Global Structured Credit Strategy

Equity today, debt later?

- **CLO spread compression led to strong 2012 returns** — Despite the tightening, we believe there is more room, in the senior and junior mezz part of the capital stack.
- **Year-end volumes were strong, and expected to rise** — 2012 deal volume was $52bn (not including middle-market CLOs), we forecast a 20% growth during 2013.
- **Strong pipeline may however lead to better debt entry points** — The number of new deals could lead to temporary supply pressures, and can occasionally create better entry points for debt investors as the last two weeks of 2012 showed.
- **Buy equity early** — Tightening in liability spreads helped the equity arbitrage but a bigger CLO pipeline can increase discounted loan prices and lead to wider liability spreads.
- **Final FATCA rule** — The final rule from the IRS and Treasury includes a transitional "deemed-compliant foreign-financial institution" group that may help CLO 1.0s but we await to see how such deals can be shoe-horned into the definition.
- **Bank buyers of senior tranches should note new proposals** — The Basel Committee proposed new capital charges that modify the current ratings-based approach, and could dilute returns for senior bonds if implemented as proposed.

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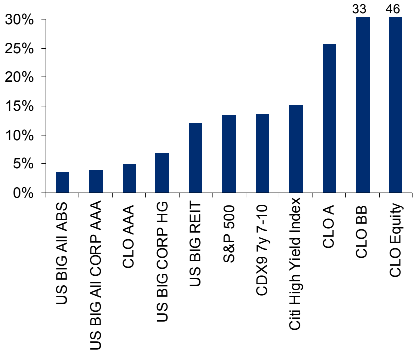
A year of strong performance

CLO returns impressive

A significant point of the spurt in issuance in Q4 2012 was that it did not result in any appreciable spread widening. If anything, the period till about two weeks before the year-end saw spreads tighten (with a slight widening at the very end). Compression of new issue spread has since been sustained in the first two weeks of January (a trend we predicted in our year-end Global Structured Credit Outlook). Overall, CLOs had a strong price performance during 2012 (Figure 1). Despite the impressive returns we believe there is some more room to tighten. In our outlook, we thought that triple-As and double-/triple-Bs would see the most upside in the early part of the year and the latest price guidance from new deals does show tighter liability spreads in these tranches.

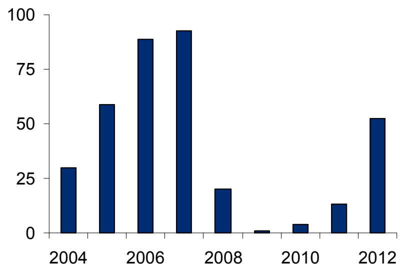
The size of the primary market is another sign of strength of the market. The year ended with $52bn of issuance (more if one includes middle-market CLOs) which was both several multiples of 2011 issuance of $13.5bn and was double the most optimistic Street research projections (including those of this analyst) at the beginning of last year (Figure 2). In our year-end outlook for 2013, we forecast a 20% growth in issuance. The market's health was also illustrated by the number of new managers who were able to execute deals. About 10 per cent of last year's issuance came from first-time managers, though nearly all were seasoned loan or CLO professionals and usually had private equity or other form of strong sponsorship.

Figure 1. 2012 CLO returns vs other assets



Source: Citi Research

Figure 2. Recovery of CLO issuance



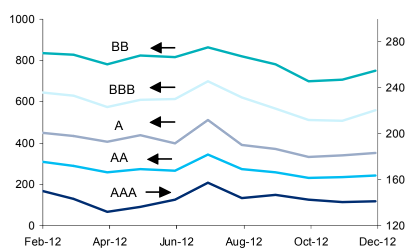
Source: Citi Research

January continues with momentum

The big event for which many structured finance investors are waiting is the ASF (American Securitization Forum) conference, during which many dealers and CLO managers are expected to present their pipeline. We have heard from investors that there are nearly 50 deals that are being presented, which may cause supply pressures depending on the speed at which these deals are launched.

Meanwhile, though, the most recent deals are enjoying tight liability pricing. Triple-As for Symphony CLO XI recently priced at 130bp, which was about 10bp tighter than Dec 2012 levels. Triple-B and double-Bs priced at 435bp and 625bp respectively, and are about 65-75bp tighter than deals pricing in December (for example, Octagon XIV).

