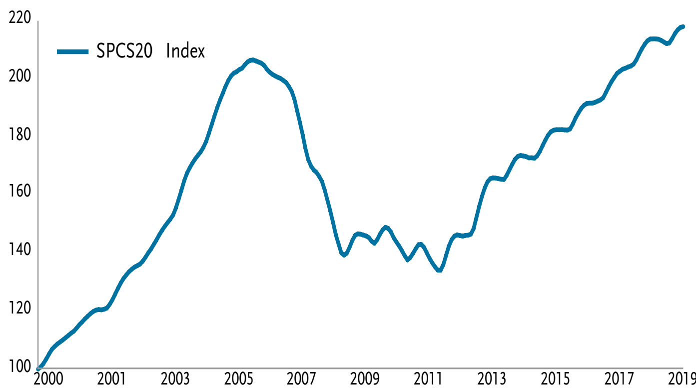
TCW Securitized Opportunities Strategy

Unicorns

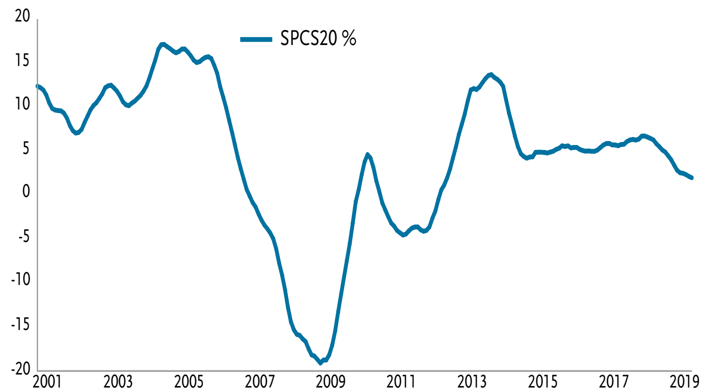
Late cycle ebullience continues to exist in capital markets. With this, exceptions have been percolating including but not limited to disinflation in the Housing Market and idiosyncratic issues in the High Yield Market.

Home Prices Have Increased Post Global Financial Crisis



Source: Bloomberg, As of October 8, 2019

Though the Rate of Change Has Been Decelerating (Disinflation) and is Flirting with Outright Declines (Depreciation)



Source: Bloomberg, As of October 8, 2019

Elements of the Minsky build up can readily be seen today in the form of complacent attitudes toward forward expectations, easy lending, and strong consumption, all leading to a more fragile ecosystem.

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Certainly, some air is being let out. Many have eloquently written about WeWork – the lack of corporate governance, the speculative private valuation, the nepotism, the affiliated transactions, the inherent risk in the business model, the accounting flexibility, the lack of profits, etc. That the public equity markets didn't take this off the hands of the private equity markets in the now-shelved IPO is at least one demonstration that not everything goes in the current capital markets construct. And the public equity markets have been punitive for Uber and Lyft, which are down in price by 27% and 42%, respectively, since their IPOs.

The High Yield market has become more discriminating of idiosyncratic issues. While nominal high yield spreads for the overall high yield index are tight over the 15yr period (i.e. prices are on the higher end of the spectrum historically), our corporate colleagues have reported that as of June of 2019 there have been 86 High Yield issuers whose debt has traded down greater than 10 points since the cyclical tights of October 2018. By August, that number had grown to over 120 issuers. The ranks of troubled High Yield borrowers have moved beyond just the Exploration and Production ("E&P") and Services sectors within Energy to include Retail, Autos, Pharmaceuticals, and Metals & Mining as well. Of course at some point, when the breadth and depth of problems becomes large enough, the characterization has to evolve from idiosyncratic to thematic.

https://www.tcw.com/en/Insights/Viewpoints/06-14-19_Beneath_the_Aggregates-_Growing_List_of_Idiosyncratic_Collapses

Counter to these specific examples where the capital markets have either pushed back and/or the fundamental issues have manifested to the point at which they cannot be ignored any longer, we've continued to observe other examples of complacency and loose underwriting. While the causes of negative yielding sovereign debt is a topic for a separate discussion, the combined construct of negative sovereign yields and complacent markets has led to significant issuance of corporations borrowing money at negative yields. Also according to our corporate colleagues, as of July of 2019 there was over $700 billion of negative yielding corporate debt, including a quarter of all investment grade euro-bonds. This is to say that in the best case outcome, if the borrower fully pays the debt obligation, the lender will receive back something less than the original loan amount at some time in the future! Of course, if the borrower defaults thus exposing and exercising the credit risk component of the security, the loss amount would be materially greater than the small guaranteed minimum loss from the negative yield. The marketed appeal of all of this corporate debt at negative yields is under the auspice of relative value and potential short term capital appreciation.

