Inside the vending machine

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Telecom vendor finance is both a new source of business and a lesson to project banks ? telco suppliers are moving faster than the banks to sell-on loans and free up cash to fuel the accelerating race for market share. The instruments vary from securitization to the on-selling of credits or part credits as well as some interesting hybrids, with 2000 likely to see further issues to feed the fast-growing telecoms sector.

It is worth remembering the sheer clout that the big suppliers have in financial terms: Swedish firm Ericsson Radio Systems appears in Capital Data's 2000 league tables as the 15th largest global project loan arranger, as well as the second largest institution doing business in Latin America last year. And whilst the alternative telecoms operators in the more mature markets of Europe and the US have become avid consumers of the latest optical and wireless kit, it is in the developing world that demand for what is essentially basic infrastructure has been explosive.

Yet the need to service demand in these emerging markets, and their associated credit risk, has put pressure on the vendors' balance sheets. Securitization, or one of its near relatives, is an almost tailor-made way of monetising these loans and freeing up cash. In the Research & Development-driven world of technology and with intense competition to provide long-term financing solutions, such flexibility is at a premium. Myron Glucksman, managing director in global securitization at Citibank points to another aspect for the vendors: ?from an equity analyst point of view there's no point in having long-term loans yielding 10% on your balance sheet when you're trying to support a stock multiple based on growing at 20-30% per year?.

The securitization of vendor credits has been a feature of the US for some time. However, in May 1997 Lucent technologies took out a 364-day commercial paper backstop facility, syndicated amongst banks, totalling $960 million, including $40 million of equity, through Citibank. The facility lacked some of the more detailed features of more recent deals, but certainly set a precedent.

The first true global vendor finance receivables deal closed in May 1999. French equipment supplier Alcatel closed the first tranche of its Securitized Vendor Finance programme, with a total potential value of roughly $500 million. The transaction was joint-led by Citibank and Salomon Smith Barney, at least in part on the back of their experience with Lucent.

The SVF programme is structured through a Delaware entity, known as the SVF 1999-A Trust. The Trust was formed to purchase interests in a portfolio of loans, usually of a sub-investment grade nature, extended by Alcatel and used the proceeds of an oversubscribed global bank syndication. The trust was able to purchase interests up to the $500 million on a blind pool basis.

There is no real limit on the markets where the interests can be purchased ? although loan sizes should be between $1 million and $50 million ? and Alcatel has operations in over 110 countries. The blind pool uses a French-registered commercial paper conduit managed by Citibank. The aim here is to ensure that the package received a higher rating than individual credits that could be cherry-picked by investors.

This represents a vast improvement on the traditional practice of managing or selling on parts or all of various loans. In part this is because there usually remains a risky rump of credits that are either impossible or extremely expensive to sell on. But in addition to this adverse effect on the supplier's credit profile, carving off individual credits is a time consuming and expensive process. Alcatel has indicated, whilst being unwilling to go into much detail, that the pricing was similar to that of normal Triple A commercial paper.

Even when the fees for management and/or the necessary backstop facility are taken into account, the savings over traditional piecemeal purchases are obvious. An equally important reason was the message that the blind pool, now 10 months into operations, sent out to investors. As Frederic Rose, vice-president for trade and project finance at Alcatel says, ?It was also a way to get the bank markets familiar with the Alcatel credit and our due diligence and documentation skills ? to demonstrate that we are a prudent lender?.

It is a sentiment echoed by Glucksman at Citibank: ?All the vendors have different credits processes and would like to validate them in the marketplace. The more investors understand these processes, as well as the risks, the easier the vendors' access to this market?. The structure of the transaction allows for a larger number of tranches than the Lucent deal. ?These tranches have the flexibility to bring in different investors at different levels over time,? says Glucksman.

A further tranche of receivables of roughly the same size might close later this year, although Rose stresses that after 10 months Alcatel is still examining the pool's performance. The blind pool approach works for Alcatel's short-lived loans ? around 50% of loan credits in the pool have already been turned over. Moreover Rose points out that, although bound by strict eligibility and diversity criteria, his business encompasses everything from space to cable to wireless technology. It is rumoured that Citibank are looking at carrying out a similar deal for Canada-based Nortel Networks, although Citi will not confirm or deny this.

