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U.S. Structured Credit Roundtable: How Risk Retention And Loan Leverage Could Change The CLO Landscape

Primary Credit Analyst:
Robert J Radziul, New York (1) 212-438-1051; robert.radziul@standardandpoors.com

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U.S. Structured Credit Roundtable: How Risk Retention And Loan Leverage Could Change The CLO Landscape

The implementation of the Dodd-Frank risk retention rules will likely affect broadly syndicated loan origination and trading liquidity, resulting in increased corporate credit financing costs. There may also be fewer collateralized loan obligation (CLO) collateral managers, as many will either not be able to compete or may choose alternative uses of their capital that are more economical for them. The regulators' Shared National Credit Program review has focused on higher loan leverage levels but may not have factored in earnings stability and cash flow characteristics that vary across industries, nor fully assessed adjustments for non-recurring items and future cost savings. As a result, the collateral managers have been more selective in managing loans that are in their CLO portfolios. Over time, CLO structures have also become more standardized, similar to other well established structured asset classes. Standard & Poor's Ratings Services recently sat down with CLO managers to discuss these developments and other trends affecting the market.

Panel Discussion

Credit analyst Robert Radziul, a senior director in Standard & Poor's Structured Credit group, conducted the roundtable with five CLO experts including Marathon’s Andrew Brady, CFA, Leveraged Loan Portfolio Manager.

What follows is an edited excerpt of the discussion to include only Andrew Brady’s answers. The full report was published Dec. 22, 2014, and is available on RatingsDirect at www.globalcreditportal.com. If you are not a RatingsDirect subscriber, you may purchase a copy of the report by calling (1) 212-438-7280, or sending an e-mail to research_request@standardandpoors.com.

Standard & Poor's: How will the Dodd-Frank risk retention rules impact your firm, the CLO market, and the economy, both before and after it becomes effective?

Andrew Brady*:* I would not expect a material impact on the economy--although clearly there is an impact for trading liquidity and the banks' ability to create certain loans if they are forced to retain risk. It's a net positive for our firm--as Marathon is a larger asset manager and a sizable equity investor in our CLO transactions historically--because it does restrict a number of other firms eligible to participate in the future CLO market. There are a number of ways to meet risk retention requirements, though many details remain subject to determination regarding the subsidiary option and the financial controlled interest. We would expect to see fewer CLO managers, though perhaps larger CLO vehicles. If aggregate credit creation decreases, corporate credit costs could increase.

Standard & Poor's: How many basis points difference are we seeing now with the new risk retention?

Andrew Brady: Most CLOs compliant with risk retention regulations are European. There is not much data yet for U.S. vehicles. CLO investors most impacted by the regulations are banks that buy 'AAA's. Their participation is often binary and driven by comfort with managers rather than pricing tranches based on retention characteristics, though certain investors could penalize non-compliant deals and increase their financing costs.

Standard & Poor's: Is the cost typically borne by the investors that want it?

Andrew Brady: Amending older CLOs to comply with new Volcker rules is generally a negotiation between the manager and 'AAA' investors. The costs are not just from the amendment process (those costs can be shared with 'AAA' investors) but also from lost opportunities that affect investors across the CLO structure. Who pays the upfront amendment cost can be driven by a single large 'AAA' investor. They could be willing to pay if under pressure to reduce non-compliant assets.

Andrew Brady: I would add that the Volckerization concept is similar to the risk retention concept in attempting to solve a problem that does not exist. With risk retention, the supposed risk is that managers without skin in the game put investors at risk. With Volcker, the supposed problem is losses from high-yield bond exposures and a blanket assumption that bonds are bad, which are both untrue. Marathon's approach is credit-agnostic, and driven by fundamentals of risk rather than labels.

There are many senior secured bonds with better risk-adjusted return profiles than many first- or second-lien loans. There are many second-liens of certain companies that have much better payoff profiles and fundamental risks than first-liens of other companies. The rational investor is not obsessed with labels but focuses on fundamentals and risks to protect and serve investors with a diversified portfolio, which should not only build par, but drive favorable returns.

Standard & Poor's: How do you think the regulators' Shared National Credit Program review, and in particular, the leveraged loan supplement, will affect CLO issuance, CLO or loans, spreads, or both?

