MEMBER NEWSLETTER

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FIIN – Membership grows globally; over 85 members

Over the last two weeks, seven new members have joined the Fixed Income Investor Network. Look for these members and their firms on page three of this edition of the FIIN membership newsletter. We are excited to see increasing interest form beyond North America. The diversity of our membership from a wide variety of structured finance investors is providing a solid foundation for the membership and its future.

Interested in learning more about green investing? Register for the Green & SRI Investing Symposium on April 9th. Complimentary passes are available to FIIN members; contact Caitlin Fitzpatrick at caitlin.fitzpatrick@imn.org for details.

Our first webinar will be held on March 7th: **In the Tranches – LIBOR to SOFR Transition - Issues and Insights - a Q&A with TD Bank.**

And go to www.theFIIN.org and click on the content library to access past issues of the newsletter as well as presentations from past IMN structured finance conferences.

REVL: Doing the ground work

Interview with Dimitri Papatheoharis; managing principal at REVL Capital Group LLC

Dimitri Papatheoharis, REVL Capital Group LLC

With the risk-off sentiment waning as we head into cycle-end, one has to wonder what the future holds for less liquid, longer duration subsectors of the securitization market. To get a sense, FIIN spoke to managing principal **Dimitri Papatheoharis** of Philadelphia-based **REVL Capital Group**, which not only invests in asset classes like Property Assessed Clean Energy (PACE), small business administration (SBA) pools and credit tenant leases, but has even helped to kick-start newer asset classes via various aggregation strategies. The firm has led four securitizations of interest only (IO) strips backed by the government guaranteed portion of underlying SBA loans and is now working on what would be the largest C-PACE deal to date, as well as a single-asset rated C-PACE deal – a market that doesn't even exist yet.

These are the kinds of assets securitization wants to be known for – contributing directly to the real economy and helping to meet sustainability objectives. PACE has created more than 40,000 jobs in the last five years, Dimitri says. C-PACE deals have generally low loan-to-value (LTV) ratios and provide commercial real estate developers a lower cost alternative to mezzanine debt and equity capital.

Dimitri also shared some of his concerns for the market. The sheer expense of post-crisis bank capital is slowing economic growth and limiting securitization opportunities; Congress and the new head of the Federal Housing Finance Authority are reportedly preparing to get Freddie Mac and Fannie Mae out of conservatorship, which means uncertainty for the mammoth agency market; and the insurance industry's regulatory body may have some surprises for real estate securitization investors in store.

We've been talking to investors that are concentrated on mitigating downturn risk by going short duration. REVL is largely a long-duration investor, though. How do you mitigate this risk with that strategy, and where is it you can go long duration with confidence?

Firstly, our clients are focused on total return rather than beating a benchmark, so we're less concerned with mark-to-market and more with achieving higher returns over a longer period. That said, the most important part of our process is understanding the credit of the underlying asset to ensure that it is very difficult to break. The issue with long duration is not just interest rate risk, which you can always hedge. It's much more difficult to hedge credit risk in structured products, as it tends to become more volatile with a longer time horizon. So the most important mitigant is getting the credit right.

Something people tend to overlook is that we look for duration in places where the credit actually benefits from high inflation, or at least doesn't suffer as much, and a great example of that is securities backed by real estate. If it's priced at the right level and the credit is difficult to break, then the collateral value should increase as rates go up, since if rates are increasing, presumably inflation is as well. And we aren't looking simply at long duration, we're looking for high rates of return with long duration. We're not looking at 30-year Treasuries at 3%; we're looking at 7%, 8%, 9% over a 30-year period. That kind of investment is much less likely to hurt you when PAGE 2 >>

rates go up, because you can reinvest your capital at higher rates of return. Locking in high reinvestment rates benefits you over a longer horizon.

