as a means of easing the pressures of senior debt.

The research, conducted by trade receivables securitization specialists Demica during January 2006, analysed the top 500 companies of both the US and Europe, (excluding financial organisations), to conclude that 17% of these top US organisations had employed TR securitization during the last decade. At 11%, Europe's growth clearly shadows that of the United States, already representing two thirds of the US level in terms of number of organisations, although somewhat less in asset volume.



Source: Demica Desk Research - Company Annual reports, January 2006

Notably, the research revealed that 67% of the firms who were using, or had previously used TR securitization were investment grade rated. This tends to counter the generally held view that TR securitization is mainly undertaken by companies whose access to conventional borrowing is either restricted or excessively expensive¹¹. The report concludes that the technique is as often used by less pressurised corporations (financially speaking), to extend their access to liquidity, as by organisations who are using securitization to isolate a highly rated asset (the receivables) from their own (lower) credit rating. Evidently, sub-investment grade companies (defined as S&P as BBB- or below) continue to find the technique immensely beneficial for providing low-cost liquidity. Notably, the broad technology sector (including all high tech sectors through from air-conditioning to IT) represented 47% of the total of sub-investment grade firms.

⁹ Milken Institute, 2005 Capital Access Index, October 2005. ¹⁰ Barclays Capital, European ABS investor survey, December 2005. ¹¹ Andreas A Jobst, What is Structured Finance?, Federal Deposit Insurance Corporation, September 2005.

A minority of TR securitizations are issued as publicly rated term instruments, the large majority being issued through conduits (and therefore privately rated). In Europe, as remarked in our introduction, Standard & Poors identified €5bn of rated notes, estimating some €31bn in issuance via conduits. This may change with the advent of Basel II, which has been identified by expert commentators as a factor that will lead to increased attractiveness of issuing publicly rated notes¹².

Private equity activity has seen a major upsurge in 2005¹³ which is expected to continue throughout 2006. This masks a further tranche of TR securitization activity, as private equity owned companies use the technique to carve out elements of senior debt which could potentially restrict rapid growth strategies and investment. There is substantial anecdotal evidence that many large private companies (particularly in Europe) have securitised receivables. This includes a significant number of post-LBO names, which although are rated sub-investment grade, are increasingly using TR securitization to optimise their capital structures to reduce their weighted average cost of debt. These transactions are typically financed through bank conduits and are AA rated. This is achieved through a combination of innovative transaction structuring and high frequency reporting (daily) which allows for proper segregation of assets from the company. This higher rating is the appeal that TR Securitization holds for the big LBO firms.

The advent of regulatory pressure (Basel II, IFRS) which is a result of the quest for increased transparency and risk management, as well as investor requirements for monitoring their assets, is increasing the reporting requirements from TR securitizations. Daily updates – which have the capability to drill down to item level – are typically a component of the administrative process.

Conclusion

The research concludes that there is a balanced geographical spread to trade receivables transactions – term and conduit - and that Europe and the US are more aligned than perhaps is commonly perceived. Not only is the technique now mainstream in both the US and Europe, but is also mainstream for investment grade firms as an extra line of liquidity to fund future growth. Naturally, the portfolio of working capital management techniques varies geographically, however it would appear that a substantial proportion of large companies are exploiting the value of their invoices as real assets, to the fullest extent. In the quest for growth (both in US and Europe), senior financial managers and their advisors are keen to apply the broadest possible range of complementary working capital tools.

US securitization volumes are likely to stay ahead of those in Europe for some years. The US provides scale of operations across a very large geography that embraces the largest economy in the world. The legal framework is consistent across North America, and there are no currency differences. Nevertheless, the US has provided a lead for Europe that region is keenly following – so keenly in fact, that cross-borders differences are being harmonised in order to provide the consistent playing field necessary to emulate the US scale of securitization. Specifically in the area of trade receivables securitization, Europe is not closer to the US than has been previously recognised – at least in terms of the number of participants.

¹² Fitch Ratings, Basel II: Bottom-line Impact on Securitisation Markets, September 2005. ¹³ Candover/Incisive Media, A Record Year for European Private Equity, January 2006. CNN Money, Outlook Rosy for 2006 M&A Activity, December 2006.

Appendix 1 - Sector Breakdown

There was no significant difference between the US and Europe in terms of the sectors represented.

Looking at the total sample (US and Europe), the significant sectors are:

SECTORS	%	EXAMPLES
Technology	17%	Jabil Circuit, SunGard, ABB
Telecoms	12%	KPN, Telecom Italia
Chemicals	10%	Huntsman, Solvay, Celanese
Utility	9%	E.on, Union Fenosa
Automotive	6%	Volkswagen, Renault
Medical	6%	Fresenius, Amerisource Bergen
Extraction Industries	6%	El Paso, Sunoco
Retail	6%	Sears, Ahold
Food Manufacturing & FMCG	4%	Dean Foods, Danone
Media & Advertising	4%	WPP, Viacom
Transport	4%	CSX
Packaging	3%	Rexam, SCA
Steel	3%	Corus, US Steel

Other sectors represented are:-

- Toys
- Tobacco
- Jewellery
- Materials
- Construction
- Catering
- Engineering

Appendix 2 – Methodology

The sample was composed of all non-financial companies in the US and European top 500 publicly quoted firms (as defined by The Financial Times in its annual listing).

Each company was investigated to discover if they had conducted a trade receivables securitization in the last ten years.

The resulting group of companies were subsequently analysed according to their industry sector and current corporate credit rating, to produce the statistics outlined in this report.

All third party research which was used to compose this management summary is formally referenced in footnotes to the text.

All research for this report took place between December 2005 and February 2006.

www.demica.com

Demica provide market leading expertise in trade receivables securitization and invoice discounting solutions. Advising the world's leading investment banks, private equity firms and global corporations, Demica enable clients to arrange and execute optimal financing structures based on real-time reporting of trade receivables portfolios. Combining expert consulting with market leading reporting solutions, Demica advise on the feasibility, structuring and implementation of trade receivables transactions.

Demica's technology platform Citadel® is deployed internationally, currently running in excess of €9 billion of rated transactions. 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 located in Dublin, London, and Tokyo.

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