

# THE MARKET FOR NON-TRADITIONAL SECURITIZATION: ESOTERIC ABS STEPS INTO THE MAINSTREAM

The market for so-called off the run securitizations boomed in 2017, particularly in whole business, aircraft and energy finance sectors. As low rates draw more investors into far flung corners of the fixed income markets, non-traditional ABS can be an attractive buy, given the premium investors can expect for added complexity and unfamiliar collateral. With cheap funding via securitization for issuers and more investor interest in nascent asset classes, esoteric ABS is becoming a focus for more portfolio managers than it has in the past. Investors at last year's SFIG Vegas conference said that non-traditional assets would be a point of focus in 2017, and that theme appears set to continue in 2018. As the market looks back at the boom in esoteric ABS in 2017, *GlobalCapital* gathered a panel of industry experts at its New York office to discuss their outlook for the coming year across a range of asset classes.



## PARTICIPANTS IN THE ROUNDTABLE WERE:

**JAMES BASKIN, HEAD OF US STRUCTURED RESEARCH, AEGON ASSET MANAGEMENT**

**RONALD BOROD, FOUNDER, RAM ISLAND STRATEGIES**

**ALEXANDER DENNIS, DIRECTOR, S&P GLOBAL RATINGS**

**JOHN DI PAOLO, PRINCIPAL, PGIM FIXED INCOME**

**DEBORAH NEWMAN, DIRECTOR, S&P GLOBAL RATINGS**

**ALEX NIXON, DIRECTOR, DEUTSCHE BANK**

**RAHUL VISHAL SINHA, VICE PRESIDENT, ATHENE ASSET MANAGEMENT**

**JING XIE, DIRECTOR, S&P GLOBAL RATINGS**

**SASHA PADBIDRI, MODERATOR, GLOBALCAPITAL**

**GlobalCapital:** Most aircraft ABS transactions in the last couple of years are backed by mid-life aircraft. This should continue in 2018 as aircraft valuation is high and there is abundant capital chasing the yield of aircraft ABS. It's a good time now for sellers of mid-life aircraft. In your view, do rising fuel prices and updating aircraft technology present problems to mid-life aircraft and what are the main risks you are seeing on mid-life air-

## craft backed securitization?

Alex Nixon, Deutsche Bank: This question comes up a lot and I think it has to be bifurcated into in-production and out-of-production. I really see it as different when you're looking at, for instance, an A320ceo that's two years old and ten years old. In ten years, that A320ceo is going to be near the end of its life and ready to be retired

whereas the two year old A320ceo is going to be 12 years old and in the middle of its expected life, but now it's going to be overtaken by many A320neos in the market. So I think that you really have to drill down into the different collateral types and it's much more important to know which will become obsolete quicker and also what else is going to challenge these aircraft as they come to market.

**Ron Borod, Ram Island Strategies:** I'm not an aircraft specialist but I just want to find out whether the type of aircraft and the vintage of aircraft would have an effect on fuel cost and would that therefore potentially be a credit negative for the mid-life aircraft in the portfolio?

**Rahul Vishal Sinha, Athene Asset Management:** I would also add the geography. A lot of airlines do not hedge their fuel costs, which can become problematic for debt performance and the performance of the underlying leases. There are also other aspects – renewal risks for narrowbody versus widebody –these situations also come into consideration.



**JOHN DI PAOLO,**  
**PRINCIPAL, PGIM FIXED INCOME**

**John Di Paolo, PGIM Fixed Income:** Rahul's comments highlight the primary issue many investors have with analyzing aircraft ABS. You really do require specialized aircraft knowledge, which we believe that traditional ABS research analysts do not possess. I believe investing in this sector requires the hiring of a specialized aircraft team that understand the different aircraft types, fuel costs, and all the factors that impact the collateral in a securitization. It is a sector that currently doesn't offer good relative.

**GlobalCapital:** We have seen many new leasing platform joining aircraft ABS market recently – for example, Sky, Wings, and World Star all issued ABS last year. What's your view of their ability to glide through the industry downturns? What are the challenges, opportunities and main risks facing these new leasing platforms?

**Nixon, Deutsche:** I'm not sure about World Star, but the rest of the issuers were founded by experienced people who have been working in this industry for decades. So if anything happens, the team can handle it.

