

# CDO/CDS Update 04/24/06

## I. Commentary

**With tight collateral spreads, the two-layer structure is creeping back into cash CDOs.** Several cash deals priced during the holiday-shortened week, and new deals are coming out with larger buckets for CDOs in the underlying portfolios. For example, Rockwall CDO, priced last week, is backed by loans (75%) and CLOs (25%). Also, Libertas, a mezzanine ABS CDO, includes 10% of CDOs in its collateral portfolio. The inclusion of CDOs seems to be a developing trend in various deal types. In the pipeline, Mercury CDO III (high-grade ABS CDO) and Vertical 2006-1 (CRE CDO) include large buckets for CDOs, sized at 28% and 14%, respectively. Including CDO tranches tend to provide wider spreads, but the extra layer may increase the tail risk of the underlying portfolio. The triple-A tranches of Rockwall and Libertas both priced at 3mL+30.

**CDS index spreads moved to the tightest levels in months, amid expectations of rate hikes nearing end.** The 5-year DJ CDX.NA.IG Series 6 index continued to tighten, closing 1.6 bps tighter on the week at 37.9 bps. The U.S. crossover and high-yield indices reached the tightest levels for the current series, as the CDX XO index tightened by 6.9 bps to 162.4 bps and the CDX HY index finished 14.8 bps tighter at 301.2 bps. The European indices also turned tighter after the holiday weekend, with the iTraxx Europe index finishing 1.3 bps tighter at 30.3 bps.

The only region that saw spreads widen was Japan, where the iTraxx CJ index moved as wide as 29.4 bps before closing the week 1.4 bps wider at 28.7 bps. A consumer finance company Aiful saw its 5-year CDS spread more than triple from below 50 bps to above 150 bps, before finishing the week at 110 bps. Japan's Financial Service Agency suspended its operations for three days for using aggressive debt collection methods against its borrowers.

Auto spreads continued to tighten amid positive headlines. In particular, Lear's 5-year CDS tightened nearly 100 bps to 589 bps, the tightest level since January, after the company revealed favorable terms of its new financing arrangements. On Thursday, General Motors announced its narrower-than-expected first quarter loss of \$323 million. Also, revenue jumped by 14% to \$52.2 billion. GM's stock price soared by 10% on the news, while the upfront fee in GM's CDS narrowed by 1% to 18.5%. On Friday, Ford reported a net loss of \$1.19 billion and a 9% drop in revenue. GMAC's 5-year CDS tightened by 20 bps to 332 bps, while Ford Motor Credit' finished the week just 4 bps tighter at 479 bps.

**Fitch reviewed the situation surrounding the "succession" event in CDS.**<sup>1</sup> A recent surge in the LBO risk has shed light on the so-called succession event in a CDS. A succession event refers to the situation where the reference entity is merged with another company or split into multiple companies.

<sup>1</sup> Merritt, R., et al., *CDS Update: Corporate Restructurings and LBOs Refocus Market on CDS "Successor" Language*, Fitch special report (21 April 2006).

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The 2003 ISDA Credit Derivatives Definitions cleared some of the ambiguity in the older CDS documentation surrounding the succession event by setting numerical thresholds for determining the successor of a reference entity. According to the current provision, for example, if a new entity assumes more than 75% of the old entity's debt, it should be considered the successor for CDS referencing the old entity. On the other hand, if no entity assumes 75% of debt, CDS contracts are split evenly among multiple entities that assume more than 25% of the old entity's debt.

However, the treatment of a successor event can give rise to divergence between cash bonds and CDS of the same issuer. For example, suppose a company is broken into three new companies, each assuming 50%, 30%, and 20% of the old company's debt. While cash bonds will be split among the three new entities in a pro-rata fashion, CDS will be equally split between the two companies that assume more than 25% of the old company's debt. Obviously, the ultimate result depends on the exact structure of the merger or spin-off.