Figure 3. New issue spreads till end 2012



Source: Citi Research

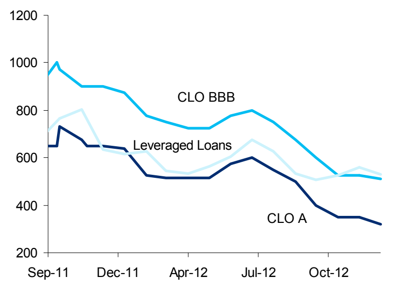
Supply is building up

If the number of deals being presented at ASF is any guide, the CLO pipeline is strong. We believe that there are many new investors who are justly looking at the relative value of the CLO asset class, and so technicals are positive. Nonetheless, supply pressures and timing can occasionally create a better entry point for debt investors as the last two weeks of 2012 show (Figure 3). We think it is very hard to time the market, especially if one has a large buying program or one wants to work with only a small universe of managers. Debt investors who do not face such constraints may find it worth their while to find such opportunities.

Early birds for CLO Equity

Improving arbitrage, till now

Figure 4. Loan and CLO mezz spreads, bp

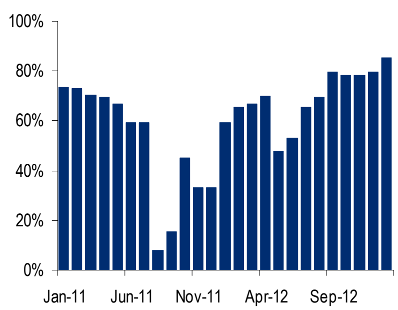


Source: Citi Research, S&P LCD

A result of the tightening in liability spreads had been the improving arbitrage between CLO assets and liabilities in the last part of the year. As Figure 4 shows, loans had compressed less than CLO mezz spreads leading to higher projected IRRs for new issue equity in the last six months of the year. Equity buyers from deals that were issued in Q3 2012 probably have a richer life ahead, than those issued six months earlier. CLO history shows us ample proof of the importance of the vintage effect (US CLO Equity Mid-year Performance). However the direction of the arbitrage may be going in an unwanted direction at certain points in time in the months ahead. First, managers have moved to choosing higher-spread, lower rated portfolios (Collateral drift in new deals) with a bigger ratio of single- to double-B loans relative to the start of 2012. Second, if a large number of CLO managers all start bidding for the loan market in a short period of time, the result could be an unwanted mix of even higher loan prices and wider liability spreads. Lack of long warehousing facilities is leading to either higher risk in the arbitrage or reduced transparency as managers launch deals with a lower percentage of the target portfolio in place. Moreover, loan ETFs are adding to the competition for loans. In this environment, the manager's access to the loan market is critical.

Higher loan prices threaten equity returns

Figure 5. Percentage of loans trading above 99

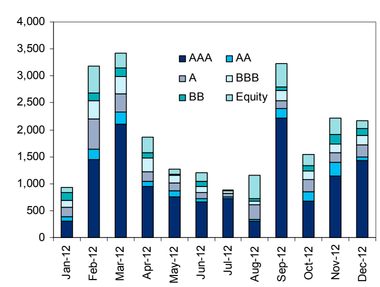


Source: Citi Research

In the last few months the percentage of loans trading close or above par has increased significantly (Figure 5). Right now, about 82% of loans are trading at or above par, while 85% are trading at or above 99. As CLO investors know, elevated loan prices have a negative impact on ramping CLOs since the rating agencies give only par credit to loans purchased above par. Therefore, CLOs which are buying loans in today's market at 101 immediately lose a point when they value the assets at par. This potentially dilutes equity returns through more dollar investment and, consequently, lower leverage. Alternatively it may motivate managers to buy a smaller amount of loans and leave a lower cushion in OC tests on the table, which could then limit future portfolio flexibility. In the worst case, the lower cushion would lead to easier diversion of cash from equity tranches. Paying up 101 for a loan for a higher coupon is no guarantee, moreover, that the coupon is here to stay – many such loans do not have 'soft' call protection (that is, a premium to investors in case the borrower prices a new loan tighter). Of course, not all borrowers will reprice their loans, but many will, and dampen equity returns.

