

## ***T. QUILA PETROCHEMICALS S.A.***

T. Quila Petrochemicals S.A. (“*T. Quila*”), a Mexican corporation, is in the business of manufacturing and selling a variety of intermediate petrochemical products (the “*Products*”) for use principally in clothing and hosiery. T. Quila sells its Products to a number of clothing manufacturers and textile mills in the United States, Europe and South America. Recently, T. Quila’s business, particularly for up-scale synthetic fabrics and nylon, has exploded due to trends toward classy “casual day” clothing. To take advantage of this boom, T. Quila’s management wishes to build a new factory, which will cost approximately \$100 million (the “*Project*”). Management is considering the best means of financing the Project.

T. Quila is a joint venture between a wealthy Mexican entrepreneur, Poco T. Quila, his brother Mas T. Quila and a large U.S. chemical company, Lycra Engineering Group Sales, Inc. (“*LEGS*”), known for its state-of-the-art technology. T. Quila is typical of many Latinamerican/U.S. joint ventures in that it is dependent upon its Mexican partners for manufacturing and marketing skills and upon its U.S. partner for technological licensing and support. Poco T. Quila, his brother and LEGS have always attempted to operate and finance T. Quila independently of each of the partners (*i.e.*, without support in the forms of guarantees or otherwise from the partners). T. Quila is profitable, consistently generating a ROE of 15-20% annually. Prior to the recent explosion in sales, T. Quila’s domestic and international revenues had been growing at 5-10% annually, with little exposure to business cycles.

### **THE PROBLEM**

T. Quila’s CFO, Don D. Esta la Plata (“*Plata*”), approaches the T. Quila partners at a shareholders meeting to request that Poco T. Quila, Mas T. Quila and LEGS severally guarantee a Mexican bank loan for \$100 million to fund the Project. The unanimous response to Plata “la plata es nuestra; find independent financing!”

Plata is despondent. T. Quila’s usual financing source, several large Mexican banks, will offer no more than three-year financing and a U.S. Dollar rate of 12% (or a Peso rate of 25%) without shareholder guarantees. U.S. banks offer little better: three-year financing at LIBOR plus 5%. Yet the project has a seven-year “pay-back” schedule, and his CEO, Poco T. Quila, will view any financing with an interest rate above 10% as an affront to his company (and a reason to contact headhunters with a request for a replacement CFO).

Plata, eager for a respite from his financing dilemma, flies off to his 10-year reunion from the Northwestern University business school. At the opening night cocktail party, Plata runs into you. You are a rising star at World Class Bank (the “*Bank*”), a prominent multi-national bank that is striving to become one of the premier universal financial institutions in the world. You report to the Bank’s worldwide head of corporate finance, who considers you a leading candidate for the to-be-created position of worldwide head of structured finance.

Plata, after a few drinks, confides to you his problem, and complains that the main reason the banks are offering such dismal terms to T. Quila is Mexico’s below-investment-grade credit

rating.<sup>1</sup> Plata asks you if Bank has any experience in raising capital in a country that has a sovereign debt rating below investment grade.

You explain that generally securities issued by a company in an emerging market country will receive a rating no higher than the country's foreign currency sovereign rating because even the best company in the country will be affected by the local government's monetary policy and ability to service its own foreign currency debt. As a result, if the local government does not have an investment grade rating for its foreign currency obligations, the rating agencies' "sovereign ceiling" will prevent local companies from achieving an investment grade rating on their own foreign currency obligations.

You continue to explain that other Mexican companies have used securitization as a method of "piercing the sovereign ceiling" and issuing debt with a foreign currency credit rating higher than Mexico's sovereign rating (currently BB+). The rating agencies will look to the local currency debt rating of the issuing company as a proxy for the level of the company's performance risk (*i.e.*, the likelihood that it will become bankrupt). Thus, if an issuer has a local currency credit rating of BBB- (reflecting the issuer's assessed ability to service local currency debt), the issuer can achieve a BBB- rating on an issue of securitized debt as long as the securitized debt has been structured so as to minimize various sovereign risks (*e.g.*, the risks that Pesos cannot be converted to Dollars to make payments on the debt or that a major Peso devaluation will occur). By securitizing T. Quila's petrochemical receivables and selling the resulting securities into the U.S. capital markets, T. Quila may be able to pierce Mexico's sovereign ceiling and obtain an investment grade rating on the obligations. As a result, the securities' marketability would improve and, in turn, T. Quila would enjoy a lower funding cost.