A recent example is the confusion surrounding Cendant Corporation, which is being split into four separate entities. Last month, the company announced a refinancing plan, where its \$1 billion's debt will be repaid and new debt will be issued under its indirect affiliate. In other words, there may be little debt under Cendant Corp. after the spin-off, making CDS protection referencing the company virtually worthless. While the exact detail of the spin-off is yet to be revealed, Cendant's CDS spreads have tightened dramatically since mid-March (i.e., 5-year CDS narrowing from above 130 bps to 45 bps last week). The confusion sparked the debate about the succession event in CDS, and many market participants seem to think that the current CDS definitions should be revised to better handle succession events in the future.

## II. Recent Pricing & Pipeline:

Issue	Date	Size (mm)	Collateral Manager	Assets	Lead	Class	Rating	WAL	Spread
Franklin CLO V	4/21	\$500.00	Franklin Advisors	Loans	MS				
		50.00				A-1 Rvlvr	Aaa/AAA/-	7.8	+27/3ML
		303.00				A-2 Term	Aaa/AAA/-	7.9	+26/3ML
		49.00				B	Aa2/AA/-	9.9	+45/3ML
		23.50				C	A2/A/-	10.5	+70/3ML
		21.50				D	Baa2/BBB/-	11.0	+165/3NL
		13.00				E	Ba2/BB/-	11.6	+415/3ML
		40.00				Equity			
GSC Partners CDO Fund VII	4/21	\$413.00	GSC LP	Loans	ML				
		252.00				A	Aaa/AAA/-	8.0	+29/3ML
		45.60				B	Aa2/AA/-	9.9	+55/3ML
		29.00				C	A2/A/-	10.5	+100/3ML
		21.70				D	Baa2/BBB/-	11.0	+205/3ML
		17.75				E	Ba2/BB/-	11.5	+575/3ML
		47.00				Preferred	-/-	-	-/-
Rockwall CDO	4/21	\$850.00	Highland Capital Mgmt	Loans/ CLO	BS				
		538.00				A1LA	Aaa/AAA/-	6.6	+30/3ML
		96.00				A1LB	Aaa/AAA/-	8.04	+50/3ML
		14.00				X	Aaa/AAA/-	4.16	-/3ML
		76.00				A2L	Aa2/AA/-	8.04	+65/3ML
		36.50				A3L	A2/A/-	8.04	+140/.ML
		10.00				A4L	A3/A/-	8.04	+170/3ML
		21.00				B1L	Baa2/BBB/-	8.04	+225/3ML
		78.20				P/S	-/-	-	

