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Covid-19 impact: European asset-backed securities

Trade opportunities emerge from price dislocations

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- Across the market, European ABS have experienced substantial spread widening, reflecting a flight to safety by investors.
- In our opinion current market prices are at their most disconnected relative to the fundamental credit resiliency of these instruments since the depths of 2008/9.
- M&G has always invested in a highly selective manner, reflected in our average new issue CLO rejection rate of 75% since 2013.
- Price declines suggest the market can provide very attractive buying opportunities for the patient, long term investor.

Significant correction signals value

The past three weeks have seen price moves that are nothing short of incredible in tried-and-tested, defensive credit assets in the European ABS market.

Indeed, the correction has been so severe in the upper reaches of the capital structure that in our opinion, current market prices are at their most disconnected relative to the fundamental credit resilience of these instruments since the lows of 2008/9.

This dislocation between price and structural credit strength is demonstrated by considering a number of examples of deals available in the market, some of which we have acquired in recent days at prices materially wider than previously.

We believe the gulf between current market price and the fair value of these highly rated instruments is driven in a large part by the virtually zero risk appetite of investment banks at present, as well as forced or highly motivated selling of high quality ABS by funds needing to maintain daily liquidity or unwind mark-to-market leverage.

For example, UK prime AAA RMBS, probably the one of the most structurally resilient fixed income asset classes available given their ability to absorb 50% declines in house prices and multiple years of double digit repossession rates without losing any principal, are now being offered at around 90-95, down from around par as of late February, less than four weeks ago.

Further, on 11 March the Bank of England also reintroduced the Term Funding Scheme (TFS) for UK banks. This cheap funding source should mean that UK banks have much less need to issue RMBS in the short term, in our view – a clear positive technical for spreads on existing instruments.

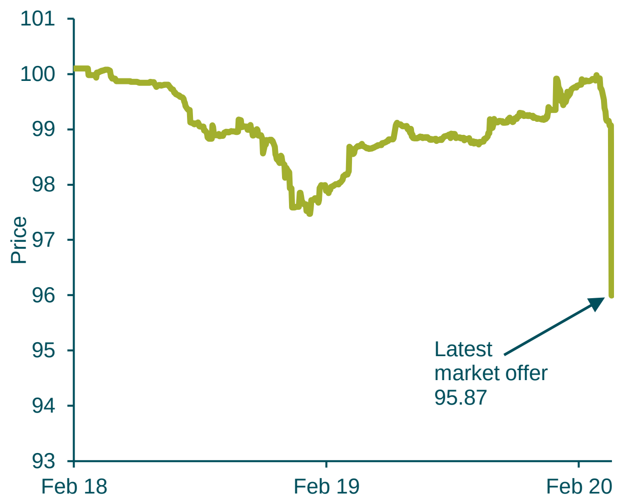
As such, we believe the current market represents an extremely compelling buying opportunity for the patient, medium term investor.

Example 1: UK prime AAA RMBS

Among the potential trade opportunities we have been monitoring is an AAA/AAA/Aaa rated bond from January 2018, part of the Lanark programme from Clydesdale Bank, a strong issuer that strengthened its footprint further with the acquisition of Virgin Money in October 2019.

Every one of the Lanark time calls has been honoured historically – the bank even called a deal on schedule during the depths of the financial crisis in February 2009.

Figure 1. UK prime RMBS trade opportunity



Source: M&G, LAN 2018-1X 2A, March 2020

The RMBS benefits from a high quality, prime-borrower collateral pool, with weighted average current indexed loan-to-value (LTV) ratio of 61.45%.

The note has also been future-proofed against the upcoming cessation of the LIBOR reference rate at the end of next year. Its coupon index converted from LIBOR to SONIA in the past 12 months, an indication of the originator's longer term commitment to its ABS programme.

As recently as 4 March, the bond was bid at 99.69px – a yield of 0.99%. Yet, despite the Bank of England's TFS support for the banking sector, the bond was offered for sale on 25 March at 95.87px – a 2.26% yield.