Beat technicals by buying equity early

Figure 6. Secondary supply through BWICs



Source: Citi Research

Our best advice for an investor – even if we repeat that it is hard to time the CLO market – is to try to get in early for equity investments. We think the risk of loan prices rising (especially of discounted loans that would be attractive for a CLO) is appreciable, and there is also the chance of temporary spikes in CLO liability spreads. The logic would work in reverse for debt buyers, a point we made earlier in the piece. Profit taking by funds has also been boosting secondary supply (Figure 6) after several dry months, and this too could have a negative impact on technicals. It is noticeable that the year-end did see a slight widening in spreads, something that we could see in the weeks after the ASF conference.

Basel and FATCA – proposal and rule

Basel wants to get closer to SSFA

The Basel Committee proposed a new approach to calculate regulatory capital for securitizations that modifies the current Ratings-Based Approach (RBA). The Committee proposed a hierarchy which banks should follow. Under this re-calibrated RBA ('RRBA'), 'senior' and 'non-senior' bonds are treated differently. The bond maturity and thickness also play a part. As the BIS report[1] says, they seek "to make capital requirements more prudent and risk-sensitive, mitigate mechanistic reliance on external credit ratings, and reduce cliff effects". The move-away from a 'mechanistic' ratings based approach is in the spirit of the US SSFA (US Bank Capital Rule on Structured Credit) which did away with ratings. In addition to the RRBA, the proposal would now also allow for the use of the SSFA for international banks but there is a sting in the tail. The SSFA-related approach treats all bonds as if they were resecuritizations which increases the capital requirement substantially. In the table in Figure 7 we compare capital in the proposed RRBA with the current RBA. We also show the capital under SSFA for a typical CLO 2.0 structure. In all cases, the bonds are not considered resecuritizations.

Figure 7. Risk weights (%) under standardized and proposed Basel rules, and under Fed SSFA rule for typical CLO 2.0

	Standardized Basel*	SSFA for typical CLO 2.0 deal	Proposed Basel 1y asset*	Proposed Basel 5y asset*
AAA	7	20	20	58
AA	15	20	67	233
A	20	22	212	360
BBB	75	98	476	553
BB	425	325	889	1024

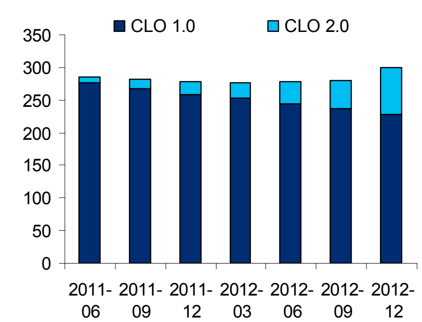
*For these purposes we assume non-AAA bonds are non-senior, and are 10% or less thick

Source: BIS, Citi Research

There are one of two hierarchies that banks should follow – the first consists of a modified supervisory advisory formula (MSFA) that banks with approved models can use; second, the RRBA introduced by Basel, and finally, a more penal Backstop Concentration Ratio Approach (BCRA) that applies to resecuritizations. The second hierarchy differentiates senior tranches (for which banks can use the RRBA or MSFA) and non-senior bonds (for which banks must have a model, or use BCRA).

We emphasize that this is just an initial proposal and, even though the spirit of moving away from a pure ratings-based approach is likely to stay, the final implementation details are likely to be different. The desire to smooth a ratings cliff effect (for senior bonds, in theory RWA could be as low as 7%) is well-taken. After all, large positions of senior structured finance bonds (typical with some US sub-prime connection) led many banks to take losses and lose capital.

