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Pigs in blankets

On Wall Street, success begets failure. Take a good idea, emulate it and embellish it, drive it into the ground like a tomato stake. Voilà: It's a bad idea. Which brings us to collateralized loan obligations, a great idea of the last recession and a potential disaster for the next one.

A CLO consists of loans and a manager. It exists to generate fees for the promoters and income for the investors. It's not quite true that a CLO is only as good as its loans. What is true is that a portion of a CLO is only as good as its loans, that portion being the junior one, equity and mezzanine debt. Deterioration in the quality of late-boom debt puts those segments at risk.

The assets of a CLO consist of syndicated (i.e., tradable) bank loans: the senior, floating-rate, secured kind. They're called leveraged loans because the borrowers are leveraged. The liabilities, too, consist of loans. The loans come in many segments, or "tranches," from senior (triple- and double-A) to mezzanine (single-A and triple-B) to junk (double-B). A sliver of equity—about 10% of the liabilities—lies under the debt.

Imagine a company that, in raising senior debt, was bound to raise junior debt and equity at the same time. Imagine having to please, simultaneously, the many separate investor constituencies. You have just stepped into the shoes of the would-be CLO builder.

Without the equity and lower-rated debt, there would be no triple-A tranches—as you will appreciate by and by. Without triple-A tranches, there would be no CLOs. Without CLOs, there would be many fewer private-equity transactions. And without lots of private-equity deal-making, there would be a very different kind of stock market.

CLOs hold about half of the $1 trillion in leveraged loans outstanding. The difference between the yield on their assets and the cost of their liabilities is what generates their income. On assets, a typical CLO earns 330 basis points over the London interbank offered rate. On liabilities, it pays 150 basis points over the same rate. Leverage magnifies the 180 basis-point net return.

CLOs are complex structures, but the problems they face are simple. The absence or evisceration of covenants in recent issues of leveraged loans is one (a covenant, as you recall, is the fine print that holds the corporate borrower to a certain standard of financial good housekeeping). The deterioration of the ratings of those loans is another problem (*Grant's*, July 13). Thus, in the second quarter, 45% of newly issued leveraged loans were spotted single-B, i.e., junk, up from 38% in 2017 and 28% in 2006. So far, the downshift in credit quality has roiled commentators more than investors. Trouble starts when defaults do. Moody's predicts that recovery rates in bankruptcy on first-lien loans will drop to 60% of par value in the next recession, from an average of 77% between 2007 and 2016. "Real bank loans are good instruments," says Michael Lewitt, publisher of *The Credit Strategist*, in conversation with colleague Fabiano Santin. "The problem is they're really bonds now."

Unsecured bonds lay a much weaker claim on corporate assets than do old-fashioned, covenant-laden, first-lien bank loans. Once upon a time there were CBOs—collateralized bond obligations. They walked the Earth at the turn of the 21st century but became extinct on account of the debilitating losses they bore in and around the 2001 recession (see the issue dated Aug. 17,

Typical capital structure of a CLO

	percentage of CLO liabilities	coupon (spread over Libor in basis points)
triple-A	62.0%	115
double-A	12.0	160
single-A	6.0	195
triple-B	5.5	300
double-B	4.5	585
equity	10.0	—
		weighted average coupon: 145

sources: *Grant's*, Wells Fargo Securities

2001). Contrariwise, in and after the 2007–09 recession, CLOs prospered. We doubt they will prosper next time.