https://www.tcw.com/en/Insights/Viewpoints/07-17-19_Move_Over_FOMO_Here_Comes_FONONYA

Looseness in one market tends to permeate in other markets as well. The feedback loop is continuous and multi-directional and fed by sometimes small and imperceptible weaknesses. Sometimes, the weaknesses are more tangible and obvious. Certain private valuations of Unicorns (privately owned venture companies with valuations north of $1 billion) have (at least until recently) averaged > 10x price to revenue multiples.

Sample of Previous Unicorn Private Valuation Price/Revenue Multiples

(As of 4/22/19)

Unicorn	Equity Value	Revenues	Rev Multiple
Uber	$100,000	11,300	8.85x
WeWork	$47,000	1,800	26.11x
Meituan Dianping	$39,300	9,900	3.97x
Tencent Music	$29,900	2,900	10.31x
Spotify	$26,200	6,200	4.23x
Pinduoduo	$25,200	2,000	12.60x
iQIYI	$17,200	3,800	4.53x
Lyft	$17,100	2,200	7.77x
Snap	$15,800	1,200	13.17x
Pinterest	$11,300	800	14.13x
Sea	$10,500	800	13.13x
Dropbox	$9,500	1,400	6.79x
Average			10.46x

Source: The Economist, USD in millions

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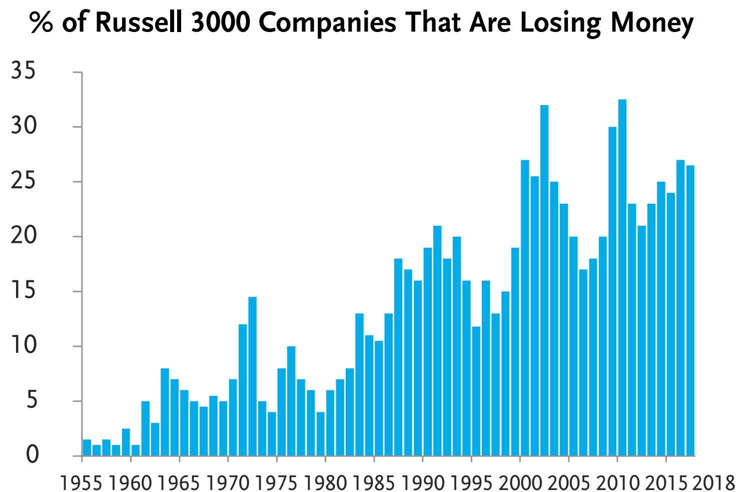
While Price/Revenue multiples are historically high, they register as even more egregious when considering profitability. The lower the profit margin, the higher the Price to Profitability ratio, and thus the worse the value. Of course, for many of these Unicorns, this goes beyond inflated price/revenue valuations combined with skinny profit margins. Many of these companies are, despite the various accounting shenanigans employed by markets to inflate profitability, simply unprofitable.

Valuations of private companies do not stand alone. Private companies going public via the IPO market are fully valued as well as evidenced by the percentage of unprofitable companies going public.

Source: Initial Public Offerings: Updated Statistics, J. Ritter, University of FL, Citi Research
As of August 31, 2019

This chain continues. Not only are valuations of private companies, and private companies going public via the IPO market expensive, but existing smaller public companies are expensive too through the lens of profitability.



Source: GMO, Citi Research, As of December 31, 2018

What does this all have to do with the securitized markets? As noted earlier, the capital markets are a delicately intertwined ecosystem with many small moving parts quietly rippling through in a continuous feedback loop. Sometimes they are perceptible, sometimes they are not. When there are so many observable concerns, investors have to make space and create margin for error for the things that cannot be quantified or seen.

With this said, there is plenty to see in the securitized markets. One example is in the 'Whole Business' sub-sector. Whole Business securitizations are typically collateralized by franchise fees (usually ~5-10%) off of top line revenues from franchisees to the franchisors. The franchise model in and of itself is an example of further specialization and efficiency in the capital markets. By franchising at the unit level, each part of the chain can focus on what it does best: for franchisees, that is operating the individual businesses at the unit level. For the franchisor it is to run the strategy, advertising, and capital markets components. This is not dissimilar to commercial real estate where the developer, owner, and operator are often different entities. Further, as it relates to any market, but using Whole Business as the example, market participants can opine on which parts of the business are of good or poor value, and invest accordingly, by buying and running a franchise or by investing in the public equity of the franchisor.