Commercial PACE is one of those examples of very long duration but very high credit quality assets. In the case of commercial PACE, the average LTV is usually no more than 12%. Compare that to a triple-A rated CMBS deal I've seen with an LTV of 40%. And C-PACE projects have two to three times the debt service coverage ratios of municipal project bonds, since the loans only represent 20% of the capital stack, compared to 70% in municipal. So C-PACE is essentially quasi triple-A. (That said, it's very important to analyze the attachment point of the assessment of each project to its hard costs, and to manage disbursements so PACE never exceeds 20% of the project costs at any point during construction.) We see those assets get done on the front end at swaps plus 400 basis points, sometimes plus 500bps – that's incredible value for something that is essentially triple-A rated, and it's over a 25-30 year period.

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Is that kind of return the result of the lack of standardization in the asset class?

Definitely. Each of them is unique and there's a lot of work involved in underwriting the asset, so there aren't many people in the market. You also need to pay for the origination infrastructure somehow, and one way to do that is to charge a higher rate of interest. The borrowers, on the other hand, are willing to pay these higher spreads compared to CMBS/CRE loans because PACE is additional leverage to the senior mortgage, and in fact it can be a substitute for mezzanine debt or equity, which we all know is much more expensive than swaps plus 400bps. So it supplements the capital stack, taking the place of mezz or equity, but because it is essentially a special "property" tax assessment, it is in a senior lien position.

You've said you're optimistic that the C-PACE market will mature and become more standardized. What makes you confident in that outlook?

Standardization is slowly starting to happen. It's still a young market: the first C-PACE securitization was last year. But it is a very attractive financing tool for commercial real estate owners and developers, who can access inexpensive, long-term financing for renovations or to fill part of the capital stack for new development. As a result, the growth of C-PACE securitizations has been exponential, but from a very low base. We might do $200-250 million in 2019 in total. So it's a very small market. But that's up from around $100 million or so in 2018. It could be a significant market, but standardization is a hurdle. That part is challenging, because PACE legislation is passed at the state level, so every state has different statutes related to it. In addition to that, some states, like California and Florida, require PACE loans to be sold as municipal bonds, which are more cumbersome to document and expensive to issue. More and more states have taken the initiative to standardize the process, though. We do think it will become increasingly important in financing commercial real estate. One sign that it is maturing is that, though there haven't been any single-asset C-PACE securitizations yet, we're seeing investors becoming more comfortable with the idea of buying them, and ratings agencies have made significant progress toward rating them. On the issuer side, REVL is working on some as we speak.

What other asset classes can you get comfortable with in long duration?

Ground lease securitizations are very similar to PACE. They are very popular, especially with insurance companies. In those, you buy the ground in a commercial real estate transaction and you lease it back to the owner of the property. Instead of the mortgage, the owner is then paying you rent on the ground property. Some of the ones we're doing have 99 year leases, but they have escalators built in, so rent goes up every year. With this compounding effect, the rents that you are receiving 30 to 40 years from years from now can be very valuable cash-flows, and when you discount these cash flows it results in higher valuations and higher advance rates for the land. This is an example of an asset that can benefit from inflation, and you lock in very high reinvestment rates.

You're involved in SBAs. Doesn't the prospect of a downturn render small business less attractive?

Absolutely, that's the case. We have seen small business loan default rates normalized at 2-3% per year, more than double in downturns. We're concerned about that, of course. But having said that, the part of the market we're most involved in actually benefits from a slowdown, downturn or recession. We're investing in the IO (interest only) strips backed by small business loans, and they tend to perform very well when pre-payments slow down because you're getting a longer stream of income, just like with mortgage IOs. Typically in a downturn borrowers have fewer refinancing options. So, again this is an example of finding assets in the securitized products universe where you can benefit from diverging market conditions. These securities do carry prepayment risk in good economic conditions, but given their short average life (class As have an expected WAL of 2.1 years), that's greatly mitigated by the existence of three-year prepayment penalties. There's also no basis risk, like in CMBS IOs, since the assets are floating-rate and the cash flows are substantially front-loaded.