Figure 8. CLO universe, $bn

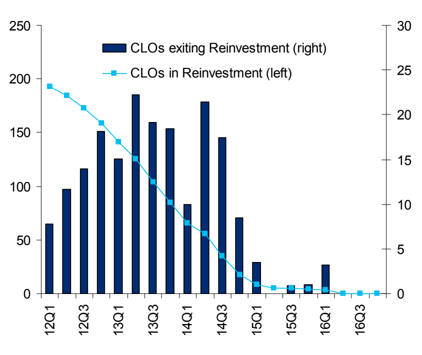


Source: Citi Research

FATCA becomes rule - almost

On Thursday, the IRS and Treasury released the long awaited final regulations implementing the Foreign Account Tax Compliance Act (FATCA). We had earlier discussed the revisions that made it seem that CLO 1.0s would be in a better position than first contemplated (Global Structured Credit Strategy). As the LSTA described it in their weekly, the final regulations include an additional transitional "deemed-compliant foreign-financial institution" (DCFFI) category for certain limited-life debt investment entities, which *may* benefit CLOs in existence on December 31, 2011. We say 'may' because lawyers need to work out how well CLO 1.0s can be shoe-horned into the IRS definition of DCFFI. The IRS acknowledged that many legacy CLOs will be unable to comply with FATCA's and, therefore, final regulations permit these entities to qualify as deemed-compliant FFIs until December 31, 2016, when their deemed-compliant status terminates. Note, though, that withholding on principal repayments begins January 1, 2017 - so effectively there does not appear to be grandfathering on this. To quantify the problem, though most CLOs are still CLO 1.0 (Figure 8), nearly all such legacy CLOs will have exited their reinvestment period by then (Figure 9). It had seemed that the CLO secondary market had discounted FATCA by not giving credit to reinvestments after the reinvestment period – the rule broadly validates this assumption.

Figure 9. CLO reinvestment profile, $bn



Source: Citi Research

[1] Consultative Document Revisions to the Basel Securitisation Framework, Issued for comment by 15 March 2013, Basel Committee on Banking Supervision, BIS, December 2012

Appendix

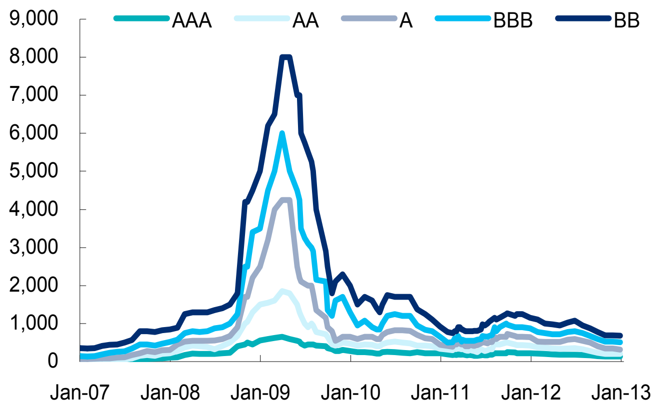
Cash Flow CDO Market

Figure 10. Secondary Cash Flow CDO Spreads/Prices

Collateral Type	AAA	AA	A	BBB	BB
US HY CLO 1.0 (Spreads) – 1-*Jan-13*	135	200	320	510	680
US HY CLO 1.0 (Prices) – 1-*Jan-13*	Mid 90s – High 90s	Low 90s – Mid 90s	Low 80s – Low 90s	Low 80s –Mid 80s	Low 80s –High 80s
US HY CLO 2.0 (Spreads) – 1-*Jan-13*	141	240	340	520	725
US HY CLO 2.0 (Prices) – 1-*Jan-13*	High 90s - Par	High 90s – Par	Low 90s – High 90s	Mid 80s – Low 90s	High 70s – Mid 80s
Euro HY CLO (Spreads) – 1-*Jan-13*	190	360	525	940	1360
Euro HY CLO (Prices) – 1-*Jan-13*	Mid 90s – High 90s	Low 80s – High 80s	Mid 70s – Mid 80s	Mid 60s – Mid 70s	Mid 60s – Mid 70s

