Credit Products/Europe
New Issue

Harbourmaster CLO 3 Limited

Final Ratings

Class	Par (EUR)	Rating	%	CE %	Rating Description
A	380,000,000	AAA	86.76	12.10	Timely I & Ultimate P
B-1	21,000,000	A	4.79	7.31	Ultimate P & I
B-2	5,000,000	A	1.14	7.31	Ultimate P & I
C	8,000,000	BBB	1.83	5.48	Ultimate P & I
D	24,000,000	NR	5.48	0.00	

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Summary

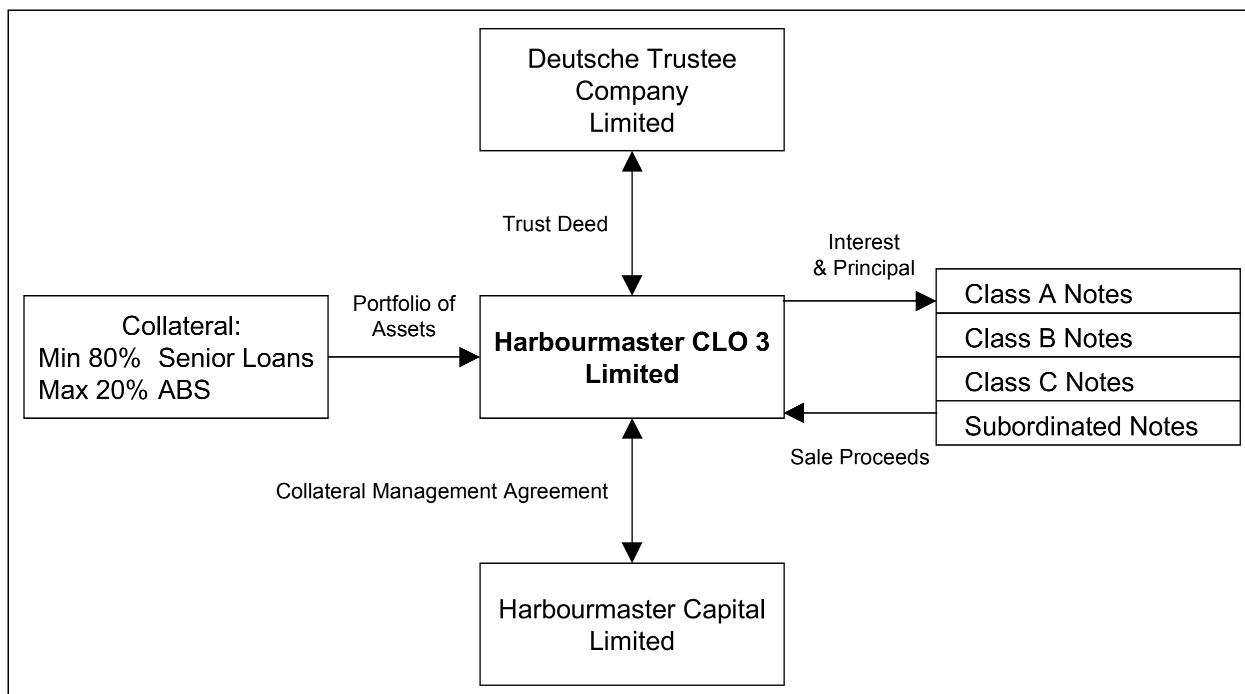
Harbourmaster CLO 3 Limited's ("Harbourmaster" or "the issuer") liabilities are assigned final ratings as indicated at left. The transaction constitutes a securitisation of senior secured loans and investment–grade asset–backed securities (ABS).

The issuer is a company with limited liability, incorporated under the laws of Jersey. Harbourmaster will issue EUR 438 million of various classes of fixed and floating-rate notes (*see left-hand table*). It will use the proceeds of the notes to purchase a EUR 430m portfolio, comprising a minimum of 80% senior secured loans and up to 20% investment–grade ABS. The portfolio will be managed by Harbourmaster Capital Limited ("HCL" or "the manager"). The ramp-up period will last a maximum of 270 days. As of the closing date, it is expected that the issuer will have purchased or committed to purchase 45% of the target portfolio.

The ratings are based on the quality and diversity of the portfolio of assets, which are selected by the investment adviser subject to the guidelines outlined in the collateral management agreement. These limit the investment adviser's portfolio allocations with respect to obligor, industry and asset type. Fitch Ratings looked at the experience of the investment adviser and is satisfied with its ability to manage this portfolio effectively. Ratings are also based on the credit enhancement provided to the various classes of notes, which consists of the subordinated notes, structural protection covenanted by the documents and excess spread. For further information on the agency's rating methodology, see research *"Rating Criteria for European Arbitrage Collateralised Debt Obligations"* dated 5 June 2000, available at www.fitchratings.com.

