EMA Asset Management's Valuation Webinar Series

Credit and structured finance investments

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Introduction

Economic background

Shutdown of nonessential business across the US and Europe severely impacted corporate's revenue. Transportations, energy, leisure and retail are sectors that are impacted the most.

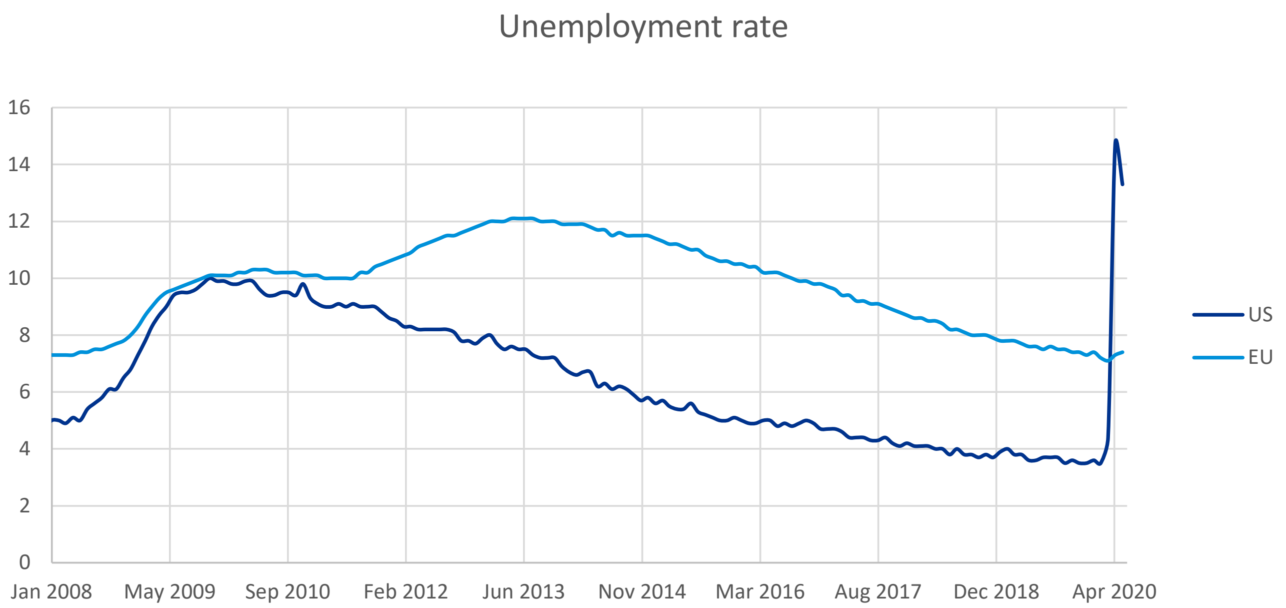
Sharp rise in unemployment rate and reduction in personal income. US/Canada unemployment's rate spiked to a record high of 13%-14%. That of the Euro area rose to 7.3%, although each country is impacted differently.

Significant reduction in demand for discretionary goods and services.

Unprecedented intervention from central banks across the globe via quantitative easing, asset purchase program and stimulus package