Solar can be a controversial asset class, given the uncertainty of future efficiencies. What makes you confident in it, and what are some other renewable asset classes you like?

With respect to the securitized products market, the largest issuers like Tesla and Sun Power have primarily issued deals backed by consumer residential solar – loans and leases financing solar installations. I'm not sure if that is really renewable energy or solar risk; I see it more as consumer credit risk. The investors buying them are relying more on FICO scores and the creditworthiness of the borrower making the payments, as far as I can tell, than the value of the solar panels 20 years from now. Yes, it's a solar securitization, but that's the question mark, when it comes to investing.

When it comes to the life of the product, we're of the opinion here that any financing against a depreciating asset has to match the useful life of that asset. We're always compelled to err on the conservative side of that equation. If I think something has a useful life of 20 years – whether it's a solar panel, mobile home, car or any other depreciating asset – I wouldn't finance it for more than 10 years, and certainly not 19. So erring on the side of caution can protect you there. You see that in utility scale solar, where you have these solar parks that have panels that are supposed to produce electricity at a certain rate over a number of years. The warranties on these and studies done on them have shown degradation rates of one or two percent a year, so they could produce a decent amount of power for 20-25 years. But investors in bonds typically don't want to invest for more than 10 years. If you look at power purchase agreements – the utilities buying the power from these projects – they typically don't last longer than 15 years. After that, no one is guaranteeing to buy the power produced by these projects, so you are at the mercy of the electricity market. We believe that

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Commercial Utility Scale solar lenders are probably more disciplined than residential solar lenders. I still think committing to buy power for 25 years is a little absurd.

How about other renewables?

We participated in a biofuel deal, but we consider that project finance. But with wind, hydro and others, it's a lot more difficult to evaluate the output of the projects than solar. Solar is unique, in that there are very accurate studies done showing you the average number of days of sunlight any given project area will get, so you can estimate the power output. With wind, you have to conduct a study for at least two years before you even start the project. That makes it a lot more difficult. And, of course, the wind changes: you could have strong wind in a given place for two years, and later wind patterns could change significantly. It's not that you need certain wind speeds, high or low – what you need is constant wind – and some turbines shut down at 11 mile-per-hour wind, so if it picks up to 20 miles per hour, you won't get any power. It's a more difficult investment to value.

I still think committing to buy power for 25 years is a little absurd.

The idea of GSE reform is back in the news. What are your thoughts about that?

Yes, recently, in the last two or three weeks, there has been talk of privatization again. There will be a lot of questions that need to be answered, one of them being, "What's the right level of capital?" Last time they had to be bailed out. So I'm assuming any kind of privatization will come with some sort of no-bailout rules attached. For the longest time, investors have relied on the implied government guarantee pre-2008, and explicit guarantee post-2008. If that's not there anymore, implied or explicit, it will have a significant impact on the bonds. I'm sure the issue will be given consideration: they aren't likely to just let trillions of dollars of bonds sell-off, but we'll certainly be watching developments closely.

So, are you still fairly confident in the agency credit risk transfer market?

We looked at CRT hard. When they first came out they were attractive value, but since then the volume has grown and spreads have compressed dramatically. We have seen first loss pieces of these deals trading tighter than 6%. I used to trade B-pieces of jumbo mortgage deals, and I don't remember seeing a first loss piece ever trading inside 12%. To me, these CRT levels are unprecedented. And they are more or less the same credit risk. It's a very crowded trade, and I think investors have been relying on the best mortgage market ever, in terms of credit performance, in these last five years. I don't know if you can really project that performance into the future as the economy heals and people start forgetting the past – you'll see some loosening in underwriting standards. And if these deals are sized the way they are now, you really can't be looking in the rear view mirror.

It is also one of very few markets where you see issuers selling down to the first loss tranches. In securitized products post-crisis, we hardly ever see double-B rated deals offered in the market. Almost no one issues below investment grade, and in CRT, they're selling them at exceptionally tight levels. I don't think investors are getting compensated for the risk they're taking, especially for those first-loss tranches.

