

RECENT DEVELOPMENTS IN THE AUTOMOBILE ABS LEASE/LOAN MARKET



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UNITED STATES AUTOMOBILE SALES HAVE BEEN ON THE RISE for seven consecutive years, setting a new record high in 2016. Low gas prices, falling unemployment, and range bound interest rates kept cars moving off dealership lots at record levels. Further contributing to the record auto sales climb has been the extension of lease and loan terms. With low interest rates and more affordable payment options, those looking for a new car are being lured back into the market. However, as a fixed income investor, we do not believe the record level of auto sales and more recent extension of credit terms is all positive news for the sector. In this market update, we explain the key components we are monitoring in auto loan and auto lease asset backed deals, trends in auto lending, and how Galliard is navigating an auto market that has seemingly reached its peak.

AUTOMOBILE VALUES – INCREASED UNCERTAINTY, THOUGH NOT A NEW CONCERN

As automobile production has increased, the investment community has closely watched used vehicle values for signs of deterioration. Used vehicle values are an important variable in loan valuations because they impact recovery values on defaulted loans (loss given default).

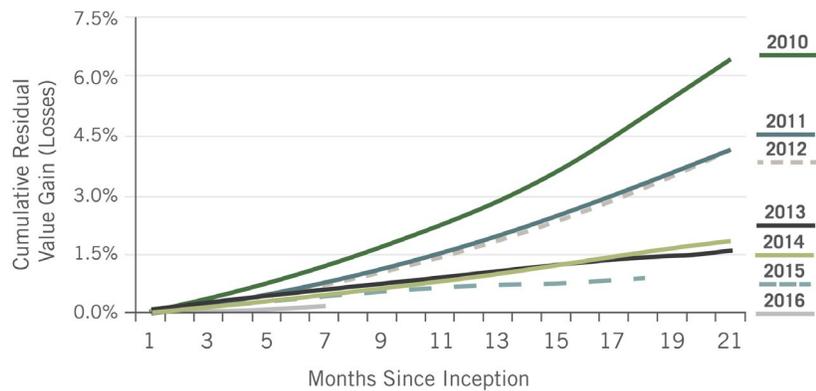
There have been many recent headlines regarding increased defaults and cumulative net losses. These losses have increased due to a growing incidence of loan defaults and the aforementioned deterioration in used vehicle values which impact loss severities. However, the increase in losses has not been completely unexpected. In the years immediately following the financial crisis, lending tightened considerably and auto ABS losses fell to unsustainably low levels. The observed increases in defaults and losses are partially attributable to the gradual return to normal at this point in the lending cycle.

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AUTO ABS LEASES

Over the past few years, more consumers are deciding to lease their vehicles. Increased lease opportunities have led to more car sales, and as an investor in this space, used vehicle resale values are of particular interest to us. In ABS securitization, leases go into trust and the values of used vehicles (also known as residual values) typically make up about 60% of the lease trust collateral. As the supply glut of used vehicles has increased, residual values have deteriorated (see *Figure 1*)—leaving lease trusts with a diminished ability to absorb defaults. The focus on increased supply has become more acute, as companies like Ford, GM Financial, and Hertz have signaled that residual losses are becoming meaningful. In comparing and contrasting ABS loans and lease valuations, used vehicle residual value deterioration is a larger concern for auto leases than loans because the ABS trusts are highly exposed to residual values.

FIGURE 1 CUMULATIVE RESIDUAL VALUE GAIN (LOSSES) FOR RETAIL AUTO LEASE ABS BY VINTAGE¹



FINANCING DEVELOPMENTS IN AUTOMOBILE LEASES & LOANS

In order to make new car sales more affordable, captive lenders have begun to extend loan terms and use leases to attract buyers. For example, many lenders will now offer 72-84 month auto loans, increasing lease penetration rates to more than 40%. These “affordability” products are designed to support automobile sales. Furthermore, the next few years are expected to see a large number of “off-lease vehicles” hit the market as auto leases from 2-3 years ago mature. In combination with high new vehicle production, off-lease vehicles could create an oversupply of available automobiles, which will likely continue to put downward pressure on residual values.