The impetus behind this gathering together of vendor credits can be as much an administrative as an economic issue. Ericsson of Sweden, for instance, had been running various financing activities through local subsidiaries on the ground. Lacking the necessary expertise and personnel to manage these credits, the loans were consolidated into a single special purpose vehicle (SPV) and removed from the balance sheet of the individual suppliers.

Ericsson approached around seven banks for suggestions, and examined securitizations, collateralised loan obligations (CLOs) and even a blanket political risk policy to reduce the risk profile of the vehicle. In the event, Ericsson decided to go with a relatively straightforward bank financing of the vehicle, albeit on a non-recourse basis.

In part this solution may have been a reflection of flagging year-end capital markets appetite. Ossie Everum, Ericsson Project Finance AB's head says, ?since we had the vehicle in place we tried this one out. We decided that this had a better chance of materialising in a short time than a bond financing?.

The $536 million financing was put together through Skandinaviska Enskilda Banken, as facility and security agent, and syndicated to Credit Agricole Indosuez, Den Danske Bank, Leonia Corporate Bank, MeritaNordbanken, Svenska Handelsbanken and Swedbank. The facility breaks down into a series of tranches, 11 in all, and is denominated in four currencies. The majority of the loans are in dollars ($502 million), although there are also DM25 million, £5.7 million and Skr105 million elements that minimise currency and interest rate exposure.

?That the banks were able to put it together shows a lot of confidence in us because we look after the assets that the banks have?, says Everum. They relate to around 37 separate transactions that would not be entirely attractive to banks on a per debtor basis. However, he says, ?the transaction was structured to make it as transparent and as close to the underlying credits as possible?. Ericsson has also included a first loss undertaking on the portfolio, which represents an important part of its loan business. Moreover, the portfolio of assets is frozen with no further additions permitted.

Vendor financiers are able to operate on a different playing field to banks. Whilst banks are constrained by Basle rules on exposure to political risk, the suppliers can afford to be more flexible. Nevertheless, as Rose from Alcatel explains, ?we take out a lot of political risk insurance, whether privately or with the agencies, but we haven't seen a pay-out for ten years. And by and large we don't lend to the really ruined countries of this world?. Using a structurally enhanced pool securitization could well be the way to create cut-price risk mitigation in the explosive Latin telecoms markets.

However, currency risk on the projects is one aspect that Alcatel, lending almost exclusively in dollars, has to shoulder. Although the Latin crisis of 1998 is fading from view, the potential for future shocks to repayments remains. But there is still potential, especially where the loans are reasonably big-ticket, for the vendors to sell off loan commitments in pieces.

Last month Nortel, Ericsson and Lucent all closed vendor finance transactions with Brazilian telco Vesper, totalling some $1.78 billion. Nortel and Lucent, the first of whom has yet to complete an off-balance sheet transaction, have said they are looking to sell at least part of their credits. Lucent imagines that this will amount to no more than 25% of its $780 million credit. ABN Amro, advisor to Nortel, has also mentioned selling Nortel's $700 million credit, possibly on a non-recourse basis, but only after an examination of project performance three years in the future.

Credit Suisse First Boston's issue aside, banks have been finding it hard work putting their loans off-balance sheet,. To a certain extent the suppliers have been lucky in that their loans rarely go beyond seven years in stark contrast to the monster tenors required of traditional project finance deals. But Glucksman is keen to point out that investments in telecoms are not an act of blind faith: ?Most projects are of a strategic nature ? most investors believe they will get done. But investors also look at the numbers and the structure, as well as the credit quality of the sponsors?.

At least some of the hard work in adapting different cultures to the new deals has already been done. There has, for instance, been a standardising of the analysis required for such loan credits. Says Glucksman, ?these loans are much larger than your typical residential mortgages and require more detailed analysis. How do you deal with a loan portfolio with different covenants, security packages, terms and tenors??

The challenge now is to move even further into murkier credit waters. Glucksman gives a few clues as to the way ahead. ?Most deals until now have been done with investment grade securities, but we'll be seeing more with sub-investment grade ratings and a higher coupon. It is safe to say that all the vendors are looking at ways to sell off their loan portfolios and securitization is at or near the top of the list?.

Look out later this year for internet service provider credits hitting the market.