INTERNATIONAL FINANCING REVIEW

Thomson Reuters

Securitisation 2004 - Debate brews on valuations

IFR Securitisation 2004

CDO professionals are using imperfect valuation models. While they concede it is almost inconceivable that a CDO will be liquidated, net asset value still remains an important test for not overpaying on a seasoned CDO – since it gives the most realistic view on the future performance of collateral. Some argue for greater use of cashflow valuations but market convention is hard to change, as David Graubard reports.

The valuation conundrum was well illustrated by DZ Bank's sale of the senior priority Aaa/AA/AAA MKP I arb cashflow ABS CDO at north of 90 cents in late Q1. The NAV supported a price of only 85. The jury is out on whether this was one-off trade or a sign of higher prices ahead.

Market participants continue to disagree with the price the investor paid on the senior notes, largely because of qualms that the market could move away from the more punitive NAV convention and never pay above the liquidation value of an asset. "There are not too many places where you can find investment-grade rated bonds quoted at pennies on the dollar," noted a source at one of the largest CDO investors.

There are a number of examples of the fundamental difference between the rating agencies' cashflow approach and NAV, or market value method. For example, the market values one Structured Finance Advisor's arbitrage cashflow ABS CDO (SFA CABS) II bond below five cents on the dollar. Yet it is rated Baa2/BBB+ (Moody's/Fitch). The class is understood to be deferring interest, which is technically capitalised, but rarely paid, say market practitioners.

Another example of the disconnect between market value and ratings is a Teachers TIASF 1A B US$5m Aa2 rated ABS CDO position that has an eight-year average life and is offered at 65 cents on the dollar. While the dealer selling the Teachers position recently had the offering listed at 658bp over Libor (nine times wider than the new issue 73bp) a handful of seasoned traders say this is not cheap enough due to its collateral deterioration. Moody's still has the class on watch for downgrade since February 24 because it breached several rating tests, including the over-collateralisation ratio.

"A key benefit of a mark-to-market approach [in valuing a CDO] is that it is a better indicator of the credit quality of the underlying assets than ratings, which are a lagging indicator," said Sunita Ganapati, global head of CDO research at Lehman Brothers.

According to Wachovia Securities' CDO trader, Zergei Zagin, "One needs to take market prices of the collateral in account when running (Monte Carlo) simulations, because market prices are good predictors of the likelihood of defaults. NAV is also crucial from the equity standpoint on the deals that are callable or near their first call date. If the deal is called, all collateral is liquidated, and all hedges and liabilities senior to equity must be paid in full, including make-wholes. If the deal is not likely to get called, then extensive simulation, scenario, and credit analysis is crucial."

According to Fieldstone Capital Group, a broker for secondary CDOs which is trying to build a model that uses NPV and market prices for its clients, a major obstacle is that there are no third-party data sources for seasoned ABS pricing marks and a legitimate proxy has not yet been found. An ABS CDO could have as many as 200 assets in its reference pool.

The most likely alternative to NAV would be something between re-rating the deal and using the original pool data as a proxy for book value, which in most cases is less conservative than NAV, said one dealer.

NAV, also known as the liquidation value, is the standard metric used for screening a seasoned CDO, partly because it can be extremely fast (assuming the buyer has prices on the pool, or knows the collateral well enough to guess). A full-blown cashflow analysis on an ABS CDO could take more than a full week to calculate and in the end could be skewed because of reliance on often lagging default probability inputs.

A trade above the NAV metric requires a buyer to either take a positive view on the recovery value of the underlying assets, and/or confidence in realising excess interest because of a senior priority.

On the other hand, rating agency methodology generally ignores the market value of the assets and opts for traditional cashflow analysis in order to take a long-term view, which is why several market participants claim that ratings are an out-of-date gauge of creditworthiness, particularly in ABS CDOs.