**James Baskin, Aegon Asset Management:** As an asset class, aircraft ABS is pretty volatile. So in the first generation of aircraft ABS, we saw fuel prices, technology, and terrorism all wildly affect the valuation of the aircraft. In the second generation of aircraft ABS, we've addressed some of the structural issues apparent the first deals. But at the end of the day, it's still a volatile asset class in and of itself. You have to have a structure that's dynamic and can handle that volatility, otherwise you're going to have investors dislocated on their projected price versus where the bonds are trading. Also, like what John mentioned, it's definitely something where you must have expert knowledge to really cover a sector that's very different from the esoteric ABS market that we're seeing today, which is generally consumer or commercial loan driven.

**Sinha, Athene:** So when we talked about Sky or Wings, they may have industry veterans leading the organizations, but the senior management provide the strategy and brand name. At the end of the day, the platform with capabilities of marketing and servicing assets are what's important. When you talk about Sky, its currently available for sale and this asset class is so service intensive that I've got to think about the motivation and strategy of the buyer. How do the capabilities change with respect to servicing the planes in the portfolio?

**GlobalCapital:** The shipping container leasing sector recovered tremendously in 2017, benefiting from increasing containerized trade growth, disciplined container supply, and rising steel prices, though the shipping line credit is still weak. What's your outlook for the industry fundamentals in 2018 and how will they impact container ABS performance and new issuance volume?

**Baskin, Aegon:** I think the container space really had a tough go last year. Declining steel prices and the Hanjin bankruptcy really tested these structures. The shipping industry is in distress globally but in terms of the structures themselves, they've held up pretty well given that level of stress. Global trade has come back, but there are still headwinds. Another point is consolidation within the shipping industry. That consolidation is going to create less diversification in the pools, which could be a challenge for rating transactions. Traditional ABS investors love diversification – the securitization model works from lots of diversification – and if you have the shipping lines consolidate, it's going to put pressure on how many defaults you can handle in that pool because they're so concentrated. Also the industries themselves are so tightly knit that it's hard to have diversification within the shipping

lines as well. All of these folks are operating with the same model.

**Di Paolo, PGIM:** One of the challenges we have in aircraft and shipping containers – and some of the other esoteric asset classes – is the amount of transparency you have into the performance of the underlying collateral. You really need to understand what's happening at the asset level. Putting on my other hat as a CLO research analyst – when you review the CLO servicer reports, you have complete transparency into the underlying collateral, asset prices on the collateral, and you have corporate credit research analysts who understand the underlying names within that pool. And CLOs price at or better levels than most other esoteric ABS.

**Baskin, Aegon:** That is a good point. When you look at container issuers that are also public entities, you gain a lot of transparency from their public earnings announcements more so than their remittance reports. So it's very important to have cross-over analysts that follow the issuers as well as the underlying ABS.

**Sinha, Athene:** The sector has definitely rebounded. But with the new issue that followed through, I expected the new issue to contain certain features providing credit protection. But eventually I saw some triggers being built in the trust, that for all practical purposes are of no value. One needs to be much more focused on the collateral, the company and global trade rules –than looking at the ABS structures for protection.

**Jing Xie, S&P Global Ratings:** To Rahul's point, previously most EBITDA accounting-driven triggers, and now many of the cash flow-based triggers we're seeing in transactions like DSCR coverage, may not be that meaningful in our analysis because we stress the deal so hard so there's barely any cash left post trigger.

**Sinha, Athene:** Yes, I would imagine that by the time the triggers actually get breached, there's barely any cash remaining in the system.

**Jing Xie, S&P:** I agree that it doesn't really matter, but we know qualitatively that it matters.

**GlobalCapital:** 2017 was an unusually active year for whole business securitizations. Several new issuers were able to successfully access the market, such as Jimmy John's, TGIF and Five Guys, and refinancing activity was robust for existing issuers like Domino's and Dunkin Brands. Should we expect the same volume heading into 2018?



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**Dennis, S&P:** You have to keep in mind that in whole business, there's a very limited number of companies in the market. S&P has public ratings on 14 businesses in this space – four of which were new last year, and out of the remaining 10, six completed refinancing activity over the last two years. Therefore, we don't expect a lot of refinancing this year, but that said, the current supply and demand dynamic makes it very attractive for new issuers to explore the market. Earlier in 2017, we heard about deals that were 10x oversubscribed, and more recently we have heard up to 16x, and you can see that reflected in the pricing. The Wendy's transaction with 7-year ARD (Anticipated Repayment Date) notes priced with about a 3.5% coupon. For a triple-B level, especially for esoterics, that's pretty competitive from an issuer's perspective. That said, we've always taken the view that whole business is really not meant for everyone. The burden of proof to convince the market that through a securitization you can transform the business and materially improve the credit profile is a tough thing.