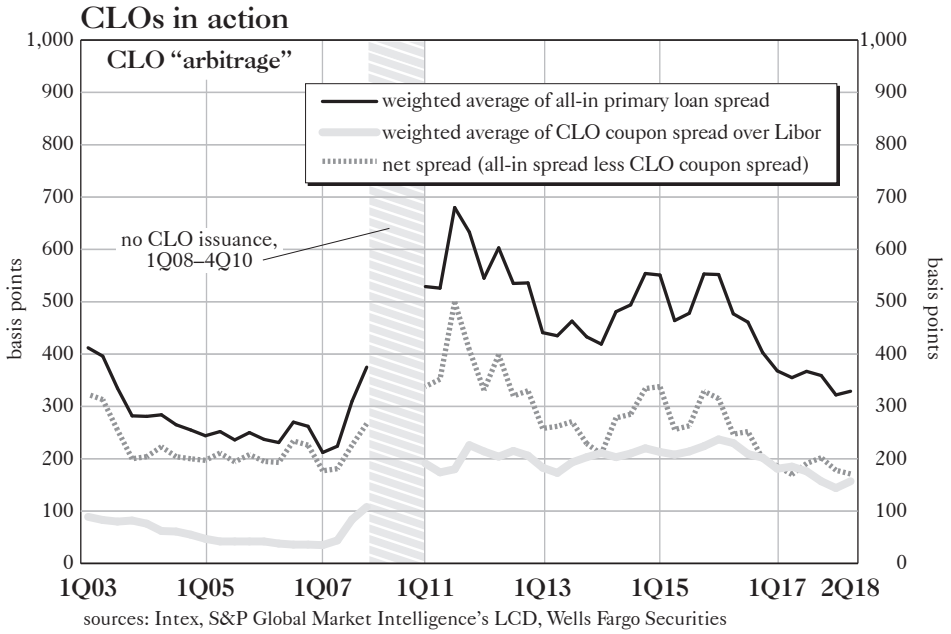
The accompanying table fleshes out the details of a representative CLO structure. Senior lenders, who fund most of the balance sheet, hold first call on cash flows; mezzanine and equity holders get what remains. The subdivision of the liabilities into tranches allows investors to pick their poison—to play it safe at the top, or seek out higher returns, with commensurate risk, in the middle or at the bottom.

There are protocols in place to mitigate risk. Thus, if a CLO does not generate sufficient cash flow to pay the senior lenders, or if it flunks the tests to assure adequate collateralization and borrower diversification, the manager must take corrective action. "Robust and opportunity-rich," the proud promoters call their creations.

And if past were prologue, a CLO critic would have nothing to complain about. Moody's reports that, among the 9,181 CLO debt tranches issued between 1993 and 2017, only 1.6% defaulted, and that not one default touched a tranche rated double-A or higher.

Endowments and regulated financial institutions find much to like in the triple-A-rated tranches, both for the safety they afford and the yields they deliver. Quoted at about 115 basis points over the Libor curve, they fetch on the order of 4%. "Compare that," as Santin suggests, "to a triple-A-rated, 10-year commercial mortgage-backed security offered at a credit spread of 83 basis points over the swap curve (total yield of 3.80%). Or to a double-A-rated, fixed-rate, 10-year corporate bond paying 62 basis points over Treasurys (total yield of 3.67%)."

Which brings us to the portion of the CLO capital structure most exposed to the downshift in asset quality—and to the upside of increasing asset prices, gently rising interest rates and a benign default environment. Equity tranches in the 2005–07 CLO vintages earned annual gains of 14%–18%, calculates David Preston, senior analyst at Wells Fargo Securities LLC. Such performance speaks for itself, though a bull might add that the majority holder of a CLO's equity exercises control over decisions to call or refinance the assets after the passage of a stipulated period (the "reinvestment" period). Fans of CLO equity call it a superior kind of private equity, as they ask: Why pay fees to KKR or Blackstone when you can reap LBO-style rewards by investing in the bottom of a CLO capital stack?



sources: Intex, S&P Global Market Intelligence's LCD, Wells Fargo Securities

There are lots of moving parts in CLOs. Here are a few: the frequency of prepayments (like the American mortgagor, the corporate borrower can refinance its leveraged loan at any time), the pricing of credit risk in the loan market, the length of time in which a manager may reinvest cash flows in new securities, the spread between interest income and funding costs within the CLO and the variation between one-month and three-month Libor (most borrowers have the option of switching to the lower of the two rates).

Especially do assumptions about defaults and recoveries inform predictions about future returns, or lack thereof. Take the simplified example of a CLO that earns 330 basis points plus Libor on its assets and pays 150 basis points plus Libor on its liabilities. After subtracting 40 basis points in management fees, net spread comes to 140 basis points—before defaults.

