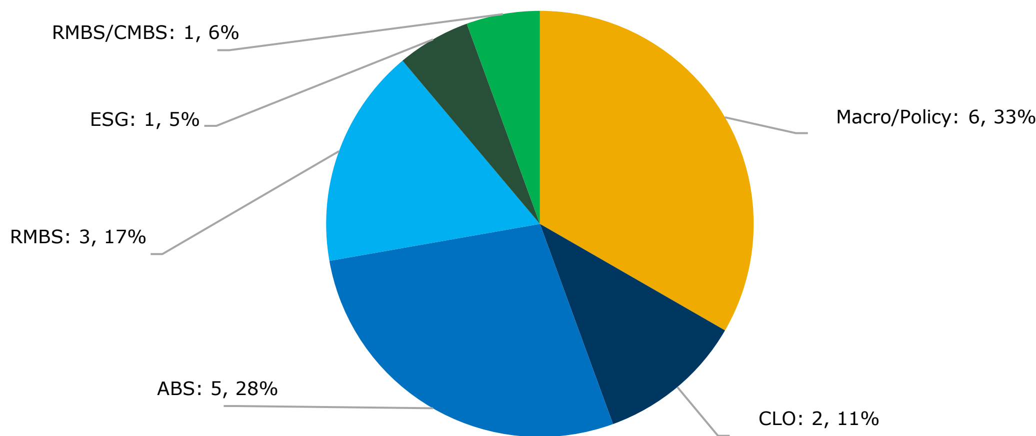
SFVegas 2024 Conference: Tuesday Recap

Tuesday began with two fireside chats with Erik Gerding of the Securities and Exchange Commission (SEC), as well as U.S. Representative French Hill (R-AR 2nd District). The fireside chats were followed by a plenary session focused on the macropolitical environment and political headwinds that could affect markets in 2024. The afternoon was once again allocated to several breakout panel sessions focused on the ABS, CLO, CMBS, and RMBS markets. A breakdown appears below, which is followed by highlights for select panel sessions.

Figure 1: Breakdown of Tuesday Conference Panels



Sources: KBRA, SFA

Aircraft ABS

With the slowdown in primary market activity following the Russia-Ukraine conflict, panelists expect aircraft ABS new issue volumes to remain fairly light until asset yields are able to catch up to the rise in interest rates over the past two years. With respect to credit performance, panel participants noted that fundamentals have improved. In 2021 and in 1H 2022, a sizable portion of aircraft remained on the ground, but starting in 2H 2022 most of these were put back to work, increasing utilization rates. When looking at aircraft with leases expiring over the previous 12 months, most leases were extended for three to five years, as airlines currently need more capacity amid huge shortages of aircraft. Even if the aircraft was returned to the lessor upon lease expiration, it has taken a much shorter time to re-lease than in recent years. During the COVID-19 pandemic, it took six to 12 months to find another lessee on average; however, this process takes approximately three months in today's environment.

Credit Card ABS Market

The panel kicked off by discussing how macroeconomic pressures affected consumer spending behavior in 2023. The consumer was selective but still spending, preferring travel and experiences over consumer goods. As inflation persists and savings have declined or even depleted for subprime consumers, the panel expects that consumers will be more cautious and focus their spending on necessities over niceties.

The panel commented on how consumers are using credit cards differently as we evolve toward a more cashless society. The pandemic significantly accelerated this trend as the consumer became more accustomed to buying online. Given the resulting strong utility of general-purpose credit cards, repaying credit card debt has moved up in the consumer priority of payments.

Despite credit card's high payment priority, the panel noted that after low delinquencies and charge-offs during the pandemic, performance has been weakening. It remains to be seen if this represents a normalization or a deterioration of performance compared to pre-pandemic levels. The panel cited the percentage of seasoned accounts versus new accounts as impacting loss curves, as charge-offs generally stabilize after 24 months.

The panel commented on the growth in nominal credit card balances. Volume is at an all-time high after dropping during the pandemic, which reflects the trend toward using less cash. It was noted that the economy has also been growing and, once adjusted for economic growth, the notional amount of card debt does not appear to be reflective of a bubble.

The panel expects issuance for 2024 to be in line with 2023 and performance of credit card ABS transactions to remain stable due to the structural characteristics of the transactions.

CRT Market

The panelists began with an overview of the government-sponsored enterprise credit risk transfer (GSE CRT) programs since their inception a decade ago. The subsequent transitions to actual loss frameworks as well as real estate mortgage investment conduit (REMIC)-eligible transactions, which expanded the investor base to real estate investment trusts (REIT) and foreign investors, were noted to be significant changes. Fannie Mae is expected to issue roughly six CAS transactions in 2024, with some front-loading to take advantage of favorable market conditions and to avoid issuing close to the upcoming election season. CRT spreads have been notably tight recently.

Bank-issued CRT transactions were also covered, and issuers were noted to include regional banks of various sizes. While European bank CRT issuance has been strong historically, in the U.S. the market has become more developed in recent years. The Office of the Comptroller of the Currency (OCC) and Federal Reserve appear to be supportive of bank-issued transactions, with the Fed providing approvals for various CRT programs. Bank CRTs were noted to differ from GSE CRTs, in that many are geared toward capital relief versus a transfer of credit risk.

Mortgage insurance CRT was also discussed including features that limit extension risk such as shorter maturities and faster prepays versus GSE CRT issuances. The panelists noted various CRT structures including direct bank-issued credit-linked notes (CLN), special-purpose entity (SPE) issuer structures, as well as direct credit default swaps (CDS).

