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Trust Preferred CDOs (TruPS CDOs): An Attractive Opportunity for Yield in Structured Credit

SUMMARY: Semper has recently invested in Trust Preferred Collateralized Debt Obligations ("TruPS CDOs") for our client portfolios. We believe that TruPS CDOs provide an opportunity for 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 in our client portfolios. It is not a recommendation to purchase any security or investment.

TruPS CDO and Market Overview

Trust Preferred Securities (TruPS) are hybrid securities with both preferred stock and subordinated debt-like features. The hybrid structure of TruPS 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 Tier 1 Capital Ratios. 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 must default. For most deferring banks, the 5 year deferral period expired in 2014, thus limiting cash flow disruptions on the CDO pools and improving the collateralization.

TruPS CDO Opportunity Assessment

Pros – attractive attributes:

- 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 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 – potential downsides and risks:

- 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, and increased interest rate risk
- 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

SEMPER CAPITAL MANAGEMENT, L.P.

- Independent investment management firm specializing in residential and commercial mortgage-backed securities
- Offers institutional and high net worth investors access to multiple mortgage-centric investment platforms, ranging from private absolute return to public index-based strategies
- Minority Business Enterprise (MBE) certified and has been an SEC - registered investment advisor since 1992

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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 security:

Example of product in the market

- 2005 vintage TruPS CDO
- Rated BBB / BBB + / A1 (Fitch / S&P / Moody's)
- 3 Month LIBOR + 38 bps coupon
- Strong interest coverage: ~3.4x
- 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.

Source: Semper proprietary credit analysis. Base scenario implies current market conditions with no prepayments and some cures; stress implies no cures and no prepayments; upside implies heightened cures and prepayments. Hypothetical example may not be illustrative of any investment.

Definitions:

Tier 1 Capital Ratio: ratio of core capital to total risk-weighted assets.

Texas Ratio: ratio of non-performing assets and loans to tangible capital equity plus loan loss reserve

Mezzanine tranche: tranche of bond which absorbs losses after the equity tranche

Roll down: when bond value converges to par as maturity approaches

Duration: sensitivity of price of a bond to a change in interest rates

Cures (bond): when a borrower repays defaults through refinance or selling the property

Basis points: one hundredth of one percent

Coverage ratio: company's ability to meet financial obligations, typically earnings before interest and taxes divided by interest expenses.

Discount margin: return earned in addition to the index underlying a floating rate security

Weighted average life: average number of years for which each dollar of unpaid principal remains outstanding

Libor: London Interbank Offered Rate