Avenue CLO III	4/21	\$500.00	Avenue Capital Mgmt	Loans	BS				
		8.50				X	Aaa/AAA-	Not Available	Not Available
		357.00				A1L	Aaa/AAA-	Not Available	Not Available
		39.00				A2L	Aa2/AA-	8.20	+45/3ML
		24.00				A3L	A2/A/-	8.20	+75/3ML
		21.50				B1L	Baa2/BBB/-	8.20	+165/3ML
		22.00				B2L	Ba2/BB/-	Not Available	Not Available
		38.00				PS	-/-	-	Not offered
Broadwick Fndg	4/20	\$1,000.00	Peloton Partners LLP	Mezz ABS (Hybrid)	GS				
		97.50				A1A	Aaa/AAA-	1.7	+20/1ML
		552.50				A1B	Aaa/AAA-	4.4	
		110.00				A2	Aaa/AAA-	3.9	+45/1ML
		112.00				B	Aa2/A/-	4.5	+57/1ML
		40.00				C	A2/A/-	4.7	
		38.00				D	Baa2/BBB/-	2.7	+325/1ML
		50.00				E	-/-		
Carlyle High Yield Partners VIII CLO	4/19	\$525.00	Carlyle	Loans	JPM				
		189.00				A-1 Reg	Aaa/AAA-	8.5	+25/3ML
		170.00				A-2a Snr	Aaa/AAA-	8.3	+25/3ML
		19.00				A-2b Jr	Aa1/AAA-	10.0	+34/3ML
		34.00				B	Aa2/AA-	10.0	+38/3ML
		28.75				C	A2/A/-	10.0	+68/3ML
		34.25				D	Baa2/BBB/-	10.0	+160/3ML
		50.00				PS	-/-		
Libertas	4/19	\$502.00	Strategos Capital Mgmt	Mezz ABS/ABS CDO	ML				
		420.00				A1	Aaa/AAA-	5.4	+30/3ML
		66.00				A2	Aaa/AAA-	5.4	+45/3ML
		32.40				B	Aa2/AA-	5.4	+58/3ML
		5.40				C	Aa3/AA/-	5.4	+67/3ML
		24.00				D	A2/A/-	5.4	+150/3ML
		13.80				E	Baa2/BBB/-	5.0	+340/3ML
		12.00				F	Baa3/BBB/-	5.0	+450/3ML
		9.0				G	Ba/BB+/-	5.0	+600/3ML
		19.00				P/S	-/-		-/-
Citius I CDO	4/18	\$2,000.00	Aladdin Capital Mgmt	HG ABS	Bar Cap				
		1,800.00				ABCP	Aaa/AAA-	-	-
		70.00				A-1	Aaa/AAA-	5.2	+35/1ML
		25.00				A-2	Aaa/AAA-	5.2	+42/1ML
		45.00				B	Aa2/AA-	5.2	+52/1ML
		25.00				C	A2/A/-	5.2	+137/1ML
		15.00				D	Baa2/BBB/-	5.0	+290/1ML
		4.00				E	Ba1/BB+/-	5.2	+625/1ML
		16.00				PF Shrs	-/-		
ACA Mezz CDO 2006	4/12	\$ 750.00	ACA Mgmt	Mezz ABS	BS				
		450.00				A1LA	Aaa/AAA-	3.71	+31/1ML
		105.00				A1LB	Aaa/AAA-	4.22	+44/1ML
		80.00				A2L	Aa2/AA-	4.29	+57/1ML
		40.00				A3L	A2/A/-	4.42	+155/1ML
		33.00				B1L	Baa2/BBB/-	3.81	+325/1ML
		42.00				PS	-/-		

New Pipeline	Size (mm)	Collateral Man.	Assets	Lead
Katonah VIII CLO	\$400.00	Katonah Debt Advisors	Loans	GS
Montauk Point II CDO	\$500.00	Fortis Investments USA	Mezz ABS	UBS
Vertical 2006-I	\$300.00	Vertical Capital Investment Advisors	CRE	BS
Mercury CDO III	\$1,000.25	Chotin Fund Mgmt	HG ABS	ML
WG Horizons CLO I	\$400.00	Westgate Horizons	Loans	CSFB
Jersey Street CLO	\$300.00	MFS	Loans	WS

