Grounds for optimism

US equipment ABS has had a good year, notwithstanding macro-driven spread widening. As **Mark Pelham** reports, there is also hope for 2023.

While most sectors throughout the global capital markets have struggled in 2022, the US equipment ABS market quietly but surely had a record year. That is not to say it's all been easy, with the gloss of new issuance volumes tarnished a little by spread widening, but there are grounds for optimism for the equipment securitisation space in the year ahead.

"Overall, ABS is one of the few sectors where we've even come close to matching last year's numbers and 2021 was the highest post-financial crisis in terms of volume, for both equipment as well as total ABS," says one New York-based banker. "2021 was a record year because rates were really low and spreads were really tight, so every single issuer came to the market and that – combined with pent-up issuance held back by the pandemic, when a lot of people didn't issue in 2020 – really boosted primary volumes."

The banker continues: "2022 equipment ABS issuance is going to surpass that, which is driven by a series of years of expansion in the equipment sector itself, with increasing activity, capital investment and so forth. And in ABS, we now have a lot more active issuers and there's a lot of issuers that have come into the space over time." ▶

Aron Bergman, Moody's

As a result, the market benefits from fairly regular debutants, which typically start with relatively small-sized deals *(see 2022 Debuts box for more)*. At the other end of the scale, there are a number of benchmark issuers that are treated as top-tier names and are widely recognised – John Deere being a notable example *(see Benchmark Brand box)*.

"From Moody's perspective, we're seeing a record number of deals in the equipment space this year," says Aron Bergman, vp – senior credit officer at Moody's. "Issuers continue to use securitisation as a primary funding source and are going to continue to issue transactions, despite increasing rates."

Karen Ramallo, associate md at Moody's, adds: "For the equipment space, in particular, the obligor profile continues to be strong. We're seeing a good mix of either large-, small- or medium-sized businesses that continue to prioritise the payments on the underlying equipment that is essential to their day-to-day operations."

Further, Bergman reports: "We've been hearing that as a result of the supply chain issues over the last couple of years, the pent-up demand for new equipment is still there, despite the increased activity in 2022. As long as there is demand for new equipment, originators are going to continue

Karen Ramallo, Moody's

2022 DEBUTS

As noted in the main text, the US equipment ABS market has benefitted in recent years from the regular arrival of new issuers, albeit typically starting out with relatively small deals. The year to mid-November, 2022 saw two such new entrants – Varilease Finance and Channel Partners Capital.

VFI ABS 2022-1

Class	Size (US$m)	Bmark	Coupon	Price	Yield	Spread	KBRA
A	141.64	EDSF	2.23%	99.99533	2.245%	100	AAA
B	15.70	Swaps	3.04%	99.97472	3.069%	130	A
C	7.72	Swaps	3.84%	99.98395	3.877%	210	BBB
D	5.79	Swaps	6.68%	99.99192	6.777%	500	BB

Pricing date: 18-Feb-2022
Lead structurer: KeyBanc
Originator: Varilease Finance

Source: Bank/rating agency research & dealer pricing information

In its new issue report for the deal, KBRA notes that Varilease Finance, founded in 2001 and headquartered in Salt Lake City, Utah, is an independent equipment finance company focused on leasing industrial and commercial equipment to upper- and middle-market businesses. Collateral for VFI ABS 2022-1 comprises leases on manufacturing (21%), food processing (12%), oil and gas (11%), construction (9.83%) and other equipment.

CP EF Asset Securitization I 2022-1

Class	Size (US$m)	Bmark	Coupon	Price	Yield	Spread	KBRA
A	134.86	I-Curve	5.96%	99.99239	6.042%	325	A
B	21.52	I-Curve	7.14%	99.98938	7.251%	425	BBB
C	6.49	I-Curve	10.51%	99.97328	10.753%	775	BB

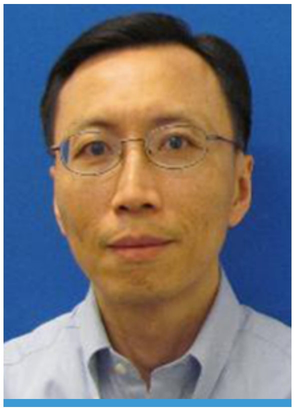
Pricing date: 30-Jun-2022
Lead structurer: Truist
Originator: Channel Partners Capital

Source: Bank/rating agency research & dealer pricing information

In its new issue report for the deal, KBRA notes that Channel Partners Capital (CPC), which was founded in 2009 and headquartered in Minnetonka, Minnesota, focused on providing point of sale working capital finance to small businesses during the first ten years of its history. This strategy resulted in CPC working with and developing relationships with equipment finance partners.

