

Why Issue or Buy a CDO?

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WHAT IS A CDO?

Lately, there has been a great increase in the issuance of real estate CDOs backed by CMBS and/or REIT debt (\$2.5 billion in the first quarter of 2003). Most commercial mortgage professionals have heard about CDOs either in the context of the rating agency dispute over “notching” or the

tightening of spreads on BBB rated CMBS due to the CDO issuer demand for these BBB bonds. However, even though CDOs have been around since the 1980s and there have been over \$300 billion issued, to mortgage professionals who are not involved in CDOs, the question remains, “What is a CDO?”

Literally, CDO is the acronym for collateralized debt obligation. Its most simplistic description is a security collateralized by bonds and loans from a relatively small number of rated obligors, as opposed to securities collateralized by pools of mortgage, credit card or other debt from large numbers of unrated obligors. In even more basic terms, it is a bond backed by other bonds.

WHAT ARE THE TYPES OF CDOs?

There are three basic types of CDOs:

1. **Market Value.** In Market Value CDOs, the key factor is *not* the cash flows from the underlying bonds, but rather the current market value of the collateral. On a regular basis, all underlying bonds in the CDO are priced, and if the aggregate value of the underlying bonds falls below certain benchmarks, the issuer has to sell collateral and/or cash flow is diverted from the subordinate classes to pay principal to the more senior classes.
2. **Cash Flow.** In cash flow CDOs, the key factor is the cash flow generated from the underlying bonds. As in a standard CMBS, the cash flow from the underlying bonds gets distributed to the various classes of CDO bonds according to the priority of payments (cash flow waterfall).
3. **Synthetic.** Synthetic CDOs use credit derivatives to achieve the same risk transfer as in a cash flow CDO without the physical transfer of any assets.

Almost all real estate CDOs are cash flow rather than market value or synthetic. Other frequently used terms are “arbitrage” CDO and “balance sheet” CDO. These are just variations on the above three categories, and the distinction is whether the assets to be included in the CDO are already on the balance sheet (and used as a financing method) or will be acquired specifically for the transaction in an arbitrage to capture the excess yield.

WHAT IS UNIQUE ABOUT A CDO’S STRUCTURE?

There are a few unique aspects of a CDO’s structure that differ from a standard CMBS. In a CDO, the pool is not necessarily static. In market value CDOs, the manager has wide latitude in changing the composition of the pool

(subject to certain constraints). The manager seeks to sell “overpriced” bonds and buy “undervalued” bonds to boost the return on the CDO. In cash flow CDOs, the manager has more restrictions on its ability to trade bonds. Sometimes the manager is permitted to change a certain percentage of the collateral every year. There generally is also an interest only period for a few years where principal payments (either in the form of prepayments, maturities, or default recoveries) are able to be reinvested.

Another unique feature is the allocation of cash flow. In a standard CMBS, all principal and interest is allocated to either the bonds or the interest only strip (IO). Thus, subordinate bonds are subject to principal losses when there are actual losses on the collateral. At that point, their principal amount is reduced, and consequently, their interest payments are reduced. However, with CDOs, the last tranche (often referred to as equity, preferred equity, income notes, etc.) does not realize losses or have a stated coupon, but rather functions more as a residual tranche, receiving all cash flow after the more senior bonds are paid according to the waterfall.

Further distinctions are the triggers and tests that determine the distribution of payments. The two most common are the Principal Coverage Test and the Interest Coverage Test.

Under the Principal Coverage Test (also known as the Over Collateralization Test), if the ratio of outstanding collateral balance divided by the balance of the bonds falls below a certain threshold, then there is a payment blockage to all bonds subordinate to the class that failed the test, and all cash flow is typically used to pay down the senior-most class of bonds until the threshold is reached.

Under the Interest Coverage Test, if the ratio of collateral interest collected divided by interest due on the bonds falls below a certain threshold, then again there is a payment blockage to all bonds subordinate to the class which failed the test, and all cash flow is used to pay down the senior-most class of bonds until the threshold is attained. In practice, the Principal Coverage Test acts as the constraining factor. Relatively few transactions are forced to pay down their senior bonds due to the failure of the Interest Coverage Test to meet its minimum required ratio.