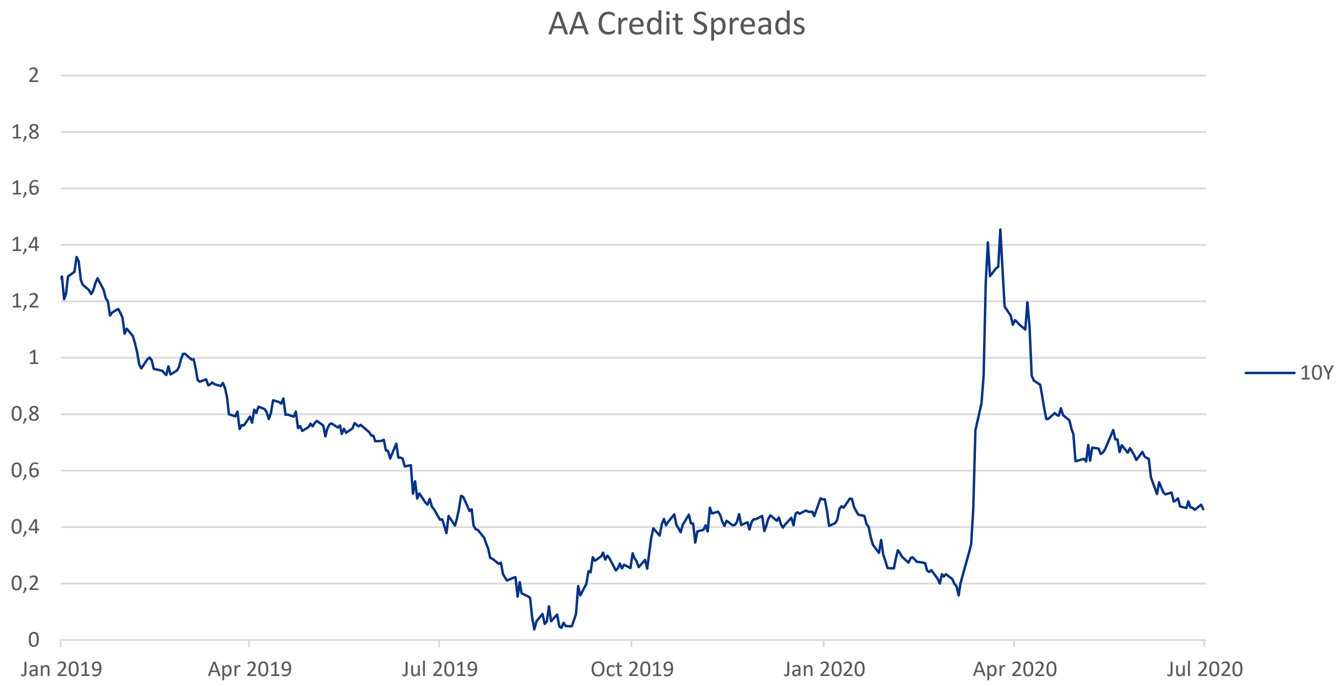
The magnitude and speed of recovery for each sector and country are varying and remain uncertain. Second wave of infections in major economies could lead to further lockdowns and prolong recession.

Economic background: unemployment effect



Source: Reuters

Economic background: impact on credit spreads



Source: Reuters

Valuation of retail loan portfolios

Valuation of retail loan portfolios - Discounted Cash Flow Analysis

Performing	Non-performing
Contractual terms of the underlying individual loans For example, coupon rates, contractual maturity, amortization and other payment features	**Recovery based cash flows** Mortgage loans: Property values versus loan amount
Behavioral elements – expected cash flows For example, prepayments (non contractual)	**Expected recovery timing** Timing of foreclosures
Discount rates Loan-by-loan or on portfolio level	**Discount rates** Portfolio level discount rates based on financing of NPL portfolios
Expected credit losses Considering the credit risk in the loan portfolios	**Expected recovery rates** Expected development of property prices

Valuation of retail loan portfolios - Discount rates

Performing

01

'Top down' approach discount rate

Estimate discount rate based on prevailing retail rates in the market

The investor's alternative: new origination

Dependent on market infrastructure and disintermediation

02

'Bottom up' approach discount rate

Estimate discount rate based on sum of cost and risk premia, including cost of funding

Non-performing

03

Financing based approach discount rate

Estimate discount rate based on financing cost to fund an NPL portfolio (secured funding plus equity return)

COVID-19 impact: key observations

Performing		Non-performing
Amended contractual terms of retail loans (payment holidays)…		Uncertain recovery scenarios, given the development of the real estate market…
….and more uncertainty around behavioural elements (prepayments), leading to more uncertainty regarding expected cash flows		….and uncertainty around recovery timing
Top down discount rates impacted by retail market dynamics (supply and demand). Bottom-up discount rates impacted by market developments (funding rates) and risks		Development of secured financing options (securitisation) impact cost of funds
Credit risk properly reflected in prevailing retail rates (top down approach) or estimation uncertainty (bottom-up approach)		

