ABS Commentary:

Taking a Dip in a Concentrated Pool, Analyzing Big-Ticket Commercial Asset Financings

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Morningstar Perspective

Morningstar Credit Ratings, LLC expects to see growth in 2016 in the number of publicly and privately rated transactions backed by concentrated asset pools, as a result of a strong U.S. economy, investor demand for yield, and investor appetite for emerging and esoteric asset classes. In referring to these transactions, we are speaking about deals backed by 25 or fewer big-ticket commercial assets, such as tanker ships, aircraft, or drug royalties. The volume of collateral deemed suitable and not currently used for concentrated-pool financing is extensive.

These concentrated asset portfolios arise under a variety of circumstances. Owners of such pools are often nascent sponsors gradually growing the amount of assets they originate, operate, and service. These pools are also common in legacy portfolios, such as tobacco-settlement securitizations, where assets have depleted or repaid over time. Additionally, concentrated pools arise in industries such as oil shipping, where assets are mammoth and expensive. As one example, the oceans are home to hundreds of very large crude-oil carriers in service, each with capacity above 300,000 tons and a valuation of tens of millions of dollars.

Securitizations backed by concentrated pools require extensive scenario analysis, as these pools are not conducive to actuarial analysis used for granular and consumer asset-backed securities, such as auto loans or credit cards. While it is beyond the scope of this article to delve into the details of Morningstar's approach to all concentrated pools, there are key considerations to analyze when rating a pool consisting of a handful of unique assets, such as shipping vessels or aircraft, which we illustrate with examples.

Focus on Assets

When Morningstar reviews financings backed by a concentrated pool of assets, each asset is individually analyzed. For a handful of ships, each vessel is reviewed by focusing on its charter rate, utilization, sale, and appraisal history. These metrics are considered in the context of the sector's economics and the relative performance of comparable ships. For example, the slowdown in China's demand for coal and iron ore has depressed bulk carrier charter rates. Conversely, lower crude-oil prices have buoyed rates for oil tankers, which are used not only for transport but also as supplemental storage for crude oil. This focus on asset analysis parallels a similar approach that we apply to commercial mortgage-backed securities, which are often backed by one or a handful of properties. For CMBS transactions, Morningstar evaluates infrastructure improvements and potential local developments in addition to underlying property data. In shipping transactions we consider, for example, the potential impact of general business environmental factors such as ongoing improvements to the Panama and Suez canals, which will allow larger vessels to traverse them. We also evaluate the potential impact that new routes create for existing fleets, such as the proposed Nicaragua Canal and the arctic passage, which may disrupt historical shipping routes because of the retreat of the arctic icecap.

For aircraft asset-backed securities deals, we conduct an analysis of each airplane. Particular attention is given to the age, number of cycles, engines, maintenance records, and operational reserves for each airplane. If the aircraft is considered strategic for the airline, there is a higher likelihood that the lease would be affirmed or minimally negotiated during a potential bankruptcy reorganization of the aircraft operator. However, that would not be the case for older aircraft servicing less profitable and less strategically important routes, and the related leases are more likely to be rejected by the debtor, resulting in termination of subsequent lease payments. Finally, macroeconomic projections and global sector developments, such as the progress of Chinese airplane construction, may affect older and more commoditized aircraft. Chinese airlines and governmental bodies will likely give preference to domestically produced aircraft, thereby disrupting historical demand and disproportionately affecting the marketability of older aircraft coming off lease.

Whenever available, we review third-party appraisal values, as well as the depth, transparency, and liquidity of the secondary markets for the collateral. We also examine historical delays and costs incurred in realizing recovery proceeds, as well as operational risks and challenges associated with seizing, foreclosing on, and monetizing collateral across multiple jurisdictions.

For physical assets such as tanker ships or mining equipment and other assets such as intellectual property, the manager or servicer is responsible for continually leasing out the vessels, signing royalty and licensing agreements, or otherwise monetizing the collateral. This is a more operationally and administratively intensive activity than servicing granular financial, self-amortizing assets, such as small-business loans, and therefore creates additional servicing risk. Operational asset collateral pools are also exposed to market value risk over the life of the transaction, which may result in significantly lower net cash flows and/or valuations. An experienced servicer and a sizable portion of the collateral pool having long-dated lease or licensing agreements with well-established or publicly rated counterparties are factors that mitigate the servicing and market risks of a concentrated pool of operational assets and reduce the expected variance of collateral cash flows.

Another consideration that Morningstar weighs when analyzing a transaction backed by tankers is that many vessel financings benefit from recourse to, or a guarantee from, the operators and owners of the collateral. However, many operators do not have an investment-grade or near investment-grade credit rating. Many are private companies, and we may not have sufficient audited financial history to support fundamental analysis of their credit worthiness. For these unrated or non-investment grade operators, we consider not just the credit rating or financial strength of the operator, but also the franchise value of the business, the centrality of the pledged assets to the business, and its long-term viability as a going concern. The rating assigned to the financing may be constrained, but would not necessarily be capped, by the rating of the entity that operates the assets because we would look to the collateral pool to provide sufficient net cash flows to cover interest, scheduled amortization, and expenses on the rated loan.

Historical Structures, Market Potential

Concentrated pools can be made up of a range of commercial and esoteric assets including aircraft, specialty mining equipment, drug royalties, intellectual property, professional and agency fees, or funds from tobacco settlements. With concentrated and often illiquid assets, the proposed liability structures we have seen have lower leverage than comparably rated granular financings, such as auto ABS. Transactions backed by concentrated pools historically have been structured targeting mid- to lower investment-grade ratings for the senior-most tranches. The benign U.S. credit environment of early 2016 combined with investor interest in obtaining yield and diversification through esoteric and innovative asset-backed deals set the stage for a diversity of structures in the coming year. In rating these transactions, Morningstar uses an asset-by-asset focused approach combined with an understanding of the key credit risk factors in these sectors.

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