We've always had a lot of inquiries for whole business securitizations but very few issuers actually make it to the securitization market. So I think this year we will have an increase in the number of inquiries given market conditions but I suspect probably not a material increase in deal volume hitting the market.

**Borod, Ram Island Strategies:** What's probably worth talking about is that the basic structure and rating methodology of a whole business securitization is different from a typical, more commoditized asset where the cash flow is self-generating, even though it might take a servicer to perform the collections function. Whole business, by contrast, is dependent upon an operating company to squeeze the value out of the franchise concept or whatever else is involved. Which means you're more dependent on the operating company and so the reason why the operating company is interested in whole business securitization is because it can achieve a rating elevation above its own rating. To Alex's point, what that means is that you have to be able to analyze that company as if it were going through a bankruptcy and see how the infrastructure and assets would perform through a bankruptcy. It's a very robust, multi-layer analysis, I just think that what also makes it unique is that a lot of whole business transactions are not securitizing gross revenues, they are securitizing EBITDA. Which means you have to worry about whether certain operating costs are going to spike and interfere with the available cashflow. So the result is that you have to go through quite a rigorous process.

**Baskin, Aegon:** I think structures are very friendly for issuers to refinance, and I think issuers are



**JAMES BASKIN,**  
**HEAD OF US STRUCTURED RESEARCH,**  
**AEGON ASSET MANAGEMENT**

going to continue to push the boundaries on what could be securitized. For those issuers who haven't tapped the market, you could potentially see them being opportunistic, having seen other issuers find a spot in the securitization market. The whole business structure itself is interesting but there is definitely a cost-of-entry for an issuer. Once you have gone through the hard work of setting up the reporting requirements – because these transactions were mostly being financed in the high yield market – and you accept in some regards, tighter covenants for the structures, then you get all the benefits, like a better rating and a lower cost of capital, and the flexibility to add debt when you want to. That flexibility gives the business model a lot of opportunity to turn some variables cost into fixed cost.

I agree that it's not a contractual cashflow unlike a traditional ABS model where you're securitizing a fixed cashflow. Remember, these are pizza and burger sales that haven't been made yet. So, you're still betting on the business itself to generate that sale, which is a different risk than what is seen in more established securitization sectors.

**Di Paolo, PGIM:** We have not been an investor in whole business securitizations. At the start of 2017, our ABS team and our corporate desk explored the sector. As we expected, 2017 was an active issuance year but we came away with no investments. Looking at the sector, the fast casual business sector is very competitive. Business plans are usually based on some level of international expansion. I wonder why someone would eat at an American fast food chain in London. When we looked at the structures, ABS investors are accepting lower compensation in terms of spreads, covenants and terms than what the high yield marketplace would require. And we find that troubling. In a stressed environment, when the ABS structure is trapping all the franchise fees, how is the corporate entity going to support

the franchises? Will you be in a death spiral, and who would step in then to recapitalize the firm? So there's just a lot of questions and ultimately we didn't feel comfortable with the sector.

**Sinha, Athene:** We talked about having structural features to support the transaction, as well as some of the issues related to projected sales and these need to be analyzed when making an investment decision. So from that perspective, all these come into play, especially in the current retail market. But what happens in case of disruptions—if for example, Amazon enters that specific market? Impact from technology disruption occurs pretty quickly. Even from a structural protection perspective, I have seen the DSCR triggers breaching on a standalone basis, and I've seen significant incentive for the issuer to continue supporting the transaction by advancing cash payment and then recouping it in the residual cash flow.

**Baskin, Aegon:** If you look at CPI data for eating at home versus eating out, it's at the widest margin in the last 30 years so it's much more expensive to eat out than to eat at home as we all know. And as that translates into whole business securitizations, it just shows how sensitive these business models are to employment, GDP, and any slowdown.

**Borod, Ram Island Strategies:** I would assume that it's stressed pretty heavily when it goes through the rating analysis.