Now assume a default rate of 2%—admittedly, a generously low one. And assume a recovery rate of 80% of par on loans in bankruptcy—admittedly, a high one. The result is a default-adjusted net spread of 100 basis points. Leverage that to 10 times the equity portion, and you get 10% in net equity return.

Under more conservative (though still moderate) assumptions of a 3% default rate and a 60% recovery rate, return before leverage falls to just 20 basis points. Even 10 times 20 basis points is, in comparison with earlier CLO equity returns, a pittance. "Clearly, the economics don't look great for CLOs coming to market at today's net spread level," Santin observes.

Few differences between today's leveraged loans and the pre-Great Recession vintages are more critical than the loss of covenant protection. Current CLOs typically allow exposure to cov-lite in more than 65% of the portfolio compared with 10% to 15% in the past—with generous allowances for redefining certain cov-lite loans as non-cov-lite.

The principal purpose of loan covenants is to keep borrowers on the straight and narrow, just as the principal purpose of traffic lights is to prevent automobile accidents. The secondary purpose of loan covenants is to generate income for the lenders, just as the secondary purpose of traffic signals is to top up municipal coffers with the proceeds of speeding tickets. When a borrower trips a covenant, that company comes hat in hand to the lender to negotiate an amendment fee and reset the loan to a higher interest rate. No more covenants, no more tripping, no more amendments—and no more extra income to the CLOs (which goes, or rather went, to the equity investors).

What the CLO equity holder wants is time and volatility—"optionality," as the adepts say. In a sense, Santin observes, the equity tranches are call options on credit spreads. In times of trouble, CLO managers can reinvest cash flows in cheap loans, as they so profitably did in the crisis 10 years ago when loan prices plunged from par to 70. But they can reinvest only during a stipulated reinvestment period, which used to span seven years. Today, it's typically four years. "You can imagine a case," Santin points out, "in which a credit washout occurs after the expiration of the reinvestment period. The CLO manager's hands would then be tied. Bargains might abound, but the manager would be unable to buy them."

A bull might counter, in the first place, that there's no predicting if or when another debt crisis will happen and, second, the equity tranches of the 2007 CLO class delivered the stupendous median return of 18.4% per annum. If the skies fell in 2008, so did loan prices (while the cost of borrowing for the 2007 vintage CLOs was only 50 basis points above Libor, one quarter of today's typical rate). Yes, mark-to-market net asset values on CLOs were sawed in half, in keeping with the collapse in loan prices, but managers boldly seized the opportunity and prices recovered. Perhaps most importantly, the loans themselves, armored with covenant protection, proved money good.

Many things are different now, of course. What is no longer different is the short-lived risk retention rule of the Dodd-Frank Act. It required CLO managers to keep up to one-half of the equity value of the structures they originated, the better to align their interests with those of their investors. To the discreet applause on Wall Street, a U.S. Court of Appeals struck down the rule in February.

Naturally, the lowest interest rates in 3,000 years have made their mark on the way people lend and borrow. Corporate credit, as Preston observes, is "lower-rated and higher-levered. This is true of investment-grade corporate debt. This is true in the loan market. This is true in private credit."

So corporate debt is a soft spot, perhaps *the* soft spot of the cycle. It is vulnerable not in spite of, but because of, resurgent prosperity. The greater the prosperity (and the lower the interest rates), the weaker the vigilance. It's the vigilance deficit that crystalizes the errors that lead to a crisis of confidence. At some unpredicted moment, there's a scramble for cash, a collapse in prices and the start of a bull market in value. You can't time the inflection point, but you can watch for the telltale signs.

The CLO market itself might send up a flare. Perhaps the issuance of leveraged loans will dry up, or the customary investors in CLO equity tranches will pull back. When all's well, CLO seed money is there for the plucking. Big banks eagerly front the senior portion of the so-called warehouse financing to give a new structure its start. CLO managers not only bankroll the warehouse equity, but also fold that initial stake into the final structure.