¹ Endnote is located on page 4

FIGURE 2 LEASE VOLUME²

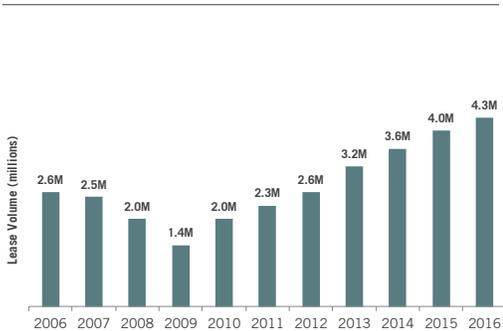
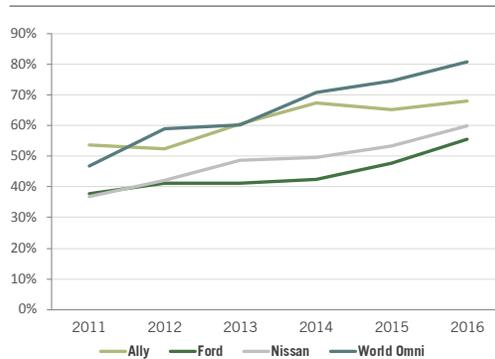


FIGURE 3 % OF COLLATERAL BALANCE WITH ORIGINAL TERM > 60 MONTHS³

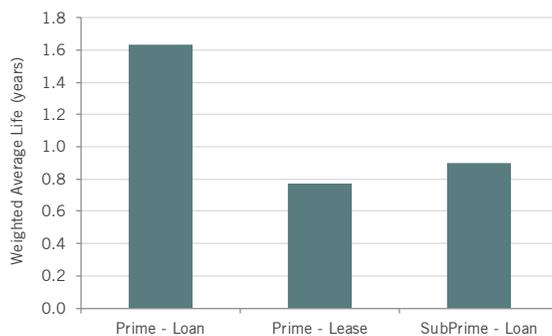


GALLIARD ONGOING INVESTMENT APPROACH

Generally, auto ABS trusts de-lever extremely fast. The collateral itself is generally short and fully amortizing, so these trusts produce significant cash flow. Subordinate bonds are locked out and, as a result, the credit enhancement available for AAA rated classes build fast. Most shelves will see the AAA-rated class credit enhancement double within 19-24 months from the initial level. We believe the structural protection available for our auto ABS positions is substantial even if losses were to accelerate moving forward.

At Galliard, we are not yet at the point of alarm, though not complacent with increasing losses either. Galliard’s ongoing investments with respect to auto leases have shifted to shorter weighted average life (WAL) tranches. Since these trusts are sequential pay, they have substantially less exposure to residual values. Additionally, as a result of the rapid de-leveraging that occurs in ABS Auto trusts, we feel lease exposures within Galliard portfolios are well insulated from residual value deterioration. We do not think that

FIGURE 4 GALLIARD AUTO ABS EXPOSURE-WEIGHTED AVERAGE LIFE



2, 3 Endnotes are located on page 4

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residual values will deteriorate enough to cause principal losses for any of the senior classes in ABS Auto Lease trusts but do anticipate that some subordinated classes could see downgrades as a result of eroded loss coverage ratios.

Consistent with our fixed income philosophy and process, Galliard's investments are naturally defensive. We continue to focus on high quality issuers in prime autos, keeping our investments to tranches that are AAA rated and generally around 2.0-2.5 year WAL. In subprime autos, we only invest in AAA tranches of issuers we have had long relationships with and who are experienced in the auto ABS market. Even so, we generally keep our subprime auto ABS exposure to shorter weighted average lives of between 1.0-2.0 years.

In closing, we expect some turbulence in the auto ABS asset class in the near term; however, given Galliard's conservative investment strategy and analysis, we feel our positions are well insulated from realizing any loss of principal.

¹ BofA Merrill Lynch Global Research, Intex

² Edmunds

³ Bloomberg, Issuer Data