

## SECURITISATION 2: BAITING WITH POWER SECTOR ASSET CASH FLOW

The Nigerian power sector has great potentials for growth, and that growth momentum has been set in motion with the government opening the door for private investors. One of the sessions at the just concluded Lagos Economic Summit (Ehingbeti 2014) focused on "Funding the Power Sector". A natural and major fall out of the privatization of the power sector is the mobilisation of private investment into the sector. Participants at the session brainstormed on how best this can be achieved, bearing in mind the interest of the investors, the government and the ordinary Nigerians, who in the short term will constitute the major consumers of electricity.

In the short to medium term, about \$17.8 billion investments in power assets are required to boost electricity generation, transmission, and distribution. The funds will be applied to fund both the capital expenditure (capex) and operating expenditure (opex) of the operators along the value chain. The funding structure could be in the form of equity or debt. While equity remains ideal, the timing of inflows through that window may take a bit longer to match the current cash requirement. On the other hand, while short term financing may be suggested under the circumstance, it may also pose a challenge as most of the banks are said to have exceeded their obligor limits in the sector.

In the face of uncertainties surrounding the actual state and value of the assets taken over from PHCN by the new investors, it was pointed out at the summit, that a realistic investment structure in this circumstance should focus on the cashflow of the projects rather than on the assets. The import here is that the assets in their current states may not carry the type of weight needed to attract investments; hence financial instruments should be designed to target the cashflows of the projects. This is where securitization comes to play.

Amide other issues surrounding the pricing of inputs and tariffs, there was a clear note that fund providers are willing to invest in the sector, but the instruments has to be right with all risks appropriately priced in.

### CASHFLOW SECURITISATION

In its simplest form, cashflow securitisation is straightforward and beneficial. For example, a firm expecting lots of monthly payments from customers who have taken out financing can get investors to fund its business more cheaply by selling them its claim to those payments. Also a bank on the receiving end of mortgage repayments or other receivables can do something similar: put the loans together and sell them, or use them as collateral to get funding, which it can then use to issue more loans. This boosts both credit and growth. There is no limit to securitisation. It is only limited by the creativity stretch of the financial adviser, and of course the risk appetite of investors.

Using this model as highlighted above, the banks that are said to have exceeded their single obligor limits in the power sector can still generate more funding through the securitization window. All they need to do is to pool their existing facilities together into an SPV with a cashflow that is tied to the cashflow of the original borrowers (in this case the power sector operators) and sell the new instruments to investors through either a private placement or public issue. This has the advantage of restructuring the instruments into a longer tenor as well as making fresh funds available for on lending.

Individual securities are often split into tranches, or categorized into varying degrees of subordination. Each tranche has a different level of credit protection or

### MARKET UPDATE

	15/01/13	15/12/13	21/04/14
Naira/US\$	154.1	155.2	155.75
Brent,US\$/BBL	109.78	107.84	109.9
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.7
MORTGAGE RATE %	22.0	23.0	23.0

### STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	21/04/14 Price (N)	%Change in Price
OANDO	12.00	15.97	-34.14
GTBANK	23.00	27.20	-0.67
OKOMU	41.00	36.02	-18.14
STANBIC	11.00	21.36	0.05
DANGSUGAR	5.98	9.60	-17.95
FIDSON	1.08	2.90	3.94
TRANSCORP	1.03	3.83	-11.95
CCNN	5.30	9.00	-23.40

	PRICE(N)	NAV (N)
	31/01/14	21/04/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	21/04/14	% Change
NSE ASI	41,329.19	39,325.28	-4.85
GMA Index	1.50	1.40	-6.95

Source: CBN, SEC and NSE

risk exposure than another: there is generally a senior ("A") class of securities and one or more junior subordinated ("B", "C", etc.) classes that function as protective layers for the "A" class. The senior classes have first claim on the cash that the SPV receives, and the more junior classes only start receiving repayment after the more senior classes have repaid. The senior securities are typically AAA rated, signifying a lower risk, while the lower-credit quality subordinated classes receive a lower credit rating, signifying a higher risk.

There may also be a special class which absorbs early repayments in the underlying assets. This is often the case where the underlying assets are mortgages which, in essence, are repaid every time the property is sold. Since any early repayment is passed on to this class, it means the other investors have a more predictable cash flow.

### REPAYMENT STRUCTURE

Unlike corporate bonds, most securitizations are amortized, meaning that the principal amount

borrowed is paid back gradually over the specified term of the loan, rather than in one lump sum at the maturity of the loan. Fully amortizing securitizations are generally collateralised by fully amortizing assets. Prepayment uncertainty is an important concern with fully amortization. The possible rate of prepayment varies widely with the type of underlying asset pool, so many prepayment models have been developed in an attempt to define common prepayment activity. A controlled amortization structure provides investors with a more predictable repayment schedule, even though the underlying assets may be non-amortising.

Securitizations are often structured as a sequential pay bonds, paid off in a sequential manner based on maturity. This means that the first tranche, which may have a one-year average life, will receive all principal payments until it is retired; then the second tranche begins to receive principal, and so forth.

### ADVANTAGES OF SECURITISATION

#### Advantages to issuer

**Reduces funding costs:** Through securitization, a company rated BB but with AAA worthy cash flow would be able to borrow at possibly AAA rates. This is the number one reason to securitize a cash flow and can have tremendous impacts on borrowing costs. The difference between BB debt and AAA debt can be multiple hundreds of basis points.

**Reduces asset-liability mismatch:** Depending on the structure chosen, securitization can offer perfect matched funding by eliminating funding exposure in terms of both duration and pricing basis. Essentially, in most banks and finance companies, the liability book or the funding is from borrowings. This often comes at a high cost. Securitization allows such banks and finance companies to create a self-funded asset book.

**Lower Capital Requirements:** Some firms, due to legal, regulatory, or other reasons, have a limit or range that their leverage is allowed to be. By securitizing some of their assets, which qualifies as a sale for accounting purposes, these firms will be able to remove assets from their balance sheets while maintaining the "earning power" of the assets.

**Locking in profits:** For a given block of business, the total profits have not yet emerged and thus remain uncertain. Once the block has been securitized, the level of profits has now been locked in for that company, thus the risk of profit not emerging, or the benefit of super-profits, has now been passed on.

**Transfer risks:** Securitization makes it possible to transfer risks (credit, liquidity, prepayment, reinvestment, asset concentration) from an entity that does not want to bear it, to one that does. Similarly, by securitizing a block of business (thereby locking in a degree of profits), the company has effectively freed up its balance to go out and write more profitable business.

**Off balance sheet:** Derivatives of many types have in the past been referred to as off balance sheet. This term implies that the use of derivatives has no balance sheet impact. While there are differences among the various accounting standards internationally, there is a general trend towards the requirement to record derivatives at fair value on the balance sheet. There is also a generally accepted principle that, where derivatives are being used as a hedge against underlying assets or liabilities, accounting adjustments are required to ensure that the gain/loss on the hedged instrument is recognized in the income statement on a similar basis as the underlying assets and liabilities.

**Earnings:** Securitization makes it possible to record an earnings bounce without any real addition to the firm. When a securitization takes place, there often is a "true sale" that takes place between the Originator (the parent company) and the SPV. This sale has to be for the market value of the underlying assets for the "true sale" to stick and thus this sale is reflected on the parent company's balance sheet, which will boost earnings for that quarter by the amount of the sale. While not illegal in any respect, this does distort the true earnings of the parent company.

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