Encouraged by your description of other emerging market securitizations, Plata sets up a breakfast meeting with you for 9:00 a.m. the next morning to discuss the transaction in detail and then heads off to mingle with several ex-classmates to discuss their preferences in hosiery products.

The next morning, over breakfast in the hotel dining room, Plata outlines his needs and constraints:

1. T. Quila requires roughly U.S. \$100 million in ten weeks, when a construction company will break ground on the Project.
2. T. Quila is willing to sell rights to payment on all of its export receivables from the sale of its Products to customers in the United States (\$100 million in the last fiscal year), Europe (\$50 million in the last fiscal year) and South America (\$150 million in the last fiscal year), primarily Argentina and Brazil. T. Quila's domestic Mexican sales in the last fiscal year were about \$400 million. Since the last fiscal year-end data, orders for the Product have leaped 50% on an annualized basis. You suggest that only receivables from certain select customers ("*Obligors*") should be part of the transaction, due to the concern that several of T. Quila's customers make payments to T. Quila in currencies other than U.S.

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<sup>1</sup> Note that the reunion took place well before Mexico's recent ratings improvements.

Dollars and that several of the South American customers are located in countries with lower credit ratings than Mexico.

3. T. Quila does not need to remove the export receivables from its balance sheet.
4. Sales of the Products are seasonal, peaking in the first quarter as manufacturers produce hosiery and lightweight clothing for spring and summer. Sales in the third quarter are lowest.
5. T. Quila sells about one-third of the Products internationally under long term contracts; the other two-thirds are sold under open account arrangements with payment due in 30 days of receipt of Products. Most of the open account customers have been customers for over five years. The largest three customers account for 10%, 8% and 7%, respectively, of total sales.
6. The price charged by T. Quila for the Products varies with petrochemical prices generally, with prices rising as oil prices rise and falling as oil prices fall. Prices are currently high due to the high level of crude prices.
7. T. Quila's main supplier is Pemex, the Mexican national oil company. T. Quila believes that, if Pemex failed to supply necessary petrochemical supplies, T. Quila could find replacements from U.S. or other suppliers.
8. T. Quila has about \$300 million in existing debt, primarily owing to Mexican banks. The Mexican bank debt is secured by mortgages on all of T. Quila's plants. The debt agreements also provide that T. Quila will not grant liens on any other assets that it owns (a "*negative pledge*").
9. The Products are used to make stockings that are the sheerest of sheer and clothes that drape the body like the folds of cloth in a Botticelli painting. The resulting stockings and clothing are of the highest quality and sold in the finest stores.
10. The official projections for Product sales growth are rosy. However, Plata confides that his astrologer has told him that financial dislocations caused by the Cubs' winning the World Series will lead to a collapse of world stock markets in 2002. If this disaster strikes, Plata believes that demand will drop and Product sales will suffer.

## THE QUESTIONS

Plata falls silent for a moment at the depressing thought of lower demand. Then he begins grilling you on the securitization structure that you have promised the Bank can deliver:

1. Will the financing take the shape of a bank loan or a securities offering? Plata prefers a loan from the Bank, an institution he knows and respects, to an offering of securities purchased by faceless institutional investors. (You pale because your boss has told you that the Bank will not, under any circumstances, take additional Mexican risk from middle market corporations.) If securities are sold to institutional investors, to what type of investors? Will the obligations bear interest at a floating rate or a fixed rate? Plata prefers fixed rate, because he does not wish to take interest rate level risk.
2. Will the financing structure use a special purpose entity and, if so, in what jurisdiction?
3. How will the transaction minimize Mexican sovereign risk? Will T. Quila be required to enter into a currency swap to protect against devaluation risk? If so, will the Bank act as counterparty on the swap? (You pale again, as you think of your chief's reaction to a proposal whereby the Bank would write a seven-year U.S. Dollar/Peso swap.)
4. What type of over-collateralization, if any, would the Bank or investors require? How should any over-collateralization be calculated -- by reference to the face amount of receivables outstanding and the amount of debt outstanding or, alternatively, by reference to the expected annual cash flow and the expected annual debt service obligations? (You vaguely recall a rating agency analyst discussing over-collateralization of 4-6 times on certain export receivables "future flow" transactions.)
5. Will the Bank or investors require a reserve account to cover collection shortfalls on the export receivables? Plata indicates that he is very much opposed to reserve accounts en principio, because such accounts tie up T.Quila's cash inefficiently. If pressed, Plata might consent to a reserve account covering a shortfall of one month's interest. Plata might also be more comfortable with a reserve account if he were allowed to direct investments as he wished, which at the moment include selling AOL stock short and buying high yield debt issued by the Duchy of Andorra.
6. Will T. Quila's existing loan agreements with Mexican banks pose a problem for a securitization? Would the Mexican banks have the right to require their consent to the transaction?
7. Will the transaction structure disrupt T. Quila's commercial relationships with its customers? Plata fears approaching T. Quila's sales department with a request for a change in payment procedures, not least because the head of the sales department is Mas T. Quila's son, Ignacio T. Quila, heir apparent to the T. Quila