Risks to the portfolio include an overall deterioration in the credit quality of the assets and excessive defaults on a significant portion of the investments. These risks are mitigated by the investment guidelines, which require a minimum level of diversification by obligor and industry, weighted average rating, spread and recovery rate, and maintenance of minimum par coverage and interest coverage ratios.

All rated notes will have a contractual right over the assets of the issuer and a stated, legal final maturity of 2014. All the classes of notes will receive quarterly interest distributions beginning on 15th January 2003. In Fitch's cash flow model, the Class A notes survived their 'AAA' stress scenario with timely payment of interest throughout the transaction and full repayment of principal at maturity. In their respective 'A' and 'BBB' stress scenarios, the Class B and C notes realised ultimate payment of full and compensating interest and principal at maturity.



Fitch monitors the asset portfolio, as well as the issuer's financial condition whilst the rated debt is outstanding to ensure that the ratings are consistent with the risk to noteholders. The issuer is required to submit monthly statements that include a detailed outline of fund investments and compliance tests.

■ Credit Committee Highlights

Asset specific recovery rates: The transaction consists predominantly of senior secured loans that will have a shadow rating assigned to them by Fitch. The agency assigns asset–specific recovery rates for Harbourmaster, which may fluctuate over time. The portfolio must maintain a minimum weighted average recovery rate of 67.2% at all times.

ABS Bucket: Unlike the two previous Harbourmaster transactions, in Harbourmaster CLO 3, the issuer can invest up to 20% of the note proceeds in investment–grade ABS. This will help the manager diversify the portfolio and have access to another asset class in the event that the supply of leveraged loans is weak.

■ Structure

The notes are issued by Harbourmaster CLO 3 Limited, a bankruptcy–remote special purpose vehicle based in Jersey. Its activities are limited to those directly related to its primary purpose, the acquisition of the collateral, entering into the collateral management agreement with HCL, entering into the liquidity facility agreement and the issuance of the notes to finance the purchase of the investments. The amount payable under the notes will be dependent on the performance of the underlying portfolio. All the rated notes will have a contractual right over the portfolio assets owned by the issuer, granted via the custody agreement with Deutsche Bank AG London.

The transaction term can be subdivided into the following three periods:

1) Ramp-Up Period

The portfolio will be built over a period of approximately 270 days, by which date the issuer will have acquired all of its assets. During the ramp-up period, the collateral manager must ensure sufficient cash flow to cover scheduled interest distributions. The time from the closing date to the effective date, the ramp-up period, may be shorter than 270 days insofar as the portfolio guidelines are satisfied. As of the closing date, it is expected that the issuer will have purchased or committed to purchase 45% of the target portfolio.

Key Information

Portfolio Characteristics

Type of Reference Obligations:
Senior secured and investment grade ABS
Total Reference Portfolio: EUR 430m
Max. Weighted Average Life: 7 years
First Reinvestment Period: 5.25 years
Second Reinvestment Period: 4 years
Weighted Average Rating: 'BB'

Structure

Collateral Manager:
Harbourmaster Capital Limited
Arranger and Book Runner:
Schroder Salomon Smith Barney
Liquidity Provider:
Deutsche Bank AG London
Collateral Administrator
Deutsche Bank AG London
Trustee:
Deutsche Trustee Company Limited

2) First Reinvestment Period

The portfolio will have a reinvestment period from the closing date up to October 2007, during which the principal proceeds from the redemption, maturity or sale of collateral may be reinvested in substitute assets. The first five years from the closing date represent the non-call period, which is the period during which the principal proceeds from the redemption, maturity or sale of assets cannot be used to redeem the notes unless an event of default occurs under the notes.

After the first five years, the issuer may call the transaction at the request of at least 75% of the Class D subordinated noteholders. This would result in the principal proceeds being applied to redeem outstanding notes in order of priority. The Class D subordinated noteholders may ask for this option to be exercised on any payment date after the end of the non-call period.

3) Second Reinvestment Period

Following the expiry of the first reinvestment period, only unscheduled principal proceeds may be reinvested in substitute assets, subject to eligibility criteria. This period will extend from October 2007 to October 2011.

Following the expiry of the second reinvestment period, all principal proceeds must be used to redeem the notes in accordance with the priorities of payment.

Collateral

The rated debt securities assume the credit risk of a diversified portfolio of senior secured loans and investment–grade ABS securities.