Example 2: Senior AAA European CLO tranche - RFTE 2019-1X A

Price fluctuations on this AAA rated, 2019 vintage senior European CLO tranche have been in the double digits over recent weeks.

Managed by King Street Capital, this CLO is the second transaction from their European desk following the establishment of their strong US platform, with 9 USD deals outstanding since 2017.

We conducted on-site due diligence on King Street prior to investing in Q4 2019 and felt sufficiently happy with their credit process, resourcing and market footprint to be comfortable with exposure down to the single-A tranche.

The class A tranche priced at par on 7 October 2019, with a coupon of 92bps over Euribor. As of 28 February 2020 we sold at 99.45. Yet less than three weeks later, on 18 March, we were able to buy the same bond back almost 12 points lower at a cash price of 88.0px – a spread of 324bps.

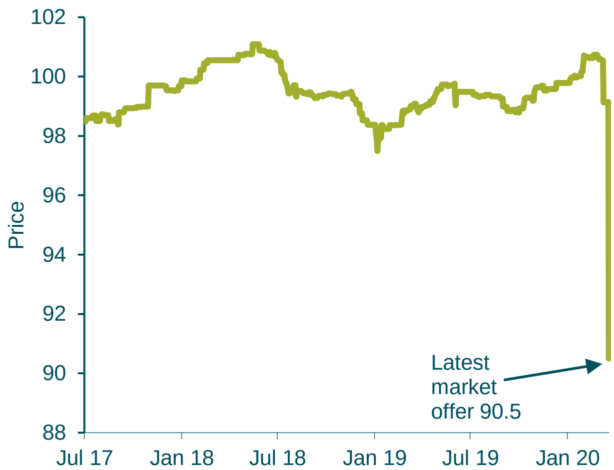
In our view an 11.5 point price decline in this AAA asset – which by our modelling is sufficiently resilient to withstand leveraged loan default rates higher than during the financial crisis in Europe, every year for the next five to seven years – feels excessive.

This is particularly the case when we consider that over the same timeframe between October 2019 and March 2020, the B/B-rated S&P European leveraged loan index fell 14.75 points – down from 97.50 to 82.75.

Example 3: UK buy-to-let RMBS AA tranche

In the high grade ABS space, we have selectively acquired assets such as RIPON 1X C2, an AA/Aa2 rated UK buy-to-let RMBS transaction.

Figure 2. UK investment grade buy-to-let opportunity



Source: M&G, RIPON 1X C2, March 2020

This was issued in 2017 following the sale of residential mortgage assets originally underwritten by Bradford and Bingley prior to the global financial crisis, and were subsequently acquired by the UK government via its UK Asset Resolution (UKAR) platform.

The collateral pool is extremely seasoned with a weighted average loan age of just over 14 years, meaning these mortgages have endured and survived the financial crisis. The portfolio is also highly granular with 67,571 underlying loans at a weighted average current indexed LTV of 56.75%.

The deal offers best in class step-up coupons, with the class C more than doubling at the call date to encourage redemption.

The class C2 bond was upgraded by both Moody's (A1 to Aa2) and S&P (A+ to AA) in H2

2019 following strong collateral performance and rising credit enhancement.

The bond was bid in the market at 100.29 with a 1.78% yield on 28 February but by 19 March we bought this bond at a cash price of 90.5 – 7.35% yield.

Investment grade opportunities at scale

In the past, mezzanine investment grade ABS, which historically has focused on the BBB part of the capital structure, has not been available at scale given the BBB segment of the market is relatively small and bonds are very much sought after, limiting the size of the opportunity for institutional buyers.

However, the scale of the price moves in recent weeks coupled with the forced selling of high quality bonds from investors having to meet redemptions or capital calls has opened a window for assets to be acquired in greater quantum – and in addition, enabling us to look higher up the capital structure to favour AAA-A risk for similar return expectations.

While the ABS market continues to reflect the price volatility seen worldwide at present, and with further volatility anticipated, as active managers we aim to be ready to take advantage of ongoing price dislocation to acquire attractively priced assets.