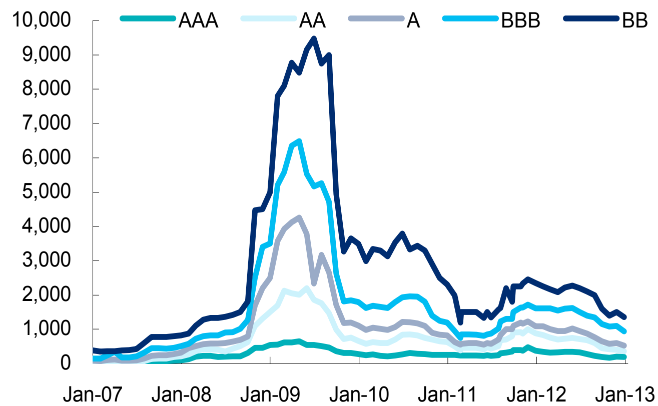
Source: Citi Research

Figure 11. US CLO Tranche Spreads



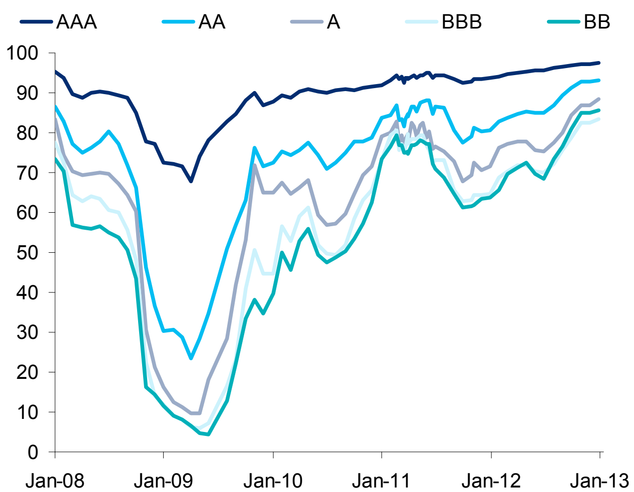
Source: Citi Research

Figure 12. European CLO Tranche Spreads



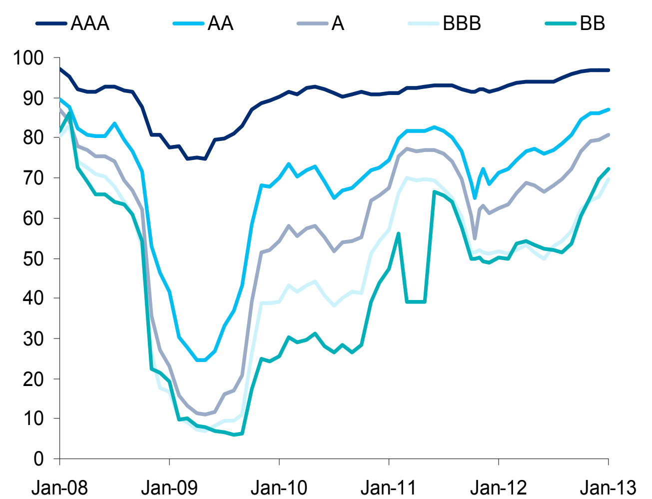
Source: Citi Research

Figure 13. US CLO Tranche Prices



Source: Citi Research

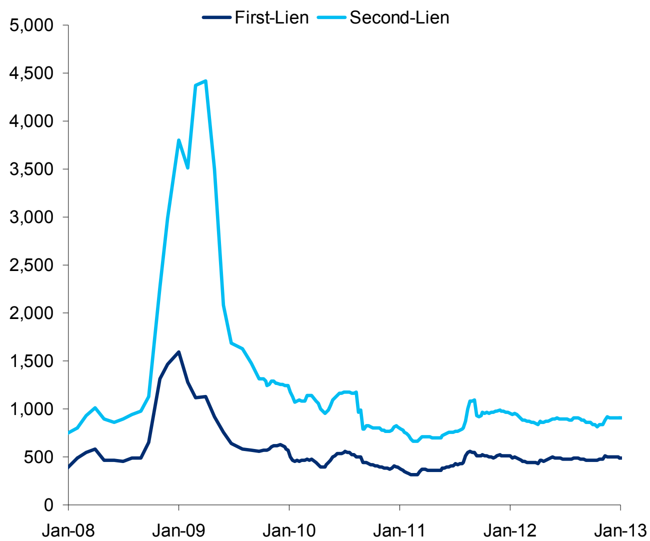
