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Trust Preferred CDOs (TruPS CDOs): growing source of high yield in structured credit

SUMMARY: Semper believes that Trust Preferred CDOs ("TruPS CDOs") provide attractive risk-adjusted returns, particularly on a relative basis.

This piece also serves as an example of a sector evaluation performed internally that resulted in our investment in TruPS CDOs.

Market and Offering Overview

Trust Preferred Securities (TruPS) are hybrid securities with both preferred stock and subordinated debt-like features. This hybrid structure allowed banks to count the securities toward their Capital Ratios without diluting shareholder value while providing investors with subordinated debt. As part of the Volcker Rule, Banks with assets of more than $15Bn have to completely phase out TruPS from their Tier 1 Capital Ratio by the end of 2016, meaning that prepayment activity will likely rise to re-balance their Tier 1 Capital Ratio. TruPS were also issued by Insurance Companies and REITs. TruPS CDOs are pools of TruPS that are structured into various risk-reward profiles.

Approximately 100 TruPS CDOs with a notional value of $60Bn were issued and sold to investors between 2000 and 2007. These TruPS were generally structured with 30 year final maturities, 5 years of hard call protection and 5 years of optional deferral. Following 5 years of deferral, all deferred coupons must be paid, or the borrower default. For most deferring banks the 5 year deferral period expired in 2014, thus limiting cash flow disruptions going forward and improving the collateralization.

Opportunity Assessment

Pros:

- Limited interest rate risk (floating rate securities)
- Exposure to residential housing and commercial real estate via the banking sector
- Post crisis regulatory environment has improved the credit quality and surveillance of banks
- Potential for ratings upgrade which would increase the buyer base
- Potential for increase in prepayments as large banks prepay (due to Volcker rule) and Mergers & Acquisitions continue
- Mezzanine bonds with low dollar prices offer double digit yields in a stable or improving economy due to large excess spread
- Potential for further spread tightening as new market participants enter the space

Cons:

- Between 8 and 25 years of spread duration
- Low carry – much of the performance is dependent on roll-down and excess spread
- Economic slowdown could lead to an increase in defaults or deferrals
- Mezzanine tranches are extremely levered to defaults and somewhat levered to prepayments
- Limited supply in the market can make it difficult to source a large volume of bonds

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Prepays are dependent on the size and cost of funds of the underlying bank as well as M&A activity:

- The prepayment potential of a bank is largely driven by its Total Assets (bank size), Tier 1 Capital Ratio[1], Texas Ratio[2], TruPS Coupon and FDIC stipulations or provisions.
- Large banks ($15+ Bn) have a strong incentive to prepay due to:
  1) TruPS being phased out of Tier 1
  2) Issuing subordinated debt at a comparable cost of funds to legacy TruPS.

  For example, Bank of America has been prepaying its TruPS despite coupons of less than Libor + 100 basis points.
- While small banks are not as likely to prepay because TruPS remain Tier 1, M&A activity has led to effective prepayment of small bank TruPS. Acquiring banks often prepay the acquired banks TruPS, especially if the acquiring bank has no TruPS.
- In many cases these small banks would otherwise not prepay TruPS due to the low borrowing cost, Tier 1 inclusion and tax benefits. However, the M&A provides this additional prepayment which provides increased return to the bondholder.

Sample TruPS CDO – ALESC 8A A1B:

- ALESC 8A A1B is a 2005 vintage Front Pay TruPS CDO
- Rated BBB / BBB + / A1
- 3 Month LIBOR + 38 bps coupon
- Strong interest coverage: ~3.4x to the Front Pays
- 184% coverage ratio
- $20mm in potential cures (improves coverage ratio to 193%)
- Average Tier 1 Ratio of 17.5% and Texas Ratio of 19.5%
- Underlying bank TruPS include JP Morgan, PNC, Bank of America, and Wells Fargo

Scenario	Yield	DM	WAL	Spread Duration
Base	4.96%	250	14.5 yrs	11.1 yrs
Stress	4.84%	233	15.9 yrs	12.0 yrs
Upside	6.48%	433	5.7 yrs	5.5 yrs

*DM: discount margin. WAL: weighted average life.

1 - Tier 1 Capital Ratio: ratio of core capital to total risk-weighted assets. 2 - Texas Ratio: ratio of non-performing assets and loans to tangible capital equity plus loan loss reserve

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(1) Informa Investment Solutions PSN Manager Database as of December 31, 2014. Ranking is based on gross performance (before deduction offees) across 56 similar mortgage-backed securities products offered by 33 investment advisors that comprise the PSN Mortgage universe. The ranking may not be representative of any one client's experience.