empire. Ignacio, although only 24 years old, has been elbowing his way rapidly up the T. Quila chain of command, and Plata believes Ignacio's next elbow will be into the CFO job.

(You recall hearing a group of extraordinarily insightful lawyers at an internal bank seminar say that obligors must receive notice in Mexico in order for an assignment of receivables to be legally binding and in order to ensure that the sale is considered a "true sale." Notice of the sale of receivables and instructions to make payment to a trust account could be included in a monthly statement to obligors. You also recall the lawyers saying that rating agencies usually are not satisfied with notice on an invoice and insist that the obligors be contractually bound to send payments to the trust account.)

8. Would T. Quila have any recourse liability on the export receivables securitized in the transaction? Would the Bank, investors or any rating agencies require a guarantee of collectibility on the receivables? (You recall that, unlike U.S. securitizations, emerging market securitizations often have mechanics for substantial recourse back to the company originating the receivables as such recourse does not affect the "true sale" nature of the transaction due to the local jurisdiction's laws' preference to look to form over substance). You make a mental note to research the possibility of recourse in a Mexican securitization, but believe that if the assignee of the receivables has recourse back to T. Quila for *non-collectibility* of the receivables, then there might not be a "true sale" of the receivables.
9. What type of Mexican government approvals would be required to do the deal?
10. Is the proposed deal an asset-backed securitization? Is that what you mean by "future flow" securitization? You explain that, unlike many U.S. deals where all of the receivables owned by an originator at one time are put into a pool and sold into a trust, a "future flow" deal means that the originator is selling the right, not only to an existing pool of receivables, but also to receivables generated by the originator for a certain number of years in the future (and until the investors are paid in full). Future flow deals, in essence, are a bet by the investors on the future viability of the originator, do not rely entirely on the quality of the existing receivables and, accordingly, do not involve the issuance of securities that are truly "asset-backed." Such deals depend on their unique structures to isolate an originator's foreign currency cash flow from the sovereign risks of the originator's home jurisdiction.
11. What would happen in the proposed deal if T. Quila were to become insolvent? Would the investors in the securitization have rights to receivables that have not yet been created when T. Quila goes into bankruptcy?
12. Finally, as Plata is starting to think about a reunion seminar he is scheduled to attend on "Stochastic Variability of Alternative Minimum Tax Assumptions in a Black-Scholes Approach to Mortality" or "Can We Take It With Us?", he asks the

question that he should have asked first, the answer to which can and does kill deals (all the time): what kind of taxes would be imposed if T. Quila sells receivables to an off-shore SFV?

You have scribbled these questions on a stack of bacon grease-stained napkins and tell Plata that the Bank's structured finance team will be back with a structure to address T. Quila's needs in a week. Plata responds that you have only until lunch time on Monday, when Plata is scheduled to dine with Mas T. Quila and his son Ignacio. Ignacio is supposedly bringing to lunch a friend from college who now works in the structured finance group of the Bank's most fierce competitor. You realize that you have less than 48 hours to bring to bear all of your emerging market securitization expertise to structure a deal that provides T. Quila with the money it needs, when it needs it, at a price T. Quila can afford and is attractive to (and has the appropriate safeguards for) savvy institutional investors.

Your task is first to identify all of the financial, legal, regulatory, rating agency and related practical problems that will arise in a securitization of export receivables by T. Quila. Then you must develop a structure to accommodate these concerns and finally you must draft documents and close the deal. Can it all be done in time?