And for now, the funds remain pluckable. However, Jim Schaeffer, deputy chief investment officer at Aegon Asset Management, tells Santin that he recently noticed some reluctance to furnish warehouse equity. Aegon is an experienced CLO builder. "We've been able to issue a couple of CLOs this year," Schaeffer says, "which has been great. But when we went back to those who had been providing warehouses, there was just a little pause in the marketplace. It's not that there wasn't any demand. It was just a little bit of a pause." And he adds, "You can't really do a warehouse without the equity or the first loss piece."

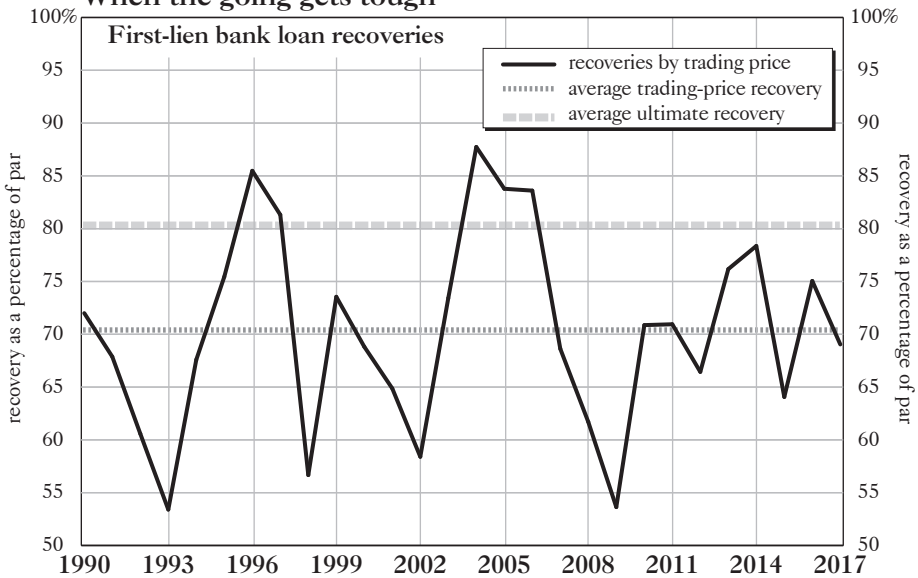
CLOs are built from the ground up—from the equity level to the triple-A level, not the other way around. Refusal to commit to new equity investments would imperil the working of the machine that sustains American leveraged finance. Based on the 10% size of the typical CLO equity stake, there is $50 billion at risk of impairment if default rates were to accelerate.

Schaeffer says he wouldn't make too much of this slight hesitation, and we won't, either. What we will do is keep a weather eye out for something greater than a pause. As Schaeffer himself puts it, "You have to be early, because when the market turns at the end of that cycle—given the illiquidity and volatility—it turns very quickly, and the whole market is trying to sell."

Those who track the credit cycle will naturally want to stay current with the changing values of CLO equity tranches. Alas, they are closely held. The next best approach is to monitor the quoted prices of the public vehicles that, according to Wells Fargo Securities, held $2.6 billion in CLO equity exposure at the end of the second quarter. Two such entities may prove especially informative.

Oxford Lane Capital Corp. (OXLC on the Nasdaq), which debuted in January 2011, buys CLO equity and mezzanine pieces and nothing else. Its market cap foots $311 million and the shares trade at an 8% premium to NAV.

When the going gets tough



Note: Trading-price recovery is based on loan price at or after default, while ultimate recovery is based on the value creditors realize at the resolution of a default event (typically one or two years following the initial default date).
source: Moody's Investors Service, Inc.

Assuming reinvested dividends, the fund has returned 10.4% a year since inception, compared with 13.6% for the S&P 500 (at no premium to NAV, performance would have been 9.2% per year). The shares yield 15%.

Eagle Point Credit Co., Inc. (ECC on the Big Board) came to market in October 2014, also for the express purpose of buying junior portions of CLO capital structures. Its market cap stands at $394 million, and the shares command a 10% premium to NAV, though traded with a 4% discount in 2016. Assuming reinvested dividends, the stock has returned 11.2% a year, compared with 13.1% for the S&P 500 (at no premium to NAV, performance would have been 8.51% a year). The shares yield 13.2%.

To enhance returns, Oxford Lane and Eagle Point both issued debt securities equal to 50% of NAV. Watch this space.

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