\* denotes synthetic. Source: MCM, IFR, Bloomberg

### III. CDS Spreads

Index Constituent	Apr. 21	Apr. 13	Moody's Rating	S&P's Rating	5Y CDS Index	Apr. 21	Apr. 13	Change
Fannie Mae	9	9	Aaa	AAA	CDX.NA.IG 6	37.94	39.50	-1.56
Boeing	15	15	A2	A	CDX.NA.IG 6 HVOL	71.88	74.67	-2.79
IBM	13	13	A1	A+	CDX.NA.IG XOVER	162.44	169.31	-6.87
Deere & Co	20	20	A3	A-	CDX.NA.HY 6	301.17	315.92	-14.75
GE Capital	15	15	Aaa	AAA	CDX.EM 5	144.64	165.65	-21.01
AIG	18	19	Aa2	AA	iTraxx Europe 5	30.28	31.61	-1.33
Dow Chemical	24	24	A3	A-	iTraxx Europe HVOL	53.28	56.25	-2.97
Alcoa	18	18	A2	A-	iTraxx Europe X-over	253.19	268.21	-15.02
CIT Group	22	23	A2	A	iTraxx CJ Japan 5	28.72	27.34	+1.38
Duke Energy	25	26	A3	BBB	iTraxx Asia ex-Japan	57.00	57.31	-0.31
McDonalds	17	18	A2	A	iTraxx Australia	28.54	28.72	-0.18
Walt Disney	18	20	A3	A-	iTraxx SDI-75 2	41.19	41.31	-0.12
Viacom	44	46	Baa3	BBB	<b>CDX Widest</b>	<b>Apr. 21</b>		
Time Warner	43	47	Baa2	BBB+	Jones Apparel Gp Inc	153		
Computer Associates	64	66	Ba1	BBB-	SUPERVALU INC	152		
Altria Group	51	53	Baa2	BBB	RadioShack Corp	115		
Tyson Foods	118	110	Baa3 /*-	BBB	Tyson Foods Inc	109		
Ford Motor Credit	457	462	Ba3	BB-	Wendys Intl Inc	109		
GMAC	316	335	Ba1 /*-	BB /*	<b>CDX Tightest</b>	<b>Apr. 21</b>		
Carrefour	17	19	A1 /*-	A	Wal Mart Stores Inc	9		
AXA	17	17	A2	A	Fed Natl Mtg Assn	9		
AKZO Nobel N V	24	27	A3	A-	Target Corp	11		
Suez	19	21	A2 /*+	A- /*+	Wells Fargo & Co	12		
GUS PLC	40	41	Baa1 /*-	BBB+ /*-	Bristol Myers Squibb C	14		
PLC	27	28	Baa2	BBB	<b>iTraxx Widest</b>	<b>Apr. 21</b>		
Renault	28	29	Baa1	BBB+	Portugal Telecom Intl	139		
Brit Telecom PLC	53	56	Baa1	A-	Glencore Intl AG	89		
Lafarge	38	42	Baa2	BBB	Degussa AG	85		
Deutsche Telekom AG	36	36	A3	A-	THOMSON	84		
METRO AG	34	36	Baa2	BBB	Koninklijke KPN N V	80		
France Telecom	37	37	A3	A-	<b>iTraxx Tightest</b>	<b>Apr. 21</b>		
Telecom Italia SpA	48	50	Baa2	BBB+	Royal Bk Scotland plc	7		
Volkswagen AG	27	28	A3	A-	ABN AMRO Bk N V	7		
DaimlerChrysler AG	56	58	A3	BBB	Barclays Bk plc	9		
VNU NV	156	156	Ba1 /*-	BBB- /*-	Nestle S A	9		
Koninklijke Ahold N V	138	148	Ba1	BB	Bco Bilbao Vizcaya Ar	10		

For the CDX index, single-name CDS spreads are on a "XR" basis (without restructuring).

Source: Markit and Bloomberg

ABX.HE Index (as of April 21, 2005)				
Index	Price	Weekly change	Spread* (bps)	Coupon (bps)
ABX.HE.AAA.06-1	100.30	+ 0.00	11	18
ABX.HE.AA.06-1	100.43	- 0.01	20	32
ABX.HE.A.06-1	100.22	+ 0.00	47	54
ABX.HE.BBB.06-1	100.76	- 0.06	130	154
ABX.HE.BBB-.06-1	101.75	- 0.10	210	267
CMBX.NA Index (as of April 21, 2005)				
Index	Spread	Weekly change	Coupon (bps)	
CMBX.NA.AAA.06-1	6.50	+ 0.33	10	
CMBX.NA.AA.06-1	17.07	+ 0.08	25	
CMBX.NA.A.06-1	27.21	+ 0.15	35	
CMBX.NA.BBB.06-1	72.00	+ 0.00	76	
CMBX.NA.BBB-.06-1	121.00	- 0.38	134	

Source: Markit \* assuming 35% CPR.

