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The International Comparative Legal Guide to:

Securitisation 2018

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EDITORIAL

Welcome to the eleventh edition of *The International Comparative Legal Guide to: Securitisation*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of securitisation.

It is divided into two main sections:

Five general chapters. These chapters are designed to provide readers with an overview of key securitisation issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in securitisation laws and regulations in 27 jurisdictions.

All chapters are written by leading securitisation lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Sanjev Warna-kula-suriya of Latham & Watkins LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

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Unlocking Value in Private Equity Transactions

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Introduction

It may well be the right time to consider using securitisation to unlock value in private equity transactions. The global economy and financial markets continue their robust growth, and the legal framework for securitisation continues to be stable and even welcoming – witness, for example, the recent publication of the EU's new rules for simple, transparent and standardised securitisations (the "**STS Regulation**", available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=EN).

We discuss in turn below how securitisation can be a valuable tool in support of the private equity sector in the following two principal areas:

- securitisation as a means of financing or refinancing all or part of acquisitions of portfolio companies by private equity houses; and
- securitisation as a means of realising value in private equity investments.

Acquisition Financing

Private equity backed acquisitions customarily involve an equity component and a debt component. Typically, the "true" equity component of an acquisition will be provided by one or more limited partnerships using funds raised and managed by private equity sponsors for that purpose. In some cases, these limited partnerships will incur debt financing against either the investment commitments from limited partners or the limited partnership's investments, or both, using securitisation structures and techniques. In that manner private equity sponsors can leverage their equity funding even before it is invested in acquisitions.

The debt component of a private equity acquisition will typically be provided in the form of leveraged loans (whether senior or subordinated, first or second lien), high yield bonds, or some combination thereof. Of course, funding which acts like equity for purposes of the senior debt financing can also be provided in the form of debt incurred at one or more parent companies and then downstreamed to the acquisition vehicle, creating so-called structural subordination. Financing will be incurred at various stages in an acquisition, from the initial bridge financing, to the more permanent take-out financing, to incremental financing which permits the private equity sponsor to extract some value after a period of initial success with an acquisition, to refinancing all or any of that debt, and, finally, to funding as part of an exit from an acquisition.

Due to its structural integrity, securitisation customarily incurs lower funding costs than leveraged loans or high yield bonds. Securitisations generally result in highly-liquid assets (for example, customer payables that turn into cash within a few months) being ring-fenced from the other credit risks of the target group operating companies. The more homogenous and predictable the cash flows from the receivables, and the more impenetrable the ring-fencing, generally the lower the cost of the financing. As securitisation financing can help lower the average cost of debt in an acquisition, securitisation financing permits private equity sponsors to bid more for target groups or can help private equity sponsors increase returns on equity, or potentially both.

While securitisations can play an important role in each stage of financing, the complexity of structuring and documenting securitisation transactions means that they are more likely to be used at the permanent financing stage or thereafter, and not at the bridge financing phase when speed is essential. That being said, lawyers at this firm have completed so-called "bridge" securitisation financings which later transformed into permanent securitisation financings once certain longer-term conditions were satisfied (and at which time the advance rates in the securitisations increased and funding costs decreased).

Raising financing via the securitisation of trade receivables alongside leveraged loans and high yield bonds in private equity acquisition transactions is now very widely used, and we have written extensively on the issues involved in documenting such transactions (e.g., see our chapter for the 2017 edition of this guide, titled *Documenting Receivables Financings in Leveraged Finance and High Yield Transactions*). Typically, the package of operating covenants for such securitisation transactions will be lighter than the covenants for leveraged loans, and even high yield bonds, and such transactions may or may not have financial covenants given their focus on ring-fenced short-term receivables. It has, for example, become typical for an acquisition to be completed using leveraged loans and/or high yield bonds, and then at a later date to use the proceeds of a trade receivables securitisation to fund a shareholder dividend.

Securitisation financing can also be raised via so-called "whole-business" securitisations in which a special purpose vehicle is established to lend, to the target group, funds raised via rated debt securities secured over the assets of the target group. The cash flows of the target group as a whole are then applied to repay the loans to the issuer and the rated securities to investors. Operating and financial covenants for a whole-business securitisation tend to be largely similar to those for the leveraged loans. Whole-business securitisations generally require target groups having stable cash flows and strong market positions (including high barriers to entry). Liquidity supporting the rated securities will be essential, and there may be some sort of credit enhancement depending on the target group involved.

Similarly, securitisation financing can be raised via so-called "Opco-Propco" structures, pursuant to which a target group is split into a property-owning part and an operating part. The property-owning part raises funds via rated debt securities secured over the properties. With the proceeds of the securities, the property-owning companies then acquire the properties and lease them to the operating part of the group. Rent on the leases is then applied to repay the securities to investors. Operating and financial covenants tend to be largely similar to those for the leveraged loans. Opco-Propco securitisations generally require target groups to have stable cash flows and strong market positions (including high barriers to entry) in addition to properties that can be sold should cash flows be insufficient to service the securities.

Finally, debt financing for private equity acquisitions is often raised by securitising the leveraged loans originally provided by lenders in the acquisitions. In fact, collateralised loan obligations, or CLOs, are now one of the biggest buyers of leveraged loans. With increasing frequency, leveraged loans are being acquired by specialist funds established by private equity sponsors for the purpose of acquiring and securitising leveraged loans and acquiring equity tranches in CLO transactions.