The issuer is subject to certain limitations on eligible collateral based on a pre-defined total capitalisation, as well as target portfolio characteristics, as set forth in the collateral management agreement (*see adjacent table – Portfolio Guidelines*). The portfolio guidelines are designed to limit the issuer's exposure to certain risks while allowing some flexibility in areas of the investment adviser's expertise.

The collateral manager may at any time sell defaulted and credit-impaired assets. This feature gives the flexibility to mitigate losses in a high-default environment and to avoid potential defaults on assets the investment manager determines to be at significant credit risk.

Fitch will shadow-rate any assets not publicly rated and included in the portfolio at closing and thereafter.

Portfolio Guidelines

Issuer Diversification (%)	
Minimum entity rating for senior secured loans	'B-'
Minimum rating for ABS	'BBB-'
Maximum Single Obligor with entity rating of 'AAA'	3.8
Maximum Single Obligor with entity rating of 'AA-' to 'AA+'	3.7
Maximum Single Obligor with entity rating of 'A-' to 'A+'	3.6
Maximum Single Obligor with entity rating of 'BBB-' to 'BBB+'	3.5
Maximum Single Obligor with entity rating of 'BB-' to 'BB+'	3.2
Maximum Single Obligor with entity rating of 'B+'	2.8
Maximum Single Obligor with entity rating of 'B'	2.5
Maximum Single Obligor with entity rating of 'B-'	2.2

Portfolio Profile Tests and Diversification by Asset Class (%)	
Maximum weighted average rating factor	43.5 ('BB')
Maximum weighted average maturity	7 years
Minimum weighted average spread	2.1
Minimum weighted average recovery rate	67.2
Minimum weighted average recovery rate for senior secured loans	75
Minimum recovery rate on any senior secured loan	50.0
Maximum proportion of loans in the portfolio with a recovery rate below 60%	8.0
Minimum senior secured loans	80.0
Maximum investment grade ABS	20.0
Maximum synthetic securities	7.0
Maximum synthetic securities and sub-participations	50.0
Maximum sub-participations from one qualifying institution	10.0

Industry Diversification (%)	
Any industry	10.0

Financial Covenants

(%)	Overcollateralisation Test	Interest Coverage Test
Class A	106.5	127
Class B	101.5	119.5
Class C	10.1.0/125.0*	117

* The Class C overcollateralisation test is 101.1% if the cumulative loss test is satisfied, otherwise it is 125.0%

Collateral Manager

Fitch's rating process included an evaluation of the collateral manager and its adviser Harbourmaster Capital Management ("HCM"). This consisted of an on-site review of the European component of its operations, interviews with key personnel, and a review of HCM's experience and performance particularly with regard to managing senior secured loans and ABS securities.

HCM (previously the collateral management team at Euro Capital Structures) is a Dublin-based company owned by its management.

HCL and/or its affiliate(s)/sponsor have committed to retain a minimum of 15% of the class D notes for the life of the CLO.

HCM is the investment adviser to HCL on investments in senior secured leveraged loans and asset–backed securities.

The HCM team consists of 10 members dedicated to the Harbourmaster programme. Senior team members have extensive experience in the loan and/or securitisation markets. Two members of the team have a combined distressed debt experience of GBP 870m, having been involved in the leveraged finance market during the last recession in the early 1990s. Fitch notes that senior HCM individuals are investing their own funds in the class D Notes, and their remuneration structure is reliant on the performance of the transaction.

Having already completed the issuance of Harbourmaster CLO 1 and CLO 2, HCM aims to consolidate its position as an issuer in the European arbitrage CDO market and expects to organise more, similar transactions. The strategy is to achieve superior returns whilst preserving capital and to this end HCM maintains a buy-and-hold strategy for assets and will continue to focus primarily on senior secured loans.

Both Harbourmaster CLO 1 and CLO 2 comply with their eligibility criteria and portfolio profile tests at the date of the latest monthly report to the Noteholders.

Fitch assigns each loan a private rating, a recovery expectation and an industry category prior to its inclusion in the collateral pool. These ratings are continuously updated through the surveillance work carried out by Fitch.

HCM assigns an internal rating to each loan and aims to detect credit-impaired assets at an early stage in order to minimise the risk of loss. HCM monitors monthly financial information as well as carrying out regular site visits and engaging in conference calls with management.

Fitch believes the collateral manager possesses the necessary experience, systems and procedures to manage the investment portfolio within the parameters covenanted in the transaction documents and implied by the ratings.

Structural Protection

Overcollateralisation and Interest Coverage Tests

Financial covenants have been established in the collateral management agreement to maintain minimum levels of overcollateralisation and interest coverage for the various tiers of rated debt (*see table above*). Additionally, the class C overcollateralisation trigger increases from 101.0% to 125.0% if the cumulative loss test is not satisfied.