"Rating agencies do an OK job, but when it comes to valuing ABS CDOs, this is one of the few 'rating arbitrage' games left to play. Agencies say they are taking a long-term view, but there is a real disconnect when you have CDO tranches rated investment-grade that are trading at 65 cents, even below 10 cents on the dollar," argued one senior CDO trader.

"The first thing customers want to know when looking at a secondary CDO is what are the prices on the underlying collateral, not the ratings," emphasised one broker.

Underlying collateral ratings also often lag the market's view on value. For instance, Moody's has the 2001 vintage Oakwood manufactured housing OMI Trust B1 class, rated Baa2, on review for downgrade despite bids in the market at three cents on the dollar.

"The market has made a fundamental shift (from early 2003 when Abbey sold off US$10bn in CDOs) when most CDOs were trading extremely cheap to their NAV (including an adjustment for coupon interest) and that was the accepted metric. Now some dealers are making the case that CDOs should not necessarily trade cheap, which co-incidentally helps justify higher prices," said one sceptical trader.

"The valuation bids that make up the NAV in deals like MKP frequently involve illiquid and distressed bids on assets such as aircraft, mutual fund fees and manufactured housing that can vary by 20 points," said one seller, "which is why the rating agency cashflow analysis remains very important. However, the NAV valuation provides an essential lowest price to start bidding, plus it's far easier to explain to a manager why you paid under NAV than over."

Keep powder dry, beware CDO illiquidity

Once the credit cycle turns in the US, many market participants fear that those who bought primary CDOs at low coupons in 2004 will face mark-to-market pain and potential credit problems. Given that many collateral managers have been chasing yield with lower quality product, there could be dangers surrounding the 2004 vintage.

Furthermore, numerous seasoned CDO investors that were surveyed are not convinced CDO liquidity has yet become a fixture of the capital markets, particularly when remembering how hard it was to find bids prior to when the credit markets started to re-price in spring 2003 and when CDOs were regularly posted on Intex – the standard MBS and CDO modelling vendor in the US.

"I think it is a good idea to hold cash for when the market has an event change [credit defaults increase], to take advantage of spread widening," said one portfolio manager with several hundred million in mezzanine and equity CDO holdings.

New buyers drive up prices

CDO new issue prices are generally running at highs not seen since the late 1990s. Veterans are quick to blame new investors from Asia-Pacific and Middle East for driving up the market

"There are several new (rating sensitive) buyers in the market that will likely be forced to sell once volatility increases. For Triple As, which are relatively simple to analyse in comparison to mezzanine CDOs, these senior positions will likely continue to see liquidity in good and bad times," added the portfolio manager. "I see value and stability in Triple As (especially CLOs), but Triple Bs (in the Libor plus 250bp area) are looking expensive relative to the liquidity risk. Once the credit cycle changes, I expect we will have a one-way market on mezzanine CDOs where dealers will opportunistically make distressed bids and little more."

Meanwhile, Triple A arb CLO spreads are hovering at Libor plus 38bp with an eight-year average life, compared to 53bp over in late 2003. "We are not buying anything under Libor plus 40bp, because under 40bp over, those CDOs prices can only go one direction (down)," said one SIV manager.

Competition saddles dealers

"I see one of the biggest risks in the CDO market going forward is dealers saddling themselves with asset warehouse lines and first-loss underwriting exposure at cheap rates to win primary mandates. Some banks may regret winning these mandates due to an event or a credit cycle shift that causes a blow-up," said one CDO banker.

These types of losses could appear even if the bonds are performing because of mark-to-market accounting rules that dealers follow. For instance, a mistake made in the past is over-utilising a bank's ABCP conduit, or asset management arm, to place Triple A and Double A CDOs – to gain market share and retain the arranging fee volume, added the source.

Source:

None

The Financial & Risk business of Thomson Reuters is now Refinitiv

All names and marks owned by Thomson Reuters, including "Thomson", "Reuters" and the Kinesis logo are used under license from Thomson Reuters and its affiliated companies.