Structured finance investments

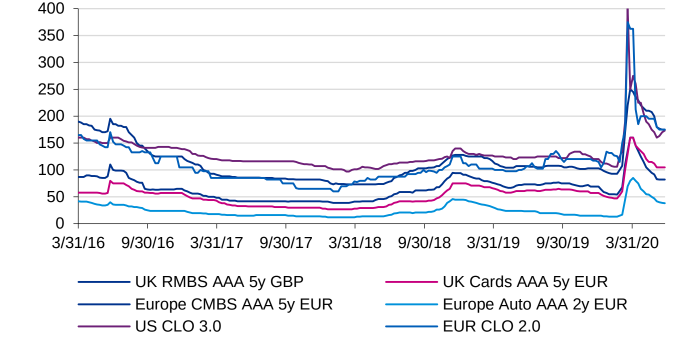
COVID-19 impact on Securitization Market (1/2) - Reduction in values

Potential deterioration of the securitization values

Structured Finance spreads have doubled/tripled in March

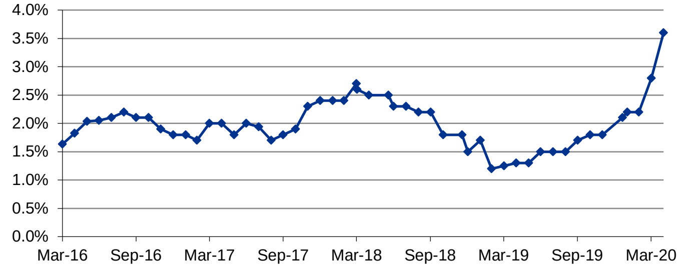
Weakening in collateral's credit quality

Spread Development for selected SF Markets



Source: JP Morgan

US Leveraged loan Default Rate



Source: Refinitiv LPC's, : Fitch U.S. Leveraged Loan Default Index

COVID-19 impact on Securitization Market (2/2) - Increased valuation uncertainty

Loan downgrades

Rising number of loan downgrades to CCC will increase CCC exposure, leading to failure in OC test and trigger cash diversion

CLO collateral concentration

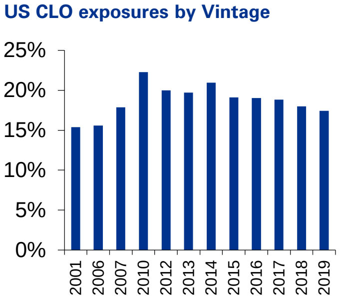
CLO Collateral's concentration on B- rated loans of from lodging/leisure, energy, transportation and retail needs closely monitoring

Credit correlation

Credit correlations among entities of the same sectors increased
Estimating correlation even more judgemental

Average exposure of CLO collateral to COVID 19 sectors:

Auto, Oil/Gas, Hotel/Gaming, Transportation, Retail & Durables



Source: Moody's

Junior/equity tranches would be impacted the most from increased credit risk.
Elevated prepayment risk and early amortizations are expected for the senior notes.

Special topics: XVA and Fallen Angels

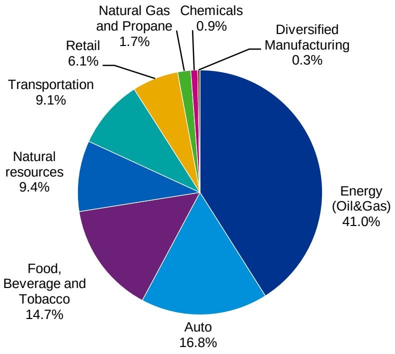
The Importance of XVA

- Increased CDS spreads
- Drop in interest rates
- CDS-bond basis spreads widened

- XVA values are increasing
- Wrong-way risk in XVA gains more relevance

The Rise of Fallen Angels

- USD 200bn Corporate debt downgraded to sub-IG.
- Mostly US entities from five sectors.