There can be many merits to Whole Business securitizations for the very best brands/businesses if offered at the right price. While there are virtually no hard assets, franchise fees off of top line revenues sit functionally at the top of the capital structure. For some of the best quick service restaurant (QSR) brands, the businesses are non, or even counter-cyclical, and offer a low cost and desired product for the customer and a reasonable profit margin for the business.

However, risks abound as the deals often pay out dividends to the franchisor from the securitization proceeds and have debt to cash flow leverage multiples in the context of the High Yield market despite being Investment Grade rated. We recently observed the first ever Whole Business deal with a pre-funding component. Usually pre-funding in ABS deals is utilized in order to have available capital to write yet-to-be made loans (i.e. buy more collateral) for granular and homogenous assets that fit certain underwriting criteria, such as Prime Auto Loans. The construct is completely different for Whole Business. There are no loans to be made like the Prime Auto market as the collateral for the securitization are the franchise fees off of top line revenues. To the extent new franchises are created there will be more cash flow to service the securitization debt but no new loans are to be made. New franchises delever a Whole Business securitization regardless of whether or not there is pre-funding. In conjunction with this pre-funding construct, additional 'pro-forma' prospective cash flow is marketed to show a lower leverage ratio. Functionally, the 'pre-funding' is simply a tool to create additional leverage upfront.

Our bigger concern though is the overall sustainability or lack thereof of many of the franchisors coming to market. While quantitative analysis is important, a qualitative assessment is also critical in assessing risk, hence the importance of recognizing how the looseness in underwriting in other markets can affect the market being observed. Originally the Whole Business market was dominated by many strong brands with highly homogenous and desired products. It didn't matter if the chalupa was purchased in New Jersey, New Mexico, or New Hampshire. The customer knew what he or she was getting and the BRAND had significant value. Now, with the markets largely open and insurance companies clamoring to book certain minimum thresholds of yields with Investment Grade rated bonds, more and more franchise business models are able to come to market with less discernment from the buyer base. For the very best low cost and well branded products, the businesses have strong moats. For a higher cost service based business, the brand matters less and the local service providers (the front line personnel) matter more. For a General Contractor or Pre-K school, would a customer care more about the national brand of the business OR the individuals doing the work on the property or educating her children? And for the average customer, could he even name a General Contractor or Pre-K education brand with national reach? If the brand doesn't matter, once the local franchisee General Contractor has the customer list and a recurring business, why renew the royalty fees for the business when they can offer the same product to their relationship customer at a higher margin for the local business and lower price for the customer by cutting out the franchisor? It just doesn't carry the same weight for the customer who wants and knows he is going to get the same chalupa in North Carolina as he's going to get in South Carolina.

In this environment of general complacency, we espouse a philosophy of creating margin for error and a healthy respect for the unknown unknowns. Within this framework and environment, there are still bottoms up opportunities in the securitized markets due to the complexity of modeling assets and the range of potential outcomes. One such opportunity is CMBS interest only (IO) bonds collateralized by commercial real estate (CRE) properties with idiosyncratic loan level merits.

Like the pre-funding construct in Whole Business, the CMBS market has enabled higher sustained leverage through the increased utilization of interest only loans. While this increases the back ended risk for principal and interest bonds of both Whole Business and CMBS, it likely decreases risk for CMBS interest only bonds as the probability of paying through the term of the loan is higher (due to lower payments on loans without amortization). It also increases the probability of upside from maturity extension modifications due to the higher leverage at maturity on the interest only loan.

With our proprietary tools, we've identified and purchased many individual bonds with the following characteristics:

- Fully delevered by maturity unlike subordinate bonds that are beholden to receiving principal at the end of the term
- Substantial interest coverage during the term without the property being of high enough quality that a maturity refinancing is a foregone conclusion - this means the bonds have a high probability of receiving all scheduled interest with some prospect and probability of getting additional cash flow due to a loan modification extension
- Positive carry across the distribution of scenario analysis with material upside should the fundamentals decline

In sum, the CMBS IOs we purchase for our clients are positive carry across the overwhelming percentage of the continuum of outcomes and negatively correlated to a decline in fundamentals. This is a construct that is rare as buying optionality for downside protection usually is a negative carry proposition.