**Alex Dennis, S&P:** Yes. We actually published an article related to this last year. What we did was look at the sales declines of the different restaurant concepts that we've rated in the whole business context over the last downturn. What we found is that on average, system wide sales growth only went slightly negative in 2009, and then started to rebound in 2010. This is largely due to average sales beginning to increase in 2010, which offset the general decline in store count. We think this makes sense as many of these businesses are fairly defensive concepts. So it's not surprising to see that they don't decline that much. Despite that, in our credit rating framework, for royalty-based cash flow, we generally apply haircuts of about 15% and then just keep them permanently reduced at that level. That compares to an average of revenue decline over the last downturn for retail concepts generally at around 3.4%, so it's a pretty high multiple of that. Obviously there's distribution, but we take some comfort that the concepts that we're looking have been a relatively stable subset of the broader retail space.

**Sinha, Athene:** I always wonder – if an 'El Pollo Loco' type of restaurant issued in the securitization

market, how would the ABS perform? I'm glad we're not there yet, but that's one thing I always think about. The existing issuers are top tier names, and that a high barrier-to-entry exists to set up ABS trust and tedious servicing requirements have kept lower tier issuers away from ABS market.

**GlobalCapital:** The demand for WBS has grown substantially over the last year as well. For businesses contemplating WBS as a source of financing, what do you see as some of the challenges and benefits they should be aware of?



**ALEXANDER DENNIS,**  
**DIRECTOR, S&P GLOBAL RATINGS**

**Dennis, S&P:** The benefit is clear – it's ratings elevation for what would normally be a non-investment grade corporate issuer, which can translate to substantial savings in terms of cost of debt for the business. One of the challenges, from a ratings perspective, is that without a substantial track record – often we're looking for 20 to 30 years of operating history – we find it very hard to rate these transactions. Ron previously said that the cashflows here are very unusual in that you're monetizing the sales that the business as a whole has generated, and as a credit analyst you often have to project sales going out for 20+ years. To get comfortable with that, we really need an equivalent amount of history to show stability in sales generation spanning multiple economic cycles and management teams running the business. The other stumbling point what we refer to as 'asset independence'.

What we're looking for here are businesses where we can take a view that the assets are independent enough that if the existing operator were to go away or be replaced, those assets would continue to generate a material amount of cash flow. Franchise restaurants are a great example, because they're literally a network of independently operating assets, run on a day-to-day basis by franchisees to generate sales, and the activity and responsibilities of the franchisor or operator are pretty limited.

They may do marketing and supply chain man-

agement, but our view is that if they needed to be replaced in the future the franchisees would continue to operate their stores and generate sales. If we don't see a business model where we can take an existing operator out of the picture, such that the assets will continue to generate cash on their own at a material level then there's really no basis for ratings elevation at all – and that turns out to be the most common stumbling block for the proposals that we see.

**Borod, Ram Island Strategies:** One implicit thing I would assume is that if you had a franchise system with a lot of company-operated stores as compared to franchisee-operated stores, that would be a credit negative.

**Dennis, S&P:** That's a great point. As the company-owned store percentage increases, you have more and more dependence on the company and hence the thesis for ratings elevation over the company's stand-alone rating is weaker.

**Di Paolo, PGIM:** For the fast-casual space, how do you stress the fact that a particular concept goes out of business? You say that people might still want to eat at a certain restaurant, but a new chain could come in and be more attractive. Some of the 20 to 30-year old businesses may be tired concepts to consumers and they may not eat at that space – so how do you factor that in?

**Dennis, S&P:** We're generally more conservative with our assumptions for casual dining and fast-casual. FOCUS brands was a really interesting concept that hit the market last year as it kind of combined traditional QSRs (Quick Service Restaurants) with some fast casual concepts, and what we saw in the data – and we've also seen this in other places – is that casual dining and fast-casual dining ticket prices are higher, so the concepts are more sensitive to downturns, but through within a portfolio of brands you have diversified revenues, and we saw that stabilize the performance of the overall business. But without that diversification benefit in general we're going to be more conservative.

However, if we don't think the brand is likely to survive over the long term, that is more of a question about are we comfortable rating the business at all. If we do believe the business is could continue to survive at some level, then it becomes a question of what is the appropriate stress level to store count and sales.