Source: Fitch Ratings

- Increased challenges in portfolio management when governing rules may forbid or limit exposure to non-IG assets.
- Corporate debt with BBB-/negative credit watch carry highest risk and are vulnerable in prolonged recession.

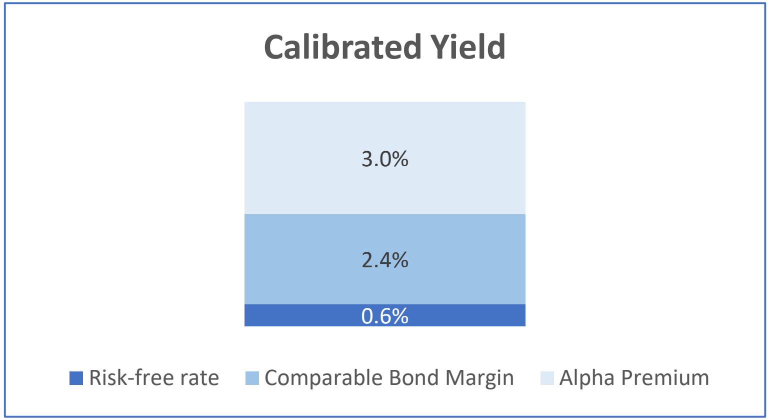
Risk category	Sector
High	*Airlines, Gaming, Lodging & Leisure, Metals & Mining, Non-food Retail, Oil & Gas, Restaurant*
Medium	*Aerospace, Auto, Chemical, Construction, Consumer products, Div.Man.& Capital Goods, Homebuilding products, media, midstream, technology, transportation*
Low	*Defence, Food retail, Healthcare & Pharma, Packaged Food, REITs, Telecom, Utilities and Power*

Non-traded corporate debt

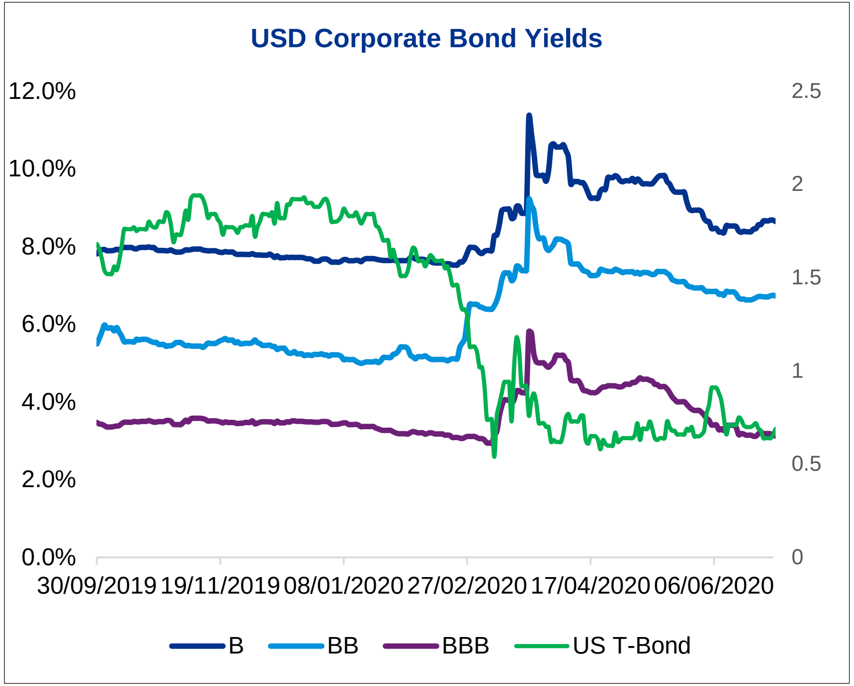
Non-traded Corporate Debt

DCF using contractual (Discount Rate Adjustment, “DRA”) or expected cash flow (“ECF”).