Beginning in 2020, CPC launched its own equipment finance offering. Collateral for CP EF Asset Securitization I 2022-1 comprises financing for "other" transport (primarily dump trucks, bucket trucks and crane trucks – 16.1%), construction (15.0%), trucking (14.5%), general equipment (13.5%) and trailers (10.8%).

"ISSUERS CONTINUE TO USE SECURITISATION AS A PRIMARY FUNDING SOURCE AND ARE GOING TO CONTINUE TO ISSUE TRANSACTIONS, DESPITE INCREASING RATES"



Benjamin Shih, Moody's

to originate contracts and fund that new origination through securitisations."

However, Benjamin Shih, vp – senior credit officer at Moody's, suggests: "There are perhaps a couple of segments within the equipment sector that may be facing some headwinds. One is the IT equipment sector, which is likely to see a bit of a slide in the next 12-18 months as macroeconomic conditions worsen. IT spending tends to be one of the areas that is cut back by corporations in such circumstances."

He continues: "The other area, more obviously, is construction equipment, as everybody knows the housing market – at least home sales – have been declining rapidly and construction is likely to decline into next year as a consequence."

Nevertheless, there is potentially a mitigating factor to the latter. "Infrastructure spending may help compensate for any decline from the housing start front," says Bergman.

Overall, Moody's is bullish on the fundamental prospects for the sector. Ramallo says: "Due to supply chain constraints, values have held up well, supporting recoveries on any defaulted contracts. As supply chain issues ease, we may not see such high values, but we still expect to see strong collateral values. And the current situation isn't something that will dissipate in just a month or two, so it will continue to be supportive of values going into the New Year."

The banker agrees and observes: "The volatile market environment has, of course, had an impact – you do see on new deals that issuers are not selling as far down the capital structure, for example. So, the funding cost is not necessarily the most attractive at the moment. But ABS is part of the regular funding process of companies in the sector,

BENCHMARK BRAND

As noted in the main text, there are a small number of issuers in the US equipment ABS market that are treated as top-tier names and are widely recognised. John Deere is, perhaps, the leading example of this.

John Deere Capital Corporation (JDCC) has been an ABS issuer since 1992. "JDCC's servicing experience, including through past recessionary environments, together with its size, scale and market position in the US, support a low degree of operational risk," says Moody's in its pre-sale for the firm's most recent deal – John Deere Owner Trust 2022-C.

In its own pre-sale on the same deal, Fitch adds: "As part of its funding strategy, JDCC has accessed the ABS market once or twice a year dating back to 2003. The JDOT 2022-C transaction will be the 40th US public securitisation issued by JDCC that includes receivables originated by JDCC."

Up to mid-November, the firm came to market three times in 2022 with equipment ABS, all referenced fixed rate loans on new/used agricultural and construction equipment:

John Deere Owner Trust 2022-A

Class	Size (US$m)	Bmark	Coupon	Price	Yield	Spread	Fitch	Moody's
A-1	312.47	Libor	0.89%	100.00000	0.889%	5	F1+	P-1
A-2	387.88	EDSF	1.90%	99.99453	1.913%	37	AAA	Aaa
A-3	437.68	Swaps	2.32%	99.97788	2.341%	37	AAA	Aaa
A-4	86.00	Swaps	2.49%	99.99015	2.506%	48	AAA	Aaa

Pricing date: 10-Mar-2022
Lead structurer: BofA

Source: Bank/rating agency research & dealer pricing information

John Deere Owner Trust 2022-B

Class	Size (US$m)	Bmark	Coupon	Price	Yield	Spread	Fitch	Moody's
A-1	313.00	I-Curve	2.88%	100.00000	2.876%	46	F1+	P-1
A-2	411.00	I-Curve	3.73%	99.98941	3.768%	78	AAA	Aaa
A-3	411.00	I-Curve	3.74%	99.99045	3.773%	73	AAA	Aaa
A-4	86.17	I-Curve	3.80%	99.97369	3.838%	80	AAA	Aaa

