

Asset-Backed Securities

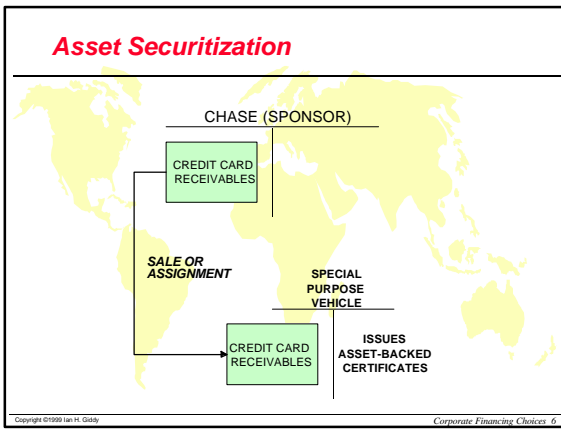
Asset-Backed Securities

Prof. Ian Giddy
Stern School of Business
New York University

Case Studies

- Finance Company Ltd (Malaysia)
- Fannie Mae Guaranteed REMIC Pass-Through Certificates
- Sears Credit Account Master Trust II
- Ford Credit Auto Owner Trust 1998-B
- Trains I PLC
- Belenus Securities
- Advanta Equipment Receivables
- Atherton Franchisee Loan Funding
- FILMS (Finance for an Italian Library of Movies plc)
- Hong Kong Card Master Trust
- Ras Laffan LNG

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Example: Formula One Bond

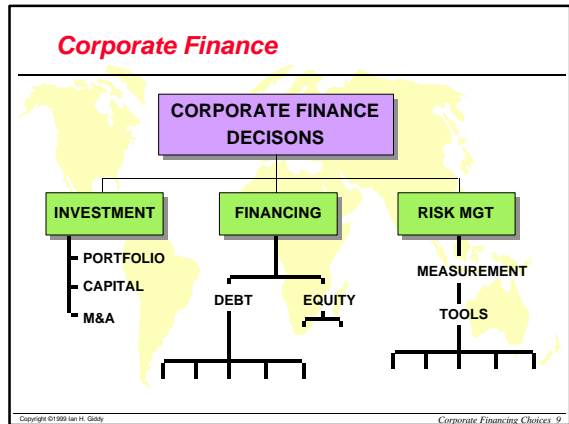
- In May 1999, Morgan Stanley Dean Witter and WestLB led a \$1.4 billion F1 Eurobond issue.
- The bond was backed by TV rights and revenues from the exclusive contract between Bernie Ecclestone's F1 company and broadcasters for Grand Prix racing coverage.

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First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
 - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt)
 - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
 - The form of returns - dividends and stock buybacks - will depend upon the stockholders' characteristics
- Minimize unnecessary financial risks.

Objective: Maximize the Value of the Firm

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Corporate Financing Choices

- Do financing choices matter?
- Debt or equity?
- What kind of debt?

Certain kinds of market imperfections allow corporations to reduce costs by improving the financing mix

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Is There an Optimal Capital Structure?

Assets' value is the present value of the cash flows from the real business of the firm	Debt
	Equity
Value of the firm = PV(Cash Flows)	Value of the firm = D + E

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Does Capital Structure Matter?

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You cannot change the value of the real business just by shuffling paper
- Modigliani-Miller

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The "Conservation of Risk" argument