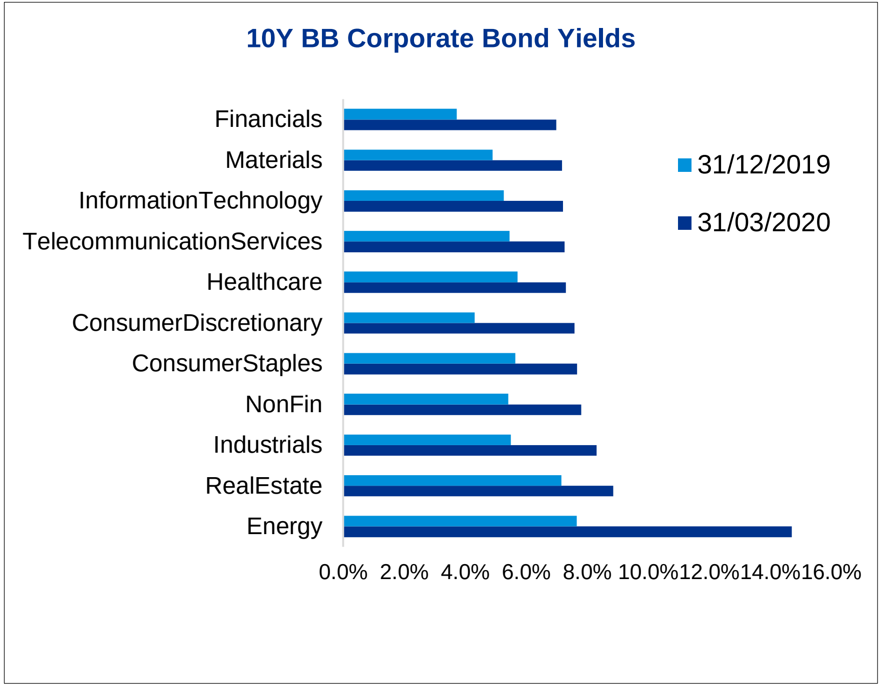
The initial yield is calibrated to the transaction price. This is often split into (1) a base rate, (2) the credit spread for the concluded rating, and (3) an alpha premium. Estimate changes in the components thereafter.



Evidence of Increased Stress/Distress



Source: S&P CapitalIQ



Source: S&P CapitalIQ

Analysing a Distressed Credit

What is the cause of the decline in performance, e.g., is there a fundamental operating issue or is the leverage unsustainable?

What is the magnitude of the deterioration in financial performance and position, e.g., does the debt exceed the enterprise value? Where does "value break"?

Is a change in valuation technique required, e.g., can market yields continue to be used or is an enterprise value analysis required?

What is the value of the collateral?

Legal issues, e.g., ability to enforce, priority of claims (e.g., HoldCo versus OpCo debt), jurisdictional issues (e.g., Chapter 11), position of other creditors, timing, etc.

Portfolio solutions

Portfolio Solutions: what covers? and how the market is evolving?

Type of Investors involved by typology of assets	• NPLs, UTPs and Single Names: Distressed Debt funds and Structured finance investors • REOs: Private Real Estate Investment Funds and REITs • Performing/Reperf. Portfolios: Assurance companies, Pension Funds and Investment banks • Unsecured debt: Industrial players and JVs of financial investors + servicers
Size of market, deal flow and dry powder available	• EBA figures as of FY2019, considered a weighted non-performing loan ratio of 3.1% totaling €529bn (mainly in France, Italy, Spain and Greece). • At the peak of the previous crises in Q4 2014, NPL ratio stood at 7.1%***. • Activity peaked in 2018, with over €200bn face value of Portfolios sold in Europe(**), in 2019 €103bn sold. To date in 2020 €16bn sold. • Dry powder of $68bn at Distressed debt funds, 20% allocated to Europe (*)
How will the market evolve?	• Securitizations are making this market much more transparent, with recurrent performance reports from rating agencies being published. • Areas of special interest: o Pre existing NPLs/REOs: performance analysis o New NPLs: challenges to transact

(*) According to EBA: "THE EU BANKING SECTOR: FIRST INSIGHTS INTO THE COVID-19 IMPACTS"
(**) According to Debtwire data
(***) According to Preqin data

Questions & Answers

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