A traditional CLO transaction begins with a fund manager establishing a warehouse facility, usually with an arranger, pursuant to which leveraged loans are acquired from the secondary market (often, right after the loans have been made at the time of the acquisition). Once a sufficient volume of loans has been acquired, the arranger helps a special purpose vehicle issue rated securities to investors secured by the loan portfolio. The proceeds of the securities are used to repay the warehouse financing and, often, to acquire more loans during a brief ramp-up period which follows. The manager will then reinvest the proceeds of loan repayments and loan sales over a several-year reinvestment period, and thereafter the CLO will be repaid as the loans are repaid.

Specialist private equity sponsor vehicles are a more recent phenomenon. Originally set up to hold retention tranches in CLO transactions in order to meet the requirements of the EU (and, later, the US) risk retention rules, these vehicles gradually became long-term owners of leveraged loans and other non-securitised investments in part due to the EU requirement that "originators" (one type of entity permitted under EU rules to hold 5% retention interests) not be "solely" in the business of securitising assets. A number of private equity sponsors have established such vehicles which not only provide an additional source of financing for their own acquisitions without using their own balance sheet or limited partnership funding, but can also earn several layers of management fees and even access the (leveraged) excess spreads generated by the underlying assets by holding some or all of the equity in the specialist vehicle.

Realising Value

A private equity sponsor can use securitisation to realise the value of its investments in several ways. For example, the sponsor can, when selling a target group, encourage bidders to include one or more of the forms of securitisation financing described above to maximise the sale price. In addition, private equity sponsors can securitise their investments in target groups by selling those investments to special purpose vehicles established for the purpose of acquiring such equity interests. Such vehicles, sometimes known as collateralised fund obligations, or CFOs, acquire such equity interests with funds raised in the capital markets (whether or not publicly rated) or through bank financing.

The benefits of such vehicles to private equity sponsors are manifold, in addition to those described above (e.g., earning management fees). For example, whilst the primary route to realising value in investments will remain an M&A or capital markets transaction in relation to a single portfolio company, sponsors may be able to use such vehicles to monetise all or part of a portfolio investment earlier than the capital or M&A markets might otherwise allow. Such vehicles might permit a sponsor to dispose of part of a portfolio investment without losing control over the remainder. Alternatively, such vehicles might permit a sponsor to dispose of control of such a portfolio investment (and, depending on the facts, achieving off-balance sheet treatment of the target group) while retaining a minority investment and thus participating in future profits. Finally, a sponsor might be able to negotiate a right to repurchase assets from the vehicle and thus enhance the sponsor's flexibility and the potential profitability of an alternative exit in future.

In order for such vehicles to appeal to and successfully perform for investors, however, they will need to apply a variety of securitisation techniques. The cash flows from private equity investments are more unpredictable than from debt investments for several reasons, and their value is more volatile. Thus, as diverse and granular a selection as possible of underlying assets is needed. Moreover, the portfolio should have an expected realisation profile which smooths out the cash flows to be received by the vehicle to the greatest extent possible. Even then, a liquidity facility to pay interest in a timely manner on the most senior tranche of debt securities, as well as perhaps even a funding reserve or other credit or liquidity enhancement, will likely be needed. Over-collateralisation requirements are greater than for normal CLOs.

The structure customarily involves the transfer of limited partnership (LP) interests by the private equity sponsor to a special purpose vehicle. In most cases the general partner (GP) of the limited partnership will be required to consent to such transfer and also to the subsequent creation of security over the LP interests in favour of the security trustee for the securitisation. Additional points for due diligence are the provisions for "clawback" of distributions made to limited partners, and indemnities given by LPs in the partnership agreement – these features, which do not exist in normal CLOs, are factored into the rating analysis for CFOs. The structure will include over-collateralisation (OC) and Interest Cover (IC) tests similar to those used in CLOs and, sometimes, additional leverage ratios which need to be satisfied to permit distributions to the equity holder. Hedging for FX exposure may be avoided because of the significant equity cushion used for over-collateralisation.

Conclusion

Securitisation provides multiple tools for private equity sponsors to achieve higher bid prices, higher levels of acquisition financing, lower costs of funding, earlier monetisation of investments, and higher returns to investors. Securitisation transactions can at times be more difficult to structure and complete than other forms of financing, but it is always an option worth exploring carefully.

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Mr. Warna-kula-suriya advises clients across a wide range of asset classes and structures, including public and private debt, equity-linked and hybrid capital markets issues, securitisations, CMBS, cash and synthetic CLOs, OTC and exchange-traded derivatives, and cross-border structured finance.

He also has significant expertise in the sale and purchase of financial asset portfolios, distressed investments and restructurings, and the establishment of alternative lending platforms and direct lending.

Mr. Warna-kula-suriya is a member of the Financial Markets Law Committee, a member of the Editorial Board of the *Butterworths Journal of International Banking and Financial Law* and a Visiting Fellow of the Faculty of Laws, King's College, University of London.

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Kem Ihenacho is a Global Co-Chair of Latham & Watkins' Private Equity Practice. Based in the London office, Mr. Ihenacho is an M&A lawyer with more than 18 years of experience, focusing on UK and international private equity, infrastructure, and M&A transactions.

"Clients say the 'exceptional' Kem Ihenacho is 'one of the best all-round private equity lawyers we deal with'." *Chambers UK 2018*.

Mr. Ihenacho has also sat on the legal advisory boards of various private equity industry bodies.

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