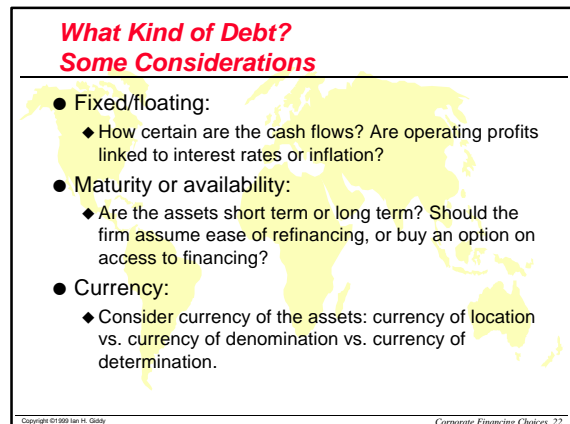
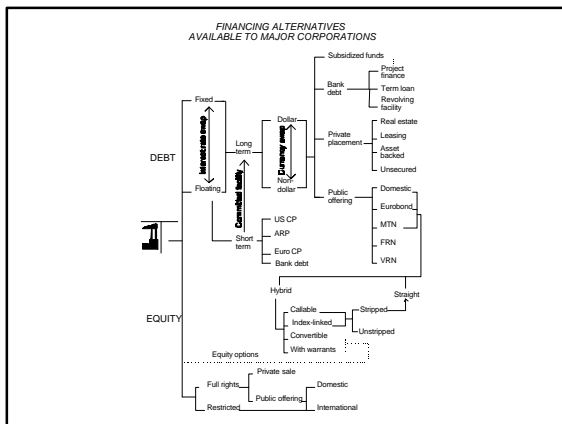
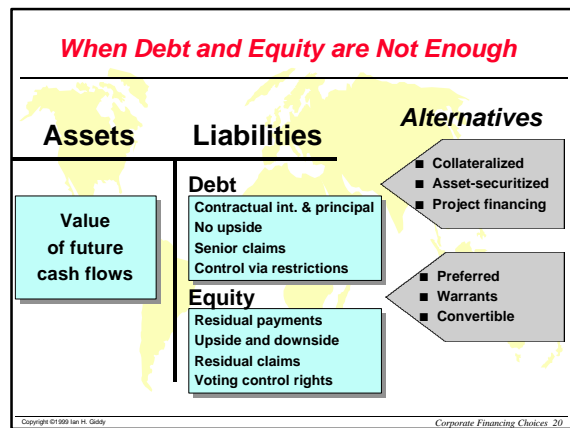
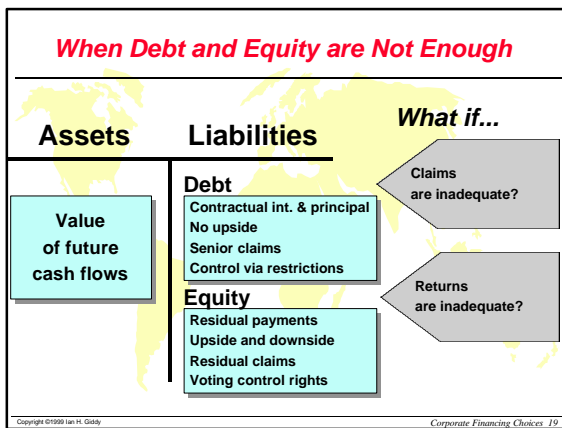
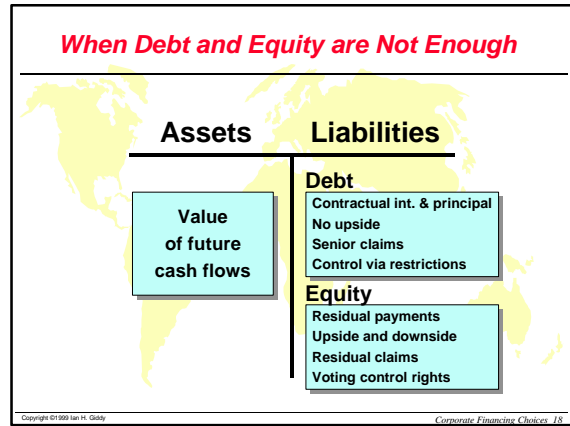
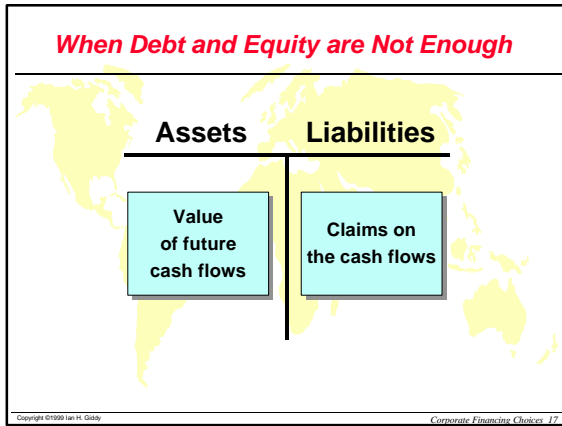
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The Financing Side: Is There an Optimal Capital Structure?

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Application

- How should Spanish oil company Repsol finance its \$13.4 billion acquisition of Argentina's YPF? (Fixed/floating; Maturity or availability; Currency?)
- Originally planned to finance it entirely with long-term US debt. But the falling Euro with a lower interest rate led the company to finance 30%-40% in Euros.

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Guidelines for Financing

- Liabilities to match assets: **economic exposure** of the firm determines base financing choices.
- Decision on whether or not to fully match depends on company's **view** relative to the view implied by market prices.
- When strategy is chosen, use the **financing/hedging** techniques that offer the **lowest effective cost**.

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Why use asset-backed securities?

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Beyond Modigliani-Miller's "Conservation of Risk" Argument

- Securitization creates assets with less risk and greater liquidity, hence a lower cost of financing
- But can the higher quality be achieved without a commensurate decrease in the quality of the remainder of the company?
- Yes -- if securitization sweetens a lemon!
- Reason: when a company faces uncertainties, investors demand a premium. But investor concerns about receivables can be dispelled at far lower cost than other concerns about the company and its overall performance.

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Financing Choices and Asset-Backed Securities

- ABS are complex and expensive to structure. Hence in a perfect market with no informational inefficiencies, no need for ABS
- Use of ABS may make sense when there are
 - ◆ Subsidies, guarantees or regulatory incentives
 - ◆ Information-based value added

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Information-Based Value Added

- Information about a company's receivables is improved
- Specialization in risk-bearing is achieved
- ABS has positive "signalling effect," especially when residual rights retained by company

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Asset-Backed Securities: Summary

- Asset-backed securities can create value for investors and issuers if:
 - ◆ The assets are for some reason worth more *off* the balance sheet than *on*
 - ◆ The right legal framework is in place
 - ◆ The costs do not exceed the benefits
- Sometimes they do not work...because you cannot make money by cutting up a dog

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