Figure 14. European CLO Tranche Prices



Source: Citi Research

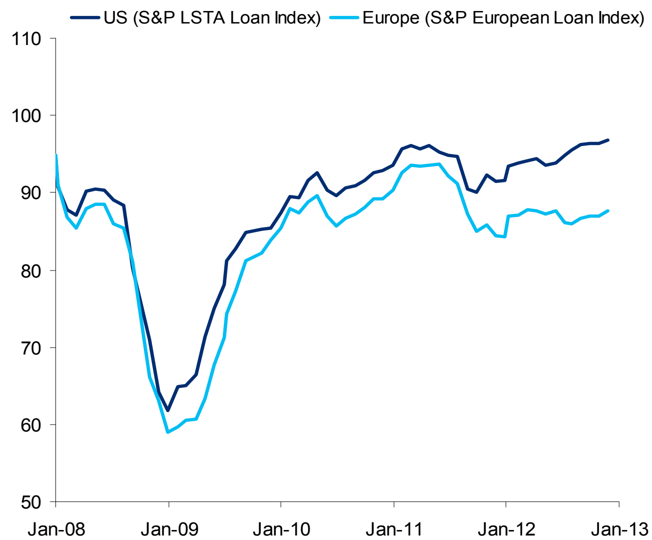
CLO Collateral

Figure 15. Avg First and Second-Lien Secondary Spreads to Maturity



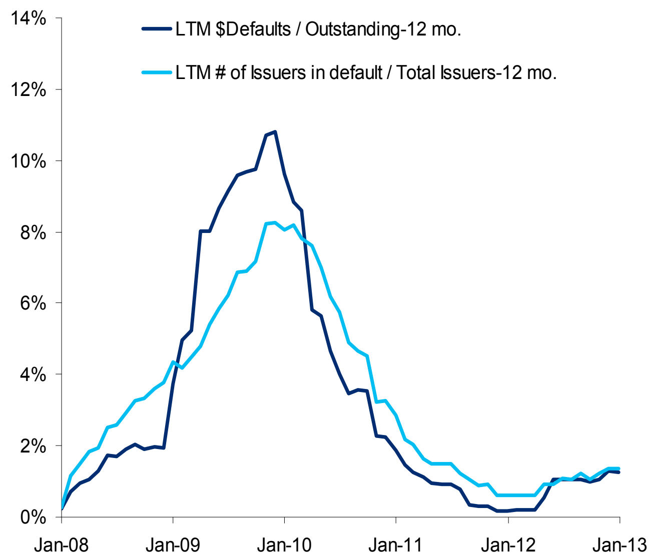
Source: S&P

Figure 16. Weighted Average Bid



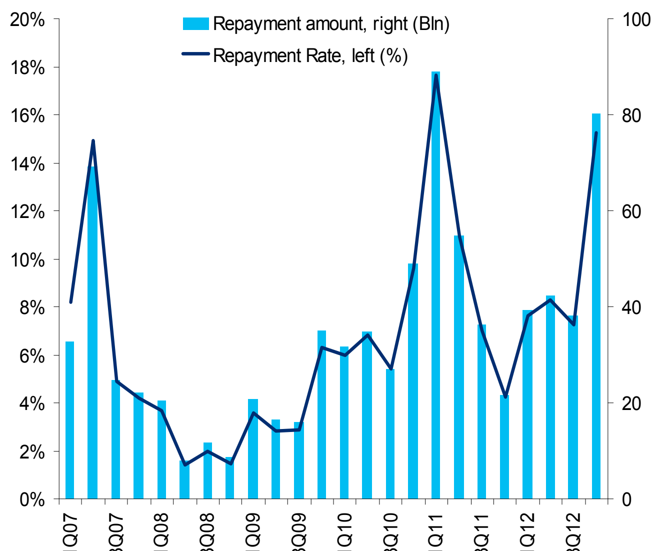
Source: S&P

Figure 17. US Lagging 12mo. Default Rate by Principal and # of Issuers