The overcollateralisation ratios are calculated by dividing the aggregate value of portfolio assets by the sum of the respective levels of notes outstanding. Defaulted assets are accounted for at a recovery rate predetermined by Fitch. The interest coverage ratios are determined by dividing the total amount of interest proceeds from the portfolio assets for a given period by the sum of the interest payments due on the various tranches of notes outstanding during the same period.

In the event that the overcollateralisation or interest coverage tests are not satisfied, the issuer must use

interest and principal proceeds (to the extent that interest proceeds fall short), to pay down the outstanding notes in order of priority until such tests are in compliance. For example, if the Class C overcollateralisation test fails, subordinate interest payments are diverted from the Class D subordinated notes to pay down the outstanding notes in order of priority until the overcollateralisation test returns to compliance.

Diversification and other Key Covenants

The issuer must also maintain a weighted average rating, recovery rate and spread for the aggregate portfolio balance.

■ Credit Analysis

The stress scenarios applied Fitch Rating's standard methodology of defaults and recovery rates for each debt rating and asset type respectively. The default rates listed in the table below were applied to a fully funded portfolio. The stress scenarios included front-loaded, back-loaded and base–case tests, which varied the timing of asset defaults. The front-loaded test stressed the asset portfolio over the first five years of the transaction at 33%, 25%, 16%, 13% and 13% of the aggregate defaults (realised as a percentage of the fully ramped-up collateral balance). The back-loaded stress test applied a 'B' level default rate evenly over the first 10 years of the transaction. Additionally, the differential between the 'B' default rate and the desired debt rating was applied evenly over the last three years of the transaction. In the back-loaded stress test, all default percentages apply to the outstanding collateral balances during the reinvestment period. After the reinvestment period, the appropriate default percentage is applied to the outstanding collateral at the beginning of each period.

The model assumed that the defaulted investments would realise recoveries of 67.2% based on the weighted average asset composition and the recovery rates assigned to each asset class. However, for the Single Obligor Test, Fitch assumed that the defaulted assets would have above-average loss severities.

Default Assumptions
(%)

Class A	43.5
Class B	27.0
Class C	21.5

Fitch assumed recoveries on the portfolio are realised 24 months after default.

The model showed that the capital structure supported the Fitch default and recovery methodology. The Class A notes survived their 'AAA' stress scenario with timely payment of interest throughout the transaction and full repayment of principal at maturity. In their respective 'A', and 'BBB' stress scenarios, the Class B and C notes realised ultimate payment of full and compensating interest and principal at maturity.

■ Counterparty Risk

Harbourmaster may purchase synthetic securities and enter into sub-participations up to an amount equal to 50% of the portfolio. These sub-participations in senior secured loans will be acquired from any financial institution rated at least 'F1+'. Synthetic securities and sub-participations expose the issuer to counterparty risk. However, this risk is mitigated by the rating requirement of 'F1+' on these counterparties. Furthermore, if a counterparty is downgraded, it will have to post collateral, find a guarantor for its obligations with the required rating or be replaced by a counterparty with the required rating, each requirement being subject to rating agency confirmation.

The provider of the liquidity facility is Deutsche Bank AG London ('AA-/F1+'). If Deutsche Bank is downgraded, it will have to deposit the undrawn commitment under the liquidity facility into a stand-by liquidity account

■ Interest Rate Hedging

98.9% of the notes and all the assets will be floating rate. However, there may be a mismatch between the base rate of the assets and the liabilities. Indeed, a portion of the portfolio may pay interest based on six-month Euribor while the notes will pay interest quarterly based on three-month Euribor. There may also be a mismatch in the timing of the interest proceeds received on the assets and the interest paid on the notes since some assets may pay interest semi-annually while the notes pay interest quarterly. This potential mismatch is mitigated by a EUR10m liquidity facility provided by Deutsche Bank AG London ('AA-/F1+'). Repayment of the liquidity facility ranks senior to payments on the rated notes.

Currency Hedging

The issuer can only purchase EUR-denominated assets and synthetic securities in which the underlying loans are either EUR or USD-denominated. A currency hedge is embedded in these synthetic securities if the reference obligation is a USD-denominated loan, therefore leaving the issuer with no currency risk.

Performance Analytics

Fitch Ratings will monitor the transaction on a regular basis and as warranted by events. Its structured finance Performance Analytics team ensures that the assigned ratings remain, in the agency's view, an appropriate reflection of the issued notes' credit risk.

Details of the transaction's performance are available to subscribers at www.fitchresearch.com. Further information on this service is available at www.fitchratings.com.

Please call the Fitch analysts listed on the first page of this report for any queries regarding the initial analysis or the ongoing surveillance.

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