Andrew Brady: It is healthy that they recognize a building supply of troubling credits. However, it is very different for regulators to cajole and criticize banks to encourage responsible lending as opposed to prohibit or penalize the aggressive behavior of lenders. Further, the usage of the blanket six times leverage guideline across all different industries ignores potential earnings stability, real cash flows, and radically different industry structures. Also, this trailing measure of earnings is often highly adjusted for supposedly non-recurring items and future expected cost savings. It is no coincidence that you see a strange number of deals marketed at 5.9 times leverage, but effectively based on forward, heavily adjusted earnings that we have deemed highly questionable if not fictitious.

Andrew Brady: Certain banks are taking the Shared National Credit Program more seriously; especially those that already face regulatory issues. Beyond regulatory encouragement or discouragement, the factor more likely to change bank behavior is getting burned by the prevalent aggressive underwriting, which is starting to happen. Many transactions they expected to offload to investors and earn large fees with theoretically little risk have instead produced large losses and/or been unable to sell. That means bankers can have the CEO and group heads, rather than a nebulous regulatory body, dictating activities, with penalty of immediate job losses for non-compliance. That tends to put the brakes on hard for risk taking within any bank.

Standard & Poor's: Several Japanese yen currency swaps on 'AAA' rated CLO tranches came into existence during 2014. Do you anticipate that this or any other types of alternative financing will become more or less prevalent during 2015?

Andrew Brady: Demand for yen-denominated tranches somewhat reflects Central Bank policies and miniscule interest rates for Japanese and other sovereign debt. The demand for yen tranches is concentrated among a couple Japanese commercial banks, though we have also seen increasing interest from other parties. Keep in mind these tranches have been used by only two underwriters and a small group of CLO managers, so they are not a major market factor. However, it has provided our recent CLOs with lower financing cost than a dollar-denominated 'AAA'.

Other CLO financial innovations could include tranches in other currencies paired with currency swaps. The swap intermediaries have generally been arranged by the underwriting bank, but certain major CLO equity investors could potentially be involved in the currency swap with even lower cost since they control the vehicle's wind-down and hence cash flow timing.

Standard & Poor's: What other innovative structural features do you anticipate we may see going forward?

Andrew Brady: Structural innovation can relate to either the CLO liabilities or assets. Liability changes are largely dictated by what the 'AAA' will tolerate, and they are not easily enticed to deviate from convention, though we could see norms change for two-year non-call and four-year reinvestment periods. Other changes could include a return of performance-based turbo amortization of junior tranches.

On the asset side, beyond stronger documentation and covenants, we would like structures to eliminate LIBOR floors, since they were added during the crisis but have become standards that benefit nobody. The first loans after the crisis had 2% LIBOR floors or more versus an average of 1% now. We continually push for loans to revert to truly floating rates since that has been a key virtue of leveraged loans. This would cost underwriters nothing, and does not add to corporate financing costs. Companies can and do hedge interest rates without using LIBOR floors. Floors simply introduce downside risk to loan investors by increasing duration. This is especially true for CLO equity investors since higher LIBOR will increase floating-rate liability costs while earnings remain unchanged for assets until LIBOR exceeds the floors, resulting in lower equity distributions. It seems the market is misguidedly unworried about this, which could continue until it is too late.

Standard & Poor's: You mentioned the two-year non-call period, which has been standard, but we saw the last couple of deals that came out were less than two. Do we see that as a trend going forward? Is it going to be a year and 11 months, or a year and 10 months, etc.?

Andrew Brady: Shorter non-call periods on 'AAA's would make sense to preserve the option to reprice deals before risk retention takes effect. You could also see costs for early calls decrease from the current 'AAA' make-whole calculations, especially since their credit risk is very low.

Standard & Poor's: What do you think about current CLO market conditions?

Andrew Brady: Credit markets are an increasingly crowded minefield, so discipline and selectivity are critical. CLO managers that create vehicles independent of market conditions are likely to be disproportionately impacted by adverse timing and weak cohorts in the primary loan market. The rush for certain managers to close by year-end and before risk retention takes effect is likely to increase their financing costs. Marathon's approach has always been doing CLOs with long warehouses and waiting to price liabilities when it made sense. We delayed pricing two past CLOs and reduced aggregate financing costs over 15 basis points. We always try to position ourselves with less pressure to buy and are comfortable holding cash. This ability to step back from riskier markets is mirrored across our other credit businesses in distressed, mortgage-backed securities, and emerging markets.