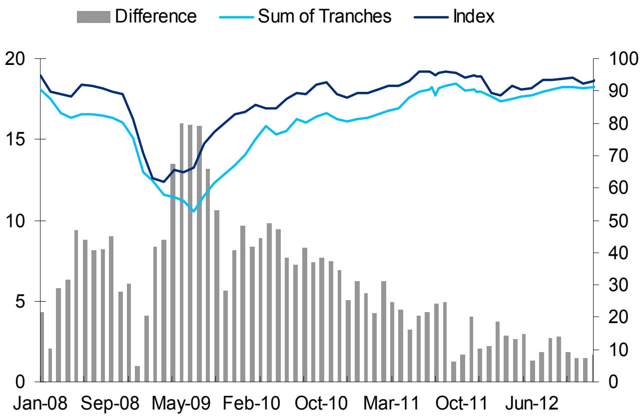
Source: S&P

Figure 18. US Quarterly Repayment Rate and Repayment Amount



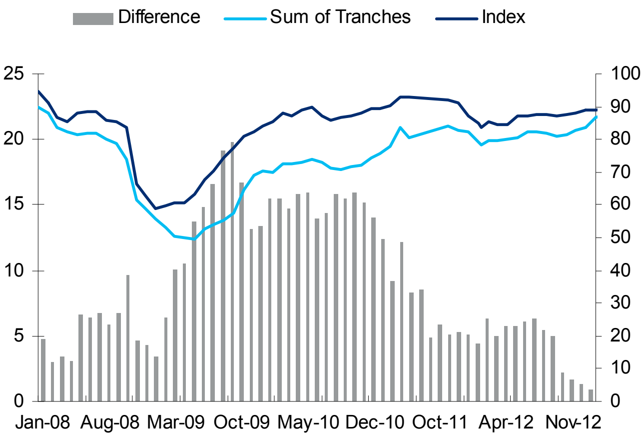
Source: S&P

Figure 19. Collateral/Tranche Arbitrage (US Deals)



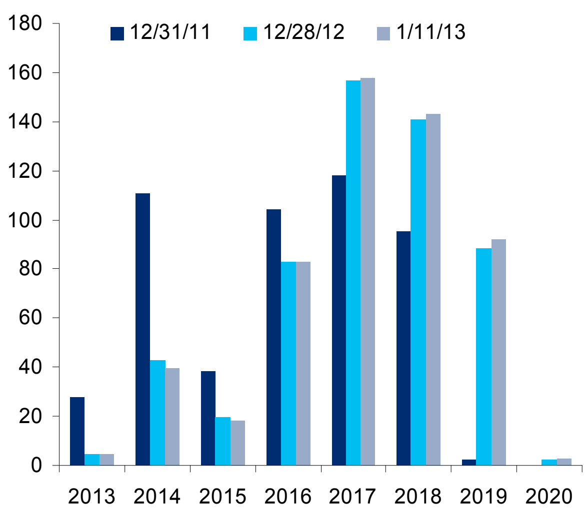
Source: Citi Research

Figure 20. Collateral/Tranche Arbitrage (EUR Deals)