**GlobalCapital:** California recently passed legislation intended to protect consumer interests by requiring PACE finance firms to consider property owner's ability to pay as part of the "underwriting" process as well as requiring contractor over-

**sight. Do you believe these protections will attract new securitization investors?**

**Borod, Ram Island Strategies:** Just a word on PACE generally – it's a state by state program that permits the installers of energy efficiency projects on real estate to secure their financing with a tax lien. That's given rise to a lot of securitization activity and most of the metrics that people have been focusing on has been ratios between the lien securing the financing and the value of the property. Another ratio is between the lien and the mortgage on the property, and that kind of analysis was not giving a whole of thought to the obligor – what if the obligor was defrauded or doesn't have the ability to pay? So I think the initiative in California is credit positive and there's now attention being paid to the underwriting standards and disclosure and I think California also adopted protective measures for low-income users.

On the federal level, there are a couple of bills that are pending that should be followed – one is the bill that would impose similar requirements at the federal level on PACE, and there's another bill by Senator Tom Cotton from Arkansas that would go a step further and make the municipalities qualify as mortgage lenders. I think you have to look behind the legislation to see what's motivating them, and it appears to be an attempt to undermine the advances that PACE financing has made. But at least at the state level, these new requirements are a positive.



**RONALD BOROD,**  
**FOUNDER, RAM ISLAND STRATEGIES**

**Di Paolo, PGIM:** I concur with many of Ron's comments. Our initial concern with this sector was whether consumers would fully understand the loan terms. While recent developments are a positive, I still think that it's a very nascent sector.

**Nixon, Deutsche Bank:** I would agree that these are structural positives, not necessarily credit positives. I think most people are comfortable with the credit quality given where the tax assessment is in the



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payment priority, but if you're an investor that looks at consumer loans, someone with whom a PACE tax assessment would not be in the same category as loans regulated by the CFPB, I think you're going to have to go much further and put all the bells and whistles with making municipalities regulated in the same way as other consumer loan originators. The regulatory implications are much bigger compared to these little tweaks that are being done.

**Baskin, Aegon:** I think we've all learned from the past that if it's a consumer-originated product, you have to follow all of the consumer regulation, and if there's a loophole here just based on what the asset is, we as an industry have to take a couple of steps back and make sure that we're doing best practices to make sure that it doesn't come back to haunt us later. We didn't mention the FHA regulation, but that's another wrinkle to the asset class where the FHA has been on and off again on their willingness to insure mortgages with a PACE lien on them. And you know, it's kind of unfortunate because it slows the development of the asset class down.

I think what the FHA is really worried about is that the improvements are not actually adding any value to the property. They should be rightly concerned – but we should as an industry look to improve the process such that if a residential PACE lien is being placed on a property it is generating the value that we intend it to through energy efficiency or structural improvements.

**Borod, Ram Island Strategies:** And what that does mean in terms of disclosures, is that the borrowers need to be told they cannot refinance using a conforming mortgage under the GSE rules if they desire to have pay off an existing loan through a refinancing or they intend to sell the property to someone else who wants to refinance, because the FHA has been on again and off again with its stance, and right now it's off again.

**Di Paolo, Prudential:** For us, the changing nature of FHA's stance (currently the FHA will not insure mortgages on houses with PACE liens), and what it means for the consumer and their mortgage just prevents us from seriously considering the sector.

**Borod, Ram Island Strategies:** If you want to get really granular, there's a lot of other issues in PACE that have to be addressed. The deal structure – number one – the assessment is collected, generally, by the municipality – and so you have to worry about municipal bankruptcy risk; and most well-structured deals would have a lockbox structure in place but you need to worry a little bit about what happens if you have a below-investment grade municipality that handles all the funds even for a short period of time.

**Deborah Newman, S&P:** I would add from a rating agency perspective – the regulations are very helpful, particularly when assessing credit quality in the context of a securitization. The guidance regarding using AVM (Automated Valuation Model) to determine property value is important because value is a key component in underwriting. As we evaluate this asset class, we might consider how to stress the AVM as provided. We've done a lot of analysis on our end to compare the tax assessed value to market values. Although we, recognize that in California the existence of prop 13 results in low tax assessed value.



**DEBORAH NEWMAN,**  
**DIRECTOR, S&P GLOBAL RATINGS**

**GlobalCapital:** Given the limited historical data, what benefit do you attribute to the treatment of PACE assessments as tax certificates? As the PACE industry develops, what changes do you believe are most likely to be implemented?

**Nixon, Deutsche Bank:** I don't really think historical data is really an issue here. Most of the PACE originators' use statutes that have existed for decades for municipalities to do special tax assessments. They are doing the same thing and just tacking on 'PACE' and separately most of the originators have sued themselves to create case law in the event that someone were to sue them. So they've kind of covered the bases on that one.