Other common triggers/tests are Cumulative Loss Tests, whereby if losses start mounting, there are cash flow blockages as a pre-emptive strike against future losses, and “turbo” features, whereby, at a certain date, cash flow may be diverted from the Equity to more senior classes to further cushion those senior classes from defaults as maturity approaches.

WHY ISSUE A CDO?

There are a number of reasons why firms issue CDOs. The most common are:

- **Increase Assets Under Management.** The issuer of the CDO receives a management fee and sometimes an incentive management fee for managing the CDO. Thus, issuing a \$300-\$500 million CDO is an easy and effective tool to increase stable assets under management and earn additional management fees.



- **Yield Arbitrage.** Since there is a large, positive spread differential between the interest received on the underlying bonds and the interest to be paid to CDO bondholders, the owner of the preferred equity (just like the CMBS B-piece holder) can retain a very high yielding instrument. However, again just like the CMBS B-piece holder, they are highly leveraged and subject to dramatically decreased returns in the event of high defaults.
- **Clean Up Balance Sheet/Cheap Source of Financing.** For an institution that already has assets on the books, a CDO is a method of removing illiquid assets from the balance sheet to make capital available for other purposes and a cheap source of financing for those assets. For example, many B-piece owners have used CDOs as a means of financing their holdings and freeing up capital for additional purchases.

WHY BUY A CDO?

Why would an institutional investor buy a CDO? There are a number of reasons:

- **Exposure to Other Asset Classes.** Not every investor has the ability to follow all of the different asset backed markets. Thus, by buying a CDO, the investor has the ability to diversify to asset types in which it does not itself have the expertise to invest.
- **Expertise of CDO Manager.** The investor is able to leverage off of the knowledge and experience of the manager and feel comfortable buying assets where their own expertise is minimal.
- **Diversity of Risk.** When buying CDO bonds, you are potentially lending on many different asset classes and a very broad array within those classes. For example, if all of the underlying bonds were conduit CMBS, that CDO could be backed by 3,000 loans as opposed to 100-200 in a CMBS conduit.
- **Increased Yields.** The typical CDO trades at spreads wider than those available through direct investment in the underlying asset classes. As a result, the investor is able to receive an increased yield.

WHAT ARE THE KEY FACTORS IN EVALUATING A CDO?

Some key factors an investor should investigate when making a decision whether to buy CDO bonds are the following:

- **Experience of Manager.** An investor should carefully research the experience of the issuer with managing the types of assets in the CDO and, when available, the issuer's results with previously issued CDOs. This is especially important where there is likely to be substantial turnover in the composition of the underlying bonds.
- **Economic Interest of Manager.** An investor should determine how much economic interest the issuer has in the success of the CDO. It is important to determine the management fee structure. Sometimes management fees, which are not a function of the CDO's performance, are the only form of compen-

sation, and sometimes the manager also receives a subordinated management fee and/or a back-ended incentive compensation, that is linked to the results of the CDO. Additionally, investigate how much of a monetary investment in the preferred equity the issuer retains. The higher the economic incentive for the issuer, the more aligned its interests are with the investor.

- **Diversity of Collateral.** The rating agencies have complex methodologies for determining the correlation risk within the collateral pool of a CDO (beyond the scope of this article). However, an investor can use their own intuition and analysis of the degree of correlation of the underlying bonds. For example, if there are 10 different REIT issues in the CDO, but they are all office REITs, a downturn in the office market could lead to defaults on the CDO.
- **Knowledge of Underlying Collateral.** Although the underlying bonds serving as collateral can change over time, it is important to understand the collateral that currently composes the pool.
- **Understanding the Bond Structure.** It is crucial to fully comprehend all of the tests and triggers that can alter the payments to the CDO bonds. Many of the tests are complicated and not easily understood but can have a dramatic impact not only on yield but also on average life and duration.
- **Scenario Analysis.** Unlike CMBS, where it is quite easy to use excellent off-the-shelf software to evaluate a transaction, modeling CDOs is more difficult since the terms of the bonds are generally unique to each transaction. If a potential investor does not have the ability to model the deal in-house, the investor should request from the underwriter some different scenarios using different CDRs and loss severities to determine the yield and average life under those alternative assumptions. Investigate, "How bad can things get before I lose principal?" Answering this question becomes more important the further down the credit curve you are investing.
- **Don't Buy What You Don't Understand.** As with all investments, if an investor does not feel that they fully understand the transaction, do not invest! □

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