Even though U.S. CLO issuance broke records this year, Marathon issued just two vehicles. That was the same as 2005, but then we issued none in 2006 and 2007 when we were concerned about extremely aggressive conditions and systemic leverage across corporate, mortgage, and emerging markets. Those issues are not the main issues presently, though default risk is higher than most people appreciate. Marathon expects to continue issuing CLOs before and after risk retention become effective, though with patience and credit selectivity outweighing the estimated interest rate arbitrage at inception since we will be managing these vehicles for many years.

Standard & Poor's: Has credit quality become a concern in this issuer-friendly leveraged loan environment?

Andrew Brady: When we look across leveraged credit and global credit, we see a tremendous number of problematic credits. Even if they seemed fine recently or upon underwriting, that was often based off either optimism, aggressive assumptions, large EBITDA adjustments, or many "venture capital" debt situations. Many of those aggressive transactions with little room for error are bound to produce defaults and losses, especially given the deterioration of covenants and other creditor protections. In a large number of companies, not just deals in syndication but those created in the past three years, you've seen those credit risks building, with high normalized leverage, aggressive dividend transactions, refinancings, HoldCo PIK deals, and commodity-related companies adding leverage for capex to boost production. We have identified many credits poised to fall. Keep in mind that, even with recent increases, average high-yield bonds still yield only about 6% and many non-investment-grade bonds yield significantly less.

Standard & Poor's: Do you anticipate that refinancings and repricings will accelerate in 2015?

Andrew Brady: Loans and bonds have manageable maturity walls for the next couple years. That follows active refinancings the past couple years that prevented certain defaults. CLO refinancing activity could be quite active as deals from 2012 and 2013 end their reinvestment periods over the next couple years and fewer managers will be able to issue vehicles that comply with new risk-retention rules.

Andrew Brady: Some large companies with excessive debt and near-term refinancing needs could be challenged by regulatory pressure on banks to avoid deals leveraged over six times. Many of those companies delayed the inevitable defaults with loan extensions and help from banks earlier. If banks bow out of such future deals, that could create investment opportunities for the larger credit managers.

Standard & Poor's: How has the increased transparency and granularity of the Standard & Poor's recovery rates affected how you manage your CLOs?

Andrew Brady: More stratification in recovery ratings is a positive, but there is still the question of their usefulness. Many CLOs are severely constrained by these recovery ratings, which did not exist pre-crisis, and the lack of such ratings for loans for finance companies, investment-grade companies, and DIP loans. We see serious pricing distortions in loans with very high and low recovery ratings, which can create opportunities outside of CLOs. Note that second-lien loans received no benefit from the new rating stratification since nearly all of them are rated six on the one to six scale, meaning they are expected to get almost zero recovery upon default. There is no statistical basis to claim that, especially since those loans are just junior debt like most high-yield bonds. These second-lien recovery ratings ignore the probability of restructuring. These low ratings make it highly punitive for CLOs to utilize their 5% to 10% baskets for second-liens even if the loans have appealing credit quality.

Standard & Poor's: When do you anticipate interest rates will begin to rise and how will that affect the CLO portfolios you manage?

Andrew Brady: It depends which interest rates increase, and if that is orchestrated by the Federal Reserve or some sort of market shock. It goes to the fundamental question of rate duration for loans. If three-month LIBOR is unchanged while 10-year treasuries jump to 6%, loan prices would suffer given the improved investment alternatives. Investors should expect higher fed funds rates within a year, barring more crises, since it is increasingly unjustifiable to retain emergency measures and negative real interest rates. The Fed is trying to communicate rates will begin to increase in mid-2015. This contrasts with past investor expectations for earlier increases, though those predictions seemed dubious since the Fed was still buying assets under quantitative easing programs. Also, the Fed can signal higher rates are imminent in various ways, including changing terms of their other liquidity provisions for commercial banks, reserve requirements, various repo activities and open-market transactions. However, it remains unclear if higher fed funds rates will increase LIBOR as happened historically, given the way LIBOR is calculated. If LIBOR increases, CLO equity distributions will be squeezed by increased financing costs. Higher duration loans could suffer the most, including highly rated loans with most of their yield from the LIBOR floor, so it could make sense to decrease portfolio exposure to those and increase exposure to assets with low duration and likely to refinance. Another way to reduce duration is getting rid of LIBOR floors, which we encourage in primary markets and any amendment requested.

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