## IV. CDS Index Tranche Indicative Spreads &amp; Base Correlation

iTraxx Europe Series 5 (5 years)						
	21-Apr		13-Apr		Change	
Overall index spread	29.4 bps		31.5 bps		- 2.1 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	21%	10.4%	24%	9.2%	- 3.0%	+ 1.2%
3%-6%	59 bps	20.8%	63 bps	19.8%	- 4.0 bps	+ 1.0%
6%-9%	15 bps	28.7%	18 bps	27.5%	- 3.0 bps	+ 1.2%
9%-12%	8 bps	35.2%	9 bps	33.8%	- 1.5 bps	+ 1.4%
12%-22%	4 bps	51.7%	4 bps	50.2%	- .3 bps	+ 1.5%
CDX.NA.IG Series 6 (5 years)						
	21-Apr		13-Apr		Change	
Overall index spread	37.5 bps		39.75		- 2.3 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	28%	9.9%	31%	9.2%	- 2.4%	+ .7%
3%-7%	82 bps	23.9%	91 bps	23.1%	- 9.0 bps	+ .9%
7%-10%	17 bps	32.2%	18 bps	31.5%	- .8 bps	+ .7%
10%-15%	9 bps	43.1%	10 bps	42.3%	- 1.0 bps	+ .8%
15%-30%	5 bps	64.8%	6 bps	63.8%	- .6 bps	+ .9%
iTraxx Europe Series 5 (7 years)						
	21-Apr		13-Apr		Change	
Overall index spread	39.5 bps		42.5 bps		- 3.0 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	39%	7.4%	42%	6.8%	- 2.8%	+ .6%
3%-6%	163 bps	17.6%	182 bps	16.9%	- 19.0 bps	+ .7%
6%-9%	40 bps	26.1%	42 bps	25.6%	- 2.0 bps	+ .5%
9%-12%	21 bps	33.1%	21 bps	32.8%	+ 0.0 bps	+ .3%
12%-22%	9 bps	51.4%	7 bps	52.6%	+ 1.5 bps	- 1.3%
CDX.NA.IG Series 6 (7 years)						
	21-Apr		13-Apr		Change	
Overall index spread	48.5 bps		49.75		- 1.3 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	46%	5.9%	48%	5.3%	- 2.3%	+ .7%
3%-7%	220 bps	17.9%	233 bps	17.7%	- 13.0 bps	+ .2%
7%-10%	36 bps	26.7%	36 bps	27.0%	+ .5 bps	- .3%
10%-15%	19 bps	38.2%	20 bps	38.7%	- 1.5 bps	- .5%
15%-30%	8 bps	63.5%	8 bps	64.8%	- .3 bps	- 1.3%
iTraxx Europe Series 5 (10 years)						
	21-Apr		13-Apr		Change	
Overall index spread	50.5 bps		53.5 bps		- 3.0 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	50%	8.2%	52%	7.3%	- 2.3%	+ .9%
3%-6%	524 bps	10.1%	554 bps	9.5%	- 30.0 bps	+ .6%
6%-9%	100 bps	18.7%	106 bps	18.3%	- 6.0 bps	+ .4%
9%-12%	45 bps	25.9%	48 bps	25.6%	- 2.5 bps	+ .2%
12%-22%	18 bps	45.5%	18 bps	46.1%	+ 0.0 bps	- .5%
CDX.NA.IG Series 6 (10 years)						
	21-Apr		13-Apr		Change	
Overall index spread	60.8 bps		62.5 bps		- 1.8 bps	
	Spread	Correlation	Spread	Correlation	Spread	Correlation
0%-3%	53%	7.1%	55%	5.9%	- 2.1%	+ 1.2%
3%-7%	547 bps	11.2%	590 bps	10.3%	- 43.0 bps	+ .9%
7%-10%	95 bps	20.0%	103 bps	19.2%	- 8.5 bps	+ .7%
10%-15%	47 bps	31.0%	50 bps	30.6%	- 3.0 bps	+ .4%
15%-30%	14 bps	58.8%	15 bps	58.7%	- 1.5 bps	+ .1%

Source: Nomura

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