CLO Investor and CLO Manager Roundtables

Panelists on the CLO Investor Roundtable expect the new issue market to be driven by refi/reset activity in 2024, with middle-market CLOs accounting for up to 25% of new issue volumes. While January's primary market activity hit a new all-time record for the month, most panelists did not expect the pace to continue through the entire year. With up to $50 billion worth of CLOs expected to exit their reinvestment period in 2024, this year's supply will likely be dominated by churn rather than growth. Panelists also expressed less interest for non-investment grade classes, as many see increasing tail risks for BB tranches, driven by higher-for-longer interest rate expectations.

Meanwhile, participants at the CLO Manager Roundtable also expected rates to stay higher for longer, and have based their investment decisions on this assumption, rather than the promise of near-term rate cuts. Panelists were concerned that a subset of borrowers are "kicking the can down the road" by burning through cash in the hope that interest rates trend downward, but managers are not seeing a catalyst for rate cuts to support this business approach.

Panelists believed that default projections of 5% in 2024, made by some analysts, are too aggressive. In their view, the 5% projection was based on biased data from a few recent large obligor defaults that had been expected for some time, and not supportive of a broader trend. Although defaults have picked up, panelists agreed they have been tame in managed portfolios and recoveries have been higher than in previous years for those credits that have defaulted.

Single-Family Rental (SFR) Market

Panelists discussed how higher interest rates have forced several changes to how deals are structured. Overall, leverage in the single-borrower market has declined about 15 percentage points to the low-60% range. Debt service coverage, rather than leverage, is now the constraining factor in structuring deals. Elevated interest rates will likely continue to force issuers to sell notes at a discount to ensure debt service coverage ratios (DSCR) remain sufficiently above trigger levels. The convergence of capitalization rates and funding costs has made the space an overall less attractive investment arena, resulting in reduced acquisition activity and issuance. A GSE takeout for build-to-rent (BTR) product was noted as likely to impact the multi-borrower SFR transactions, as borrowers that have sufficient scale to do a stand-alone deal will most probably just contribute their BTR properties along with their scattered-site assets to a deal, whereas smaller operators do not have that option.

Expectations regarding home price appreciation varied widely, with some participants expecting a 1%-2% decline in prices nationally, while others voiced an expectation that prices would increase up to 5% nationally. However, all agreed that the SFR industry's concentration in the Sunbelt states, which tend to have higher home price volatility, may result in more vulnerability to price declines. The pace of rent growth continues to slow, with Q4 2023 showing the slowest rent growth since 2019; Class A rent growth turned negative in 2023.

Expense growth continues to challenge margins at the operational level. There was some disagreement as to whether tax expense had stabilized, with some panelists noting some states lag in updating assessed values, leaving owners exposed to potential tax increases once values are eventually updated, while others noted the recent flattening in home values should translate into minimal increases in the near term. While increasing insurance expense has been an area of concern, some panelists note this represents a minimal percentage of total costs, so even a headline-grabbing percentage increase in this item can generally be absorbed. More worrisome is the inability of regional and midsize owners with concentrated exposure in Florida to get any insurance.

Solar ABS Market

The panel opened with an overview of primary activity, highlighting the record new issuance volumes that came to market in 2023, with 14 ABS transactions totaling approximately $4.47 billion. In addition to record issuance, the first AAA rated solar ABS tranche came to market in 2023, with the transaction benefiting from government support in the form of a guarantee from the U.S. Department of Energy.

It was noted that higher interest rates posed challenges for the sector. With the primary driver for residential solar being the cost savings, some issuers are on the backfoot as higher interest rates have translated into higher monthly payments, eroding the solar loan value proposition. Similarly, with rates going up, the sector saw some negative excess spread, which increases credit risk, all else being equal. However, panelists stated that issuers are savvy and are positioned to be resilient while walking the tightrope of how much they can increase rates while still providing value to borrowers.

Digital Infrastructure: Cell Towers, Data Centers, and Fiber ABS

There was approximately $12 billion of digital infrastructure ABS new issuance in 2023, with data centers accounting for about $5.5 billion (46%). Looking ahead to full-year 2024, one panelist expected data center ABS to be front and center and likely experience the highest growth among ABS asset classes over the next five years. They called for $10 billion-$15 billion of data center new issuance in 2024 with continued growth in the years ahead. This same panelist believed that the asset class will grow to as much as $70 billion by 2030 from roughly $17 billion outstanding today, at which time it would become the largest commercial ABS asset class. Their expectations for ABS growth were based on the nearly $1 trillion of data centers that are projected to come online over the next five years.

Auto ABS Market

Panel participants discussed macro trends and credit performance. Despite the low unemployment rate and relatively stable economy, they expect the consumer to remain under pressure in 2024 owing to rising debt levels, which are at all-time highs, and increasing costs of living as inflation remains elevated. That said, panelists generally expect a soft landing, pointing to GDP growth near 2%, interest rates coming down in 2H 2024, and slowing quantitative tightening following the May Federal Open Market Committee (FOMC) meeting. Further, they expect the unemployment rate to remain range-bound, increasing slightly, and peaking in Q4 2024.

Panelists agreed that this base case scenario generally bodes well for spreads, as well as underlying consumer credit performance. From an origination perspective, panelists agreed that there is a shift toward higher-quality prime originations and a reduction in subprime volume, which is being driven by higher vehicle values and interest rates. These factors result in increased monthly payments and decreasing affordability.

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