**Newman, S&P:** At the risk of putting you on the spot, in Florida delinquent taxes including PACE assessments are sold through an auction process. Do you have any concerns that delinquent PACE Assessments might behave differently than a typical tax certificate in an auction process?

**Nixon, Deutsche Bank:** I was thinking more about the California program and the case law, but I guess that is potentially one of the pitfalls of PACE. Many states do it differently so you have to understand the different ins and outs.

**Borod, Ram Island Strategies:** Just moving over to delinquent tax lien securitizations, which is its own asset class, there are a lot of potential controversies there. I know in Massachusetts the Boston Globe is doing a series on these transactions and a lot of the homeowners are oblivious to what's going on. Although the sponsors are saying the homeowners have been given notice and numerous opportunities to pay those deficiencies, it's not totally clear that that's really happening. So I can see consumer issues arising in that sector if those certificates start getting detached from that program, or sold separately.

**Di Paolo, PGIM:** I think until those consumer and regulatory issues have more clarity, I don't think you're getting any value in a PACE product relative to a CLO, so why take on all this uncertainty in an investment?

**GlobalCapital:** Residential PACE took off much faster than commercial PACE. What do you attribute this to and what is your growth forecast for commercial PACE?

**Borod, Ram Island Strategies:** There's a bit of a difference between commercial PACE and C&I solar – I've been focusing a lot on C&I solar. It's almost a non-existent subclass of the ABS market. Commercial PACE has only seen one deal – by Greenworks – that Morningstar rated, but it's not clear what methodology was used. As to the reasons why commercial PACE issuers have not been in the market, it is because the aggregators have not been able to scale up and those individual transactions relative to whole portfolios tend to be lumpier and they're larger loans as well. Likewise in the solar space, it's fragmented and sponsors don't have critical mass to get into the market.

The difference is that in PACE, you're not trying to evaluate as much the creditworthiness of your off-takers compared to C&I solar because you have the tax assessment. As long as you're complying with the requirement that you get your property owner's mortgagee's consent, which commercial PACE also requires, I think it's a drag on the originator – it's harder to aggregate, harder to grow to critical mass and go to the ABS market. But I think it's going to happen and issuers are trying to grow their businesses.

**Di Paolo, PGIM:** As investors in CRE, both in terms of securitizations and within the underlying whole loan, we are not very supportive of commercial PACE. We believe you're priming a commercial real estate loan.

**Baskin, Aegon:** To address the volumes, I think lender consent is currently an obstacle, but it is

just as important to build out the infrastructure to address the market – it's clearly a big market and most of the big projects are going to require lender consent, and to John's point, you have to work with the existing CMBS market with this product to get there.

But there's clearly a need in the market for energy efficiency on the commercial side – so I'm a little more optimistic on its growth. Many states have adopted the program but you don't really have many issuers on the ground educating commercial banks on how the product works yet. That process has just now started.

**Di Paolo, PGIM:** Some jurisdictions like Florida don't require lender consent and even if you think about CMBS securitizations, they have loans that are small enough where someone can come in and prime that loan and that just lowers the overall credit quality of a CMBS securitization. That's a concern for us.

**Newman, S&P:** So is that a concern despite the energy efficiency improvements?

**Di Paolo, PGIM:** It's very hard to assess the improvement – if you look at the standard terms of a CRE loan, you can't prime the loan or put a debt ahead of it. Somehow you're getting around this promise that you made, so we don't think it's a good policy.



**ALEX NIXON,**  
**DIRECTOR, DEUTSCHE BANK**

**Nixon, Deutsche Bank:** I think it's more qualitative than quantitative. I think that's the same reason why so many domestic banks generally stay away from PACE because they're big mortgage originators in both the residential and commercial space. Not because they don't believe in the product but they don't believe in priming themselves.

**GlobalCapital:** Right now, is anyone seeing any new deals or collateral types on the horizon for

**esoteric ABS this year? Are there any new innovations in the market you are keeping track of?**

**Dennis, S&P:** In a non-traditional ABS ratings role, there's certainly no shortage of ideas being presented at any time – one of the more interesting ones that we assigned ratings to was a data center securitization. In that structure, your assets are commercial real estate housing servers and other networking equipment, for what we would call 'hyperscale' tenants. So these are high data usage companies often providing cloud services and the cashflows in the securitization are lease payments from these tenants. So we think it's interesting from a credit perspective because it's pretty similar to triple-net lease – but you benefit from having relatively long lease terms -the transaction we rated has a little more than an eight year average lease term, and 75% are IG lessees. Beyond that we think there's a relatively favorable supply and demand dynamic for data centers at least in the near term, and then the transaction has the credit enhancements floor of owning the actual real estate. So we're keeping an eye on this area of the market. After that report came out, a lot of investors reached out with questions along with other capital market participants starting to think about similar transactions.