There has been talk that the National Association of Insurance Commissioners may change the ratings buckets – which determine the capital insurers hold against their investments – on certain real estate securitizations. What's going on there?

I don't think investors are getting compensated for the risk they're taking, especially for those first-loss tranches.

This is a developing story. The NAIC is threatening to re-classify certain real estate securitizations other than RMBS and CMBS – such as credit tenant leases or ground leases – and require much higher capital charges for them. If you're an insurance company or other investor who requires an investment grade rating, and you're holding a bond you bought at an NAIC 1 rating, which is the lowest capital charge bucket, any change in capital treatment will have negative ramifications for that asset class. Depending on the outcome coming out of the NAIC, some investors may decide to unwind their positions, but at a minimum the cost of capital in these transactions will undoubtedly increase and it may affect the value of more than $25 billion of securities. Insurance company investors are a big part of these markets. It's an issue that isn't getting a lot of attention, since many of these deals are done as private placements, but it could have a big impact if NAIC goes through with it.

Latest FIIN Members

Oliver Fochler
CEO and Managing Partner
Stone Mountain Capital

Jesse Singh
VP & Portfolio Manager
American Century

Mikio Itabashi
Senior Portfolio Manager
Nikko Asset Management

Malik Chaabouni
Managing Director
Christofferson Robb & Company

Terry Lanson
Managing Director
Seer Capital Management

Chris Greener
Founding Partner
White Circle Capital

Sa'ad Malik
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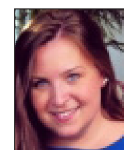

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News in Brief

UMBS debate heats up
Officials from the US Treasury Department and the Federal Housing Finance Authority denied a claim from Pimco that the new nominee to head the FHFA, Mark Calabria, expressed opposition to the Uniform Mortgage-Backed Securities market. Pimco and other money managers are against the initiative, which would effectively merge Fannie Mae's and Freddie Mac's to-be-announced (TBA) mortgage markets (GlobalCapital, subscription).

Congressman proposes radical GSE reform
Senate Banking Committee chairman Mike Crapo (R-Idaho), proposed an outline for the reform of government sponsored enterprises that would privatize Freddie Mac and Fannie Mae, removing their explicit government guarantees, and expanding Ginnie Mae's role, as well as major reforms to the Federal Housing Finance Authority (GlobalCapital, subscription).

Regulator restricts loanDepot
Ginnie Mae restricted loanDepot from pooling Veteran Association single-family guaranteed loans in Ginnie Mae I and II multi-issuer securities, in a move to stem a surge in lenders pushing VA borrowers to refinance into loans that do not substantially benefit them, apparently to increase volumes and revenue (GlobalCapital, subscription).

Subprime could get a boost from CFPB proposal
The head of the Consumer Financial Protection Bureau, Kathy Kraninger, has proposed revisions to the Payday Lending Rule that could fuel the subprime consumer loan securitization market. The change would remove requirements that make it more difficult to originate certain loan types targeted to non-prime borrowers. Critics say the CFPB is proposing to gut a key consumer protection (HousingWire, free).

SocGen plans to up securitization game
Société Générale said in its fourth quarter results that it plans to add 10bps-20bps to its capital via risk-weighted asset optimization, which would include securitization, 'originate to distribute' and other risk transfer techniques. The bank did not specify which regions it would focus on. (Société Générale, free).

