Non-performing Loans/Re-performing Loans: Attractive Exposure to the US Post-Crisis Housing Market

SUMMARY: Semper views the Non-Performing Loan (NPL) and Re-Performing Loan (RPL) market as an attractive way to access years of home price appreciation in U.S. residential real estate, as well as growing embedded credit convexity in the respective legacy loans. We further believe that the US economy is now transitioning from a post-crisis, recovering market back into a normalized market, and NPL/RPL investments should disproportionally benefit from the increases in credit availability and home price increases that typically occur during these transitions due to the embedded structural leverage to these factors.

Market Overview

During the financial crisis and through the years following, there was an unprecedented increase in U.S. home mortgage delinquencies and defaults, transforming portfolios of clean, current-pay loans into mixed bags of underwater, non-performing assets. The NPL/RPL market allowed for the transfer of impaired mortgage loans from holders preferring performing assets to investors who saw opportunities through active loan servicing. In addition, as a result of the post-crisis changes in banking capital requirements, many holders of NPLs and RPLs, collectively referred to as NPL(s) herein due to the similar nature of the investment opportunities, were forced to reduce holdings of these assets on their balance sheets, creating excess supply in the market. Investors with less stringent capital and regulatory constraints emerged - generally private equity, hedge funds, and REITs - to absorb the supply.

Key Components

- Multiple investment approaches have included: a) purchasing distressed whole loans outright where investors prefer to directly control the servicing of the loans, or b) investing in securitizations where issuers (buyers of these NPL/RPL portfolios) seek term financing through the creation of securities.

- Market size is large and flow continues on a periodic basis: today, we estimate an NPL inventory of ~$105 billion (not including RPLs) compared to estimates of $35 billion prior to the financial crisis (2000-2006). NPL securitizations represented roughly a quarter of total RMBS post-crisis issuance in 2016[1].

- Various sources of cashflow through: active management of borrowers focused on re-performance through modifications of borrower terms, deed in lieu of foreclosure, re-selling sub-portfolios, and ultimately foreclosure and sale of REO properties.

Levered to Improving Housing Market

Historically known as a "distressed trade" following the financial crisis Semper now views this as a significantly different trade that is both attractive and timely. Previously, while the economy was in repair, the housing market was experiencing a significant re-pricing lower, banks were still reflating out of insolvency, and credit availability became more limited. Investing in NPLs during this time was viewed as a high nominal yield trade where risks were also high due to significant leverage to a broken housing market in recovery, the ever-present risk of a double dip recession, and active government intervention through programs that were detrimental to loan investors. Through the recovery, more favorable current market conditions have risen, such as expanding credit availability, higher home affordability, growing home prices – recently burgeoning above pre-crisis highs, low interest rates achieved through fed accommodation coupled with political support of real estate and structured credit investment activity, have all contributed to changes in the risk profile of these investments. Today, we view opportunities to achieve strong returns within the NPL market with fewer significant downside risks.

The Ongoing Opportunity

The NPL trade has lost some focus among investors who may assume that a lack of market distress combined with a shrinking market, has resulted in a trade no longer offering outsized returns. However, not only is the supply of NPLs still well above pre-crisis levels, NPLs are still well over double historical levels (as noted above), and the market continues to draw new supply from a steady stream of ongoing loan defaults within the outstanding universe of pre-crisis mortgages, as well as post-crisis origination. The need to effectively work out the NPL borrower base has not changed. Further, these borrowers are being liquidated in a much more stable and functional credit environment than what we saw in the period immediately following the financial crisis. As certain players have exited the trade, the supply and risk reward profile remains, but it is now combined with our positive outlook on housing technical and fundamentals.

[1] *FDIC Quarterly Loan Report, Q1 2000 – Q3 2016 (data refers to NPLs and does not include RPLs)*

Semper Position:

The NPL market allows investors to gain exposure to continued home price appreciation and strength in a market where we see few potential downsides. Here are some strategies we find constructive:

- **NPL Securitization Senior Tranches (VOLT/BOMFT/GCAT A1 and A2)** These are generally unrated front or second-pay sequential tranches primarily structured from NPL collateral. These bonds also feature structural enhancements that greatly improve the risk profile: i) Generally structures are created with 40-50% credit enhancement, ii) coupon step-ups limit extension of the securitizations encouraging issuers to exercise optional redemptions, iii) many feature bulk sale provisions allowing issuers to sell RPL sub-portfolios resulting from active servicing and modifications. Given these features, the enhancement provides significant stress case loss protection, while the coupon and sale provisions continue to keep these profiles short. Following the crisis, rating agencies have largely stopped offering ratings on these securitizations and as a result, these short, well-enhanced credit profiles offer additional yield and spread on a duration-weighted basis, and we continue to remain focused on these investments.

- **RPL Shifting Interest Securitizations (NRZT/CMLTI)** These come in a variety of ratings buckets, and are structured as senior-subordinate shifting interest waterfalls off seasoned RPL legacy collateral. Generally, issuers have accessed large loan portfolios through exercising optional redemptions on collateral in legacy securitizations. Target loan securitizations have often centered on high coupon and heavily seasoned underlying loans. These bonds boast a very strong credit profile given the significant seasoning and fundamentals we like, including: a) embedded home price appreciation, b) refinance-able high coupon mortgages, and c) strong recent borrower performance. Structurally, the shifting interest nature protects against significant contraction in low rates (high re-financings and increased mobility) and the embedded borrower seasoning and high coupon limits extension. We continue to add in this sector as stable duration-adjusted return profiles.

- **NPL Whole Loans** NPLs allow opportunities to invest directly into an active asset management strategy based on the underlying credit. It allows many of the underlying benefits and fundamentals of these sectors, coupled with direct control through active management of the underlying assets, the ability to interact directly with borrowers, and the choices of various workout strategies, each adding the potential to extract additional returns in these investments. Further, during acquisition, investors can choose to highlight or reduce exposure to certain sectors or loan characteristics such as legal jurisdiction, property type, etc.

We remain focused on investments and liquidity within the NPL and RPL sectors and remain constructive on the fundamental outlook of the assets and within the investment strategies above.

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