**Borod, Ram Island Strategies:** I've been involved with a long term project and to put it in context – there's a group of studies that were made by some financial engineers at MIT based on the fact that a lot of drug therapies never make it to the market because there's not adequate venture capital – the VC industry is not large enough to fund these and also they generally bet on single drugs. So the thesis – the mega fund theory – is that you aggregate a large enough portfolio of early-stage biomedical assets but then statistically it would take only a few to succeed in order to repay debt and to pay return to equity. And so I've been working with a well-known life science institution in the Midwest to take that theory and create an early stage biomedical asset securitization. It's not easy because it runs counter to a couple of basic securitization principles, which is a) you need to have an identifiable asset and b) you have to have cash flows. But it's an ongoing project and I think the ultimate benefits are worth the effort. We'll see where it all goes.

**Di Paolo, PGIM:** I think the challenges for estimating the cashflow stream for ABS investors like myself, would be – do I have the expertise to understand the underlying research that's getting done, and can I assess the probability of outcomes. Statistically speaking, something is going to hit, but that seems much more what a venture capital fund should be for, not necessarily securitization that potentially issues investment-grade rated debt.



**JING XIE,**  
**DIRECTOR, S&P GLOBAL RATINGS**

**Borod, Ram Island Strategies:** Most of the deals we've talked about are after the advance rate – solar is trying to get above 75%, PACE is up to 95% advance rate and in this early-stage biomedical asset transaction, the debt has not been used to really create leverage as much as complement the equity that's in place so that the size of the portfolio is large enough to be able to use the statistical analysis of the mega fund theory. And so, we'll see how this plays out but some of the structural features are hopefully going to be robust enough so that even if you're not an expert, you can attain confidence that there are sufficient reserve funds, overcollateralization, covenants and trapping events to make timely payment likely and default unlikely.

**Jing, S&P:** With regards to transportation ABS, I would say that for aircraft securitizations, we expect that there would be some new collateral like business jets or all-freighter deals. In the past, we have seen some stress or challenges in those assets, for example the value retention risk or oversupply issues. I think these issues can be addressed by how the structure works to accommodate or overcome those challenges.

**Baskin, Aegon:** I think the growth of the esoteric market, going forward, is hiding in plain sight. A lot of the old asset classes are new again – aircraft ABS being one of them, versus the 2000s. But just this week, we saw some very interesting assets that were hiding out right in more traditional ABS sectors like Tesla's deal. Auto leasing is not new but we've now seen it on electric cars so we're all expanding our horizons within existing asset classes. I'll give you another example – student loans or consumer loans are not new to anyone in the ABS markets, but originated through a fintech platform does start to feel more esoteric than it did before.

**Di Paolo, PGIM:** I agree with Jim. We work in the



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traditional space where we have deep history and knowledge – searching for unique opportunities to complement the work that we already do, as opposed to trying to go out into a different asset class in which we have no expertise.

**GlobalCapital:** How are you feeling about where esoteric ABS is in the current credit cycle and the value it presents compared to other ABS sectors? From a risk-return perspective, what asset classes are you paying attention to this year?

**Di Paolo, PGIM:** I think we're still in a very benign credit environment today, but given our history in the sector, a few extra basis points on a one-off trade isn't worth the effort and it's not a good long-term strategy. CLO triple-As and double-As are still very attractive at 100/135bp over and that's what our focus has been.

**Dennis, S&P:** S&P economists recent put out a report noting the increase in corporate leverage in 2017. They estimated that 37% of the corporate borrowers had 5x leverage on an EBITDA basis – that's relative to 32% in 2007. I think we would all agree we have been in a pretty benign credit environment for a long time and to the extent rates normalize, that could put pressure on a number of borrowers that we see in securitization structures.

**Sinha, Athene:** Leverage ratios in whole business securitizations continue to increase, so with respect to that, how do you expect to counter that situation?