Pricing date: 12-Jul-2022
Lead structurer: RBC

Source: Bank/rating agency research & dealer pricing information

John Deere Owner Trust 2022-C

Class	Size (US$m)	Bmark	Coupon	Price	Yield	Spread	Fitch	Moody's
A-1	310.00	I-Curve	4.14%	100.00000	4.140%	35	F1+	P-1
A-2	439.21	I-Curve	4.98%	99.99642	5.034%	75	AAA	Aaa
A-3	439.21	I-Curve	5.09%	99.99224	5.147%	83	AAA	Aaa
A-4	82.25	I-Curve	5.20%	99.98497	5.261%	98	AAA	Aaa

Pricing date: 12-Oct-2022
Lead structurer: Citi

Source: Bank/rating agency research & dealer pricing information

Theresa O'Neill, Bank of America

so there's always going to be a certain amount of deals, regardless of what level they can fund at."

Bank of America figures put equipment (ex-aircraft, container and railcar) ABS new issuance volume at around US$21bn for the year to mid-November 2022. That represents a year-on-year increase of 11% and surpasses the record annual volume of US$19.91m seen in 2019.

However, Theresa O'Neill, ABS strategist at Bank of America, observes: "From a new issue standpoint, we've seen decent volume. But from a spread perspective, we've definitely seen widening spreads, which is really only what we're seeing overall in the ABS market. Some of that is normalisation from flows that we saw during the pandemic and not major weakness or anything that's giving us any sector-specific concerns at the moment."

At the end of October 2022, BofA generic spreads indicated year to date spread widening for a three-year triple-A tranche in an agricultural or construction type deal was around 94bp to Treasuries plus 145bp. In comparison, three-year prime auto ABS triple-As had widened 69bp to Treasuries plus 100bp in the same period.

O'Neill explains: "Prime autos are the most directly comparable ABS sector to equipment because the structures and the maturities and the ratings tend to very similar. However, prime autos is a much larger market, which has a much broader investor base, and equipment ABS doesn't have as active a secondary market either."

She continues: "The lack of liquidity hurts equipment relative to prime autos, especially in the current volatile market. Equipment deals are typically buy-and-hold investments and – at US$20bn of new issuance – it's not a huge market and it quickly amortises, so the outstanding amount generally is much smaller than prime autos."

"FROM A NEW ISSUE STANDPOINT, WE'VE SEEN DECENT VOLUME. BUT FROM A SPREAD PERSPECTIVE, WE'VE DEFINITELY SEEN WIDENING SPREADS"

Equipment does at least offer some pick-up to compensate – 40bp from the example figures cited previously. "You definitely get incremental spread relative to prime autos and that does attract people to the sector," O'Neill concedes. "But, again, if I'm an investor and I'm not sure if I'm going to need to raise cash because of redemptions, I'd rather be in prime autos because [it's] much easier to sell, thanks to the sheer number of investors being much larger. That number gets even smaller when you move into small ticket equipment."

While the investor base isn't showing any signs of growing dramatically, it does have the virtue of consistency, the banker argues. "It's really solid – equipment might be at the yieldier end of ABS, but it's still pretty high quality and it's not aircraft or rail car, which is very esoteric. The normal equipment space is fairly generic, so that it gets it a wider and more loyal investor base than you might think."

In the current volatile environment and with expected continued economic headwinds ahead, that loyalty is unlikely to decline. "I don't know if there's anything particularly unique about equipment ABS itself, but the unique point is it's doing pretty well," says the banker. "It's not a particularly exciting story, but that's probably what investors are looking for these days – they don't want the excitement of even higher yield products right now."

Looking ahead, BofA's O'Neill also expects current spread patterns to continue. "For credit in general, we have a bias towards weaker performance that's going to carry into 2023 and we're looking for spreads to continue to be biased wider. Our house view on the economy is the expectation of a recession next year and that will impact the equipment sector's performance," she concludes.