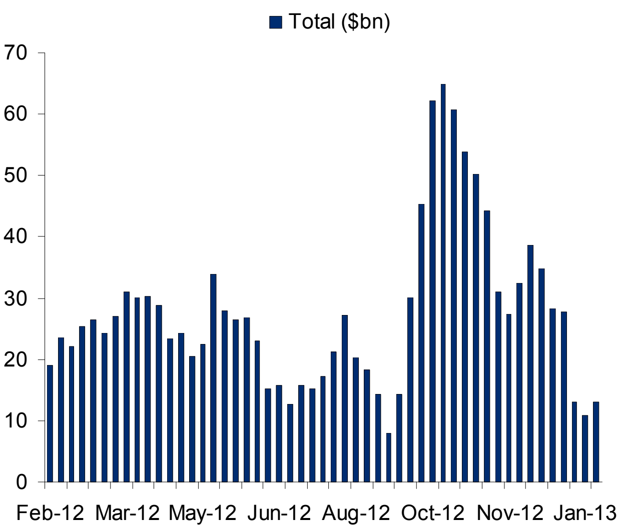
Source: Citi Research

Figure 21. US Loan Distribution by Year of Maturity



Source: S&P

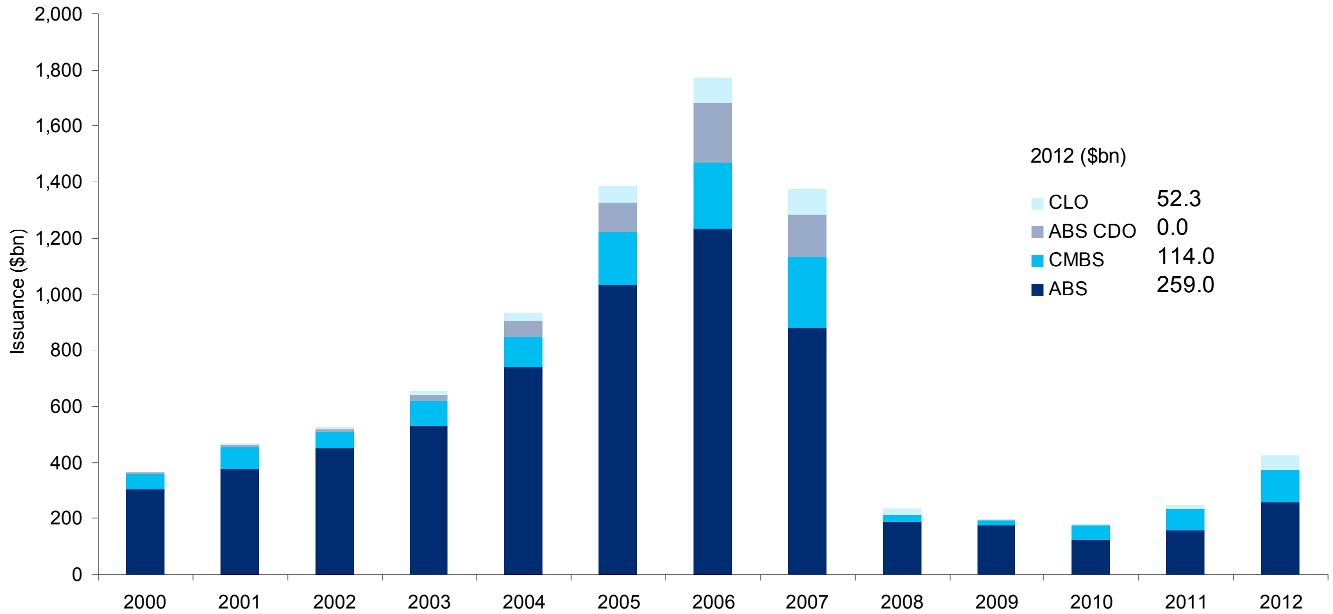
Figure 22. US Institutional Loans Launched to Market (Rolling 30-Days)



Source: S&P

Securitized Products Issuance

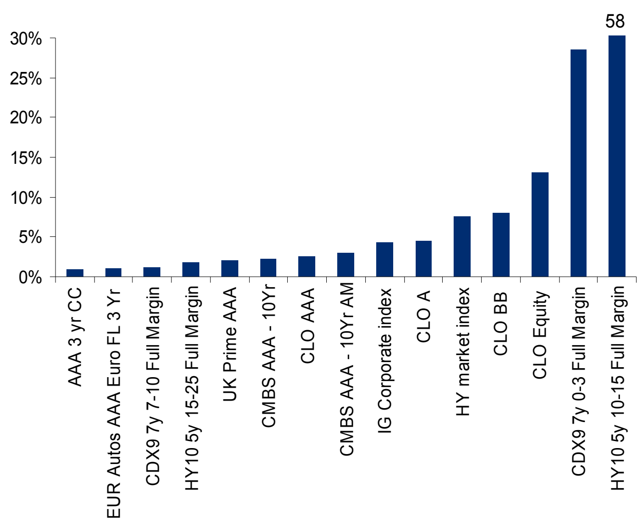
Figure 23. Year-to-Date CDO Issuance and Securitization Market Historical Issuance ($bn)



Source: Bloomberg, Citi Research

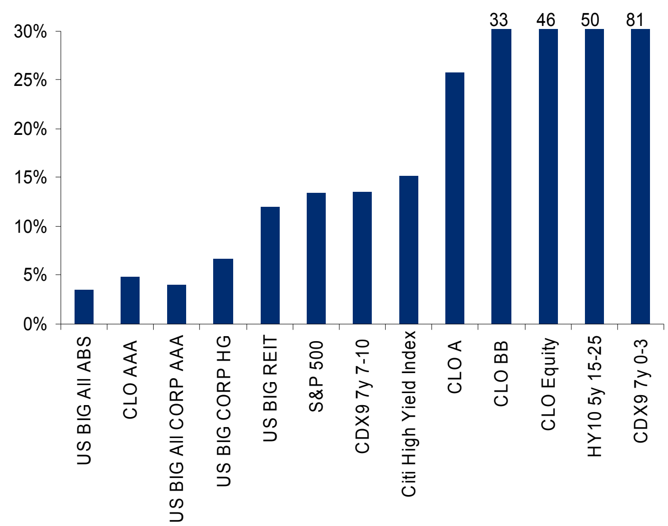
Securitized and Non-securitized Products Returns

Figure 24. Simple Yield



Source: Citi Research

Figure 25. Total Returns, 2012



Source: Citi Research

Appendix A-1

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