Securitizations priced February 1 - February 7

www.globalcapital.com

DEAL TYPE	ISSUER	DEAL NAME	SIZE (IN $ MILLIONS)
CLO	CarVal Investors	CarVal CLO II Ltd.	732.75
CMBS	Bank of America	BANK 2019-BNK16	916.96
AUTO	DriveTime Automotive Group	DT Auto Owner Trust 2019-1	373.5
Esoteric	Stack Infrastructure	SIDC 2019-1	725
CMBS	Deutsche Bank	BMARK 2019-B9	774
CMBS	Société Générale	SGCMS 2019-787E	178
CMBS	Credit Suisse	CSMC 2019-SKLZ	335
AUTO	Avis Budget Group	AESOP 2019-1	600
AUTO	Flagship Credit Acceptance	Flagship Credit Auto Trust 2019-1	247
AUTO	Global Lending Service	GCAR 2019-1	268
RMBS	Fannie Mae	CAS 2019-R01	960
Esoteric	GreatAmerica	GALC 2019-1	612
Esoteric	Volvo	VFET 2019-1	755
AUTO	Nissan	NAROT 2019-A	1250
AUTO	Ally Financial	ALLYA 2019-1	1056
Esoteric	Marlette Funding	Marlette Funding Trust 2019-1	249
AUTO	Toyota	TAOT 2019-A	1212
RMBS	Pretium Mortgage Credit Partners	Pretium Mortgage 2019-NPL1	379
CMBS	Freddie Mac	FREMF 2019-KF57	1010
Credit Card	American Express	AMXCA 2019-1	1564
Total			**14197.21**

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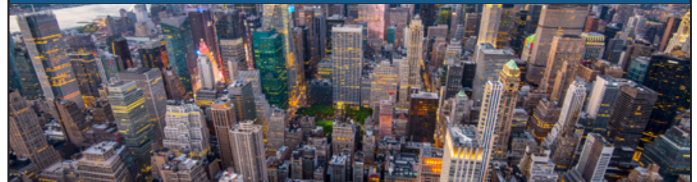
STRUCTURED FINANCE CONFERENCE SCHEDULE

2019 Conference Schedule - www.imn.org

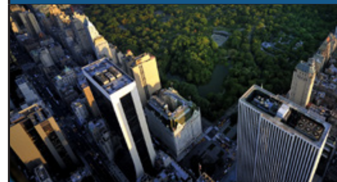
The 2nd Annual Investors' Conference on Synthetic Risk Transfer
13 February 2019
London, UK

The 1st Annual Investors' Conference on CRE CLOs
March 14, 2019
New York, NY



The 1st Annual Global Investors' Conference on Securitization In China
March 30-31
Beijing, China

The 18th Annual Investors' Conference on Equipment Finance
March 20, 2019
New York, NY



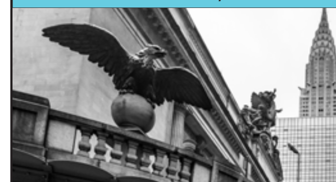
The 6th Annual Investors' Conference on European CLOs
2 April 2019
London, UK

The 12th Annual Global Covered Bonds
4 April 2019
London, UK

The 7th Annual Green Investing Conference
April 9, 2019
New York, NY

The 4th Annual Credit Risk Transfer Symposium
April 25, 2019
New York, NY

The 8th Annual Investors' Conference on CLOs and Leveraged Loans
May 20-21, 2019
New York, NY



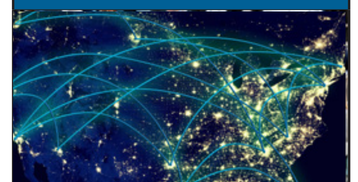
The 23rd Annual Global ABS
11 - 13 June 2019
Barcelona, Spain

Synchronize Europe
18 June 2019
London, UK

The 25th Annual ABS East
September 22-24, 2019
Miami Beach, FL

The 4th Annual Investors' Conference on Italian & European NPLs
November 2019
Milan, Italy

The 5th Annual Investors' Conference on Online Lending
November 2019
New York, NY



For complimentary attendance, please contact Caitlin Fitzpatrick at 212-224-3530 or caitlin.fitzpatrick@imn.org
For speaking opportunities, please contact Jade Friedensohn, at 212-901-0560 or jfriedensohn@imn.org

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