**Dennis, S&P:** We approach it in two different ways. One is on the cash flow side. Obviously there has to be enough cash flow generated by the assets to support the higher quantum of debt. But we also have a qualitative adjustment that has nothing to do with the model, where if we start to see leverage creep up we have the ability to notch the rating downward. At the end of the day, these transactions rely on projecting sales going out over a very long period of time, and that's why we try not to be overly reliant on model results and think qualitative adjustments for increasing leverages is appropriate.

**Baskin, Aegon:** I would echo that the market today for pretty much every asset class is doing quite well. If you go back in time, you always had some part of the market, whether it is manufactured housing or subprime auto that gave investors some range in quality from performing to distress. Today, credit problems are pretty benign. I think we all know that this environment won't last forever. The market is certainly pricing a benign credit market today. We're starting to see the pressure

between senior and subordinate securities even in the esoteric space. That compression is starting to feel a little too tight to us and I know the esoteric market can be an illiquid market at times and when it's also coupled with credit performance, it's a pretty volatile asset class. So we're starting to see more value in the seniors than subordinates in some sectors as valuations get stretched.

**Di Paolo, PGIM:** One of the areas that we concern ourselves with is liquidity. When you want to exit a security who will be there to provide secondary liquidity. The value of call options imbedded within esoteric securitization are another aspect of investing that we believe is often undervalued.

**GlobalCapital:** What are the policy and regulatory trends you are paying attention to this year? In this shipping space for instance, are market participants still concerned about a slowdown in global trade due to protectionist trade rhetoric or conflicts around agreements like NAFTA?

**Jing, S&P:** In the shipping space, we have seen global trade has recovered and we've seen some positive increase in terms of containerized trade growth. Containers are global assets. NAFTA may limit certain trade volume among U.S., Mexico, and Canada, but on other sides of the world you might see an increase, like trade between China and Mexico. Our container transactions are all backed by global container portfolios. If you look at the shipping routes, they are all over the world. So you need to look at global trade and global economy. On regulatory developments, one thing we should pay attention to is tax reform. For example, tax reform for airlines may allow them to have more capital to spend and maybe pay down their debt. From a leasing perspective, if airlines buy more aircraft, that could cause some slowdown on leasing demand from some U.S. airlines. There's also the accounting rule change – there is discussion on whether companies would prefer long or short-term leases. The accounting change could mean that companies could go with shorter-term leases.

**Borod, Ram Island Strategies:** As an esoteric securitization lawyer, when Dodd-Frank was enacted I thought it would have no effect on me. Subsequently I learnt that I was totally incorrect about that, and I'm spending a lot of time working through risk retention structures and complying with the risk retention requirements of Dodd-Frank. The rules are ambiguous in certain important respects but having said that, ABS issuers have adapted to the new regulatory order pretty well. I know there's a movement in Congress to try to deregulate our industry. Risk retention is one of the targets of that, and as someone who was there

10 years ago, I'm just sounding a warning that we have to remember what went wrong in 2008, both from the investors' and issuers perspective.

Even though it's hard to work through these issues and getting deals to market on time, I think it's still beneficial to have and I think that more risk could be created by a deregulatory environment that we haven't even begun to think about; and I hope the ABS industry will speak up about this and not allow the regulations to be swept away just because they may cause some inconvenience to issuers.



**RAHUL VISHAL SINHA,**  
**VICE PRESIDENT, ATHENE ASSET**  
**MANAGEMENT**

**Sinha, Athene:** One thing we haven't mentioned is the QE program – as the US, Europe and Japan talk about reducing their QE size, I wonder how much of that is going to result in some sort of asset class shift in terms of investment strategy?

**Newman, S&P:** With regard to PACE, we are tracking whether other states would follow California's lead and adopt similar legislation.

**Sinha, Athene:** Capital restriction in China is also creating some amount of stress for asset classes. The capital controls have created pressure to entities such as HNA and probably there will be more shoes to fall.

**Baskin, Aegon:** You really have to be careful on the regulatory front. Just on this panel alone, how many of the previous questions have we discussed where regulation wasn't an important credit factor? Trump imposing a 30% tariff on solar panels – could you have seen that coming? Maybe, but those are the risks that investors have to be prepared for. Those are the complications of managing a big esoteric portfolio – you're in a lot of different areas that might be on the fringe where regulatory regimes haven't been fully fleshed out yet. That's what creates opportunity, but that's also what creates some of the risk around the asset class as well.